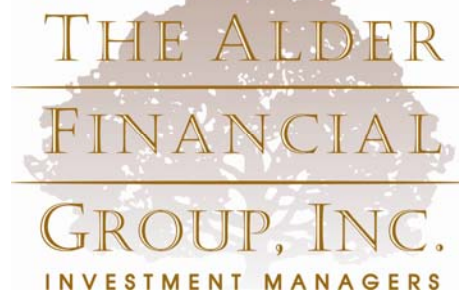


MARKET NEWS

Keeping our Clients Informed

January 2008



The Third Rewrite

It seems that every time we've tried to get our newsletter out this month we've had to rewrite it because there has been yet another major event to rattle the markets. Although these events have involved different institutions and markets, they've all been rooted in the subprime mortgage crisis that began this summer. If nothing else, these past few months have been an important lesson in the interdependency of the global financial markets. From a broad perspective, the scenario playing out right now looks like this:

The real estate markets soften, putting pressure on property owners who can't afford the mortgage payments long-term and were hoping to flip their property in the short-term.

Rising foreclosures and higher interest rates further depress housing prices, making it increasingly difficult for property owners to escape from the high debt load.

More and more people are forced or willing to walk away from their properties, leading to alarmingly high default rates in the mortgage backed bonds that now own these loans.

As the losses mount, bondholders become aware of the disturbingly high number of bad loans wrapped inside their bonds due to appallingly poor underwriting practices that have been prevalent in the mortgage industry for several years.

Unable to ascertain the magnitude of this problem, buyers of private-label mortgage backed bonds or anything associated with them vanish from the market in a matter of weeks. Prices of these securities plummet.

Owners of these securities that have used them to collateralize loans get margin calls as the much lower bond process no longer supports the debt levels. Hedge funds are the first to get hit.

Forced liquidations from margin calls further drive prices of these securities down, creating a cycle of more margin calls.

The Fed, European Central Bank, fund sponsors and money center banks have to step in and act as counterparty for the forced sales of these securities.

Commercial and investment banks make huge write-downs in the value of their portfolios to reflect the lower prices of their own securities as well as the massive

amount of capital contributions made to their leveraged subsidiaries.

Shocked by their loss of capital and the known losses of their peers, financial institutions severely cut back on their lending activities, curtailing economic activity.

Additionally, consumers' lack of available credit further pressures GDP down. Unemployment rises as a result of this slowdown.

The Fed steps in and lowers short-term interest rates hoping to keep the economy from slipping into a recession. The value of the dollar against other currencies drops due to our lower rates. Oil gets more expensive in dollar terms.

The Fed is slow to aggressively lower rates because of the inflation fears brought on by the already weak dollar.

Recession fears are magnified by the Fed's slow response and seemingly unending data showing a slowing economy. The stock market drops 10-12% in the first 3 weeks this year.

Counterparties to credit default swaps are finding it difficult to fulfill their contractual obligations due to higher than anticipated default rates.

Major monoline insurers Ambac and MBIA have trouble raising needed capital to shore up their balance sheets leaving in question the quality of their bond insurance contracts.

That's "B" as in Billion

On the surface, it's hard to believe that the residential mortgage market could lead to a recession in an economy our size or the global liquidity squeeze we saw this fall. But these are really big numbers we're dealing with here. To be sure, the bond market is by far the largest financial market in the world and the mortgage market comprises roughly 60% of the U.S. credit market. Furthermore, according to the FDIC, real estate related holdings for U.S. banks accounted for 58% of total assets. This is up from 45% in 2000.

Since May, specific losses reported by the world's biggest banks have climbed to more than \$100 billion as a result of U.S. subprime mortgages. Hardest hit, Citigroup Inc. posted its largest loss in the bank's 196-year history this past week, driven by \$18 billion of write-downs on its mortgage and other fixed-income investments. On the brokerage side, Merrill Lynch had write-downs of \$14 billion.

It's still uncertain if the worst of the write-downs are over. Citigroup, for example, ended the fourth quarter still exposed to \$37 billion of subprime mortgages, and \$43 billion of corporate-loan commitments for leveraged buyouts remain on its balance sheet. Still, losses from the current credit crunch (nearly equivalent to 0.7% of U.S. gross domestic product) haven't reached the level seen in the savings-and-loan collapse in the late 1980s, when losses reached \$189 billion, or 3.2% of average GDP.

Globally, foreign banks have been hit by these write-downs as well. Analysts estimate that state-owned Bank of China, traditionally the most international of the country's big banks, may have to write off a fourth of the nearly \$8 billion it holds in securities backed by U.S. subprime mortgages.

Similar situations have been seen across the European Union banking sector. German bank IKG Deutsche Industriebank nearly collapsed in August under the weight of its subprime investments. Multibillion Euro write-downs have been taken by French and British banks as well.

The "R" Word

The credit crunch that was sparked by problems with residential mortgages is spreading to the broader economy with banks making it harder and more expensive for some small and midsize businesses to borrow.

While companies with strong balance sheets still can borrow what they need at good rates, others are beginning to feel the chill. In particular, start-up and smaller companies are finding that banks are setting higher rates, seeking more collateral or lending smaller amounts.

This is the way it often unfolds when there is a squeeze on lending. The last significant credit crunch, which ran from about 1989 to 1992, began with a pullback on lending for commercial real estate that then spread to business lending. This time, the problems spread from residential real estate and are being felt by everyone from commercial farmers to makers of heavy machinery.

With other indicators pointing toward a possible recession (including falling stock prices and rising unemployment,) a widening credit crunch doesn't bode well for the economy. Start-ups and small businesses are generally the companies that create jobs in a downturn. But tighter credit could curb business investment and hiring as companies recalculate the costs of investing in new machines, marketing campaigns or ventures. This could magnify the current slowdown in growth.

These scenarios have a wider economic implication than just in the United States. Because the U.S. comprises over a fifth of world-wide GDP, a meaningful slump in growth domestically would surely be felt around the globe.

Equity prices are already pricing in the expectation of slow or negative growth around the world. In addition to U.S. stock prices being down somewhere in the neighborhood of 15% in a few short weeks, European and Asian markets are down significantly as well. This pessimistic outlook is being

echoed in the bond market too. While the risk spreads have increased the yields on many corporate issues, the core risk free rate has declined, reflecting the view of slower growth going forward. The ten year treasury yield is now down over 50 basis points since this summer.

Looking Forward

It seems unavoidable that this is going to be a rocky road for all financial markets for, at least, the first half of the year. Stocks will have to mount a healthy rebound to overcome January's double digit declines. That would be difficult, to say the least, in an unhealthy economy.

In our opinion, the biggest impediment to any recovery is the continued default worry in the credit market. The most recent scare and possibly hardest to quantify is in the credit-default swap market. These are complex financial arrangements where one entity contractually sheds its portfolio default risk to someone else for a fee. This is essentially buying default insurance for particular securities in a portfolio.

Many financial institutions have been using these contracts to hedge much of the risk in their portfolios. Now, due to the elevated default rates, the ability of these counterparties to actually make good on these swaps have come into question.

This month, bond insurer ACA Capital Holdings requested a one month grace period to unwind \$60b of credit-default swap contracts it can't pay. Standard & Poor's cut ACA's rate 12 levels to CCC, casting doubts on the company's guarantees. ACA is an important case to follow because it shows how the banks react to fast-deteriorating counterparty creditworthiness.

Because most of those guarantees are in the form of derivatives, these contracts are required to be valued at market rates. Those valuations are now highly suspect and may require further write-down's in the banking industry, further depressing earnings and capital.

These problems will get sorted out. It's just a matter of how long and at what price. In the meantime, the question remains as to where to hide. U.S. stocks clearly aren't the place. International equities offer no relief. Last year every category of bonds posted negative returns except treasuries. There were even worries with money market funds.

Short of liquidating everything in your portfolio and putting the cash in treasuries, there is probably little that can be done to sidestep the expected price volatility. That being said, there is a saying that in crisis there is opportunity. We believe the opportunity in this market is income.

Through all of this, yields on dividends and interest have risen considerably. We now have the opportunity to pick up as much as 2% higher income returns than we've seen as recently as last summer. Our focus now is to lock in these higher long-term yields. In addition, U.S. Based firms with large international revenues will greatly benefit from the weak dollar. We just need to keep an eye on their credit worthiness.