Investment Focus

ISSUE HIGHLIGHTS

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Allegiant® Asset Management Company

The Discipline of Investing, a Commitment to Results

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REMEMBRANCE OF THINGS PAST

By Richard J. DeKaser, National City Chief Economist

The rising tide in mortgage losses understandably draws comparisons to the S&L crisis of the late 1980s. Loose real estate lending and unrealistic assumptions about property price appreciation – in each instance – ultimately saddled lenders with heavy losses. If this analogy holds up, we should brace ourselves for a long, hard slog. As late as 1991, several years after the crisis was first acknowledged, Fed Chairman Alan Greenspan lamented the "headwinds – primarily generated by the constriction of credit in response to major losses at banks."

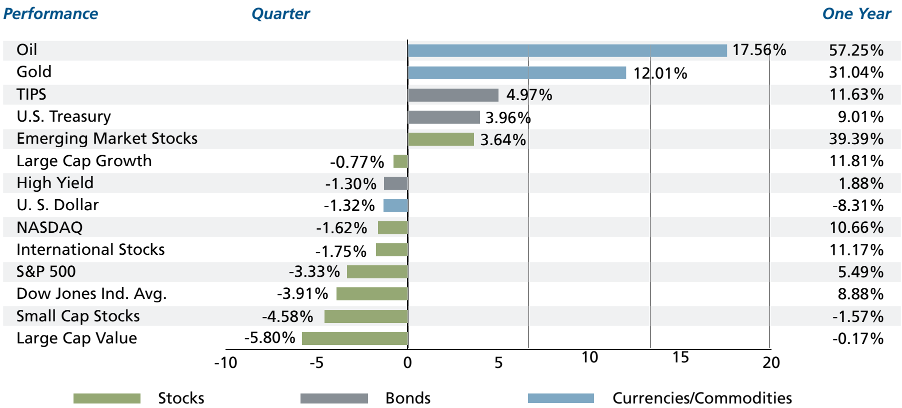
But while qualitatively similar, the episodes are quantitatively different. First, consider the size of the loss. According to the FDIC, the S&L losses were $153 billion. Total losses were obviously much higher. By comparison, estimates put the total magnitude of today's mortgage losses at between $200 billion and $300 billion. So, if we take the smallest estimate of previous losses and the largest estimate of current losses, the difference is a factor of two. But since the economy expanded 2.5 times over this period, even this hyper-conservative accounting makes prospective mortgage losses relatively smaller.

Second, the banking system now is far healthier. Even after the large losses booked so far this year, for example, total loan losses at banks amounted to just 0.56 percent of assets – half of the 1.15 percent rate averaged from 1985 to 1993. Meanwhile, bank capital has risen dramatically, from consistently below 6 percent of assets during the late 1980s to consistently above 10 percent in recent years.

Third, evidence on bank lending is encouraging. While banks have tightened underwriting standards and increased loan spreads over their costs of funds, these changes should be viewed in the context of the easy lending that prevailed in 2007. By any longer historical perspective, business loans are available and affordable. More to the point, they've grown by leaps and bounds; business lending by banks posted faster growth over the past six months than any time since 1973. While some of this resulted from troubled investment funds running up credit lines at banks, even smaller banks that do no such lending experienced double-digit growth rates.

While none of this should trivialize the consequences of impending loan losses, a replay of the S&L crisis this surely is not. ■

Market Scoreboard *(as of December 31, 2007)*



Source: Bloomberg

WHAT LIES AHEAD

Two dominant economic issues during 2007 were the housing collapse and the rebound of foreign trade. By our preliminary accounting, the former subtracted a percentage point from growth, while the latter added about half that amount. But the housing drag is likely to diminish in 2008, while the benefits of foreign trade only grow.

Relief from housing is likely because construction activity is already running well below sales, evidenced by the declining inventory of unsold new homes. So long as sales don't fall much further (and we don't expect they will), current levels of homebuilding are sufficient to gradually work off the glut of unsold homes. Most likely, a building retrenchment will persist, but any further decline will pale in comparison to the utter collapse of 2007.

Meanwhile, foreign trade benefits from a weak dollar, which progressively lost altitude during 2007. And because exchange rate changes tend to affect foreign trade with a lag of six-to-12 months, these benefits should only increase as next

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CREDIT CRUNCHES: A PRIMER

By Holly R. Harrison, Director of Investment Communications, holly.harrison@allegiantgroup.com

There has been much talk over the past six months of a credit crunch that is severely impacting investors across the globe. This credit crunch is not a unique event; there have been similar periods across the history of global markets, some more impactful than others. While the origins and outcomes of all credit crises differ, there are similarities. To gain a better understanding of the current situation, it is important to review the types of credit crunches and their origins, and delineate the difference between a financial crisis and a credit crunch (see the accompanying article).

A credit crunch is a period in which banks are simply not willing to lend due to deepening loan losses that diminish capital. As losses mount on their balance sheets, banks suddenly stop lending, specific areas of the credit markets may evaporate, and investors/creditors become increasingly risk averse. Severe credit corrections tend to follow periods of strong credit expansion at attractive rates to borrowers that do not compensate for the inherent risk in the loan.

The causes of credit crunches vary and can lead to serious consequences, depending on the structure of the financial system involved. What spurs most of these causes is the realization, or fear, that a borrower will not be able to satisfy the terms of his debt, thus putting the value of that debt into jeopardy and prompting banks to deal with issues such as[1]:

Reduction of Reserves: A country's central bank can suddenly contract the amount of reserves available within the banking system, which directly restricts the banks ability to make loans.

Bank Failure: A bank needs to add reserves against defaulted loans which forces the bank to lower its risk profile and be more restrictive with in the lending process.

Bond Default: Bonds issued (a form of credit) can default, leading investors to fear further problems. Credit spreads widen and investors move to higher quality assets. This lowers the amount of capital available to investors through the debt capital markets.

Investor Panic: A flight to quality occurs as investors rush to rapidly sell securities to increase their cash holdings.

Currency Problems: A specific currency can face issues, causing investors in assets denominated in that currency to rush to quickly sell those assets to transfer into assets of another currency.

Over the last 20 years, the U.S. has experienced two notable credit crunches with a striking number of similarities: the Savings & Loan crisis and our current subprime related credit crunch.

The seeds of the S&L crisis were planted way before its explosion into a full-blown credit crunch that spanned nearly a decade, from 1986 to 1995. Prior to the late 1970s, S&L activity was defined by legislation passed in the 1930s as a way to promote home ownership. S&Ls' primary activities were to accept savings deposits and extend mortgages. Soaring inflation in the late 1970s led to years of mounting losses at S&Ls and, in an attempt to prevent these institutions from going under, several regulatory changes were made that broadened operations and risk levels while loosening restrictions. While deregulation was intended to diversify the S&L business model, it sowed the seeds of destruction.

Many S&Ls extended risky mortgage loans which eventually went bad. To compound matters, oversight and regulation were lax, meaning problems compounded longer than they should have. In 1986, 54 S&Ls were deemed insolvent. From 1987 to 1989, the U.S. government passed a series of acts designed to rescue the S&L industry. Nearly 1,000 S&Ls would be closed to a total of around $153 billion in losses.[2] Many blame the ensuing slowdown of the financial and real estate markets

LTCM Losses

The total losses were found to be $4.6 billion. The losses in the major investment categories were in order of magnitude:

- $1.6 billion in swaps
- $1.3 billion in equity volatility
- $430 billion in Russian and other emerging markets
- $371 million in directional trades in developed countries
- $215 million in yield curve arbitrage
- $203 million in S&P 500 stocks
- $100 million in junk bond arbitrage
- No substantial losses in merger arbitrage

PriceWaterhouse

Nassim Taleb compared LTCM strategies to "picking up pennies in front of a steamroller."

Dow Jones (20-Jul-1987 through 18-Jan-1988)

Largest subprime and mortgage related losses by banks and Wall Street firms:

Citigroup	$17.4B
UBS	$13.8B
Morgan Stanley	$10.8B
Merrill lynch	$7.9B
Bank of Amer	$5.1B
HSBC	$3.4B

Thomas, Landon, Jr. "Wall Street Firm Posts Loss, It's First Ever." New York Times 20 Dec. 2007: A1, C1.

that followed the S&L collapse as cause for the recession from 1990 to 1991.

Today's credit crunch is most similar to the S&L crisis of the 1980s and early '90s. Most agree that the current crisis was spurred by the combination of rising mortgage defaults and falling home prices, which severely impaired the value of securities backed by these loans. Given these events, we may be facing a more severe crisis based on insolvency and larger fundamental issues very similar to the S&L experience.

Like the S&L crisis, banks are unwilling (or unable) to lend due to mounting losses. Many U.S. homeowners find themselves insolvent. Not only are subprime borrowers affected, but shaky lending affects almost 50% of the loans made in 2005 and 2006.[3] It is estimated that there will be hundreds of thousands of defaults and foreclosures. Many mortgage lenders also find themselves insolvent, and over 60 subprime lenders have gone out of business. Homebuilders may face serious issues as orders have fallen almost 40% and cancellation rates top 30%. Finally, the investors who bought securities backed by these loans are mired in losses difficult to estimate.

The risks are growing that this credit crisis may last considerably longer and may not be so easily diffused with an injection of liquidity by the Fed. Like the S&L crisis, both the finance and real estate industries are contracting significantly with the economy slowing and possibly heading into recession. Real estate is not a liquid asset; foreclosing and recouping value is slow and expensive. The credit boom just passed lasted five years and was marked by notably poor lending standards. American consumers, business, and global investors are all suffering the far-reaching effects.

At the time of this writing, the Fed has already moved to provide liquidity to the markets and remains at the ready to inject more if necessary. While this credit crunch will pass, it may take some time for government regulation and Fed action to take effect, just like the S&L crisis. Though we face a credit crisis, liquidity alone is not enough to cure it quickly. The markets instead will need time to work through these excesses and restore confidence, something cash simply cannot do. ■

[1] J. Orlin Grabbe, "The Credit Crunch, " Laissez Faire City Times, vol. 2, No. 35.

[2] "The Cost of the Savings and Loan Crisis: Truth and Consequences", Timothy Curry & Lynn Shibut, FDIC Banking Review, volume 13, no. 2, December 2000.

[3] Nouriel Roubini, "Worse than LTCM", RGE Monitor, August 9, 2007.

Financial Crisis vs. Credit Crunch

There is a distinct difference between a financial crisis and a credit crunch. In many news publications, you may have seen comparisons of today's subprime-related credit crunch to either the Black Monday Crash of October 1987 or the Long Term Capital Management (LTCM) bailout of September 1998. Though all three are financial crises, they are not all credit crunches.

On Monday, October 19, 1987, the Dow Jones Industrial Average plunged 22% in one day. The crash was mostly technically based. A large number of investors were using an investment strategy called "portfolio insurance." Portfolio insurance was intended to hedge a portfolio against large market losses using stock market put and call options. Once markets started moving downward, sell orders flooding the market, causing additional panic.

What is interesting about 1987 is that these market events occurred against a backdrop of a relatively stable U.S. economy. The economy was growing, businesses were doing well, inflation was moderate, and interest rates stable. Ultimately, the crisis was abated as the Fed stepped in to provide liquidity to the markets and calm investors. However, it took the markets nearly two years to reach prior levels of the Dow Jones Industrial Average.

U.S. investors remember 1998 as the year LTCM failed and almost brought markets to their knees, but there were many moving parts behind the scenes that ultimately caused the liquidity crunch. LTCM was a hedge fund established in 1994 by market master John Merriwether. The fund had enjoyed years of phenomenal success and at the beginning of 1998, had approximately $4.7 billion in assets, estimated to be levered about 25 times.

Some may remember the Asian currency crisis in 1997 that ultimately led to many countries facing recession. In August 1998, after a year of severe economic damage, Russia announced plans to devalue the ruble and restructure all official domestic currency debt, essentially defaulting on its loans. This scared investors across the globe who feared the worst, causing a sudden demand for cash, driving up both credit spreads and equity volatility in a dash for quality. Investors began to unwind highly leveraged positions, leading to a lack of liquidity in cash markets around the world.

Though the fund had many strategies in place, LTCM had a large position in place to take advantage of its belief that credit spreads would narrow across the globe. In the panic that followed the Russian default, LTCM saw many of its positions sell off sharply, with the fund down 44% in August 1998. Given its leverage and the scope of its holdings, fears grew that unwinding LTCM's holdings would crush the financial system. The Fed constructed a bail-out plan in which banks injected a total of $3.65 billion into the fund.[4] In addition, the Fed cut the target fed funds rate three times to restore liquidity. Equity markets later went on to rally over 28% off their lows by year end.[5]

These two crises were both financial crises: there was a short-term lack of liquidity due to forced selling in the capital markets. Though painful in the short run, these capital market-oriented crises have little long-term effect on the broad economy and markets, as fundamentally, nothing changes. ■

[4] J. Orlin Grabbe, "The Credit Crunch, " Laissez Faire City Times, vol. 2, No. 35.
[5] Steven Wieting, "The Two-State Solution: Perfection and Crisis, " Citigroup, August 9, 2007.

DIFFERENT DOG, SAME FLEAS

By Andrew D. Harding, Chief Investment Officer, Fixed Income Investments, andrew.harding@allegiantgroup.com

Financial crisis is not uncommon or lacking in history. In my 28 years of experience as a trader and investment manager, there have been a handful of major crises such as stagflation of the late '70s and early '80s, the Crash of '87, the S&L bailout during the George H. W. Bush administration, the Asian Contagion and demise of LTCM in 1998, the Tech Bubble bursting in 2000, and the accounting scandals in 2002 of WorldCom and Enron. These crises of Wall Street evoke latent spirituality in traders and investment managers as they lay awake at night staring at the ceiling with internal inspection. In their mea culpa, they declare that, "Yes, the writing was on the wall but everybody was doing it and I know it was stupid but if you let me off the hook, just this once, I promise you with all my heart that I will never do this again and I will learn to manage risk or just not take risk at all. Please, please, please…PLEASE!!" How do these "masters of the universe" get into a position that results in financial crisis such as the current subprime crisis, and is this crisis du jour different? And while this may be impossible to answer, how does each new crisis become "the worst ever"? Gordon Gekko, the iconic character from the 1987 movie "Wall Street," might dismiss the whole situation as "a dog with different fleas." I think a more accurate assessment would be that the current credit crunch is a different dog with the same fleas.

In reflecting on previous debacles, I believe there is always a cavalier disregard for common sense as in this current credit crunch.

The common fabric of financial crisis is laced with extended periods of unchecked excesses or leverage and complete disregard for potential risk. Potential risk in this case is defined as the impact of total downside such as a loss of 100%. When one has never been hit by a car while crossing the street, should they accept $10 to cross the street blindfolded? After all, there is very little traffic on that street and the drivers are "usually" cautious. Overly simple? Let's review common declarations that precede financial crisis:

- "It's different this time; it's a new paradigm!"
- "We have superior risk management tools now."
- "The financial markets are more sophisticated than before."
- "You worry too much and you just don't take enough risk."
- "The bartender at Rick's Café likes XYZ Corp."

In reflecting on previous debacles, I believe there is always a cavalier disregard for common sense as in this current credit crunch. For instance, homes cannot appreciate at 20% a year in perpetuity. Providing a mortgage to someone with a weak credit history at an amount five to 10 times their income is insane. Anecdotally, a colleague told me of a friend who was an elementary school teacher in California and married to a pool cleaner. They sold their house at a profit and used the profit to purchase a house for $750,000 which was greater than five times their joint gross income!

The good news is that in my experience all financial crises are resolved after traders and investors complete the five stages of grief: denial, anger, bargaining, depression and finally acceptance.

Denial - Problems in the housing market are contained…these bonds are rated AAA…how can they go down in value? Home prices never go down!

Anger - Why me? Why did the rating agencies do this to me and why won't anyone buy my CDOs? The markets are irrational!

Bargaining - As stated in the beginning, there is a plea to God and a search of a bargain that will let you off the hook…just this once…for old time sake! I promise that I'll never buy subprime again!

Depression - This is the worst ever and it will never get any better. My career is over and I have no future. I am a victim!

Acceptance - This is realization of loss (as in dollars) and the ability to rejuvenate one's psyche. Furthermore, this is recognizing that mistakes were made and you have to confront them, move on, and willingly accept responsibility and consequence.

Acceptance is key to reaching the bottom of a financial crisis in that the affected parties accept loss or permanent impairment. At this point, resurrection and emergence are possible because common sense and a high-level picture emerge, and this enables investors to stop drowning in the moment.

In the end, the warning signs are easily recognizable if one is able to elevate his view and not get caught in the school yard rationale that "everybody's doin' it!" While one would expect that all participants learn from these mistakes – thus, arriving at a point of a prolonged goldilocks environment – it is my experience that the pendulum of financial markets always swings from distress to quickly past equilibrium and back out to the extremes of unchecked excesses and undue risk. In effect, investors as a whole do not maintain a strong conviction to proven investment principles that achieve consistent and superior risk-adjusted returns through all investment cycles. ■

WHAT LIES AHEAD

Continued from front cover

year plays out. Overall, look for a decent year in 2008, with real GDP growth averaging 2 percent in the first half of the year and closer to 3 percent during the second half.

Inflation, meanwhile should throttle back somewhat. The dollar's decline, which makes imports more expensive, and the relatively taut labor market will create these pressures, but they are likely to be offset by some commodity price relief. Fixed income markets, however, which tend to focus on "core" inflation measures will remain on edge as no meaningful improvement is expected.