



# Market Update

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## Bad Banking, Bad Regulation, But Still Solid Credit Market Performance

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IndyMac Bank was a poster child for lax origination standards. It was the biggest "alt A" mortgage originator. (An alt A mortgage has either little or no borrower documentation or little or no down payment or a high loan to value ratio—or a combination of these issues.) Why lenders thought these loans were a good idea, much less the even lower quality subprimes, I will never understand. Subprime mortgage originators like Countrywide put together mortgage pools that were quite risky at the outset and are now experiencing high default rates.

And the regulators were completely asleep at the switch. As recently as the summer of 2006, the FDIC had this sunny conclusion in their FDIC Outlook, publication which featured "the results of analyses of national and regional economic and banking trends that may affect the risk exposure of FDIC-insured institutions":

"However, banks and thrifts will head into the next phase of the mortgage credit cycle from a position of strength. In recent years, the industry has generated record earnings and reached near-record capital levels. Given a gradual transition to higher delinquency and foreclosure rates and assuming only modest potential declines in collateral values, it does not appear at this time that deteriorating mortgage credit performance would present unmanageable risks to most FDIC insured institutions."

Relying on sunny assumptions is not what taxpayers pay the regulators to do. Regulators are supposed to be more in the "worst case" camp.



As for leverage, a group of big, prominent financial institutions, including Fannie Mae and Freddie Mac, lost sight of risk control and built up huge portfolios of mortgage and mortgage related securities. With high leverage comes high risk, so when a relatively small slice of the mortgages in their portfolios started to default (mainly sub prime and alt A's), the leverage magnified the hit and wiped out a substantial part of their net worth.

But the Federal Reserve Bulletin breezily noted in the second quarter of 2007 that things were just hunky dory on bank balance sheets:

“During the past few years, financial institutions introduced a variety of nontraditional mortgage products, and more mortgages were made to subprime borrowers. The July 2006 BLPS contained several questions about the importance of these mortgage products for commercial banks. According to the responses, commercial banks generally appear not to have been involved significantly in making nontraditional and subprime mortgages. About 45 percent of banks indicated that less than 5 percent of their mortgage holdings were nontraditional loans. **About half the respondents did not answer the questions on subprime lending; the nonresponse suggests that they are not engaged in this type of lending.**”

“Finally, banks may be exposed to subprime mortgages through their holdings of mortgage-backed securities, **but these holdings are largely backed by the U.S. government or by government-sponsored enterprises.**”

“Despite banks’ generally strong balance sheets and continued profitability in the first quarter of 2007, an index of the stock prices of the 225 largest banks underperformed the S&P 500 index over the period. **Investors apparently became concerned about possible implications of the troubles in the subprime mortgage sector for banks’ earnings.**”

I changed the font color to red on the three big assumptions/observations made by the Fed that they should have noted as big red flags but did not. For a regulator to assume that no response means “no problem” is ridiculous. Banks had extensive exposure to bad mortgage-backed securities, and in any case, protecting U.S. taxpayers from unnecessary risk is not a responsibility that allows for complacency. Finally, not taking investor concerns seriously is usually a mistake, especially for a regulator.

But I digress. With all the turmoil in banking, the failure of IndyMac and the troubles at Fannie Mae and Freddie Mac, it is important to check whether these problems are generating more widespread credit market problems or remain isolated.

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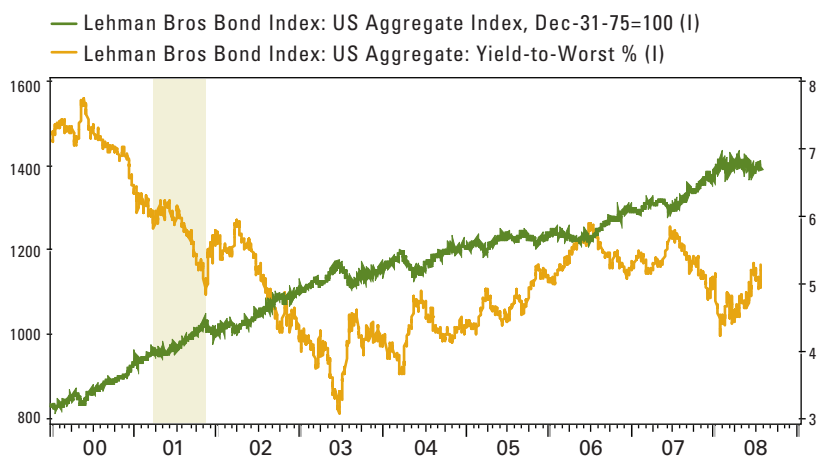


Despite the carnage on Wall Street, it is important to note that much of the U.S. credit market remains healthy. The Lehman Aggregate Bond Index, which is representative of the entire U.S. investment grade debt market—a big chunk of total debt—is doing just fine with a positive total return.

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So, while there are significant problems associated with cleaning up the damage from lax lending standards and highly levered balance sheets, it is also true that the damage is less widespread than many seem to think. The chart below shows the daily total return index for the Lehman Aggregate Bond Index. It shows none of the turmoil going on in financials; no big decline and a medium size rise in the yield.

Total Return Index and Yield

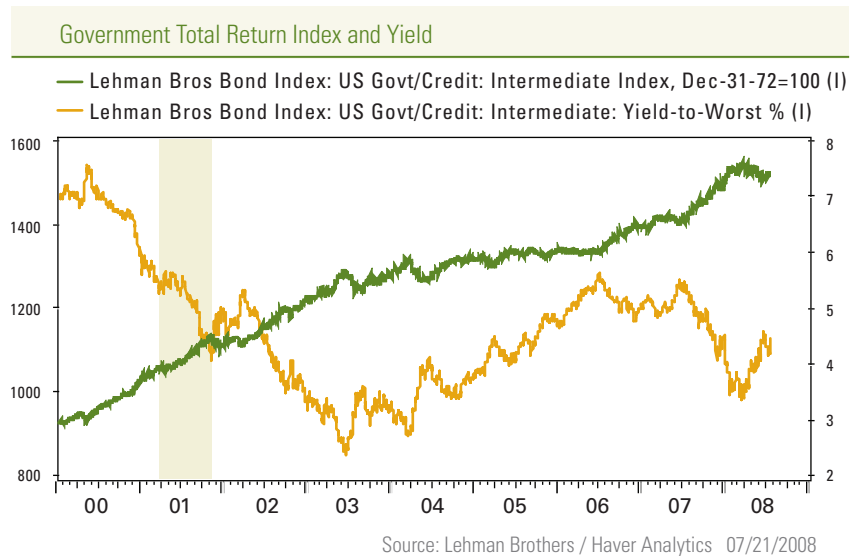


Source: Lehman Brothers / Haver Analytics 07/21/2008

And various component indices show little trouble.

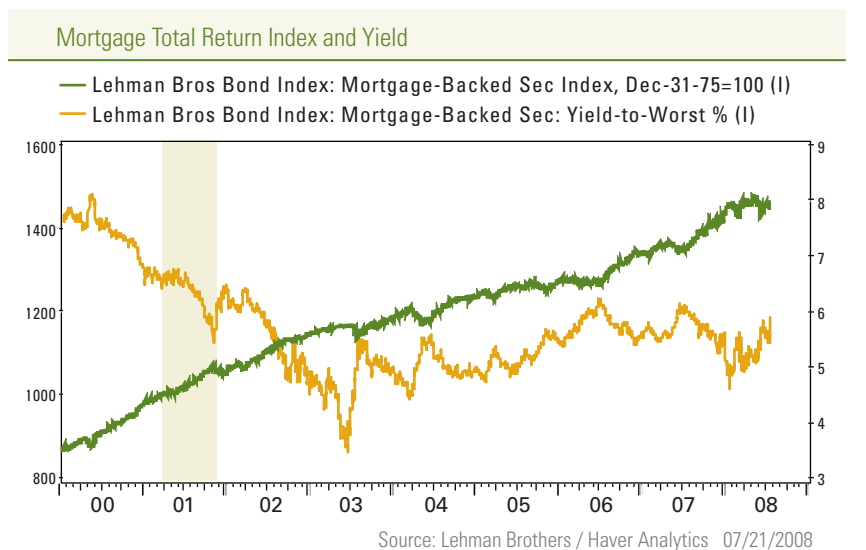


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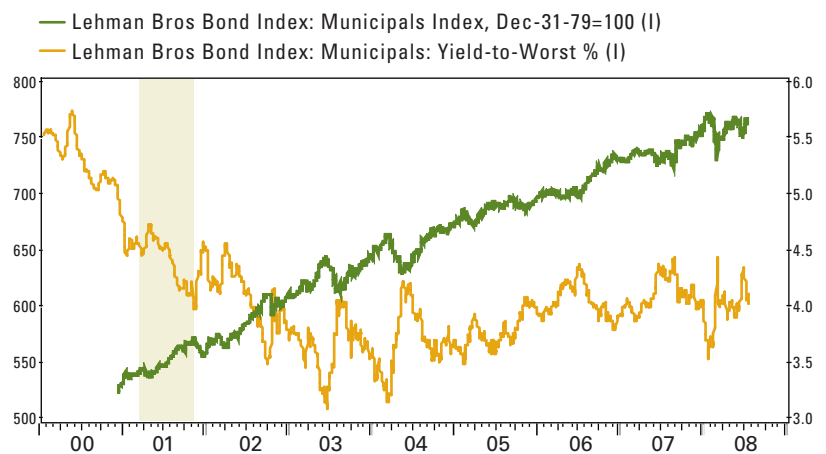




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The investment grade Lehman Brothers Muni Bond Index had a stumble earlier this year, but is back on track with stable yields. High yield munis are a just a small part of the total muni market, and they are also not selling off dramatically. One problem area has been a liquidity issue, not a principal issue, with Auction Rate Muni Debt. That liquidity issue is slowly being cleared up as these securities are redeemed.

Municipals Total Return Index and Yield

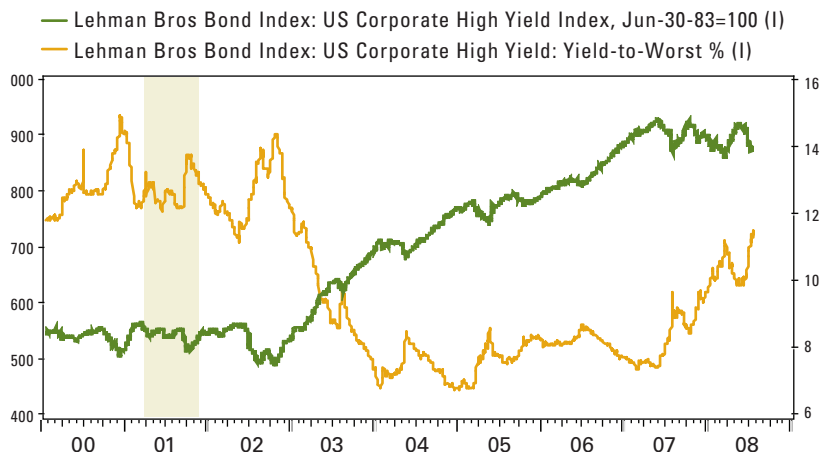


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Outside of investment grade debt, the Lehman U.S. Corporate High Yield (junk bond) Index has been hit somewhat but not in any extraordinary way. The index took a similar pounding back in 2002, which produced 14%-15% yields (and which turned out to be a great buying opportunity). Today the yield is a bit below 12%, and we view this as a decent buying opportunity.

Junk Total Return Index and Yield



Source: Lehman Brothers / Haver Analytics 07/21/2008



In summary, it is clear that a number of financial institutions made serious errors in judgment over a number of years and that the regulators charged with overseeing risk completely missed a major deterioration of financial institution risk in their earnings profiles and balance sheets. And the workout process is bloody—big write-downs, bank failures, reduced credit availability and rising taxpayer expense. That said, it does not appear that this hit on many big financial institutions is spreading widely to the general U.S. credit market. Total returns are generally stable and net corporate bond issuance is at record levels with yields generally below peaks in 2006 and 2007. The damage appears contained.

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

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