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MONTHLY COMMENTARY

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The Economy

In our February 2009 Monthly Commentary, we wrote: "…February was also the month in which the Obama Administration launched its multi-pronged attack on the problem. The main thrusts of the attack are to fix the economy (with the stimulus package and a budget with trillions in deficit spending), the housing market (the Housing Affordability and Stability Plan) and the country's banking system (the Capital Assistance Program)."

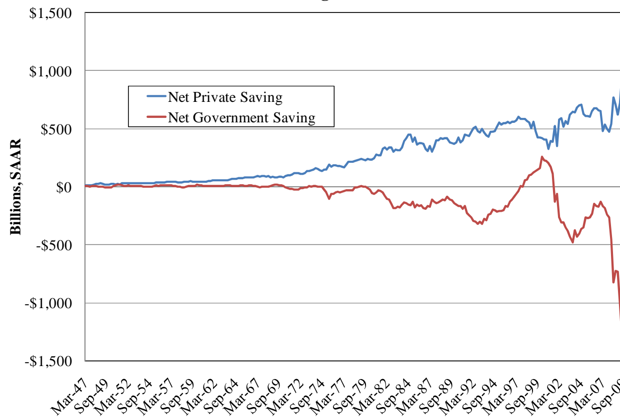
So, after trillions of debt-driven stimulus and spending, what's the report card say? We'd give it an 'incomplete.'

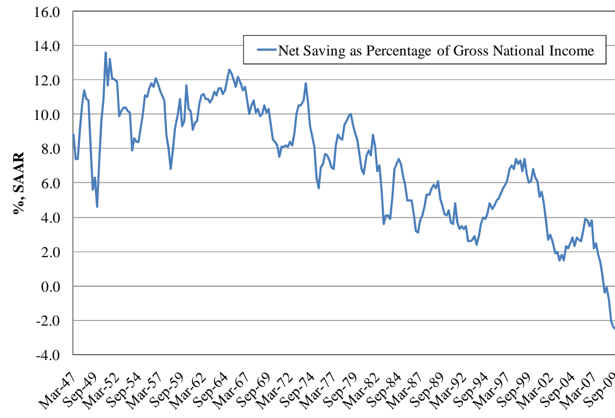
Regarding banks, the Supervisory Capital Assessment Program, a.k.a. the bank stress test, showed back in May 2009 that 10 out of the 19 banks tested needed to take action to raise more capital, which they did. In the meantime, credit has worsened and loan loss provisions have increased dramatically, but loan loss coverage ratios have dwindled to new lows. After a recent rush of TARP repayments that reduced capital cushions at the time when they seemingly are most needed, it's tough to say definitively what kind of shape the banks are currently in. FASB's softening of mark-to-market rules has only added to the opacity surrounding bank balance sheets.

Some have suggested that the housing market has staged a small recovery in recent months, but it is mostly the effect of a flurry of government-sponsored activity concentrated in cheaper, existing houses. A rebound in building activity and private residential investment hasn't materialized, and there remains a stubbornly high shadow inventory of foreclosed homes. Sales of existing houses don't really do much for economic growth, and despite the small bounce in nationwide home prices, the dramatic decrease in household real estate wealth has not managed to recover much.

The economy is showing signs of life, but we still can't confirm that what we're seeing isn't a mirage. Gross domestic product managed 2.2% growth in Q3, and it appears that Q4 will turn out better than that (the current consensus is for 4.2%, according to Bloomberg). The question is sustainability. Have we simply pulled future GDP growth into the current period by stimulating spending which would have happened further down the road? Will the expected inventory rebuild prove to be transitory? Can the economy stand on its own once the stupendous government support is removed? The great Keynesian hope for 2010 is that lower rates and bigger deficits will stimulate the animal spirits, which will start a self-sustained recovery.

In order for this to occur, a corrective process has to be allowed to run its course—higher savings rates, lower personal consumption, market-clearing pricing and reduced leverage across the entire economy. This process has started. Households, businesses and financial institutions alike have increased their savings, refinanced their debt and begun the process of de-levering their balance sheets. The progress made by the private sector, however, has been completely offset by the borrowing and spending of federal, state and local governments. The contrast between the contraction in bank, consumer and mortgage credit and the expansion in government borrowing is well known. Through the third quarter of 2009, total domestic nonfinancial debt outstanding increased $1.5 trillion year-over-year to $34.6 trillion, and the federal government component of that increased $1.7 trillion to $7.6 trillion. The story is the same in spending and its inverse, the savings rate. Gross savings is simply income less expenditures, and net savings is calculated by subtracting the consumption of fixed capital from gross savings. The headline savings that we usually think about is the household one, but the same calculation can be applied to the government. The two charts below show savings on an aggregate nationwide basis. On the left is net savings of the private sector (which has been generally rising) and net federal government savings (which has been plummeting). On the right is the total savings rate for the country—net savings divided by gross national income.





We do not pretend nor aspire to be economic forecasters. We leave that to others, including that famous discounting machine, the stock market, which is up almost 70% since the programs we described in our February 2009 Monthly Commentary were initiated. There are always tailwinds and headwinds in an economy as large as ours. The strong tailwinds today are a US Government motivated to stave off economic collapse, a steep yield curve, low inventories and the historical precedent of powerful snap-backs from recessions. The headwinds are equally strong—too many underutilized factories, empty storefronts, unsold homes and unemployed people to respond to the stimulus in a sustained fashion. Our grade is 'incomplete' because we don't think the course is over yet.

The Residential Mortgage Market

Driven by fewer days, seasonality and, most of all, Fannie Mae's decision to temporarily suspend HAMP-related buyouts (Housing Affordability Modification Program), prepayment speeds in November (December release) on 30-year Fannie Mae fixed rate mortgage-backed securities fell 6% month-over-month to a 14.5% constant prepayment rate. Looking ahead, day count and a reinstatement of HAMP-related buyouts have most analysts calling for a 25% to 30% month-over-month increase in prepayment speeds.

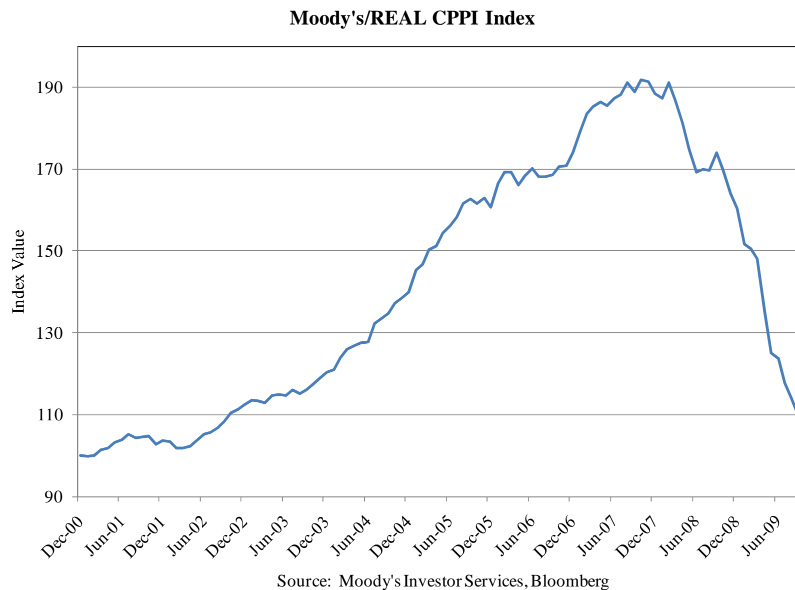
MBS investors received an early present on Christmas Eve when the US Treasury announced an amendment to the GSE Preferred Stock Purchase Program (PSPA). Although the announcement was greatly appreciated, it was also widely expected and market reaction was muted. There are two main elements to the amendment. First, prior to the announcement, under the PSPAs the retained portfolios of each firm were capped at $900 billion, and each firm was required to reduce the size of their portfolios by 10% per year beginning in 2010. Now, the requirement to reduce their portfolios by 10% per year applies to the portfolio caps rather than to the actual size of the portfolios. Fannie and Freddie's portfolios each total approximately $770 billion, so this change affords each firm greater flexibility and time to meet the portfolio reduction requirement. Second, prior to the announcement, under the PSPAs the Treasury had committed to provide up to $200 billion in funding to each institution in order for them to maintain positive net worth. Although neither of the two Agencies is expected to need more than the original commitment of $200 billion per institution (total funding to-date provided under these agreements had been just $51 billion to Freddie Mac and $60 billion to Fannie Mae), now the cap on Treasury's funding commitment for each company essentially has been raised to $200 billion plus all cumulative losses incurred over the next three years.

At the same time, in a sign that market conditions have stabilized, the Treasury announced that it is not extending the short-term credit facility established for Freddie and Fannie (which was not utilized in any case) as well as its Agency MBS purchase plan.

The amendment to the PSPAs has two important effects for the MBS market. It will prevent large scale selling of securities by the Agencies by adjusting the portfolio cap hurdle and enables them to be more aggressive in engineering buyouts of their seriously delinquent loans. While this stepped-up activity will have negative prepayment effects (a buyout looks like a refinancing), it should also enable the Agencies to better serve the policy objectives of the current Administration. This latter point, as well as the virtually unlimited capital backstop, should fundamentally remove any uncertainty about the US Government's commitment to support these firms because of their central role in the housing market.

The Commercial Mortgage Market

Approximately one year ago we initiated coverage of the commercial real estate sector in our Monthly Commentary. We discussed the market's process of downward revaluation of commercial real estate by examining trends in cap rates and the amount of financing that was extended to projects on a per unit basis. As the graph below illustrates, since that time property prices (as measured by the Moody's/REAL CPPI Index) have declined 36%, right in line with our year-ago forecast. Going back to the inception of the index in January 2001, we find the maximum price was reached in October 2007, resulting in a peak to trough decline of 44%. Prices have now fallen to levels last observed in September 2002.



There have been a few CMBS transactions in the market recently. Does pricing on those deals reflect this reversion in property valuations to 2002 levels? The short answer is yes. According to the National Council of Real Estate Investment Fiduciaries, cap rates during 2002 (a building's cap rate is its net cash flow divided by its sales price) for retail properties ranged from 8.7% to 9.5%, for office properties ranged from 8.6% to 9.1%, and for industrial properties ranged from 9.4% to 9.6%. Deals recently priced in the market in these asset categories are within these historical ranges. Moreover, leverage on new transactions, expressed on a debt per square foot basis, are also well within levels observed in 2002.

While the amount of newly originated CMBS is limited compared to historical issuance, clearly originators and appraisers have effected some appropriately underwritten transactions. While it is still too soon to tell, it appears that participants in the CMBS origination process have gotten religion, at least in the short run. Assuming this discipline continues, we are likely to see more stability in property prices in 2010, albeit at these new lower levels.

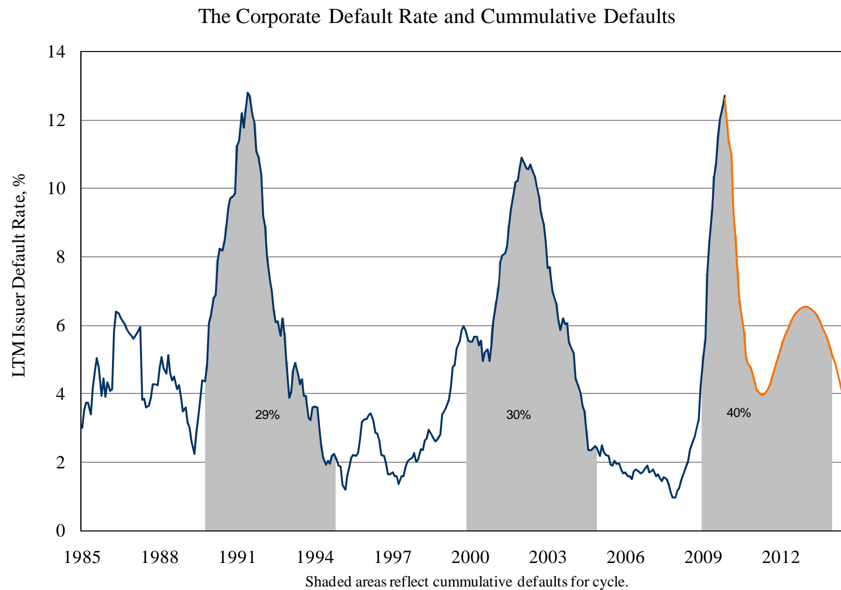
The Corporate Credit Market

Corporate credit performance closed out 2009 on strong footing. The confluence of robust market technical factors and improving credit fundamentals are underpinning the highest valuations in two years. Notably, the last segment of the primary market to open up, leveraged loans, witnessed heavy deal flow going in to year end. Perhaps the most telling sign of resumption of the market's capacity to take credit and liquidity risk is the return, albeit very nascent, of primary Collateralized Loan Obligations (CLOs).

Credit spreads are a measure of expected loss, so the rally in corporate loans and fixed income securities partly reflects the fact that corporate credit losses have peaked for the current credit cycle. This presents an interesting contrast to our sister residential and commercial mortgage markets, which continue to see credit deterioration. At the same time, the corporate market shares some interesting parallels to these markets that could contribute to more "lumpy" behavior of defaults than usual.

Late 2009 will likely mark the corporate default rate's cycle peak of just under 13%. This rate is consistent with the two prior cycles, despite the "great recession" and unprecedented credit-related losses elsewhere. Furthermore, the corporate default rate is

likely to contract sharply over the next year. Street estimates for the 2010 year-end default rate range from 4% to 6%. One driver of these forecasts is simply numerical: since the default rate is measured on a trailing twelve month basis (LTM) basis, we can count the number of defaulted credits falling out of the metric each month. For example, based on Moody's data the default count was extreme in the months of December 2008 to June 2009, averaging over 28 failures per month. For the most recent months of October and November, the default count has dropped off to 10 and 8, respectively. The cumulative default rate in this cycle will likely be consistent with prior cycle experience, if not a tad higher. The high yield distress ratio, or the percent of below-investment grade bonds trading at option adjusted spreads of over 1,000 basis points, is the most robust predictor of future defaults: This ratio peaked at a historic high at 84% in November of 2008 and has now collapsed to 15%.



As usual, much is lost in "average" statistics. The nuances behind corporate defaults partly explain why defaults have not been higher. Part of the default experience was a result of firm and investor behavior during the easy money years of 2005 to 2007. The result was twofold: 1) many failures were idiosyncratic, rather than systemic, and 2) recoveries on secured debt have been depressed. In a word, Leveraged Buyouts (LBOs) define the story. A disproportionate share of bankruptcies have been peak-cycle LBOs characterized by aggressive multiples, low equity contributions, and optimistic assumptions about EBITDA cash flow and future asset sales. Furthermore, financial sponsors layered heavy amounts of secured debt on new capital structures. The consequence was that both senior unsecured and secured recoveries were well below historic means. In fact, many default losses were catastrophic with recoveries in the mere single-digits.

Many LBO names and other highly leveraged companies have greatly benefited from the corporate sector version of modifications. Like any type of modification the goal is to mitigate loss. Specifically, firms have engaged in 1) distressed exchanges; 2) amend and extend agreements; and 3) pre-packaged bankruptcies. At best, these actions will give firms time to fix stressed capital structures. At worst, firms are not successful and defaults drift up in 2011, compared to the clear spike down in prior cycles. Investors are hoping the economy is on solid footing past 2010. Otherwise the re-defaulting that the residential mortgage market calls recidivism the corporate credit market will be calling Chapter 22 beyond next year.

The Markets

Something spooked the US bond market in December—inflationary expectations, Fed-watching, supply concerns, or none of the above. The dollar strengthened, gold and oil remained elevated and stocks flattened out. Refinancing activity declined. The stage is set for a new decade.

	12/31/2009	11/30/2009	12/31/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	1.139%	0.667%	0.768%	70.8%	48.3%
10-year US Treasury	3.839%	3.200%	2.214%	20.0%	73.4%
10-year JGB	1.295%	1.266%	1.174%	2.3%	10.3%
10-year euro	3.387%	3.159%	2.951%	7.2%	14.8%
10-year UK Gilt	4.015%	3.523%	3.020%	14.0%	32.9%
10-year Canada Treasury	3.613%	3.223%	2.684%	12.1%	34.6%
30 yr conventional mortgage	4.895%	4.339%	4.283%	12.8%	14.3%
Barclays US Corporate	4.736%	4.514%	7.567%	4.9%	-37.4%
Dollar Index	77.86	74.88	81.31	4.0%	-4.2%
Japanese Yen	93.14	86.31	90.78	7.9%	2.6%
S&P 500	1115.10	1095.63	903.25	1.8%	23.5%
Nasdaq Composite	2269.15	2144.60	1577.03	5.8%	43.9%
Gold $/oz (nearby contract)	$1,096.20	$1,181.10	$884.30	-7.2%	24.0%
Oil $/bbl (nearby contract)	$79.36	$77.28	$44.60	2.7%	77.9%
MBA Refi Index (month end)	2008.9	2866.4	6733.8	-29.9%	-70.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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