

Do We Need to Be Rescued?

By Mark Luschini, Chief Investment Strategist



The misbehavior of the financial markets over last several weeks comes as a result of a broad-based crisis of confidence. Confidence in the markets, in the value of assets, in the solvency of institutions from big to small, is an amazingly delicate yet integral part of what enables the financial system to function. Financial institutions rely on knowing that the parties with whom they are conducting business will act and respond in a way that is predictable. Recently, a loss of confidence has occurred in the financial markets—particularly the banking system. That has manifested itself in falling equity prices, tightening credit conditions and a lack of liquidity that jeopardizes the abilities of even the most creditworthy companies to be able to fluidly conduct business. This phenomenon is not proprietary to the U.S. either: in fact, it has crossed the Atlantic into places like Iceland, Ireland, the U.K. and Europe.

It is common for banks all over the world to lend funds to each other on a short-term basis for funding purposes or to meet regulatory requirements. The interest rate charged is known as the London Interbank Offered Rate (LIBOR). Recently, LIBOR spiked to more than 2.5% higher than the U.S. Federal Reserve's fed funds rate, which stands at 2%. This is an unusually high disparity between these two rates of interest, which often trade at levels close to each other and indicates serious stress in the markets.

Another litmus test for judging confidence in the markets comes in the form of something called the Treasury Bills and Euro Dollars spread (TED). The TED spread is a measure of liquidity and shows the degree to which banks are willing to lend money to one another. The TED spread is calculated as the difference between the three-month U.S. Treasury Bill interest rate and three-month LIBOR. For the last five years, the TED spread has averaged 0.6%. Today, that spread has spiked to more than 3.5%—wider than even experienced during the market's decline on Black Monday, October 19, 1987, a day the stock market fell more than 22%. The economic impact of this reluctance to lend amongst global banks, if only to each other, implies that these financial institutions are more concerned about protecting their capital and hoarding cash than lending to consumers and businesses alike. This, of course, stifles economic activity.

What led the credit markets to tighten and crimp the fluidity of capital? The reasons are many; but the root of the problem is the housing market. Falling home prices resulting from oversupply and mounting foreclosures are seen by many as a threat to the U.S. financial system and economic growth here and abroad. At issue for the financial markets, initially, was the declining value of those securities pegged to mortgage loans, which has now descended to a near inability to value, let alone trade, the securities. That lack of price discovery has created a very high level of mistrust, the ramifications of which have not impacted the credit markets alone. Stocks have fallen from a peak last reached in October 2007, and once mighty corporations have been bankrupted, sold or placed on some form of governmentally-sponsored life support.

Left unattended, the markets would probably resolve these issues—but not without a more protracted and dire economic impact. Recognizing the intensity of the current conditions, a rescue plan, entitled the Emergency Economic Stabilization Act of 2008 (EESA), was drafted to remove up to \$700 billion in bad mortgages from financial institutions. Important provisions in the plan include the means by which the Treasury will attempt to stabilize the economy. These range from purchasing troubled securities and temporarily raising the FDIC deposit insurance limits to \$250,000 from \$100,000, to enhancing programs already in place to help keep families in their homes. Generally speaking, the intended outcome is to bring liquidity, capital and confidence back to the marketplace by stabilizing banks and the housing market, which then can bring hope for a better economic climate.

In the meantime, the Fed remains exceedingly accommodating, interest rates are reasonably low and growth around the world has slowed but is far from having stopped. Moreover, oil prices are down more than 40% since July, today trading below \$90 per barrel, while inflation has trimmed somewhat from the runaway price increases seen through mid-year. In other words, any economic problems that the U.S. faces today should not be overlooked; but there are some positive attributes that cannot be ignored either.

With the rescue plan in place, it would not be unreasonable to see a recovery in the credit and equity markets at first, then the economy over time. Fortunately, the leaders of central banks and governments around the world have also collaborated on an intervention to supply money to the financial system. Without the coordinated efforts of so many on such a broad scale the troubles in the financial system could weigh even heavier on the already tepid economic conditions that persist today. One clue that the impact from these efforts is manifesting positively in the credit markets would be in a narrowing TED spread.



Stock Market Commentary

By Gregory M. Drahuschak, Vice President

Hope that this September would not match its typical role as the worst market month of most years was dashed as credit market worries overwhelmed everything else. Not only was this September the worst month of the year so far, it ended as the third worst September in the last 59 years with a 9.21 percent drop in the S&P 500.

Biggest Losses in September

| | Percent Change |
|------|----------------|
| 1974 | -11.93% |
| 2002 | -11.00% |
| 2008 | -9.21% |
| 1986 | -8.54% |
| 2001 | -8.17% |
| 1957 | -6.65% |
| 1960 | -6.25% |
| 1981 | -5.38% |
| 2000 | -5.35% |
| 1956 | -5.30% |
| 1990 | -5.12% |

Source: Janney Montgomery Scott LLC

For a time in September, it appeared as though the market was aligning itself with seasonal factors that could allow October to perform as it often does by reversing the market's September direction, which is exactly what happened in every October following the four previously worst Septembers.

This October, however, the driving influence, at least early in the month, centers around the Emergency Economic Stabilization Act of 2008 (EESA), which created the

\$700 billion Troubled Asset Relief Program designed to ease the logjam in the credit markets.

The enactment of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in August 1989 that authorized the establishment of the Resolution Trust was similar to the purpose of EESA today.

As Chart B shows, over time, the Dow Jones Industrial average responded very favorably to the proposal and enactment of FIRREA. Chart C shows the average monthly change in each of the ten sectors within the S&P 500 from the enactment of the RTF-enabling legislation to one year afterwards.

The introduction and enactment of the 1989 legislation allowed the stock market to breathe a sigh of relief. The onset of the 1990 recession, however, soon became a focal point. There are numerous market similarities between now and 1989. One of the most obvious is the level of fear generated by the credit market concerns.

Fear often prompts investors to part with stocks at very inappropriate times. In 1990, the Volatility Index (VIX), which often is referred to as the "fear index," moved sharply higher to a peak in August. Two months later, the Dow hit its bottom of the cycle and embarked on a recovery that largely went uninterrupted for two years. The initial move up from the market low is illustrated in Chart D.

Late in September, the VIX spiked to close to 50 just as it did in 1998, 2001 and 2002, as depicted in Chart E. Early this month, the VIX moved above the peaks in all three of these years. After the 2001 VIX spike, the Dow rallied 1400 points in less than a month for a roughly 14.6% gain. A spike on Oct 9, 2002, in the VIX was followed by a 17.2% rally in the Dow, also in about three weeks. In 2001 and 2002, the Dow, in time, went to a lower level than it was when a VIX-induced initial rally began, but the relief rallies obviously were significant. The smaller spike in March of '03, however, led to a lasting recovery that extended over four years.

Obviously, there are no guarantees of a VIX-induced rally of the 2001–2002 magnitude, but the numbers back then are interesting to contemplate.

The market's reaction to the rescue plan was similar to its reaction to FIRREA. Stocks initially went lower on doubts that the legislation would make much difference, short-term. The market's worries about credit conditions and a possible recession have depressed prices significantly. At some point, however, valuation will become a factor that could offer stocks support.

Price-earnings ratios often are used as a simple valuation benchmark. The problem with P/E ratios is the "E" portion. Based on present conditions, the "E" is likely to fall, which would raise the P/E ratio and make stocks look more expensively valued. Assuming, however, that the S&P 500 has an across the board 30 percent earnings decline, most of the S&P 500 stocks still are trading at significant discounts to their ten-year average P/E ratios. Momentum, however, often trumps valuation on a short-term basis. As this month began, momentum clearly was negatively biased.

Internal market extremes like the VIX suggest that selling in stocks has reached extremes that often spawn at least a snapback rally. Nonetheless, even if the market has a temporary reversal to the upside, we doubt that we are yet at a point where the market can sustain a long-term advance.

We, therefore, would maintain a conservative approach to new buying. It will take a more than an oversold bounce to correct the technical damage done in recent weeks and months. A robust rally from early October's levels likely would encounter significant difficulty surpassing 1300 in the S&P 500. From an economic standpoint, chances for a technical recession here and abroad have increased markedly in recent weeks.

Chart B: DJIA—Proposal of FIRREA Through Enactment and the End of 1989

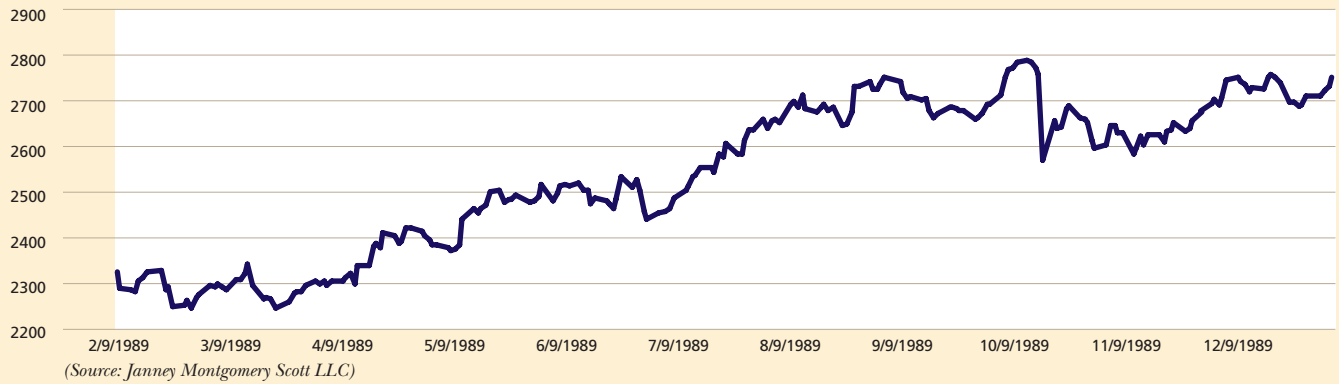


Chart C: 12 Months of RTC Introduction—Includes Month of Introduction

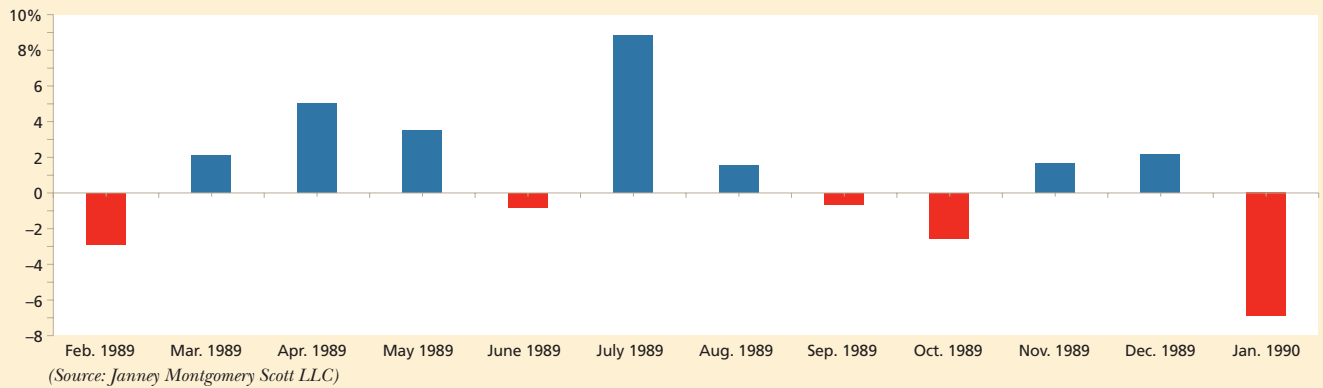


Chart D: S&P 500 During the Recession 1990–1991

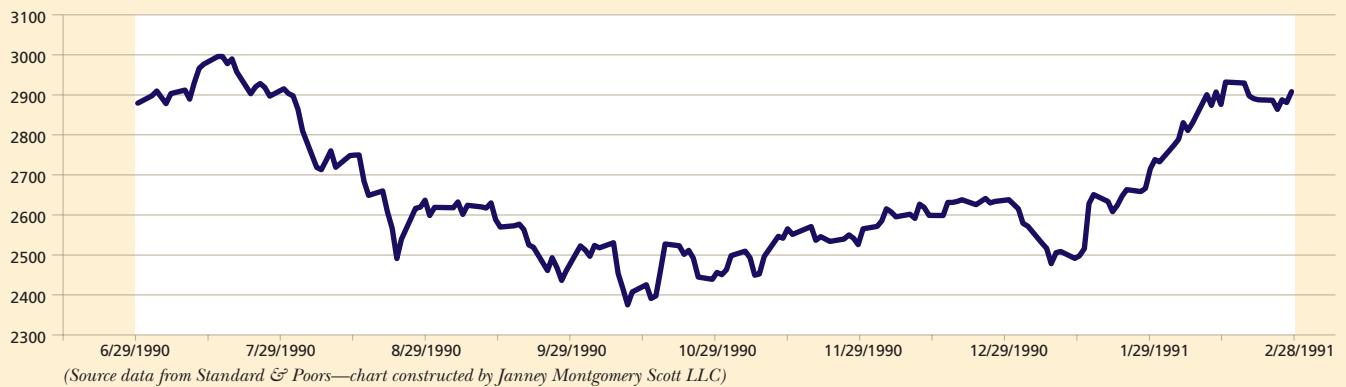
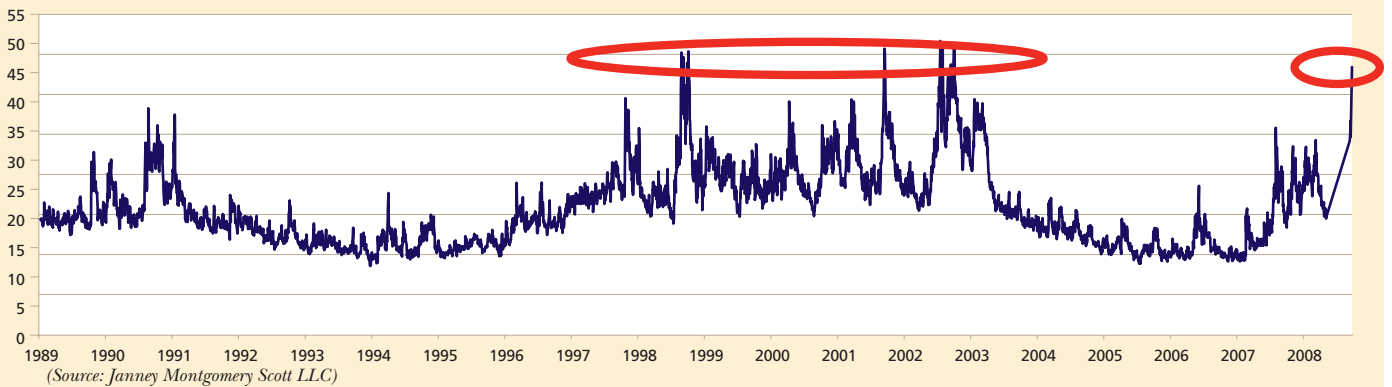


Chart E: Volatility Index (VIX): 1989–2008

Date of the year shown is January 3.



Converting the Improbable

By Guy LeBas, Vice President



The month of September was filled with a series of credit events that any analyst twelve months ago would have termed individually highly improbable and, in combination, nearly impossible. Nonetheless, the effective nationalization of Fannie Mae and Freddie Mac on Sept 7, the bankruptcy filing by Lehman Bros. on Sept 15, the Federal Reserve bailout of AIG on Sept 17, the failure of Washington Mutual on Sept 25 and the Citigroup acquisition of Wachovia's banking assets on Sept 29—followed, of course, by Wells Fargo's introduction into the deal—have become strings in a series of events with international financial and economic impact. Moreover, these events served to alter the traditional model of acquisitions and the impact on the capital structure of those acquisitions. In the "olden days" (meaning 2007), when one institution acquired another, it also took on the target company's debt and preferred obligations; and when a company declared bankruptcy, its debt and preferred holders had priority on the company's assets. With the more recent round of transactions, however, the acquirer has ended up as often not stripping the target company's assets and leaving debt and preferred holders with only a shell of a corporation.

While a number of issues related to the string of bankruptcies and faux bankruptcies have shaken the corporate credit markets over the course of recent weeks, relatively short shrift has been given to the problems these creatively-structured transactions have created. Even so, we believe that the elimination of the traditional merger and bankruptcy models is actually responsibly for a great deal of the uncertainty facing investors of financial institutions. When the structure of acquisitions and bankruptcies is so fluid, it becomes impossible to determine the terminal value of a company and its assets with any certainty. With so many firms in a stressed position, that terminal value has become a very important concept in the market value of debt: without confidence in those terminal values, investors are requiring much higher returns to take on credit risk than they might otherwise.

Another element of uncertainty pervading the debt (and equity) markets is, of course, the Emergency Economic Stabilization Act of 2008 (EESA), which was authored to set up a \$700 billion Treasury-funded investment pool for buying assets from bank balance sheets. The EESA creates an entity not unlike the late eighties Resolution Trust Corp, save for the fact that the EESA program involves buying assets from ongoing concerns and not just defunct depositories. Despite the initial "nay" vote on the part of the House, the market has nonetheless hung a great deal of its hopes on the passage and ultimate success of the EESA plan. It's become a maxim of late that investors depending on hope are headed for disappointment; and the impact of the EESA bill may only serve to ingrain that maxim even further into the credit markets. While the EESA legislation should add liquidity to the bone-dry interbank markets based on improved sentiment alone, there are two aspects of the EESA which reduce the probability that many financial companies will participate in the plan.

First of all, the EESA requires that any institution that participates in auctions to sell distressed securities to the Treasury fund will be required to give the fund warrants for the company's common stock. This requirement gives the Treasury some potential for greater return on investment at the expense of current company shareholders. In the event that a company sells assets to the Treasury outside the auction framework in an emergency sale, the Treasury can obtain a majority stake in that company, which provides an incentive to seek outside support rather than use the Treasury in liquidity crunches. Finally, the EESA includes a provision which requires the sitting president in five years to, if the Treasury has a net loss on its distressed asset fund, author rules or legislation which will recoup the losses from the corporations that sold assets to the Treasury. So not only are participating firms giving up some of the upside in selling assets via the EESA, they're also holding on to the long-term downside risks.

From an economic perspective, this makes the decision to participate in the Treasury plan a very challenging one, even for troubled institutions. In addition, it suggests that only the most stressed companies will participate and introduces the potential that any entity that sells assets to the Treasury will be branded as one of these "most stressed companies." Such a stigma could actually accelerate the type of liquidity events that the EESA seeks to prevent. Though there is a significant risk that the EESA bailout package isn't as positive for credit fundamentals as it is for credit market sentiment, there are relatively limited negatives that can come from the creation of this Treasury asset acquisition fund.

JANNEY MONTGOMERY SCOTT LLC

1801 Market Street, Philadelphia, PA 19103 • 215.665.6000

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