



Quarterly Economic Report – 1st Quarter 2009 *A Monetary Fire Hose Has Been Turned On*

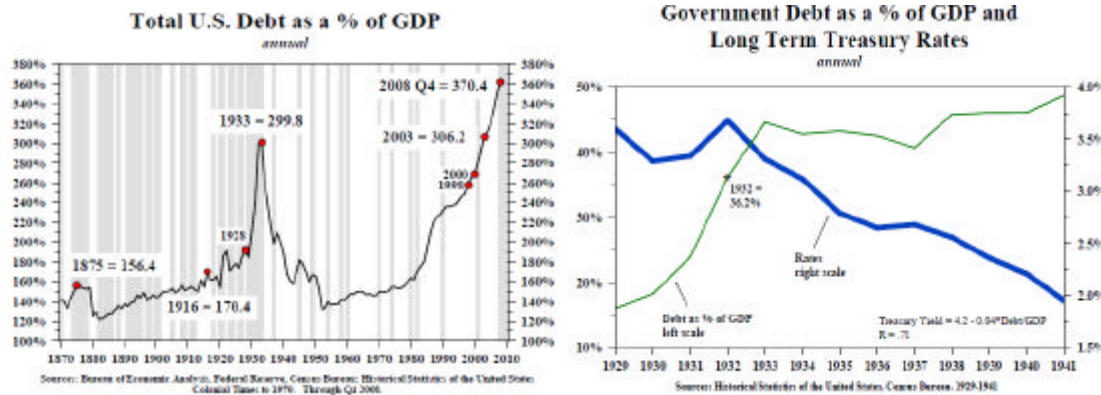
This has been a quarter of Federal actions, market reactions and bailout tabulations as a governmental, monetary fire hose was opened full volume to address economic woes both domestic and international. The debate of whether the government has the ability or will to reduce the flow or reverse it to control inflation in the future, will undoubtedly continue for many months. With so many programs initiated in this first quarter of 2009, the Treasury and Federal Reserve will soon have to pause to tally the dollars and the unintended risks that have been generated. The new administration frustrated all the markets by delaying plans on the stimulus and bank support, taking the Dow from 9000 in November to 6500 in early March, but then we unfurled the financial fire hose. A long series of initiatives have been implemented as part of the Financial Stability Plan for economic recovery. Primary to these efforts are the Public Private Investment Plan (PPIP) and the quantitative easing by the Federal Reserve.

PPIP is designed to use \$75-100B of TARP funds and private capital to generate \$500B in purchasing power. It is based on three principles: *maximizing dollars* through leverage of public-private investment, *sharing risk* with private investors to spread potential loss and potential gain on profitable returns between the investor and taxpayer, and *adding competition* to establish a market price for the assets. (Unfortunately the banks were subsequently told to reduce by \$1T their book values on already depressed prices which can only further stun the banks. This and stress test pressure will continue to keep financial institutions in a tenuous position regardless of funds released. The stresses are leading many banks to question their decision to take funds in the first place.)

PPIP is intended to buy newly dubbed “legacy” (aka ‘toxic’) loans and securities from domestic financial institutions through leveraged equity sharing and guaranteed-debt funding. It has two parts. First, the FDIC will take the lead on attacking legacy loans which are stuck on bank balance sheets and which reduce their ability to access private markets or lend. The public/private split will be 50/50 of equity share leveraged 6:1 on total equity via a FDIC guarantee. The estimated \$700B in loans is to be bought by investors, funds, insurance companies and pension plans from domestic banks. This represents about 16% of the \$4.3T in mortgage loans on the bank books. The key will be to stop further foreclosures while this has time to work. Best case it could increase transparency and end the deleveraging that resulted from declining prices.

The second half of the PPIP addresses legacy securities with Treasury in the lead and the market setting the new security prices. These purchases are to be funded through non-recourse TALF funds. Here again the split is 50/50 on equity with a Treasury financed loan of 50-100%. Only approved fund managers with experience in MBS are permitted in the program and these managers will create vehicles for further investment. They will submit regular reports to establish market prices. This program will fund up to \$400B in securities which Barclays estimates is 1/3 of the \$1.1T market value of the designated securities. Much of this plan remains to be defined leaving questions of haircuts, leverage and borrowing capacity on the table. The plan will allow the markets to set prices but they are set by private bidders supported by government guarantees (so leverage was not a problem??) and government partnerships to absorb losses. The question will be whether lop-sided sharing will entice appropriate or sufficient investors.

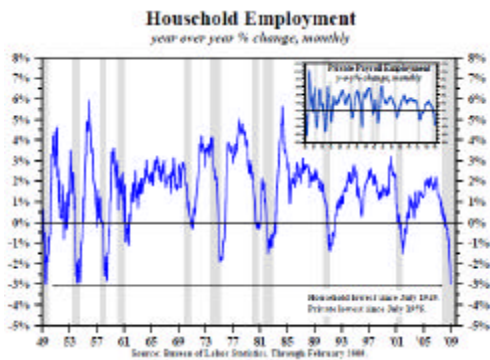
The Federal Reserve has simultaneously embarked on a massive quantitative easing. At 0-0.25% Fed Funds additional targeted easing is impossible so “to provide greater support to mortgage lending and housing markets” the Fed will



increase their balance sheet by buying an *additional* \$750B agency MBS to a new total of \$1.25T in 2009—doubling the planned amount. In addition, it will purchase up to \$300B in longer-term treasuries over 6 months. (They will issue new debt to buy the debt.) While some of this was expected, the size and timing was amazing. The FOMC stated that the increasing economic slack here and abroad should keep inflation subdued from this extensive easing. The markets are not so sure.

Considering the extent of this action, in concert with other programs which continue to be discussed weekly, the claim of inflation containment appears to strain credibility. This incredulity extends to the administration’s notion that the \$1.75-2T budget deficit can be halved in four years, especially with new programs introduced daily. It appears that policymakers instead have adopted the consumer’s approach of the past two decades: spend, consume and forget about tomorrow. Someone else will pay. Initial deflation may result from continuing cash investment but high inflation expectations will inevitably devalue the dollar and raise rates with commodities outperforming bonds and equities. It remains to be seen whether the government can begin to unwind accommodations even before the economy starts to rebound as it should to harness the worst of inflation impacts. Premature unwinding is as dangerous, extending the problem.

Early April indications show some economic improvement stemming perhaps from increased confidence and the announcement of definitive plans. We have seen improvement in consumer spending (relative to 4Q08) which was aided by lower gas prices and cost-of-living adjustments in Social Security and government wages. Inventories which had to be reduced have started. Re-energized consumers are still cautious but less fearful and have been out buying their Easter finery. We don’t know how much is on credit cards. Home sales and construction activity have improved slightly (although commercial real estate is showing signs of cracking). The biggest obstacle to growth remains the key stone of the consumer: jobs. The unemployment rate has soared to 8.5% with a possible 10% on the horizon. Nearly 12.5M people are unemployed and another 5.6M would take a job, but are not officially counted. This pool of workers has to be reduced. Though payrolls are a lagging indicator, claims are a leading indicator and are expected to continue upward. All employment charts show an increased downward pace in every category.



The programs in place should have a positive impact as bank balance sheets are freed to lend and businesses rebuild inventories with rehired workers. Much depends on confidence in the sustainability of the impact. Unfortunately with all the pep-talks and massive money plans, we have also seen some cross-purposes in regulations and a general vilification of business. Even as legacy instruments are bought, the FDIC is raising premiums to insure bank deposits. The FDIC fund must be rebuilt but asking banks to pay when capital is eroding is counter-productive. In addition, regulators are forcing new levels of loan loss reserves. The incidence of Congress’ reaction to bonuses and travel are symptomatic of the general bailout rage that still exists and probably will exist for many months until the economy rights itself.

On a positive note, non-financial corporate America is functioning and showing profit margins that hint at an end to the recession. It will take time but it will come. Rates for Treasury investors will also start to rise in the middle of the curve as Treasury (and potentially the Fed) issue massive debt to pay for all the programs in place and to come. We expect overnight rates to stay near zero for 3-4 more quarters and the long end of the curve will stay down to encourage mortgage lending, but, with all this debt the rate will have to rise slowly as demand weakens with this enormous supply. The pace should be very slow but the direction is difficult to miss.