Green Shoots, But Dead Roots?

According to the calendar, spring has arrived, but we still have concerns that a late-season frost could pose a threat to the green shoots sprouting up on the economic front. Indications of tempered rates of decline, if not stabilization, have shown up in many areas of the economy. These so-called “green shoots” have grown out of lower gas prices, tax refunds, favorable year-on-year comparisons for economic indicators, better-than-expected earnings from some banks, and improving consumer confidence as the stock market rallied off its multi-decade low in early March. We have seen a reduction in volatility, improved investor psychology, and sector performance differentiation. All of these developments we cited as signs we would need to see before becoming more positive in our market outlook. So the obvious question stands: *have we become more positive in our view of the equity market?* The answer is, unambiguously, a little.

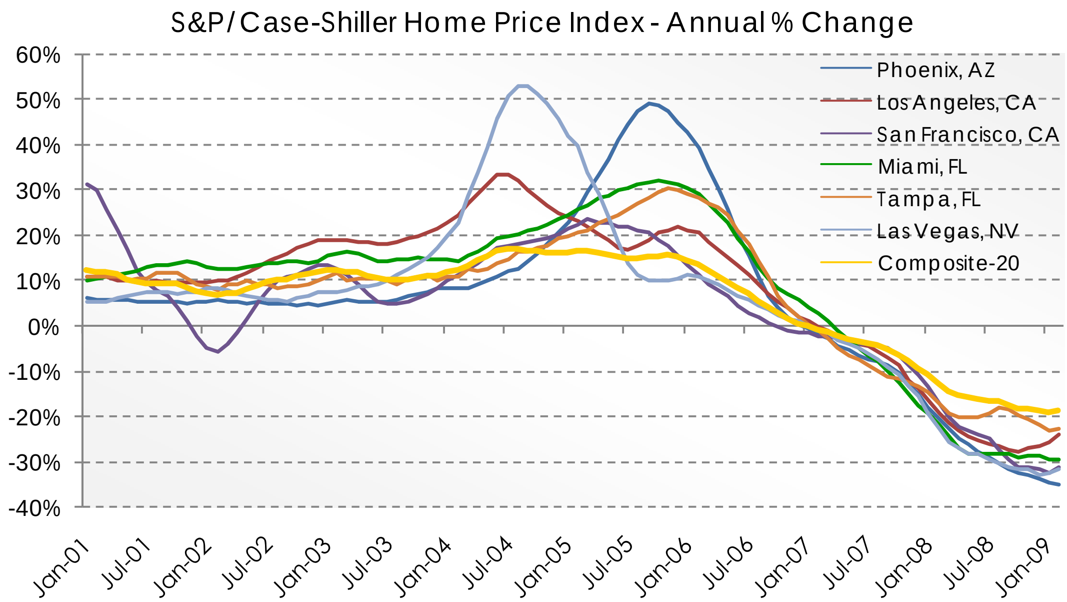
The First Signs of Spring

The markets are digesting bad news quite easily these days. Reports of Q1 GDP contracting at a -6.1% annual rate sparked an equity rally. A record slump in inventories was viewed as setting the stage for growth in the second half of 2009, as companies surely will have to rebuild their depleted stockpiles when demand resurfaces. Earnings announcements coming in better than (dismal) expectations have positive impacts on stock performance. A report that the rate of decline in home prices in 20 major U.S. cities slowed to “only” -18.6% year-on-year was greeted as good news. Taken together, these reactions mean that the market has finally returned to a forward-looking indicator instead of a backward-looking one.

Yes, this is what we wanted to see. We do, however, have reservations that keep us from jumping back into U.S. equities in any significant way. The short-term reason is that the market, as measured by the S&P 500 index, has run up nearly 30% since its low on March 9th. We are not market timers, and while we expect to miss the first leg of a rally as we await confirmation of a sustained turnaround, the odds of a technical retrenchment at this point are high. We would look for a pullback of 10-15% before dipping our toes back into the water. Even with this pullback, however, we would not be ready to move fully to our long-term strategic developed equity allocations. We did not jump into the markets a few weeks ago, despite the rally, because we felt that lingering questions about housing, the banks and the government relief programs were too large to ignore. Below we discuss some of the issues that are keeping us from putting those winter clothes into summer storage just yet.

The Roots of the Problem

This bubble-turned-recession originated in the housing arena, and real estate remains an area of vulnerability. A vicious cycle is at work. As long as home values continue to fall, it is difficult to forecast a bottom for the toxic assets on banks' balance sheets that are backed by these properties. As long as foreclosures continue, it is difficult to foresee an end to price declines, as forced sales drive down home values. As long as the employment picture keeps deteriorating, it is likely that foreclosures will perpetuate. We know that employment is a lagging indicator, and in a typical recession it is not worrisome when the unemployment rate continues to rise despite improvements in leading and coincident indicators. This time, however, it poses a valid concern in the context of foreclosures and consumer credit worthiness. Despite the fact that mortgage rates are low, the lack of credit-worthy buyers is not making up for the rate of foreclosures.



Source: Standard & Poor's

Recent studies have highlighted the connection between foreclosure rates and declines in housing prices. Research from David Ranson, of Wainwright Economics, shows that the two series have an almost perfect correlation. The four states with the highest foreclosure rates, Nevada, Florida, California, and Arizona, were the only states exhibiting house price declines of greater than 20%. Another study from researchers at the University of Virginia found that 62% of foreclosures in 2008 were in the four states mentioned above. On one side of the coin it is encouraging that the bulk of foreclosures were confined to areas that experienced the frothiest housing bubbles, however, on the other side it presents a preview of price declines we could see in the rest of the country if job losses continue to mount.

Data have shown some slowdown in foreclosures recently, but this was likely due to the banks biding their time as they waited for more information on the administration's foreclosure prevention plan, the Helping Families Save Their Homes Act of 2009. Preventing forced sales would be good news for stabilization of price declines, but some components of the plan have met a great deal of opposition.

Seeds of Discontent

Some mortgage-backed investors are lobbying forcefully against the Act. The plan targets households spending a large share of their income on housing-related expenses, and will try to prevent foreclosures by allowing downward adjustments to mortgage rates in cases where Fannie Mae and Freddie Mac have purchased the loans. The main complaint of investors lies in the favorable treatment of riskier, second-lien mortgages, which are largely owned by the banks who also own the mortgage servicers. A "servicer safe harbor" provision in the legislation would shield servicers from lawsuits brought by the investors who own the mortgages which have had their terms modified. Investors who own securities backed by senior mortgages fear that banks owning the second-lien loans could avoid billions of dollars of losses which would instead be borne by them. Once again in this crisis, we see the dilemma of moral hazard appear. Banks that own riskier mortgages could choose to modify first mortgages instead of the second mortgages they own, giving themselves an additional *de facto* bailout.

The proposal in its current form is supported by the four largest mortgage servicers: Bank of America, Wells Fargo, JPMorgan Chase and Citibank. Together they own more than $400 billion of second-lien mortgages, and hold a 55% share of the servicing market. Meanwhile the opposition, consisting mainly of pension funds, insurance companies, and hedge funds who own the senior mortgages, is taking its case to Washington.

	Mortgage Servicing	
Originator	**$Bn**	**%Share**
Bank of America	$2,056.5	18.4%
Wells Fargo/Wachovia	$1,780.9	15.9%
JPMorgan Chase	$1,503.2	13.5%
Citibank	$809.6	7.3%
Total Top Four	**$6,150.2**	**55.1%**

Source: Financial Times, Amherst Securities Group

We believe that stemming the tide of foreclosures would be beneficial for banks, mortgage investors and homeowners alike, but it should be done in a way that does not damage the long-term viability of the securitization market. In 2006, banks issued about $1,800 billion of securities backed by mortgages, credit cards and other debts. In 2008, that number fell to $200 billion, and year to date the amount is negligible. The current securitization market consists mainly of central banks buying these assets to remove them from banks' balance sheets, however, this government intervention is not sustainable for the long term. As we wrote in our August 2008 research publication, Everything you always wanted to know about financials*, but were afraid to ask, *"We believe that until there is resurgence in* *securitization, borrowers will face tight credit standards and rising lending rates...Banks need to be able to repackage loans and offload the risk from their balance sheets in order to free up capital and extend additional credit."*

A balance must be struck between supporting the banks and avoiding moral hazard. Until the dead roots of the housing market are adequately addressed, however, banks will continue to be saddled with toxic assets, businesses and consumers will continue to face tight credit conditions, and unemployment will continue to rise.

Exterminating the Pests

One of the primary drivers behind this recent equity rally was the long-awaited release of details on the government's plan to unload toxic assets from the banks. The goal of the PPIP – **P**ublic-**P**rivate **I**nvestment **P**lan – is to try to create a market for the mortgage loans and complex synthetic debt securities which otherwise have no free-market value. It has been nearly impossible to estimate the value of these securities as prices of the underlying properties collapsed, and borrowers stopped making payments on the loans. They have become a virtual fungus, eating away at the stability of banks' balance sheets.

The administration plans to buy about $1 trillion of these toxic assets and loans with the help of private investors. The plan would involve government-selected fund managers who will supply a pool of private money, and who will negotiate to buy the securities at some estimated price. These private funds will be matched by the government, and then the Fed would provide loans or loan guarantees to cover the rest of the purchase price. In theory, private investors would be willing to take a chance on these risky assets since they can use government-provided leverage to sweeten the pot.

Despite the initially-positive reaction to the plan, concerns have been mounting as the details are thought through. Potential applicants for the PPIP fund management role are concerned about Congressional oversight. Although the Treasury Department has said that private investors who receive government subsidized PPIP funds will not be subjected to the executive pay limits imposed on banks in the TARP program, some are skeptical. The rules for the TARP program were changed along the way, and fund managers fear the same could happen again. Average Americans, wary of the institutions they believe got them into this mess, fear that the plan is ripe for manipulation. The government and taxpayers bear the lion's share of the risk by providing leverage, and many economists and bankers are still unsure if the plan will even mitigate the crisis.

Whether the banks will participate in the program is also a question mark. If the prices of troubled loans are set too low, banks may be unwilling to sell since marking these assets to market could cause additional losses. Similar to forced sales driving down home prices in foreclosure-laden neighborhoods, loans sold at low prices by one bank could force others to mark down the value of their loans, even if the bank did not intend to sell. The pricing must be low enough, however, to entice the private investors to take on the risky securities. JPMorgan Chase CEO Jamie Dimon has said that his bank will not, and does not need to, participate in PPIP, while Citigroup and Bank of America are taking a wait-and-see approach. The same may be said for Miracle Mile Advisors. We think that the plan could potentially ease some of the burden on banks, but with so many uncertainties surrounding its implementation, we would like to see some proof that a market for these securities can be established before calling it a success.

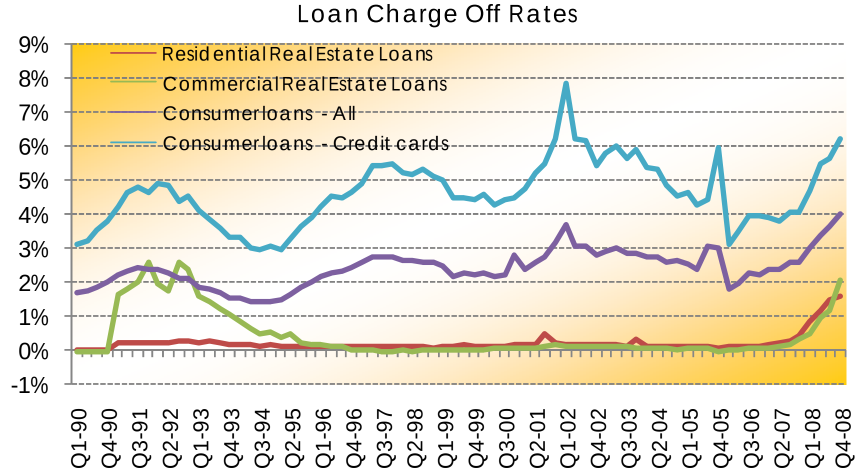
Without yet knowing the value of the toxic securities, we are also skeptical of the results of government stress tests performed on the banks. Furthermore, the Treasury is caught in somewhat of a Catch 22: if the reported stress test results are too rosy, then they will not be believed; but if they single out particular banks as weak links, they will be further punished by the market. Treasury Secretary Timothy Geithner downplayed the idea that there would be a "pass/fail" grade attached to any institution, and said that banks found to need additional capital will have a range of options available to them, including using taxpayer money, raising funds from private investors or converting previous government investments from preferred to common shares.

Frost in the Air

Until we see hard evidence to the contrary, we fear that the banks remain in a very precarious situation. Although several institutions reported surprisingly good Q1 earnings, they were driven largely by one-off cost cutting measures and trading profits, not strength in their core businesses. Citigroup announced $1.6 billion of first-quarter net income, but still reported increased delinquencies on home and credit-card loans. Revenues from their credit card business fell 10% due to credit losses, and consumer banking profits fell 18%.

One analyst estimates that Bank of America needs an additional $60 to $70 billion of capital, on top of the $90 billion in bailout funds it has already received. Ken Lewis, the bank's embattled CEO, said on a conference call, *"Credit is bad, and we believe credit is going to get worse before it will eventually stabilize and improve. Whether that turn is later this year or in the first half of 2010, I'm not going to hazard a guess...For the rest of the year we look for charge-offs to continue to trend upward. I think it will be at a slower pace than we've experienced. Reserve build will also continue for the next couple quarters, though not at the level we experienced this quarter."*

Banks also can expect further deterioration in the commercial real estate market and consumer credit businesses. Jamie Dimon, CEO of JPMorgan Chase, warned that the banking industry has to brace itself for rapidly rising losses related to commercial real estate. In a recent investor conference call he said, "In general, the losses are going up and I think if you talk about the whole system...you are going to see rapidly rising charge-offs in real estate loans."



Source: Federal Reserve Board

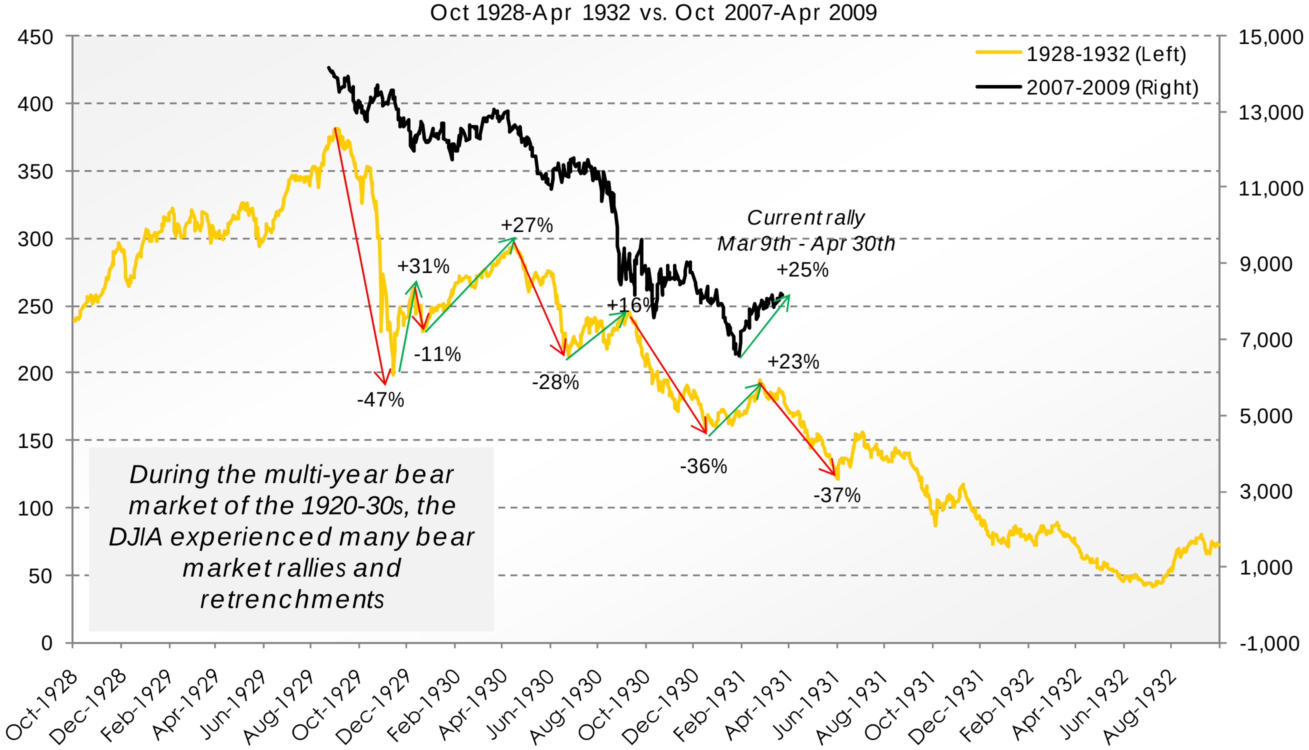
The Seasons Ahead...

Going forward, banks will have to adapt to a new, post-leverage world. Favorable conditions for debt and currency trading in the first quarter of 2009 helped support revenues in the short run, but the consistently high margin businesses of securitization and prop trading are a thing of the past. Once the crisis is fully behind us, the financial industry will face a full reversal of the lax regulation that devolved over the past 30 years. The ravaged consumer will also pose a challenge to renewed growth. Sharply devalued homes, big investment losses, damaged credit histories and reduced access to borrowing will make it difficult for Americans to recover the $10 trillion in net worth that has been lost in this downturn. We expect that personal savings rates will (and should) increase as consumers continue to deleverage. Meanwhile, government spending will constitute a larger share of output to take up the slack for a battered private sector. None of this adds up to a strong or quick bounce back.

In terms of our equity view, we have seen signs that the market has found some footing, but we remain cautious. Reduced volatility, some narrowing of credit spreads, and improved investor and consumer confidence all give us hope that some stabilization is occurring, and we will likely start rebuilding a small equity allocation on a market pullback. We believe that a test of the new low established on March 9th should materalize as the market starts to digest the concerns we laid out above. Before we would be willing to return to long-term strategic equity weightings, we would like to see hard evidence that the government plans are working and banks have severed their dead roots. In the mean time, we expect equities to experience periodic rallies and retrenchments, the magnitude of which could be significant. This is what occurred as the U.S. struggled out of the Great Depression in the early 1930s.

The chart below shows the price history of the Dow Jones Industrial average from October 1928 through April 1932, and from the most recent market peak in October 2007 through the end of April 2009. Within the broader, multi-year bear market of the 1920's-30's, the DJIA posted several rallies of 15%-30% between repeatedly making new lows. We do not think that the market will necessarily hit a series of new lows, but we do think we could see a choppy trading range in the months ahead, which could provide us with chances to buy equities on an opportunistic basis.

Dow Jones Industrial Average Daily Closing Price
Oct 1928-Apr 1932 vs. Oct 2007-Apr 2009



Source: Yahoo! Finance

April 30, 2009

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