

Credit Crisis Update – Is Stage 2 Upon Us?

June 2, 2008 Newsletter

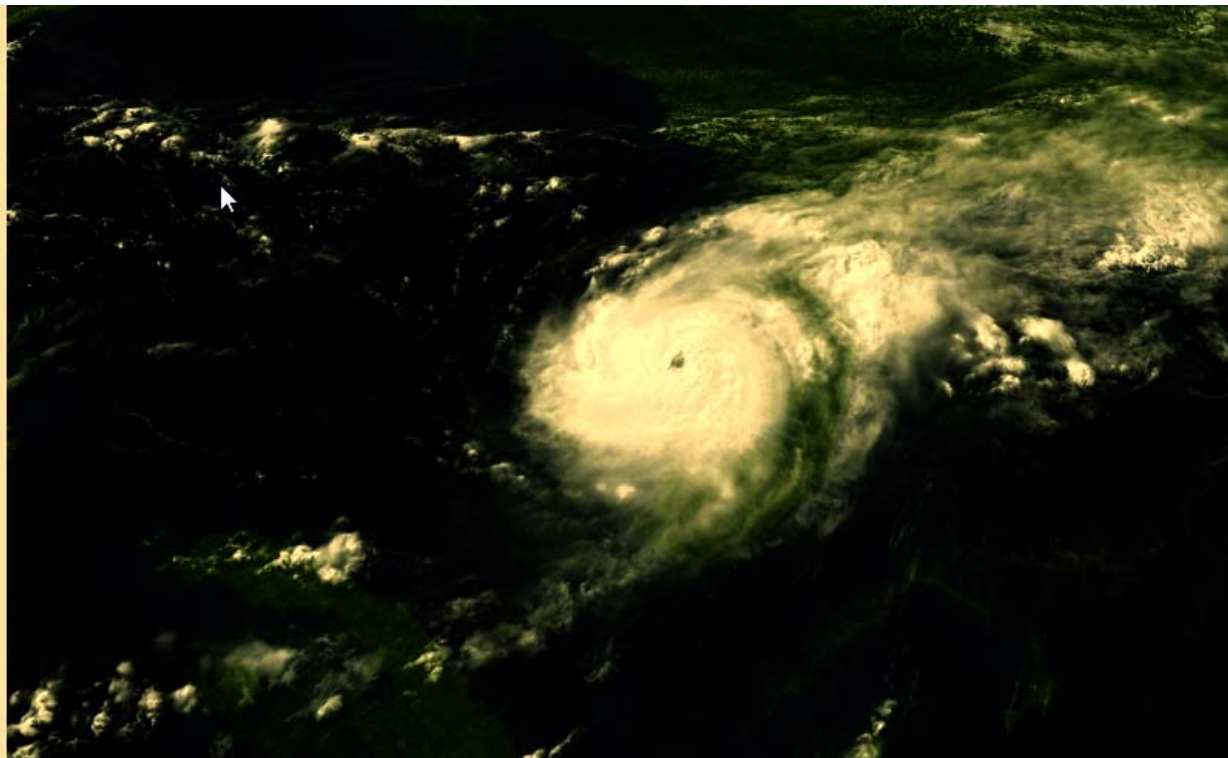
“Our understanding of the best practice in monetary policy evolved during Alan Greenspan's tenure at the Fed, and it will continue to evolve in the future,” Fed Chairman Ben Bernanke.

About 10 days ago, I was interviewed on Fox Business News as a part of a Minyanville daily Fox News ritual. The first question I was asked was, ‘What inning of the credit crisis do you think we are in?’ I have to confess that the answer I gave was one that I heard one morning on the way to the office. A British economist on Bloomberg Radio stated that ‘we have heard the National Anthem but we haven’t had the Seventh Inning Stretch’. I have to admit that I couldn’t have said it better myself.

On a recent business trip to New York City and Greenwich, I had the pleasure of speaking with some of the brightest professionals in our industry. My biggest take away from the trip and meetings was that the over-40 crowd is concentrating mostly on the macro-economic or big picture. At Atlantic Advisors, that is where we have always begun and let our big picture beliefs guide our asset allocation decisions and let other, more cyclical indicators such as investor sentiment, valuations, cyclicity and short interest influence actual portfolio positioning. Another important takeaway was that the older and more experienced investors were more concerned than I was. After all, if you haven’t lived through a credit crisis, it is hard to fully appreciate what that unwinding of a credit crisis looks like. When we consider that the build-up of credit and derivatives during this past cycle is so unprecedented, the more difficult the unwind is likely to be.

Another analogy I like to use is one of a hurricane (which for someone like me who has lived in Florida for twenty years; I know what one looks like). Hurricanes that hit the East Coast of the USA usually begin to form off of the Western Coast of Africa in the Eastern Atlantic. We aren’t usually concerned or ready to take action, but take note just in case it begins to build and heads our way. This is how I felt several years ago during the 2003-2005 bubble in housing and in low quality credit creation. We became cautious and very aware of the storm forming. As hurricanes begin to gather steam and build in size, the Weather Channel begins to track the storm and project potential paths of the storm. I recall a day in 2004 when Hurricane Charley was heading for Tampa out of the Gulf of Mexico. The storm was ‘supposed’ to hit Tampa and then bounce off the coast into the Gulf of Mexico and then unexpectedly turned-directly towards Orlando and a dead-on shot to the neighborhood where we live. To be honest, we had no time to prepare as the meteorologists misjudged the storm. The next thing I know, Charley was banging on the front door with winds of 110 MPH. Had we known it was coming our way, we would have been gone in a New York Minute. But no one had time to react, so everyone just heads towards the most interior part of the house and hopes for the best. Thankfully, no one got hurt, many lost power for a few weeks, but the storm moved quickly out to sea. The outer bands are easily defined, but what was behind it is what took out most of trees in my yard. Just like the bad loans and esoteric securities could take out the foundation of more than one financial institution.

Hurricane Charley Imagery



This is how we felt in 2006 when it was clear that the bubble had burst and the implications seemed so negative that we went to a 'no credit risk' position, a position that we maintain until this day. The next stage of a hurricane is that the storm nears the shore and we are hit by the outer bands of the storm. The outer bands are bad enough to get your attention and you take cover. I happen to think that the happenings leading up to the Bear Stearns collapse and bailout by J.P. Morgan that was completed last week were the outer bands of the hurricane. What follows the outer bands is a period that is rather benign and lets people breathe easy. Some prudent people living on the coast will then take cover and evacuate. I guess I feel like I am part of the evacuation crowd—in other words, I see the leading edge of the large part of the storm heading our way, and have taken cover in our lowest long-only position in equities since 2000 and continue to avoid credit risk at all costs. We have heard so many stories about people that stubbornly refused to leave their homes and then got

nailed by the hurricane. Many times it is a 'better safe than sorry' move, and that seems to be the majority view on Wall Street these days, that the worst is behind us. To be frank, I could not disagree more vehemently. I believe that the credit crisis is about to rear its ugly head again, potentially unannounced. It is possible that the storm will miss us and that the worst is behind us and if so, the worst thing that will happen is that we will make less money than the next guy, which is OK by me. I believe the next part of the crisis will be more widespread and have a larger impact on the real economy than many believe. Delinquency rates in everything from credit cards, home equity loans, auto loans, utility bills and telephone bills are increasing. The one-two punch of dramatically higher oil and gasoline prices and a slowing economy, along with the high levels of indebtedness are taking its toll. Now back to the hurricane analogy.

If we are correct, the next stage of the credit crisis, which I firmly believe is at our front door, could make the first stage feel like a walk in the

park. This is when the hurricane makes landfall, and many that didn't evacuate as they were instructed to (those taking credit risk at present no matter how disturbing the economic data has become will wish they had). Let's say the storm comes and lasts six to nine months, and the newly elected President will likely blame past administrations and possibly wish they had never run for office and likely have a term of 'one and done'. If you are lucky enough to make it past the front part of the hurricane, a seemingly calm period takes place (the eye) and once again, people feel relieved, see the sun and hope that the back end of the storm will break up as it hits shore. This could happen in 2009 at which point Stage 3 shows up, and the back end of a hurricane can be the most damaging and is the knockout punch. We think this could be a late 2010 event which could be followed by a huge rally in markets worldwide in both credit and equities. It is possible that this would be a cyclical move

What Might Stage 2 Look Like?

The economy most certainly seems to be stalling with money still growing at rates near 20% annually. It is expected that the Bureau of Labor and Statistics will release the fifth consecutive month decline in non-farm payrolls this Friday. Who would have thought that the economy would stall with excessive credit growth, bubbles in equities, real estate and commodities over the past ten years? If the economy were on stable footing, surely the economy would be expanding at a rapid pace and the Fed would be forced to tighten monetary policy, not hand out cash to all its Wall Street buddies. But where is MY bailout? When I make a bad decision in a portfolio, I don't have a backstop. Rather, I have to pay

within the confines of the secular bear market that began in 2000, but one that we would love to be positioned for. The investor that recognizes the issues we face and is prudently positioned (sometimes with positions to the downside using defined risk via puts) will likely be able to weather the storm, while those that hope it is over will wish they had paid more attention to the news flow. Virtually every data point that I am seeing these days gets worse by the day, yet the data is being greeted with complacency. Since the Fed has played the ultimate 'Moral Hazard Card' ([Moral Hazard article](#)) by back-stopping banks and brokers with their repo lines and term facilities, I suppose many feel that the Fed will be there to bail them out.

I think they are sadly mistaken and that the Bear Stearns will be nothing close to an isolated instance.

for my mistakes, which is now happening at an even greater pace on Main Street. Homes are collapsing in value, equity markets around the world stagnate, credit spreads stay stubbornly wide and delinquencies accelerate. The sole reason, in my opinion, is that much of the expansion and bubble creation were stoked by credit and derivative creation. Since the creation was unprecedented, we can only conclude that the unwind will be like something we have never seen before. The poster child of the unwind are the bank and brokerage stocks, the parties responsible for providing easy money and financial alchemy. The two charts below tell the story without much of a description.

KBW Bank Index (in logarithmic terms)



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Amex Broker/Dealer Index (in logarithmic terms)



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The credit bubble that was created by financial institutions, as a result of the bad loans with rising delinquency rates, now resides on the balance sheets of the banks and brokers. Additionally, much of the 'nuclear waste' that was created also resides on their balance sheets, much of which is unpriceable, untradeable and in some cases several times more than the shareholders equity on their books. According to Bloomberg, there are now over 668 publicly traded companies with Level 3 Assets on their books, which is 133 more than just last month. What I find highly interesting is that the companies aren't limited to just banks and brokers. We are increasingly seeing them on the balance sheets of insurance companies like AIG, Metropolitan, Hartford, etc. This leads to a very interesting possible scenario that could get Stage 2 of the credit crisis rolling. Insurance companies are usually forbidden to buy junk bonds and most of them have 'downgrade language' in their charters. Downgrade language is language that can force an insurance company to sell bonds if they are downgraded from say, AAA to BBB. Level 3 Assets have three magical words in their definition-'no observable inputs'. What would happen if insurance companies slowly had their holdings downgraded and they were forced to sell? A couple of notable possibilities

come to mind. First, other holders of similar securities would likely be required to mark their bonds to market, possible wiping out shareholder equity in the meantime. Secondly, it could force other holders to sell as well, or at a minimum, raise more assets to cover their write-downs/write-offs. And while the market has been open for those willing to raise money in the capital markets, it is open at stubbornly high rates. National City raised money at 9 7/8% and then 12% before it was forced to sell a huge amount of shares at a multi-decade low of \$5 per share that effectively diluted existing shareholders by 50%. Key Bank, which operates in almost identical markets as National City as does Fifth Third Bancorp, has had to pay nearly 9%. Merrill sold a \$2 billion preferred deal at 8 5/8%, J.P. Morgan at 8.1%, Fannie Mae and Freddie Mac at 8 1/4%, Citigroup at 8 1/2%, Regions Bank at 9%. To drive home the point, below is a chart of bond yields dating back to the 1920's. Note that in the 1930's Treasury Bill yields plotted, just as they have today, except that BBB rated bonds actually spiked simultaneously as the Fed eased to 1%. Does that have a particularly familiar ring to what is happening now? It sure does to me. See the Level 3 Assets below. Ouch.

Level 1, 2, 3 Assets (ranked by Level 3 in descending order)

Ticker	Level 1	Level 2	Level 3	Level	SE:Q (M)	Level 3	Level	Level 3	
1) C	US	183,801.00	1,153,862.99	160,345.00	125.06	128,219.00	-8,657.00	18.54	160,345.00
2) JPM	US	261,124.00	1,571,734.03	98,856.00	78.69	125,627.00	1,631.00	15.04	98,856.00
3) GS	US	135,426.00	620,985.97	96,386.00	191.56	50,316.00	2,878.00	12.50	96,386.00
4) MER	US	111,292.00	1,022,443.98	82,367.00	225.40	36,542.00	-1,216.00	17.30	82,367.00
5) MS	US	197,562.01	304,052.01	78,168.00	234.88	33,280.00	1,123.00	14.94	78,168.00
6) FNM	US	6.00	321,060.01	62,967.00	161.48	38,994.00	-2,396.00	17.86	62,967.00
7) AIG	US	108,794.00	599,688.02	48,464.00	53.47	90,637.00	-13,331.00	6.91	48,464.00
8) CFC	US	2,493.49	36,992.29	42,516.79	323.20	13,155.06	-3,804.67	56.95	42,516.79
9) LEH	US	61,757.00	199,830.99	42,508.00	171.18	24,832.00	228.00	13.98	42,508.00
10) BAC	US	76,384.00	1,113,600.03	39,730.00	25.42	156,309.00	-551.00	8.17	39,730.00
11) BSC	US	26,262.00	332,979.01	37,350.00	313.97	11,896.00	-905.00	25.50	37,350.00
12) WB	US	6,908.00	160,421.00	32,592.00	40.21	81,060.00	-240.00	16.30	32,592.00
13) PRU	US	88,944.00	275,948.01	27,090.00	119.36	22,697.00	-165.00	6.97	27,090.00
14) WFC	US	45,278.00	71,139.00	23,422.00	48.63	48,159.00	-2,848.00	16.75	23,422.00
15) ALL	US	18,366.00	71,265.00	23,002.00	113.29	20,303.00	-1,383.00	17.89	23,002.00
16) HIG	US	140,323.00	131,323.00	19,356.00	108.52	17,836.00	-1,801.00	6.65	19,356.00
17) GE	US	1,606.00	39,613.00	15,029.00	12.10	124,234.00	475.00	28.67	15,029.00
18) IMB	US	220.00	3,038.00	11,001.00	758.69	1,450.00	-65.00	91.55	11,001.00

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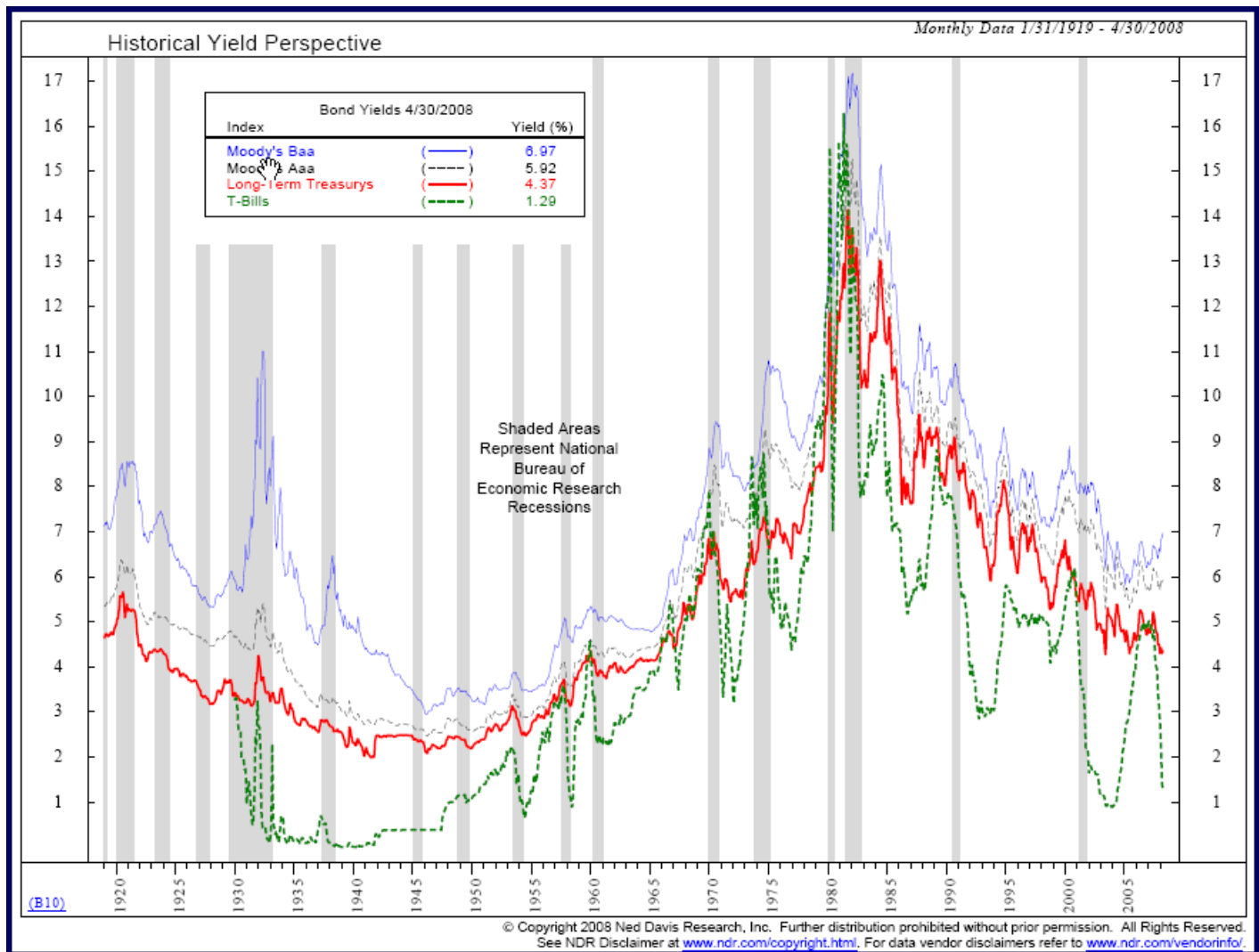
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This table is not here for shock value. I present it because it slowly undresses all of the emperors. There are only two companies that have over 3:1 Level 3 to capital and both of those are being acquired (Bear Stearns (BSC) by JPMorgan) and Countrywide Financial (CFC) by Bank of America. Others that are high on the list are Merrill Lynch, Morgan Stanley, Goldman Sachs, Fannie Mae and Lehman Brothers. Earnings season ought to be rather interesting. There are conflicting stories out in the Street—some say folks like Goldman put lowball prices on their Level 3 Assets and then sell them at higher prices, passing this on as ‘earnings’. Others, like AIG and Citi, haven’t

been nearly as lucky. The worrisome part, though, continues to be how rapidly bonds are being downgraded, less are able to be priced, less have an observable market and their business models are hopelessly flawed. This explains our caution. In a normal market, one that had relatively normal liquidity, I could liquidate the Harbor Pilot Fund’s holdings in a day. I may not love every price I could get, but we would be able to sell relatively quickly. If someone yelled, ‘SELL, (fill in the blank for your favorite investment bank), I highly doubt they would be solvent, hence creating the nasty chain reaction the Fed was so frightened about with the BSC bailout.

Historical Yield Perspective



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And these were not small deals—rather; they were deals approaching \$5 billion each. I have to admit that, in a vacuum, the deal seemed cheap, but my hunch that they are value traps and most now trade below issue price. You may be asking yourself why these companies had to pay up so much for capital. The simple answer is that ‘they needed the capital desperately and sold while they could’. My belief is that while these issues are awful from an earnings point of view, they still allow them to function—not necessarily normally, but at least they can remain open for business. My belief is that at some point in the next six to twelve months, the financing window will shut, and shut hard. When these companies can no longer fund themselves, it could be curtains for many of them, and there will likely be many forced marriages. When one thinks about it, the JPM/Bear deal was a shotgun marriage with the Fed and Treasury Department acting as matchmakers. This is how many of the brightest folks I know feel the next wave will look like—the Fed will simply try to retard the speed of the crisis by innovatively creating new financing facilities and have more ‘good bank/bad bank’ marriages. In truth, I really don’t know of many banks that are truly good in the pure sense of the word so you may say they may be ‘not-so-great/bad bank’ marriages with a shotgun at the altar.

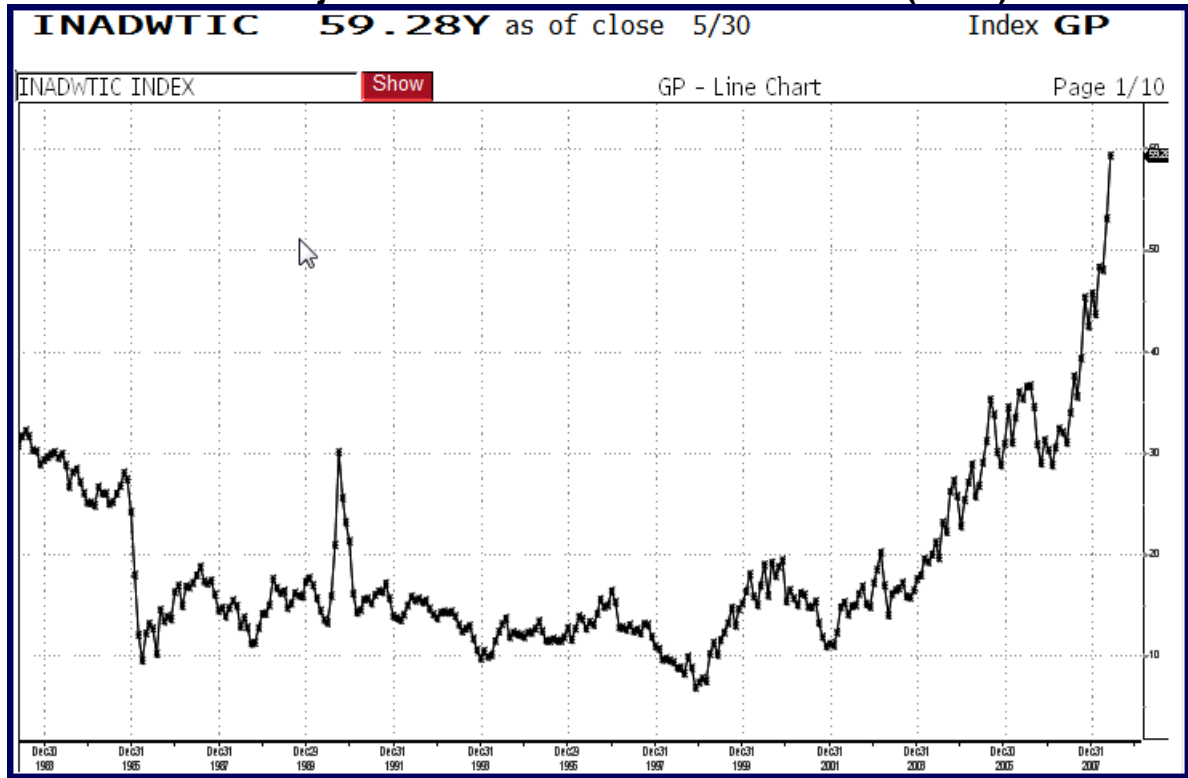
Where it all Begins

When I think of all the bad loans and low quality securities floating around, the question that should come to mind is ‘where on Earth did all of this originate?’ The key word in that simple is ‘originate’. The bad loans are a function of banks and mortgage brokers making low quality loans—whether this was the mistake on the part of the borrower or predatory lending on the part of the lender is moot at this time. Suffice to say that the loans

aren’t performing for reasons other than the fact they were made on over-priced real estate at rates that benefitted the lender. Throw on top of that a slow economy, rising unemployment and soaring gasoline prices, one gets a sense of why there are nearly 3 million homes vacant in this country and 2-3 million more to be foreclosed on this year. Just take a look at the chart below of West Texas intermediate Crude on an inflation adjusted basis over the past 25 years.

A picture, indeed, tells a thousand words. Gasoline consumption is slumping precipitously now and we can now be sure that gasoline isn’t completely inelastic anymore. Anecdotally, all the signs are there. I see people dropping out of country clubs, travel being curtailed, and budgets being cut. I don’t enjoy paying nearly \$100 to fill up a tank any more than do people who are less fortunate than me. It is a tax those over-leveraged consumers don’t need as they face foreclosure and potential layoffs. It is no surprise, then, that consumer confidence is plummeting to a 28 year low, with a distinct difference this cycle. In the recent past cyclical lows in consumer confidence has been accompanied by cyclical lows in equities. But again, the unwinding of credit is something we have not seen the likes of since the 1930’s and it is my belief that consumer confidence will go down and stay down. The key takeaway from all of this is that unless the loans that the alchemists used to put together the esoteric garbage that resides on balance sheets of brokers and banks, the brokers and bankers (and other investors embroiled in this mess) will not perform either. The daisy chain has begun; the hurricane is approaching our shores. Since we operate under the principle of ‘you cannot be too cautious with other people’s money’, we are as cautious as ever.

Inflation Adjusted West Texas Intermediate Crude (WTIC)

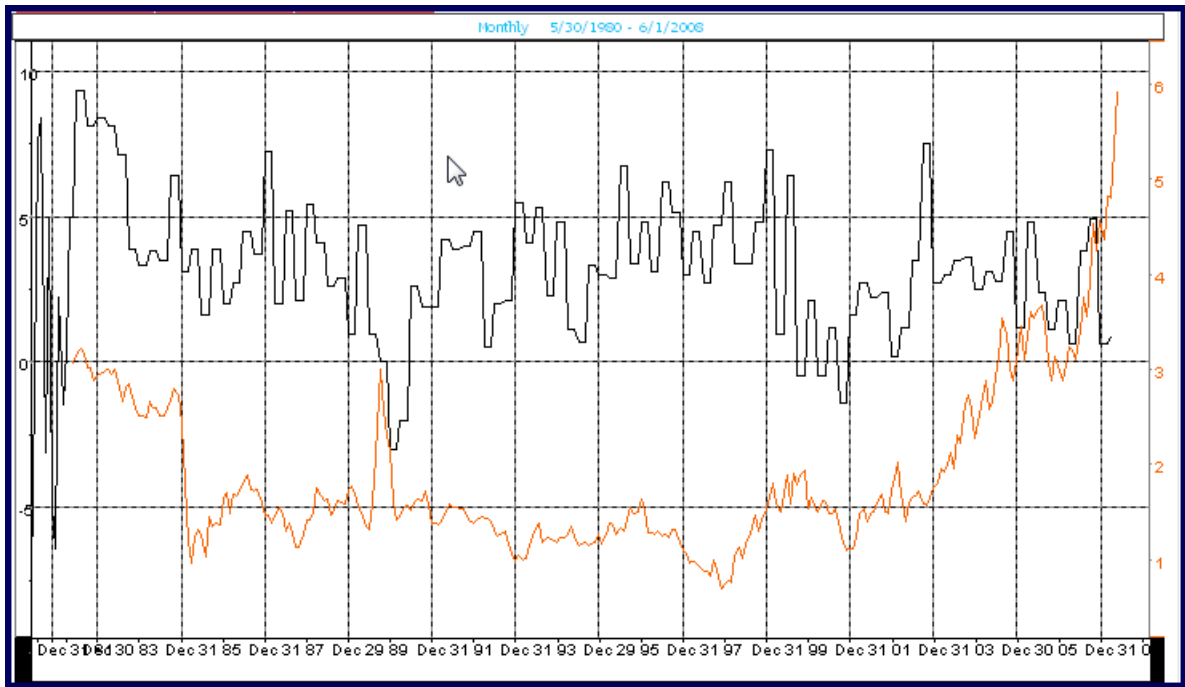


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It is no surprise that oil crises have led to both recessions and lower stock prices. In the chart below, note that when oil rises dramatically, GDP growth slows or turns negative. Again, since this cycle is so unprecedented in so many ways, the economy is likely to stay weak for a protracted period of time. One of the big questions going around Wall Street these days is not if we are in a recession, but how long will it last and what 'shape' will it take. Will it be a quick 'V bottom'? I find this highly unlikely. A 'W' bottom, or a 'double dip', which some critics of President Bush find to be fitting? I don't buy that either. The nastiest possibility is

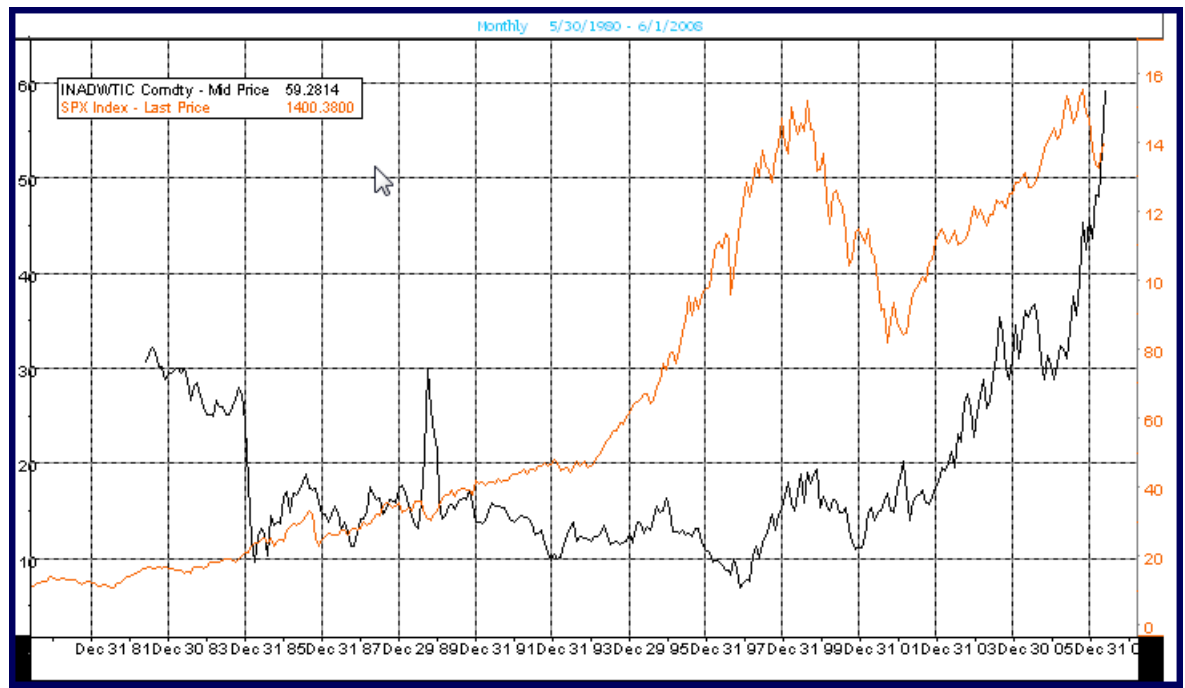
an 'L shaped' recession where we go into recession and stay in recession, much like the 1930's experience here and the post-bubble experience in Japan. I am not a proponent of that as well. I am looking for a saw tooth pattern where the economy drifts in and out of recession for many years until many of the excesses are wrung from the system. This should not be a great time for long only equity investing. Rather, an absolute return approach with capital preservation at the core, which includes credit risk avoidance for the most part.

Inflation Adjusted WTIC versus Quarter over Quarter GDP (Annualized)



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Inflation Adjusted WTIC versus S & P 500 Index

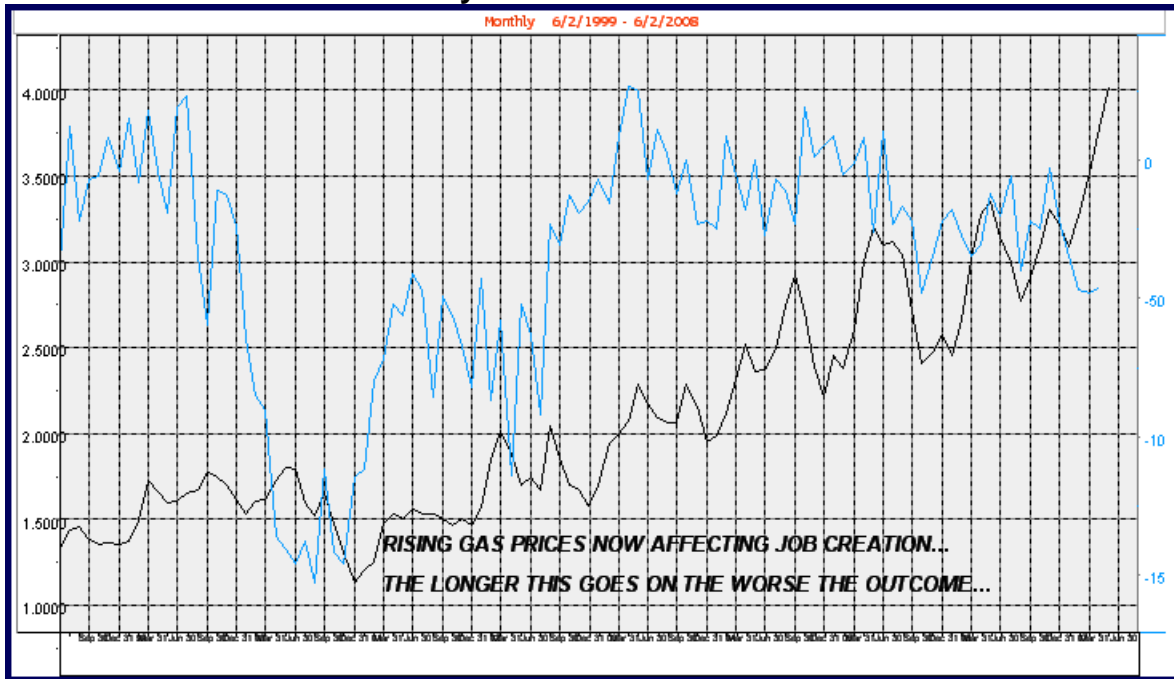


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The stresses on the economy are really being felt with the price of gasoline heading north of \$4.00 per barrel. The longer prices stay up here, in oil and/or unleaded gasoline, the longer the economy will have a drag on it, and the more pronounced the change in the consumer's buying habits. There were points along the line, at \$2 per gallon and then \$3 per gallon, consumers continues to spend. For the longest time, consumers were using their house as an ATM machine, then credit card

usage spiked, and now finally, gasoline consumption is dropping, and dropping rapidly, We are now at the point that the vicious cycle has begun—when higher prices lead to less spending which leads to less job creation (or job destruction) all at a time when the consumer is strapped. This will likely make the recession more protracted than almost anyone believes. The chart below, which plots unleaded gas against Non Farm Payroll changes, says it all.

Non Farm Payrolls versus Gasoline Futures



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What is the Fed's Next Move

One thing is for sure. The Bernanke-led Fed has its hands full cleaning up after ex-Chairman Greenspan, who is slowly going from hero to villain. The Maestro certainly didn't create the whole problem by himself, but his legacy likely won't be what he had hoped for. We have been critical for years as the Fed from 1995-2005 was clearly targeting asset prices. Like they say 'you know you are in an asset-based economy when the stock market has more of an impact than the real economy does on the stock market'. We are there for sure. While Bernanke has been very imaginative in his policies, there is a sense of desperation in the air. We believe that the fed will keep at it and simply try to slow down the

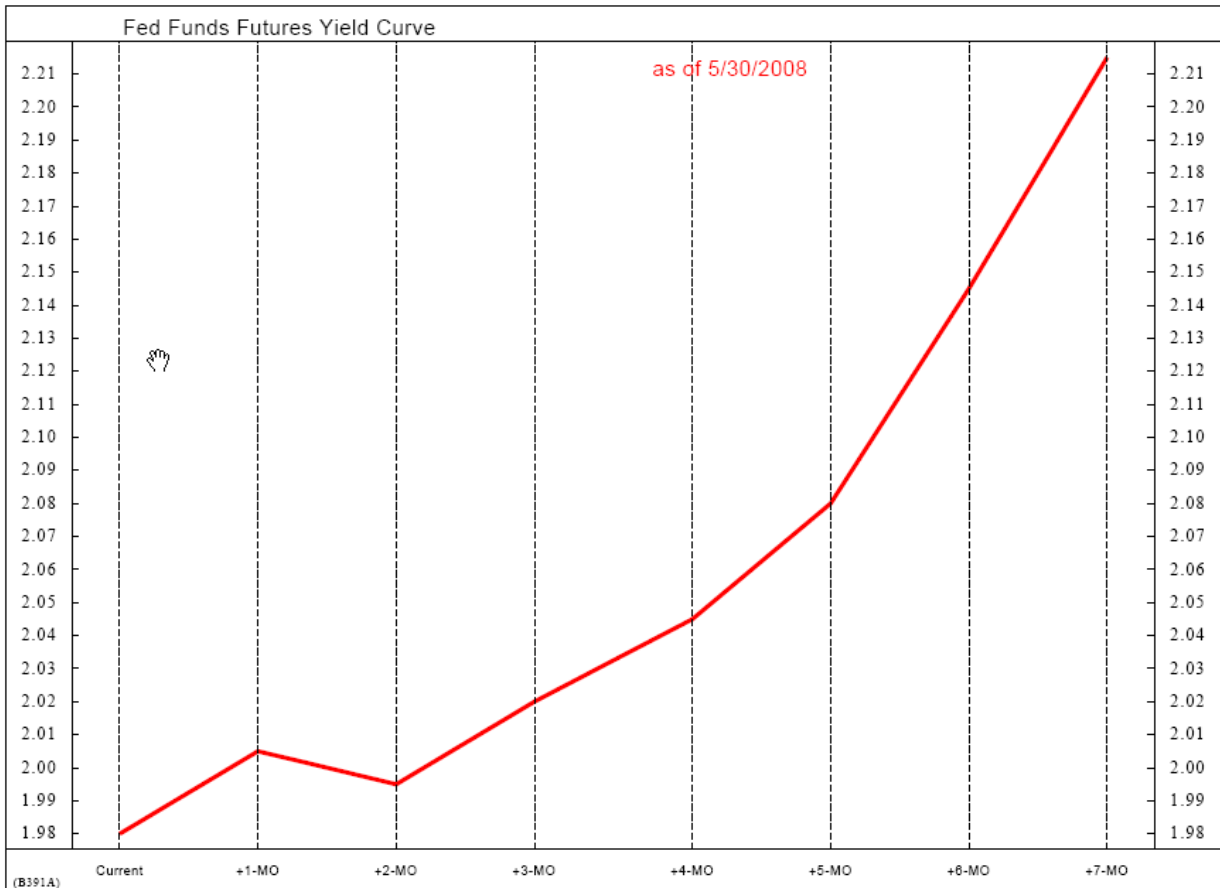
unwinding process. Note the Federal Funds Futures graph below, which for the first time in a long while the market is pricing in a Fed tightening or rate hike by year-end. I am betting the opposite way and will be adding duration and convexity to portfolios over the next month as I think inflation fears will switch to deflation fears; this is because we are in a period of debt destruction and periods of debt destruction are usually accompanied by bouts of deflation. I don't buy the theory that the falling dollar will result in skyrocketing rates as some do. The U.S. is certainly in trouble, but we aren't alone—we may just be 'the best house in a bad neighborhood'. We are all in this together and emerging markets, after a nasty correction, will likely lead the next economic leg up.

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Demographics, in terms of birth/death rates and deficits for as far as the eye can see are a miserable back drop for our economy. Had the Fed left the business cycle alone and not targeted asset prices, we likely would not find

ourselves in this mess. It would be nice if we could just click our heels and make it all go away. It will take time and some pain to pay off all these debts. Longer than most 'hoppers' are hoping for.

Federal Funds Futures Curve



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Summary - Time to Buy the Storm Shutters

Anyone that has a place on the beach in Florida or other hurricane-prone locales knows all about hurricane shutters. I had them at my beach place, but we always laughed that if a real hurricane hit, the shutters and the building would be swept into the ocean. One thing we never did was to tempt Mother Nature—we always take over 'just in case'. Such is the environment now. While I would love to take loads of risk (like that to hanging at the beach and hoping the hurricane misses you), we are

not. There are days, weeks and months that we are humbled by the market's ability to shake off bad news. I think there will be four words that many will hope they had heeded—FULL FAITH AND CREDIT (we even believe that while Fannie Mae and Freddie Mac have an 'implicit guarantee from Uncle Sam while Ginnie Mae has an implicit guarantee, we think that Fannie and Freddie, before it is all over (as their balance sheets may possibly be the worst of all as they soak up all the unwanted loans from defunct lenders and originators) they will

also have the explicit guarantee of Uncle Sam. What happens to the common shareholders is anyone's best guess, but my thoughts are that the preferred shares are likely money-good (even though we have recently pared back those positions), the mortgage pools will likely end up like Ginnie Mae. It is why we, in 99% of cases, do not take credit risk. In the first place, we don't think we are being properly compensated. In the second place, given what we know about the balance sheets of everyone from consumers to banks/brokers to the U.S.

Government itself, we find leverage and way too much of it. I am humble enough to say that I could be wrong and the fears I have are overblown, but that is something I can deal with. What we cannot do is to recklessly take risk in the face of what will likely go down as the greatest unwind of our lives.

Bennet Sedacca
President

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