

## **Market Update – May 3, 2009**

### **Getting Ready for the Stress Tests**

This past week, the Fed released details concerning how their stress tests were conducted. In actuality, we already knew most of the details that they shared with us. Supposedly, Fed officials met with representatives of the 19 banks on Friday (April 24<sup>th</sup>). Next week, the results will be made public.

#### **A few things you should know about the stress tests:**

1. the banks were asked to provide their estimates as to how they would do under different scenarios; then, Federal officials reviewed the bank estimates. I'm assuming that these are the same regulators that have been overseeing these banks for the past five years – so I feel really good about their ability to identify problems...
2. the different scenarios include a baseline case which assumes 2009 GDP of -2% followed by 2.1% gain in 2010. The baseline unemployment is 8.4% (2009) followed by 8.8% (2010). There is also an “adverse” scenario where GDP is expected to be -3.3% (2009) followed by .5% (2010). The more adverse case unemployment is 8.9% (2009) followed by 10.3% (2010). Considering Q1 GDP was -6.1% and unemployment is already 8.5%, you have to expect that the adverse case is not adverse enough. (The Fed said that the adverse case is not supposed to be a “worst case” scenario. I hear what they're saying, but the adverse case is looking like the best case scenario and that's not really stress testing – although it's stressing me out.)
3. obviously, some banks have less exposure to the riskiest areas, better capital and better management. It's difficult for the stress test to capture the management issue.
4. Large US banks have reported more than \$550 billion in writedowns and losses since 2007.
5. The Fed has said that common stock should be the dominant part of Tier 1 Capital. Most (but not all) already have common equity that is greater than 3% of capital. In effect, it sounds like the rules are being set up so that the banks will succeed. With that said, Bank of NY Mellon has tangible common equity of 2.14% and Wells Fargo has TCE of 2.48%.

#### **Here's what I'm thinking about:**

1. what will the government actually tell us? Are they going to simply name a few banks which need to raise capital? What I really want to know is what loss rates were applied to the loans and securities of each bank
2. analysts generally expect Goldman Sachs, Morgan Stanley, JP Morgan and (probably) US Bancorp to be okay.
3. Analysts expect Citi and BAC to be told that they need to raise capital. Regional banks, such as Fifth Third, SunTrust and Regions Financial are thought to be in trouble because of losses in commercial loans as well as

- exposure to rust belt loans or Florida home loans. (As a side note, when two banks merged and management thought that "Fifth Third" was a good name, you were on notice that you didn't want your money invested here. It reminds me of when I suggested to Jenny that we name our children "1", "2" and "3". She said, how'd you like it if I start calling you "16"? I'm not sure what she meant by that, but I don't think I like it.)
4. The government may still end up acquiring large stakes in many of these banks. If banks can't raise new capital, they will be able to convert the government's preferred stock into common stock. The Administration says that it doesn't want to make operational decisions for the banks, but we've already seen them get deeply involved with GM and Chrysler. In addition, Congress may have other ideas. (This may explain why, as of March 27<sup>th</sup>, more than 250 financial firms had withdrawn their applications for capital injections.)
  5. If unemployment reaches higher levels (such as 12%), all of these banks are going to be in deep trouble.
  6. We can't return to minimum capital levels. We need a greater level of protection at this point so that banks don't constantly have to fix a new problem. (Otherwise, it's like an investor who keeps meeting margin calls by adding the minimum required capital...the margin calls just seem to continue.)
  7. The stress tests seem to be judging whether the banks can survive a recession. They don't tell us enough about whether the banks will be in a strong enough position to lend and lead us into recovery.
  8. The government (Treasury and Fed) is in conflict: they want to show that they are doing their due diligence before injecting more capital. At the same time, they want people to have confidence in the banks.
  9. There is very little trust for the government after how they handled Bear Stearns and Lehman. I think that the much bigger issue is how they handled BAC's acquisition of ML. They showed a willingness to screw some investors in order to help the entire system. What do you think that they are willing to do now?
  10. Ultimately, the markets are going to have to decide what should happen to the banks. But the government is turning a bet against the banks into a bet against the government.

## **GM's UPDATED Viability Plan**

GM announced an updated viability plan because their earlier plan was not well received by the Administration (i.e., their new Board of Directors). There are four key pieces to the plan:

1. **Focus on four brands:** Chevrolet, Cadillac, Buick and GMC. They will phase out Pontiac by the end of 2010. They will try to get rid of Saab, Hummer and Saturn by the end of 2009. They will decrease the number of dealers from 6,246 (2008) to 3,605 (2010) – a 42% reduction. (They are trying to get rid of 500 more dealers four years earlier.) The goal is higher sales effectiveness.
2. **Reduce the inventory problem** by cutting the summer production schedule by 190,000. Also, they have assumed that their market share will drop to a range of 18.4% - 18.9%.
3. **Lower costs so that breakeven will be 10 million cars per year** (in US). They will reduce the number of assembly, powertrain and stamping plants from 47 (2008) to 34 (2010) and 31 (2012). US hourly employment levels will be reduced from 61,000 (2008) to 40,000 (2010) and level off at 38,000. This is a 34% reduction. The plan also assumes a reduction of US hourly labor costs from \$7.6 billion (2008) to \$5 billion (2010) – also a 34% reduction.
4. **Fix the balance sheet.** They want to eliminate \$27 billion of their unsecured debt through a debt to equity conversion (discussed below). They are also negotiating to eliminate part of the \$20 billion of debt to the UAW's healthcare plan (Voluntary Employee Benefit Association). They would eliminate \$10 billion of this debt by giving them 39% of the new GM stock. Finally, the US would convert their debt and receive 50% of the company.

**Summary:** GM is planning on becoming a much smaller company with far fewer employees, fewer brands and fewer dealerships. I don't understand why the plan is to reduce the number of employees by 34% and labor costs will only drop 34%. I thought that the hourly labor costs were supposed to drop (meaning that the drop in labor costs should be greater than the drop in employees).

### **The Financial Restructuring – This One is Bizarre!**

As part of the restructuring, the parties are being asked to give up their claims that were based on the following:

1. Unsecured bondholders -- \$27 billion face value of debt
2. US government – approximately \$20 billion of loans
3. UAW healthcare plan -- \$10 billion that GM owes (GM will agree to pay the other \$10 billion – as they currently owe a total of \$20 billion)
4. Shareholders – entire equity position

If everyone agrees, the “new” GM will be owned in the following percentages:

1. US government – 50%
2. UAW healthcare plan – 39%
3. Unsecured bondholders – 10%
4. Current shareholders – 1%

**THINK ABOUT THIS...**the UAW’s healthcare plan will receive 39% in exchange for a \$10 billion release (GM will still pay the remaining \$10 billion they owe the plan). The unsecured bondholders will surrender \$27 billion of (face value) bonds and receive 10%. It is my understanding that these two claims will be equivalent in bankruptcy. If you were a bondholder, would you agree to this? I wouldn’t.

GM has said that the Treasury will probably not approve this plan unless 90% of bondholders tender their bonds. Here’s the KEY QUESTION...how many of these bondholders have hedged their positions with credit default swaps? If they have, they would prefer the default so they can recover face value. In fact, I would think (???) that anyone who speculated by buying credit default swaps would be buying these bonds right now (they are selling for less than 10 cents on the dollar) in order to guarantee that the bondholders will not vote for this deal.

GM has also said that they will need \$11.6 billion more by May 1. The government has already given them \$15.4 billion.

### **WAIT A SECOND...**

Have you thought about what is going on here? The UAW played a huge role in driving GM into the ground. Now, the government (meaning you and I) is bailing out GM and the UAW is getting a huge stake in the existing company. We’re rewarding / bailing out the UAW. How did the UAW lose in this deal? They didn’t. They won. I much rather see GM file for bankruptcy than have this happen. I’ll accept whatever a bankruptcy judge says is fair. But this is a government sponsored wealth transfer from bondholders (and taxpayers) to the UAW and I don’t like it.

### **Two Final Thoughts**

1. There is a tremendous potential for conflict of interest if the government owns 50% of GM. GM’s most successful US products are gas-guzzlers (such as the Escalade) and the government wants GM to promote energy efficient cars.
2. You really should think about Pontiac in order to appreciate GM’s ineptitude. At one point, Pontiac was a great brand, producing very popular big-engine cars. They produced the GTO, the Grand Prix, the Firebird, etc. Then, they produced the world’s ugliest car – the Aztec. They produced a minivan – a very ugly minivan. They started naming cars the G6 and G8. This past week, GM CEO Fritz Henderson (talking about Pontiac) said “it’s in many ways a very fine car but we’re just not able to put the marketing resources behind it.” How many resources were necessary for your marketing department to

come up with G6 and G8? I'll save you some money – I've just come up with some new Pontiac names: B53, H7, F99. Anyone who worked on any of this should be banned from profit seeking businesses. It's pathetic.

## **GDP Numbers are Not as Bad as They Sound**

Q1 GDP decreased at a 6.1% annual rate. In the US, we look at how much GDP changed from the prior quarter and we annualize the rate. (Some other countries, such as China, calculate their GDP growth rates differently. I only mention this because it's always interesting to find intellectual property that the Chinese government didn't steal.) This is the worst six month performance in 51 years and the first time since 1975 that the economy has shrunk for three consecutive quarters.

### **The Four Components of GDP Changed at the Following Annual Rates:**

1. Consumer Spending (~70% of GDP): +2.2%
2. Business Spending (aka Gross Private Domestic Investment): -51.8%
3. Exports: -30%; Imports: -34%
4. Government Spending: -3.9%

NOTE: the drop in government spending is being attributed to the transition between administrations (on the Federal level). On the state level, it is likely the result of the drop in tax revenue. We would expect Federal spending to greatly rebound (b/c of the stimulus plan), but state spending will continue to have issues.

### **The Four Components Had The Following Impact (How We Ended -6.1%)**

1. Consumer Spending: +1.5%
2. Business Spending: -8.83%
3. Net Exports: +1.99% (the drop in Exports reduced GDP by 4.06% and the drop in Imports increased GDP by 6.05%)
4. Government Spending: -.81%

### **Key Component of Business Spending: Inventories**

Inventories dropped significantly (companies sold inventory and didn't replace it) and that reduced GDP by 2.79%. If inventories had stayed stable, GDP would have only dropped 3.3%.

### **Going Forward**

1. Consumer spending seems to be stabilizing, although it will probably be weaker in the future due to continued job losses and increased savings. It's hard to believe that we'll see tremendous strength here, particularly since we will see reduced use of leverage to buy goods and services.
2. Government spending is going to increase in the coming quarters.
3. Inventories will probably not drop much more.
4. The conclusion has to be that GDP will sound much better in coming quarters.

## **The Best Analogy**

My best analogy for the economy is to compare the economy to a 180 pound man who got sick, went through chemo and is now 150 pounds. Soon, he'll stop losing weight and may even gain a pound or two. Unfortunately, when that happens, he's not going to be the same as when he weighed 180 pounds. In addition, he's not going to be consuming as much as he used to and that means that we may have a high unemployment rate for a fairly long time. Hopefully I'll be wrong.

## **Housing Bottom? Be Careful of the Crap You Read**

The Case-Shiller home price index was released this week and the headlines throughout the newspapers brought the good news: "The Pace of Decline Slowed." The common interpretation is that we're seeing a sign of a bottom. I have absolutely no idea whether we're hitting a bottom or not, but I want to make sure that you understand what is really going on.

The big news is that nine of the twenty cities (measured in the index) did not set a record in the annual drop. In other words, imagine a city that revealed an annual drop of 20% measured based on January 2009 vs January 2008. In February (the numbers just reported this week), this city might have only been down 19% (if you compare February 2009 vs February 2008). Since nine cities stopped setting records, this is being seen as a good sign – a sign of a bottom.

Understand the math behind this! All this is saying is that in nine of the largest twenty cities, the February 2009 drop in prices was not as bad as the February 2008 drop in prices. In February 2009, ALL twenty cities saw prices decline. Granted, nine had a better February than they did last year. But that doesn't mean prices are coming back. See the numbers below (and also notice that the average decline in February 2008 and 2009 was virtually identical):

City	Feb 2008 Drop	Feb 2009 Drop	
Cleveland	-1.54%	-4.99%	
Chicago	-2.00%	-3.44%	
Charlotte	-0.36%	-1.63%	
Detroit	-2.56%	-3.82%	
Atlanta	-1.39%	-2.55%	Cities at the
Denver	-1.16%	-1.72%	top of this
New York	-1.07%	-1.57%	list saw much
Seattle	-0.97%	-1.46%	worse
Portland	-1.44%	-1.90%	performance
Phoenix	-4.08%	-4.46%	this February
Miami	-2.95%	-2.99%	than last
Boston	-1.40%	-1.30%	February.
Washington	-2.46%	-2.30%	The nine cities
Minneapolis	-3.36%	-3.13%	at the bottom
Dallas	-0.68%	-0.31%	of this list had a
Tampa	-3.11%	-2.65%	better February
Las Vegas	-4.77%	-3.65%	in 2009 than 2008.
San Francisco	-5.04%	-3.25%	
Los Angeles	-4.27%	-2.03%	
San Diego	-3.60%	-0.96%	
Average	<b>-2.44%</b>	<b>-2.47%</b>	

You do see that the cities which have had the biggest drops (from their peak) do seem to be showing smaller drops this February.

If you want to be depressed, look at the drops from the market peak in each city.

<b>City</b>	<b>% From Peak</b>	<b>Month of Peak</b>
Phoenix	-50.8%	Jun-06
Las Vegas	-48.4%	Aug-06
Miami	-45.1%	Dec-06
San Francisco	-44.9%	May-06
San Diego	-41.4%	Nov-05
Detroit	-41.3%	Dec-05
Los Angeles	-40.4%	Sep-06
Tampa	-39.0%	Jul-06
Washington	-33.1%	May-06
Minneapolis	-32.0%	Sep-06
Chicago	-25.1%	Sep-06
Atlanta	-21.9%	Jul-07
Seattle	-20.9%	Jul-07
Cleveland	-20.8%	Jul-06
Portland	-19.1%	Jul-07
Boston	-18.5%	Sep-05
New York	-17.5%	Jun-06
Denver	-14.3%	Aug-06
Charlotte	-12.5%	Aug-07
Dallas	-11.1%	Jun-07

Whoever thought that homes in the desert wouldn't appreciate? Go figure.

## **Ken Lewis Stripped of Chairman Position – Did We Really Win?**

BAC shareholders voted to separate the Chairman (of the Board of Directors) position from the CEO position. The vote was close, as 50.34% voted to separate the positions. As a result, Ken Lewis was replaced as Chairman but remains the CEO. He was replaced by Walter Massey, a 71 year-old physicist and academic who is President emeritus of Morehouse College. Massey has been on the board since 1998 (and really since 1993, as that is when he joined the Board of BankAmerica). He has no other banking experience.

For several months, I have argued that Ken Lewis should be replaced. He has destroyed a tremendous amount of value by rushing into purchases of Merrill Lynch and Countrywide and by overpaying for these acquisitions. He has argued that the government forced him to not re-negotiate the ML acquisition, yet he has also argued that these were great acquisitions. During this week's shareholder meeting, Lewis said that the Countrywide and Merrill deals are "looking more and more like successes to be celebrated." Try telling that to your shareholders who bought the stock for prices as high as \$40. (On a related note, with New York real estate prices falling, Bernie Madoff said that his ability to obtain free housing for the next 30 years was also a success to be celebrated.) Lewis is exactly the type of CEO who needs a strong board.

For any of you weenies that feel bad for Ken Lewis, I'd remind you to feel bad for all of the people who had huge amounts of their wealth invested in BAC. I'd also remind you that there were many families that built local banks over generations and sold out to BAC and now have very little. If you still have trouble getting your arms around this, I have a question for you. Imagine you hired a money manager who decided to invest in Countrywide last year (believing that their model of originating and selling mortgages was sustainable?) and then bought Merrill Lynch in the fall. Would you fire this money manager? Most people would. It doesn't mean that someone is a bad person. It just means that you don't want that person managing your money. If I was a BAC shareholder, I wouldn't want Ken Lewis managing my money. (If you're happy with that type of performance, you should consider hiring me.)

What really surprised me about this entire incident was that Ken Lewis didn't give up his title of chairman a couple of months ago. He knew that this was going to be a close vote and that nothing good was going to come from it. In fact, it might have been even worse for him if the vote had been slightly in his favor. (At that point, the dissenters would have gone beserk.) By allowing this to go to a vote, he was openly agreeing to a referendum about him. He would have been much better off resigning as chairman and keeping his strength as CEO. Of course, no one has ever accused Ken Lewis of making great decisions.

The board's decision to appoint Massey was horrible and is a slap in the face to the idea of corporate governance. Don't get me wrong – Massey must be a VERY smart guy – he's a physics PhD (who studied quantum liquids and solids and now will apply this to a quantum mess...), he's run several universities and organizations and has been on several boards. But BAC needs more than a smart guy. They need someone who represents strong corporate governance and someone who will also have the respect of the regulators. In fact, a big-name former bank regulator would have been a good choice.

Instead, Lewis was replaced with an ally who had been on the Board for more than ten years (and didn't stop these value destroying transactions), was an academic (in physics), with no real banking experience and who is approaching mandatory retirement age. Wow, that's strong. I really trust him to keep Ken Lewis in line. The Board furthered its image of strength when news leaked out that they didn't consider anyone else.

On the good side, now that Lewis has lost this power struggle, many shareholders feel emboldened to argue that Lewis needs to leave. Aside from his past transgressions, some investors are upset that he no longer has a strong relationship with regulators (due to his testimony concerning the government pressure during the ML acquisition) and others simply say that BAC doesn't need a CEO whose core competency is overpaying for acquisitions. Many watchers also complain that Lewis has not groomed a successor.

Some commentators have compared Lewis' situation to two other bank CEOs who lost their title of Chairman and very quickly were ousted as CEO. Last year, this happened to both Kennedy Thompson (Wachovia) and Kerry Killinger (Washington Mutual).

One final, pathetic story. Articles came out that shareholders cheered for Ken Lewis at the annual shareholder meeting (this past week). Does that make sense to you? The company supposedly packed the shareholder meeting with employees and friendly faces. Lets face it, if you put all BAC shareholders in a room, I don't think that the average person would be cheering for Ken Lewis. (As a side note, I once tried to pack a classroom with people who liked me, but Jenny was the only person in there and she ended up dropping the class.)

## The Bailout Plan

There's a great chart in the Christian Science Monitor that allows you to see all of the spending plans and loans in order to deal with this crisis. I've put the link below.

<http://www.csmonitor.com/2009/0429/p19s01-usgn.html?page=1>

In addition, if you go to the PDF page of my website, you can see the main chart as a PDF.

Finally, I have used their work to create a table below:

<b>Amount in Billions</b>	<b>Program</b>
\$1,800.00	<b>Commercial Paper Lending Facility (CPFF)</b> Lend to corporations by buying their short term debt
\$1,450.00	<b>Buy Mortgage Securities</b> Invest to ease long term interest rates
\$1,400.00	<b>Temporary Liquidity Guarantee Program</b> Insure newly issued bank debt
\$1,000.00	<b>Term Asset-Backed Securities Lending Facility (TALF)</b> Lend to help revive stalled lending to consumers and businesses

- \$787.00 **Stimulus, Obama**  
Spend and cut taxes to revive economy
- \$600.00 **Term Auction Facility (TAF)**  
Lend to banks against a wide variety of collateral
- \$540.00 **Money Market Investor Funding Facility (MMIFF)**  
Invest in commercial paper, bought from money-market funds to bolster their liquidity
- \$500.00 **Currency Swaps with Other Central Banks**  
Lend to ensure adequate supply of US currency for foreign institutions
- \$500.00 **Public-Private Investment Program**  
Lend for purchase of bad assets from banks
- \$400.00 **Fannie Mae and Freddie Mac Rescue**  
Invest to keep key mortgage firms operating
- \$300.00 **Buy Treasury Bonds**  
Invest to ease long-term interest rates
- \$300.00 **Hope for Homeowners Program**  
Spend to reduce strain on housing market

- \$250.00 **Capital Purchase Program**  
Invest in banks to maintain confidence and lending
- \$234.30 **Citigroup Rescue**  
Insure risky assets at a major bank
- \$200.00 **Term Securities Lending Facility (TSLF)**  
Lend to investment banks against a variety of collateral
- \$168.00 **Stimulus, Bush**  
Spend and cut taxes to revive economy
- \$112.50 **AIG Rescue**  
Lend to prevent collapse of nation's largest insurance firm
- \$100.00 **Consumer and Business Lending**  
Invest in Fed's TALF to stimulate lending
- \$100.00 **Public-Private Investment Program**  
Invest in troubled assets from banks
- \$87.20 **Bank of America Rescue**  
Insure risky assets at a major bank
- \$70.00 **AIG Rescue**  
Lend to prevent collapse of nation's largest insurance firm

- \$60.00 **Student Loans**  
Lend to keep college credit available
- \$58.00 **Primary and Secondary Credit Programs**  
Lend to prevent a freeze-up in short-term funding for banks
- \$50.00 **Foreclosure Prevention**  
Spend to reduce stress in housing market
- \$50.00 **Money-Market Fund Guarantees**  
Insure to prevent a run on cash accounts
- \$29.00 **Bear Stearns Merger**  
Lend against risky collateral to JPMorgan Chase  
(to enable its purchase of Bear Stearns)
- \$27.50 **Bank of America Rescue**  
Invest and insure assets to stabilize a key bank
- \$25.00 **Citigroup Rescue**  
Invest and insure assets to stabilize a key bank
- \$24.90 **GM, Chrysler Rescue**

Lend to prevent auto industry collapse

**\$18.30 Primary Dealer Facility**

Lend to investment banks against broad collateral

**\$15.00 Small Business Credit**

Lend to revive economy

**\$10.00 Citigroup Rescue**

Insure risky assets at a major bank

**\$6.10 Money Market Liquidity Facility**

Lend to banks to buy commercial paper from  
money-market funds

**\$5.00 Auto Supplier Aid**

Lend to auto suppliers and insure payment on some bills  
they're owed

**\$2.50 Bank of America Rescue**

Insure risky assets at a major bank

Source: US government agencies, Christian Science Monitor