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2008 Q3 Research Note

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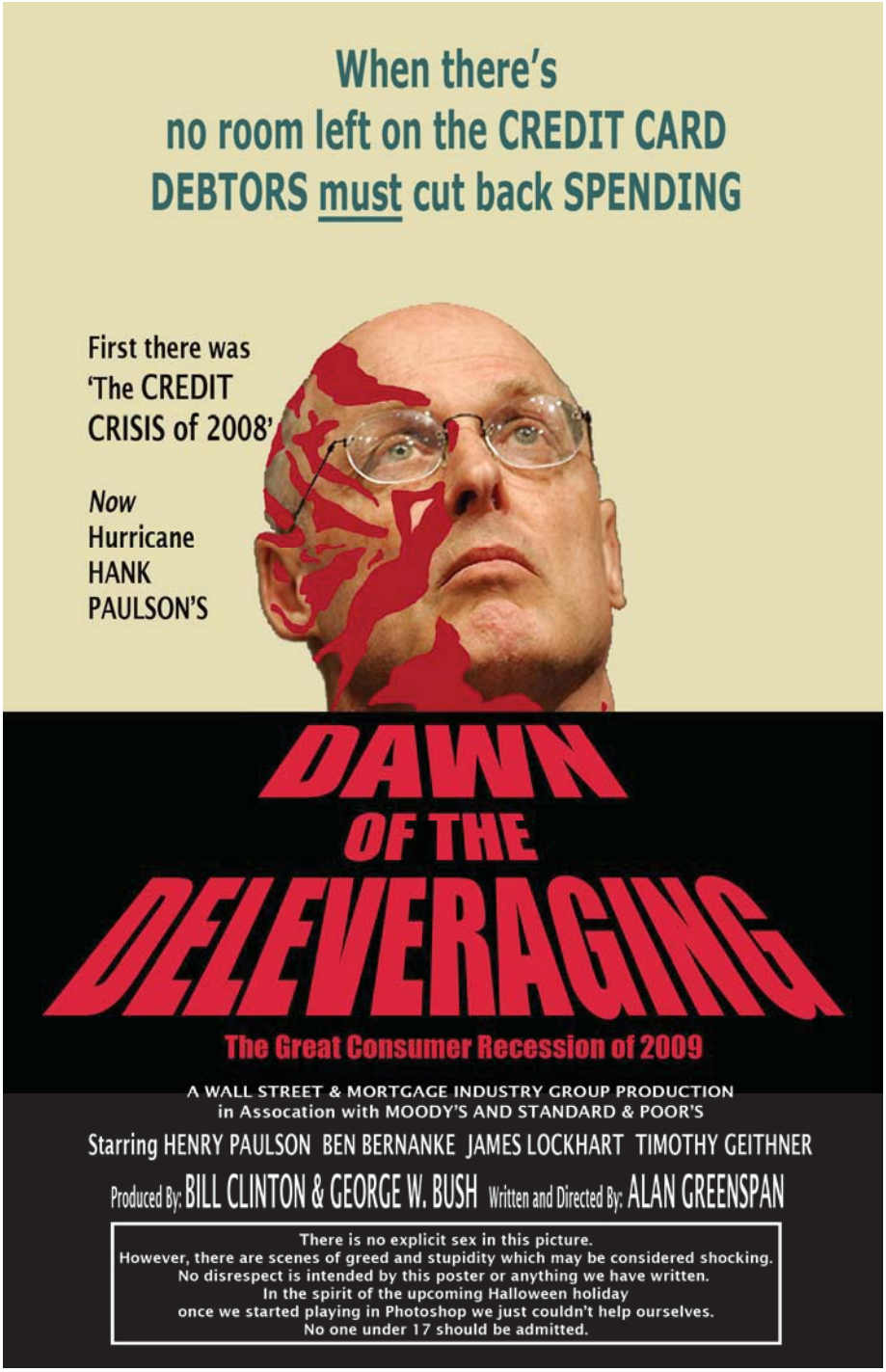
Q3



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Editor's Note & Introduction

In order to prevent outright collapse, the government was forced to take control of Fannie Mae & Freddie Mac this last weekend. These epic and historic actions clearly show that the credit crisis is still intensifying and highlight the fact that systemic instability has reached extreme levels not seen since the Great Depression.

To many people, extreme volatility in the financial markets probably seems irrational. It's not. These are not normal times and those who have insisted on going about business as usual have been rudely awakened. Over the past two years we have chronicled events and tried to explain what was happening to our clients as clearly as we could. Hopefully, our clients have used these insights to help them navigate the storm with their assets and liabilities which are outside of our scope of management.

We are not insensitive to the pain the American people are experiencing. Nor do we dispute that our government is aggressively working to prevent a complete financial meltdown. Clearly, the financial sector, the markets, and the economy as a whole would be much worse off **right now** if the government had been sitting on their hands. We are also aware that our very defensive posture does not fully immunize us from the ravages sweeping through the markets. But as always, we approach our task from a long-term perspective and as clear-headed and logically as we can.

Our best guess is that the worst of the financial storm will hit over the next 5 to 8 quarters. At some point between now and then we expect to make long-term investments in several great businesses. We won't be trying to call a bottom when we start buying. We will simply be making investments at very attractive prices from a long-term investment perspective.

Part of me wanted to close this editor's note by quoting Winston Churchill, indicating that although it wasn't the beginning of the end, it was the end of the beginning - but I stopped myself because I think we are actually past that. Even though I think the worst of the market turmoil potentially lies ahead of us, I now think we may actually be approaching the beginning of the end. - Kevin Tanner

9/18/08 Insert: A great deal has happened in the financial world even since we published this report for our clients on our website on September 10th. Indeed, the domino effect set in motion by the seizure of Fannie and Freddie (not quite 2 weeks ago) has literally reshaped the face of U.S. finance. Also the market has fallen enough that a rally could occur at any minute. Clearly, the situation is very fluid but nothing has happened that would change any of our conclusions presented in this essay.

Dawn of the Dead

Recently, I had a discussion with a colleague and long-time friend about the remarkable stubbornness of the American consumer. I asked him to remember a movie we had seen as teenagers back in 1978 called "Dawn of the Dead." A sequel to the classic 1960's horror flick “Night of the Living Dead,” it chronicles a small group of survivors who dash for the countryside in a helicopter. Low on fuel, they land at a shopping mall and decide to make a stand. The problem: each day flesh-eating zombies re-infest their redoubt. To figure out why, the survivors climb to the roof to survey the ghoul-filled parking lot below, and one protagonist asks another: “Why do they come here?” The response she received is what triggered my use of the movie as an analogy and title of this essay. “They're after the place. They don't know why,” proffers the group’s leader. “They just know they want to be here. It's some kind of instinct. This was an important place in their lives.”

Even for these zombies, old habits died hard. And although individually they were not the toughest of monsters - it didn’t take much more than a whack on the head to put them out of their misery - they traveled in hordes and could turn a survivor into one of them with a single chomp. In my view, the American consumer has become all too zombie-like. They spend by instinct, seemingly oblivious to their financial status as the walking dead. Already, the credit contraction that began with the sub-prime mortgage crisis in mid-2007 is whacking them hard. Now, it is evident in the earnings reports of several credit card companies that they are beginning to fall in droves. More and more consumers are starting to hit their limits on their credit cards and delinquency rates are now clearly on the rise. Individually, their maxing out doesn’t mean much. But like the automatons in the movie, their sheer numbers make them extremely dangerous to everyone else. Just as today everyone is piling on the mortgage lenders for having been overly aggressive in lowering their lending standards, a year from now, people may lament that credit card lenders also became overly complacent. Ultimately there is no shortage of people to point fingers at. For too long, too much credit was made too readily available to too many people.

Eventually, reduced access to credit will likely force a large portion of America to significantly curtail its spending habits. Sliding home prices, a shuddering stock market, mounting job losses, meager wage growth and a sharp rise in the cost of living have pushed millions of Americans to the breaking point. But oh, do we cling to our old habits. I have to admit, I often marvel at the stubbornness of U.S. consumers, millions of whom are broke but nonetheless continue to spend with remarkable regularity. And why not? Considering the path that our government is leading us down – national insolvency – why should households behave any differently?

Part 1: Where We Are Now

As clearly as I can state it, our economy is a mess. The credit crisis continues to intensify as it enters its second year. Having already cost some $500 billion in financial sector losses, it now threatens to take down literally hundreds of banks. The danger has spread to most every insti-

tution that touched mortgage finance and has wrought havoc to even the government-sponsored behemoths in home finance, Fannie Mae and Freddie Mac, which the Federal Housing Finance Agency de facto nationalized over the weekend to prevent their outright collapse. Together they own or guarantee more than half of all residential mortgages in this country, so it was no surprise that Washington deemed them "too big to fail." Indeed, the consequences of inaction could have been catastrophic. But that's not to say the rescue will be painless or even that there won't be unintended consequences. The immediate casualties are the current Freddie/Fannie shareholders. Ultimately, the restructuring price tag may actually impair the balance sheet of the United States, adding to the burden of all taxpayers.

Over the last two years we have emphasized the dangers of excessive leverage. As Fannie and Freddie have now proven, when leveraged 60 to 1, it doesn't take much to get completely wiped it out – no matter how big or venerable. By the time de-leveraging has run its course, the gods of credit will have feasted on the flesh of any institution that failed to understand or respect the risks involved with leveraged finance.

The U.S. Treasury, in conjunction with the Federal Reserve are doing their best to prevent an outright systemic collapse. So far, their efforts have been successful. Whether they will ultimately be able to keep it up is an open question but there is no question that they will keep on trying. As John Williams recently put it, "The Fed and the Treasury will do whatever is necessary to save any entity that might otherwise implode the system. They will create and spend any money needed, they will arm-twist anyone they have to, they will manipulate any market, financial statistic or news medium that will help contain the still intensifying crisis. Failure here is not an acceptable option."

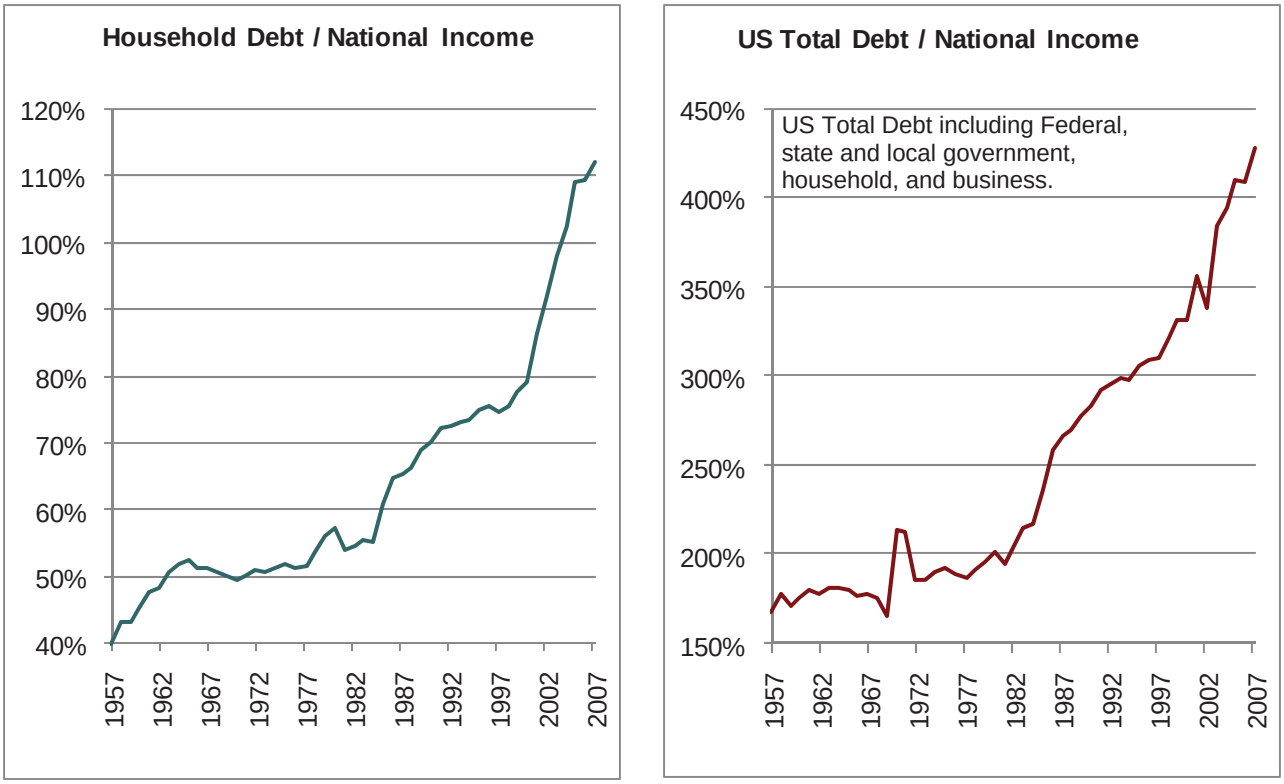
In the face of mounting credit losses, banks and non-bank lenders of all sizes have no choice but to shrink their balance sheets. They have already become less willing to make new loans to consumers and corporations. Going forward, they are likely to become even stingier. Lenders have raised credit requirements for new loan applicants, frozen or even revoked home equity lines of credit and raised interest rates. In the long run this is a good thing, of course, because it will ultimately force the lenders who weather this financial storm to operate with less leverage and more prudent lending standards.

The short run consequences are problematic. As lenders retrench, so must American consumers whether they want to or not. It is important to understand that borrowers and lenders are mirror images of each other. Lenders cannot make fewer loans without borrowers taking on less debt. As lenders deleverage, borrowers, like it or not, must also deleverage. Point being, savings-strapped American consumers will find it impossible to continue to live beyond their means. Those who can't boost their incomes by working more, paying less taxes, etc. must spend less. But businesses are not passing out many raises these days and a tax cut for the masses doesn't seem to be in the political cards, so a safe and logical assumption is that the outcome of the credit crunch will ultimately be a massive curtailment of consumer spending.

Consumers will kick and scream all the way because Americans have come to believe that their standards of living are deserved -- that they are more of a right than a reward. And I understand that. The kids need new computers, they want cars and college is frighteningly expensive. But their parents, predominantly baby-boomers, are often also supporting the grandparents in their retirement years. Basically, the largest generation in the history of this country is now being squeezed on both demographic ends. And because they already sit atop a mountain of debt and often struggle to make ends meet, the vast majority of American consumers are ill-prepared to cope with the cold fact that it will become increasingly difficult to finance shortfalls in monthly cash flows. On the way up, leverage (see figure 1) played a huge role in supercharging consumption as household debt grew at a rate far faster than did income. Going forward, as credit becomes less available, a larger and larger number will be forced to limit spending to disposable income. Even worse, already-high debt servicing ratios are worsening as mortgages continue to reset to higher levels and interest rates rise on credit cards, student and auto loans, etc.

In sum: the American economy is clearly at an inflection point. Millions of households are teetering on the edge of insolvency and, ready or not, the mother of all belt-tightenings may be just around the corner.

Fig. 1: Leverage - The American Consumer's Performance Enhancing Drug



Source: SaratogaRIM, Federal Reserve, Bureau of Economic Analysis and US Department of the Treasury Bureau of Public Debt

Part 2: How We Got Here

The U.S. economy should have fallen into a deep recession between 2000 and 2002. Instead, a confluence of forces limited the damage to a very shallow slump and ultimately catalyzed a seven year debt-driven buying binge by the U.S. consumer. Above and beyond using esoteric mortgage products to buy more home than they could afford, Americans have misused home equity lines of credit, credit cards and auto loans to enable them to live beyond their means. Their “buy now, pay later” mantra could not hold indefinitely, of course. To paraphrase the late presidential economic advisor Herbert Stein: "Things that can't go on forever, don't."

In sheer size, the injection of leverage into the economy over the past decade is unparalleled in modern history. Much as performance-enhancing drugs in sports have artificially enhanced athletic performance, the leveraging up of the consumer balance sheet delivered super-human buying power. Cheap credit made available to the masses was the financial equivalent of steroids. Banks and other lenders were the dealers. Wall Street's innovative credit products (RMBS's, CDO's, CMO's etc.) and lax lending standards (by mortgage brokers and banks) enabled, en masse, the American consumer to live like pumped-up East German weightlifters.

And the financial firms sampled their own product. Just as people borrowed far more money than they could possibly afford to pay back, banks leveraged themselves to the hilt to maximize their short-term performance at great risk to their long-term health. For years the inviolate assumption was that home prices would go up forever, and as they did so such lending would ultimately prove risk-free.

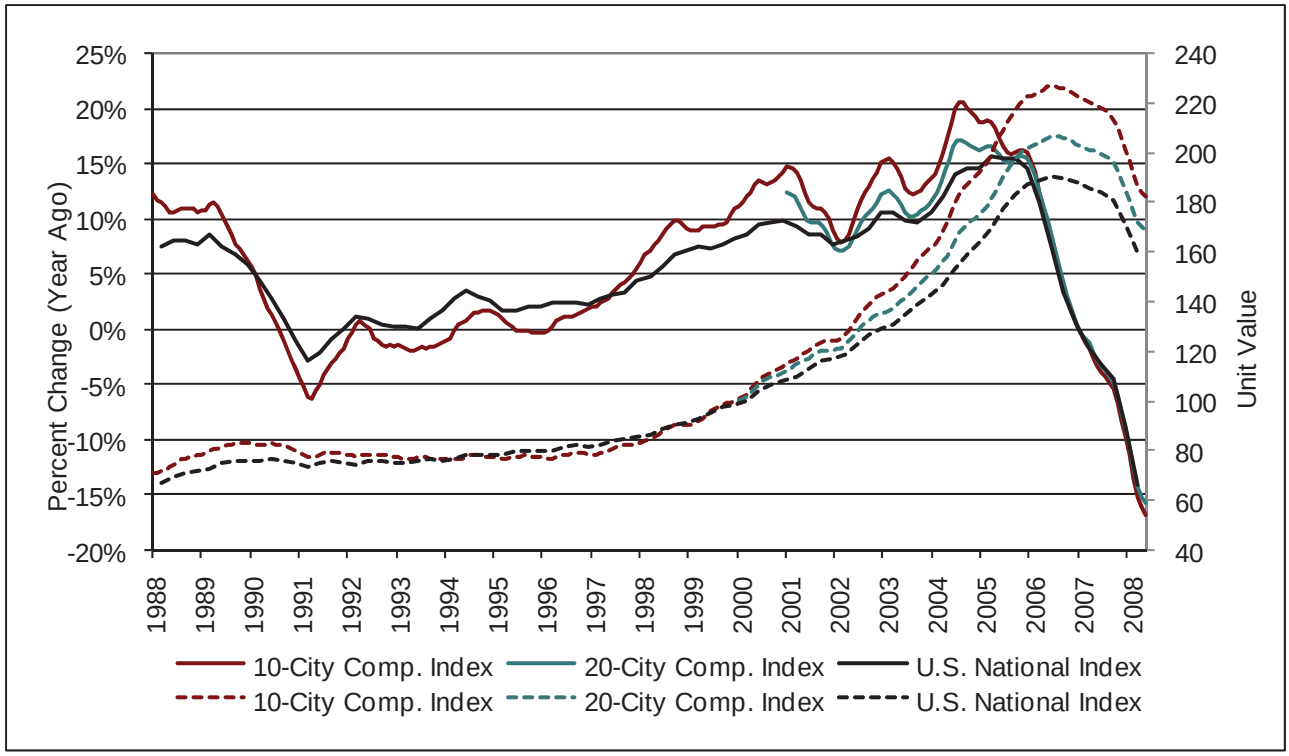
RISK FREE. HA!

To be sure, the debt purveyors were not the only culprits. Short-term thinking has dominated the agenda of policymakers on both sides of the political aisle in Washington for most of my career. Politicians govern by election cycles, not by business cycles, and their agendas just don't correlate very well with the forging of sound economic policy. It is important to understand that these policymakers do not have a magic wand that can make the nation’s problems disappear. There are many tools they can (and have) used, but rather than addressing underlying problems most simply push the necessary fix out into the future. The Fannie & Freddie rescue is no exception. It's a band-aid that will simply slow the bleeding and leave the permanent fix to the next President and Congress.

Part 3: Don't go where the puck is. Go where it is going.

To date, American consumers have somehow managed to keep up their mall trolling. But as the surge in credit card delinquencies shows, millions of them are approaching the financial abyss, and to us it is obvious, as Mr. Stein postulated - that this status quo cannot hold forever. The only question is how long it will take before the ongoing credit contraction forces a consumption contraction sufficiently large to trigger an official recession. Honestly, though, I don’t think it matters much; the “when” here is less important than understanding the inevitable ramifications of credit contraction. It is less important to us precisely when we are correct than it is that our conclusions are ultimately proven right.

Fig. 2: S&P/Case Shiller Home Price Indexes



Source: SaratogaRIM and Standard & Poor's

In our most recent Quarterly Report we said that we think rare investment opportunities are lining up on the horizon. Nothing has changed to challenge this belief. But it is important to re-iterate that we expect things to get worse before they get better. The Fannie/Freddie news over the weekend does not change the facts that home prices are still falling (Figure 2) or that a second wave of mortgage resets is coming. We don't think housing prices will stabilize before late 2009 or early 2010. Until that occurs, the credit crisis will continue. And until a majority of investors come to recognize this as reality it is unlikely that damage caused by the credit crisis will have been adequately priced into the financial markets.

In our Q3-2006 quarterly report we warned that the probability of a collapse and/or prolonged downturn of housing prices was much higher than was then recognized, and if that were to materialize the U.S. was in for a severe recession. We also said earnings expectations were way too high and that risk premiums were untenably sanguine. True to our expectations, housing prices entered prolonged decline, corporate earnings have collapsed relative to expectations and risk premiums have widened as the prices of nearly every "risky" asset class in the world have fallen.

The correction is not over. In our view, risk premiums are still not wide enough to comfortably compensate the savvy investor. It is important to understand that there are many forms of risk. The biggest single systemic risk today may very well be with the so-called "risk-free" rate of return paid on United States Treasury securities. They represent a promise backed by the full

faith and credit of the United States to pay back a specified number of U.S. Dollars over a pre-set schedule. Such notes or bonds maturing over more than a year represent a contractual schedule to pay interest every six months and the principle amount at maturity. They are called "risk-free" because the government owns the printing presses. At the end of the day the biggest difference between our government and cash-strapped homeowners struggling to make mortgage payments, may be that our government can simply print money when it mismanages its finances.

This, of course, is inflationary. And inflation is essentially a regressive tax on the poor and the middle class. Our greatest fear is that the United States government itself may become (if it hasn't already) over-extended as it commits ever-larger percentages of our national wealth to policy adventurism and to keeping our financial system afloat. Add up the mounting costs of our war in Iraq, funds already incurred to mitigate the credit crisis and the capital infusion required to recapitalize Fannie and Freddie (as well as any other bank deemed “too big to fail”) and it is obvious that something will eventually have to give. The government will come under increasing pressure to either raise taxes, cut spending or some combination of both. Unless they are uncharacteristically disciplined and are able to get their affairs in order with these tools the only other options would be to bridge the swelling gap by borrowing or by monetizing the debt – which is a fancy way of saying they will print money. If history is any guide, they are less likely to solve this crisis through the tax codes than they are through the printing press. Politicians just don't seem to like to be the guys associated with raising taxes because that usually turns out to be a bad career choice. Think “read my lips....”

Either way, the economic ramifications would be ugly. If the U.S. government fires up the printing presses, inflation over the next decade will almost certainly be significantly higher than we’ve experienced over the last ten years. Yet, at the present time all maturities of U.S. Treasuries yield LESS than even the officially recognized inflation rate. And here's what really gets us scratching our heads: When financial types talk about risk premiums, they mean the spread that can be earned above and beyond the "risk-free" rate of return. That is the amount investors are paid to assume risk. Why would anyone want to lock up money for 10, 20 or 30 years by buying (taxable) U.S. Treasury bonds yielding less than inflation? They shouldn’t, but right now they do. So what happens if/when the so-called “bond vigilantes” of the 1980s reappear and drive up treasury rates to levels that more appropriately reflect future inflation? Well, not only would the prices of the Treasury bonds themselves actually drop but all other forms of risky assets priced off of them would also decline to re-establish their risk premiums ABOVE the new higher “risk-free” rates.

Nobody knows with absolute certainty how the future will play out. Nonetheless, these are important issues to be thinking about. Indeed, they may ultimately prove to be the most critical determinants of prices of virtually every type of investment asset in the world for the foreseeable future. Eventually, markets will adjust prices of risky assets such that long-term rates of return adequately compensate investors for both inflation and a risk premium attached to the underlying asset. When they do, the last zombie will have been whacked on the head, and the foundation for a new secular bull market established.

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