

That Was Then... and This Might Be Then, Too

Remember what got us into this mess? Arguably, it was the worst housing and credit crises of our lifetimes, along with a near meltdown of the banking sector. On the one-year anniversary of the Lehman Brothers collapse, the event most blamed for accelerating the economic and market downturns, it's worth taking a look at where we've come. Now six months into a vibrant rally in the stock market, the bulls' rationale has been widely publicized in the media. Therefore, let's look at the other side of the story – what **hasn't** changed.

Continuing Difficulties in the Housing Sector

Despite recent signs of improvement, the housing market is still a shell of what it was during the past two decades. Home prices are back to levels last seen in 2003, having fallen about 34% since their peak in the second quarter of 2006. Prices continue to fall in some Sun Belt markets. Much of the home buying that has taken place has been in distressed homes, with these properties still accounting for about one third of existing home sales. The new home market has barely budged. The \$8,000 tax credit for first-time home buyers has generated some activity, mostly moving demand forward in time, but that opportunity is set to expire in November (unless it is extended). In addition, relatively few jumbo loans are being made, which has stifled activity. Foreclosure filings set a record in July and were 88% higher than they were a year ago. Analysts estimate that more than 6 million Americans could lose their homes over the next 3 years. The inventory of unsold homes is far too high, still at an 8.5 month supply. Even so, that's only the reported number. There's thought to be a "shadow inventory" of unsold homes held by the banks that amounts to some 7 million units. If this inventory were added to the reported supply, then the overall inventory would amount to a 14-month supply. Note the tremendous build-up of inventory in the graph that follows



Given the importance of housing to the overall economy and the hit we have all taken to this significant part of our balance sheets, are we consumers really likely to feel good enough about our financial health to spark a classic consumer-led economic recovery? Asked another way, if the bubble in housing was built over two and a half decades, is it reasonable to believe the significant damage to the housing market ends up being repaired in less than two and a half years?

Credit and Banking: Skirting Death Does Not Mean the Patient Isn't Still Sick

As the calendar rolled into 2009, the debt markets seemed to be telling us that the risk of a major meltdown had dissipated. However, there are still a host of issues weighing on the health of the financial arena. On the regulatory front, Democrats' efforts to re-regulate the sector have bogged down amid infighting between the various agencies and opposition from many lawmakers who believe giving these bodies new powers will only exacerbate the issues. So, a year after the demise of Lehman Brothers, there are no new rules in place to:

- control the vast "shadow banking industry" of mortgage originators and insurers that caused the crisis
- beef up regulatory agencies like the SEC so they can better police Wall Street
- limit excessive risk-taking by big Wall Street banks
- rein in the short-term incentives in lavish pay and bonus packages that tempted executives to take excessive risks

In fact, the big Wall Street banks are still churning out financial instruments similar to the ones that ignited the crisis – securities backed by home mortgages and commercial loans, often repackaging their old mortgages as new offerings... and they still aren't required to disclose exactly what's in them. These banks appear to have short memories, as their renewed appetite for risk clearly shows. They've made a LOT of money over the past two quarters -- \$23.3 billion – much of it off their \$56 billion in **trading** revenue. This is just slightly under the \$58 billion in trading revenue generated in the first half of 2007, which was the peak of the boom. Their own estimates of what they could lose in a single trading day -- **\$1 billion** – was running 70% higher in the second quarter than during the boom. White House National Economic Council Director Lawrence Summers may have summed it up best when he said, "The concern... is that a resumption of confidence, which is a good thing, not become a return to hubris, which would be a very bad thing".

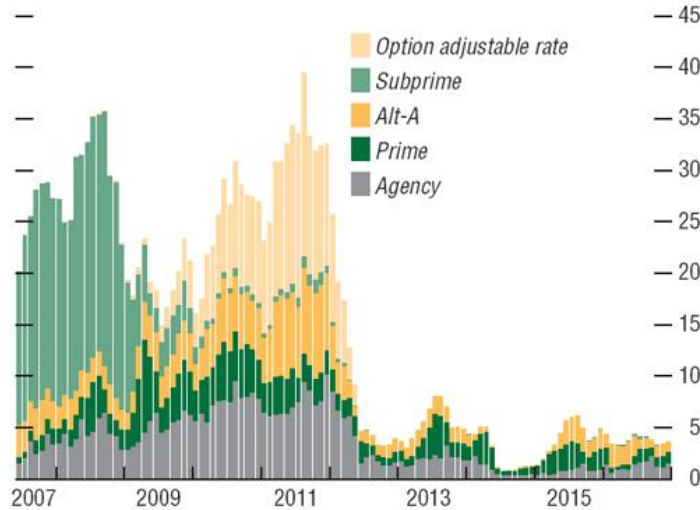
As to executive pay, I need only mention that the top five banking firms set aside \$61 billion in the first half to cover compensation and benefits for their employees, making it obvious that the old incentives are still in play.

Just today, the FDIC's board proposed to have banks prepay \$45 billion in fees, given the ongoing realization that their \$10.4 billion insurance fund will be negative in a matter of days. There have already been 95 bank failures in 2009, with an additional 416 on the FDIC's problem bank list.

Two new shoes to drop? The first is the dearth of commercial loan defaults about to befall the banks, especially in commercial real estate. The other is the \$800 billion in option ARMs (adjustable rate mortgages) scheduled to reset over the next 18 months, which looks as bad for

the consumer as it does for the banks. In the charts that follow, we provide evidence of these new challenges to economic recovery.

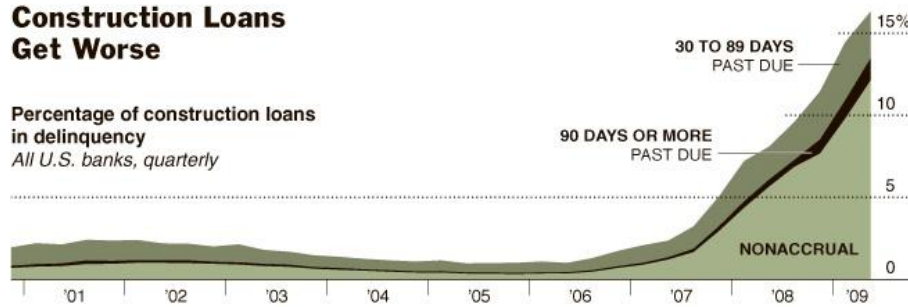
Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Construction Loans Get Worse

Percentage of construction loans in delinquency
All U.S. banks, quarterly



Percentage of construction loans in delinquency



Construction loan delinquency rates by sector Quarterly



Sources: FDIC; Foresight Analytics LLC. Figures for differing types of loans and for metro areas are estimated by Foresight.

Political reality suggests that as each successive month goes by without reform, the urgency passes, making reform harder to push through Congress, especially with competing interest in a

health care bill. Experts wonder whether the reforms are even worth waiting for, since the administration is mostly focused on consumer protection and banks' capital levels, probably not the key issues.

If that wasn't enough, as of March 31st, the estimated notional value of credit derivatives outstanding stood at \$14.6 **trillion**, according to the Office of the Comptroller of the Currency (OCC). That's triple the amount of three years ago.

Is it really that easy for investors to have forgotten what they were feeling about the health of the banking industry just twelve short months ago?

Here are some other questions we should be asking ourselves:

Given that the consumer accounts for 70% of the economy, with unemployment going higher and the consumer's net worth badly bruised, can Corporate America get real revenue growth going again? Can corporations continue to beat Wall Street earnings estimates in the out quarters without revenues, but through continued cost cutting and asset sales, or are they running out of tricks? Can we get a true economic recovery without these things?

Is it rational to think that the damage to the housing sector, credit markets and financial services industry gets repaired so quickly as to give us a V-shaped recovery?

How likely is it that a new secular bull market has started on such light trading volume, especially given the fact that much of that volume continues to take place in a handful of heavily-traded financial services stocks?

For over a year now, there has been a strong inverse correlation between the stock market and the U.S. dollar. When the dollar has been in a precipitous decline, the equity markets have rallied powerfully... and vice versa. As much as the dollar has come down over the past several months, is it reasonable to expect some kind of meaningful corrective reversal in our currency -- even if only a "dead cat bounce" -- that trips up this rally in the stock market?

Have we forgotten that the costly bailouts of our banking, insurance and auto industries, plus an expensive health care plan, have to be paid for eventually... and that this "tab" will inevitably induce inflationary (maybe hyper-inflationary) pressures? What do you suppose that means for the markets?

Can the Administration, the Fed and the Treasury really "thread the needle" by spurring economic growth, but keep the banks solvent, hold inflation at bay and somehow revive the housing sector?

Given the tone of my questions, I'm sure by now you've surmised our answers. With strong headwinds still pushing against a true economic recovery, we believe a significant pullback is in the offing for the equity markets before this bear finally goes into hibernation. That said, it's still our preference to maintain equity positions at levels well below our strategic targets. We'll use any meaningful pullbacks from here to begin feeding dollars back into the equity markets in

preparation for the next bull phase. In the meantime, we still favor the risk/reward trade-offs in the debt vehicles that have been so prominently featured in your portfolio throughout this year. We'll also continue to watch for opportunistic investments that will allow us to take advantage of certain sector dislocations. Defense in equities, offense in debt, core hedge positions, and a few select opportunistic investments... feels like the right recipe in the face of the economic scenario I hope I've clearly painted for you.

We're fast at work producing third quarter reports, which will be distributed at month's end. Additionally, we're developing the design and structure of an Opportunistic Fund that we intend to launch as we turn into 2010. This fund will be designed to produce outsized returns by aggregating the kinds of opportunistic investments we've employed in portfolios in the past (and more). We'll look forward to discussing the potential of this fund with you during our quarterly reviews.

In the meantime, enjoy the onset of fall.