

## Viewpoint

By Mark Luschini, Chief Investment Strategist



### In Banks We Trust

The banking sector has taken a drubbing. Even after a record setting rally two weeks ago, financial stocks have incurred the worst decline for any major industry group since the technology bubble burst in 2000. The KBW Bank exchange-traded fund is down 55% from its February 2007 high and the financial sector's representation in the S&P 500, which principally includes banks, brokers and insurers, is down to 14% from a high of 23% in late 2006 as more than \$1 trillion of market value has vanished. With the write-downs from bad loans continuing to plague banks from coast to coast and from big to small, the very foundation of the banking system is being stress tested. At the moment, the question for shareholders and depositors alike is whether most banks will be able to absorb further write-downs without having to seek significant amounts of additional capital or face the alternative...insolvency.

The credit crisis facing these financial institutions is over a year old at this juncture. The origins can be traced to bad loans being made to individuals who were buying houses on aggressive terms offered to them by mortgage lenders, including banks and other financial institutions. While loans written up to the 2006 peak in the housing market were to borrowers of varying credit quality, it is the higher risk loans known as "sub-prime" that are now the biggest problem. Many of these loans are in trouble due a variety of factors, including slowing economic conditions and adjustable loan resets triggering higher rates forcing an unbudgeted jump in many borrowers' mortgage payments.

Not to be left out of an opportunity, Wall Street investment houses were busy the last few years packaging and reselling these mortgages into an alphabet soup of instruments (the one most often in the headlines goes by the acronym CDO, for 'collateralized debt obligation') in order to profit from the appetite of buyers for these seemingly low risk, high return investments. Unfortunately, homeowners began to fall behind in their payments. Suddenly, the entire structure of these packaged products, which relied on a predictable stream of interest payments, began to unravel. Since so many banks underwrite, hold and/or then sell these loans, the radiation from this now toxic sub-prime paper has been a key cause of the banking sector rout.

While some of the biggest banks, such as Citigroup, JP Morgan Chase, Bank of America, Wells Fargo and Wachovia, garner the most attention on a national basis, state-chartered or regional banks account still for 37% of the U.S. deposit market. Therefore, regional banks are very important for the economy. The failure of IndyMac Bank, a huge player in the mortgage market, is notable not just for its size but rather the response by regulators to ensure depositors have access to their funds. There have already been a few other smaller bank failures and there could be more amongst those most vulnerable to decaying real estate values in their marketplace.

A recovery in the banking sector is inevitable; but it is more a question of when. A brief checklist to identify a recovery in the banking market includes: 1) a trough in housing prices that is accompanied by a stabilization, if not a draw down, in housing inventories; 2) fiscal support that is offered from the passage of the FHA Bill that is designed to help ailing homeowners stem defaults and restore confidence in the quality of bank assets; 3) a steep yield curve which improves the net interest margins for banks as they borrow from the federal reserve cheaper than they loan the cash back out.

We will only know in hindsight that the worst of the today's conditions for the banking sector has passed. The peak in the sub-prime resets later this year offers some comfort that the defaults may start to slow. In the meantime we do not believe that we are facing financial Armageddon. The problems have been widespread, and the wounds deep, but we have not lost trust that the U.S. banking system will eventually satisfy its problems and operate in better times again.

## CD Update: Bank Failures

By Guy LeBas, Vice President



Investors that understand the details behind FDIC coverage have an advantage in ensuring they're adequately compensated for the risks they're taking.

### Introduction

In the nineteen months between January 2007 and July 2008, the U.S. banking system has experienced "failures" at ten depository institutions, about the same as the number of banks that went out of business in the prior five years. That group of ten includes, most notably, IndyMac Bank, which was seized by the FDIC on July 11, making for third largest bank failure in history after Continental Illinois in 1984 and American S&L in 1988. The FDIC, or Federal Deposit Insurance Corp, an arm of the government charged with protecting depositors and the safety of the banking system, is meanwhile anticipating further problems that could force the agency to seize as many as 90 more institutions before the ongoing financial crisis resolves itself. Against this backdrop, it's more important now than ever for investors to understand the protections—and the limits on those protections—that they receive for investing in FDIC-insured instruments, namely brokered certificates of deposit, or CDs.

While we'll explain some of the concerns facing CD investors in more detail, there are a few major points that are particularly important to be aware of in today's environment:

- Understand the details behind FDIC insurance coverage limits.
- Beware of potentially overlapping coverage. For example: a checking account, an FDIC insured money market and a brokered CD at the same institution count together against coverage limits.
- Know that accrued interest on a CD counts against FDIC coverage limits.

### FDIC Insurance

The primary mechanism for ensuring the safety of consumer deposits in banks is FDIC insurance, which is backed by the full faith and credit of the U.S. Government. FDIC coverage allows depositors to recover up to the insured amount in the event a bank does fail. While there are a number of complexities in calculating coverage limits, individuals generally have up to \$100,000 coverage for individual accounts and up to \$250,000 for self-directed qualified retirement accounts, such as IRAs. The coverage for each account type is separate and not cumulative, meaning that a depositor in a bank with \$110,000 in an individual account and \$240,000 in an IRA account is not covered for the \$10,000 coverage. The same principles apply to coverage in an individual account versus a joint account—\$100,000 per person, separate and not cumulative.

#### FDIC Insurance Coverage Limits

Account Type	Maximum FDIC Coverage
Individual	\$100,000
Qualified Retirement Account (IRA)	\$250,000
Joint - 2 Person	\$200,000
Trust - 1 Beneficiary	\$100,000

Source: Janney FI Strategy; FDIC

While this coverage does represent a valuable protection for CD investors, it's crucial to understand the limitations on FDIC insurance coverage. First of all, insurance applies to a given individual at a given bank. As a result, no distinction is made between a checking account, traditional bank CD and a brokered CD. For example, if an investor has a \$50,000 checking account, and a \$75,000 brokered CD at ABC Bank, both in individual accounts, only \$100,000 of the total \$125,000 is covered by FDIC insurance. Particularly for major national banks that handle many individuals' personal banking business and that issue brokered CDs, it's very important to ensure that there's no overlap that would exceed coverage limits. Even if a bank appears "safe," it doesn't make sense to invest in excess of coverage limits, as depositors aren't paid for taking on the extra risk and would be better served in other investments. This also applies to FDIC-insured money market products offered by a number of broker/dealers, including Janney. These products place cash balances into banks, so it's very important to be sure that there's no overlap between the banks in an FDIC money market fund, the banks at which an investor has a checking, savings, and/or CD account, and the banks from which an investor purchases brokered CDs offered by Janney and other broker/dealers.

At the same time, it's worth noting that many financial companies actually operate through separate banks. For example, a major national financial company may operate one bank headquartered in New York and another separately chartered bank headquartered in Utah. The two banks in this example are actually separate for insurance purposes, so an investor with an individual account can have \$100,000 in protection from each bank.

One other frequently overlooked point about FDIC insurance is that the \$100,000 limit (or \$250,000 for retirement accounts) covers both principal and accrued interest. Accrued interest is the periodic coupon payment than an investor earns on a CD or bond in the time between scheduled coupon payments. For example, for each day that an investor holds a \$100,000 5% CD, that investor is owed \$13.70 in interest payments, but the payments are typically only made on a semiannual basis. For FDIC insurance purposes, this accrued interest gets tacked back on to the principal amount to define an investor's full exposure. As a result, an investor who purchases a \$100,000 CD in an individual account will actually exceed the coverage limits and will be exposed to the issuer in the amount of the accrued interest which, for a 5% CD with semiannual payments, could total as much as \$2,500. As a result, we recommend purchasing CDs in an amount 5% below the applicable limit (i.e., \$95,000 for individual accounts and \$237,500 for retirement accounts).

#### FDIC Insurance Coverage Individual & IRA

Name	Account Type	Amount
Jane Depositor - Individual	Checking	\$110,000
Jane Depositor IRA	1 Year Brokered CD	\$240,000
<b>Total Value</b>		<b>\$350,000</b>
Maximum Coverage Individual		\$100,000
Maximum Coverage IRA		\$250,000
<b>Uninsured Amount</b>		<b>\$10,000</b>

#### FDIC Insurance Coverage Individual & Joint

Name	Account Type	Amount
Jane Depositor & Jim Depositor - Joint	3 Month Brokered CD	\$200,000
Jane Depositor - Individual	6 Month Brokered CD	\$100,000
<b>Total Value</b>		<b>\$300,000</b>
Maximum Coverage (2 owners joint)		\$200,000
Maximum Coverage (Individual)		\$100,000
<b>Uninsured Amount</b>		<b>\$10,000</b>

Source: Janney FI Strategy; FDIC

## Bank Failures

In the U.S., depository institutions are basically not permitted to go out of business. Instead, when a bank or thrift becomes too distressed to continue operating, the FDIC steps in and effectively takes over the bank with the full backing of the federal government. For brokered CD holders, this takeover can result in one of two outcomes. In many cases, the FDIC lines up a buyer for a distressed bank and sells that bank within hours or days after taking it over. In this case, the acquiring institution can elect to acquire the brokered CDs of the distressed bank; if the acquirer chooses to do so, the brokered CDs remain outstanding, but become the obligation of the acquirer. Essentially, from an investor's perspective, the CDs simply change name. Typically, in such a case, FDIC coverage is based on the bank that initially issued the CD and not on the current CD obligor. For example, if XYZ Bank failed and its brokered CDs were acquired by ABC Bank, an investor owning CDs in XYZ and ABC prior to the acquisition would have up to \$200,000 in coverage. In many cases, the additional coverage "lapses" after a six months.

#### FDIC Insurance Coverage Limits

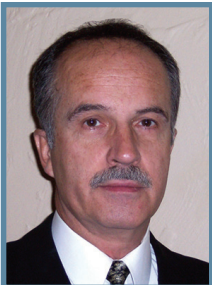
Name	Account Type	Amount
Jane Depositor	1 year XYZ CD (Failed Bank)	\$95,000
Jane Depositor	5 year XYZ CD (Acquirer)	\$75,000
<b>Total Value</b>		<b>\$170,000</b>
Maximum Coverage - 6 Months		\$200,000
<b>Uninsured Amount</b>		<b>—</b>

Source: Janney FI Strategy; FDIC

The alternative to another institution taking over a failed bank's brokered CDs is for the FDIC to repay outstanding brokered CDs, up to the applicable insurance coverage limits. In such an event, the FDIC promises repayment within 60 days, though experience suggests that funds are usually returned within several weeks. During the period between bank seizure and CD repayment, however, investors do not continue earning interest, which represents a lost opportunity cost. In addition, investors with deposits in a bank above the applicable FDIC limits will likely experience a partial or total loss of the excess portion of their investment.

For additional information, see the FDIC website at <http://www.fdic.gov>.

If there are two lessons from recent bank failures, they're simple: limit investment to the FDIC caps and be aware of bank exposure in all its forms, be it checking accounts, FDIC money market funds, or brokered CDs.



## Stock Market Commentary

By Gregory M. Drahuschak, Vice President

### Investment Perspectives

A late-month rally fueled by a robust rebound in the financial sector was not enough to allow the S&P 500 to match its typical July results. The S&P 500 ended July with a loss of 0.99%, compared to the month's 58-year average gain of 0.75%. July, however, might have been a transitional month for stocks.

For most of the first half of this year, credit concerns plagued the equity market. The market, however, rallied from mid-March through the first week of May on hopes that tax rebate checks might enliven the economy enough for stocks to overlook the drag from credit issues. That rally, however, quickly was snuffed out by asset depreciation concerns and rapidly rising energy prices that shoved the S&P down 16.65% off its May 19 intraday peak. These same concerns weighed on the market for the first half of July. However, as the market's worst fears failed to be realized, the market started to discount an end to the credit market woes.

Bank stocks were braced for the worst; but the worst did not materialize. Beginning with Wells Fargo's (WFC) consensus-beating earnings and a surprise common stock dividend boost, a string of major banks reported earnings well above dire second quarter expectations. Investors likewise expected the worst from the major investment banks – and, in some cases, they got it. The market, however viewed the tens of billions in write-downs as an indication that the investment banks finally were willing to face their depreciated assets head on, which many analysts viewed as a significant step toward putting the group on a more positively biased path.

The key for this month is whether August can overcome its mediocre history and allow the market to make further progress toward forming a durable market bottom. Through the prior 58 years, the S&P 500, on average in August, has produced no gain or loss, which makes it the third worst month of most years.

The fall from the most recent S&P 500 peak created numerous technical resistance points. The first of these points is the S&P 500's 50-day moving average at 1315. The S&P 500 has not reached its 50-day moving average since early June. The second and by far more significant level is around 1390, which is approximately the S&P's 200-day moving average. With only one exception early in May, the S&P 500 has not been at or above its 200-day moving average since late last December.

The financial sector SPDR faces a similarly important target level. The late July rally in the sector took the XLF to its 50-day moving average for the first time since mid-May. Breaching its 200-day moving average, which is fractionally above 26, would be an important indication that the market is willing to discount long-term financial improvement.

With the overhead resistance in the S&P 500, it would be foolhardy not to consider the consequences if the S&P fails to surpass any of important levels noted earlier. In S&P 500 terms, 1170 appears to be a formidable support level, which is not far enough below the July 31 close to avoid gradually increasing equity exposure to portfolios.

By the end of July, approximately 75% of the S&P 500 had reported earnings. Fiscal quarters for many retailers, however, end a month after the end of calendar quarters. These firms will report earnings in August. The benefit of the tax rebates should be reflected in retailers' earnings. Comments from retailers about their post-rebate sales prospects will be critical parts of the normal commentaries that accompany earnings releases.

Technical factors and near-term economic prospects are likely to inhibit stocks for a time. July appeared to be a lackluster month for equities; but there were internal signs that the market took several important steps toward forming a durable bottom.

More steps need to be taken, however, before adopting a significantly more aggressive approach to buying stocks.

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