

# What Now?

October 2008

# Agenda

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- What happened and why?
- A couple of ugly years in prospect
- Making money out of it all
- Commercial break
- Discussion

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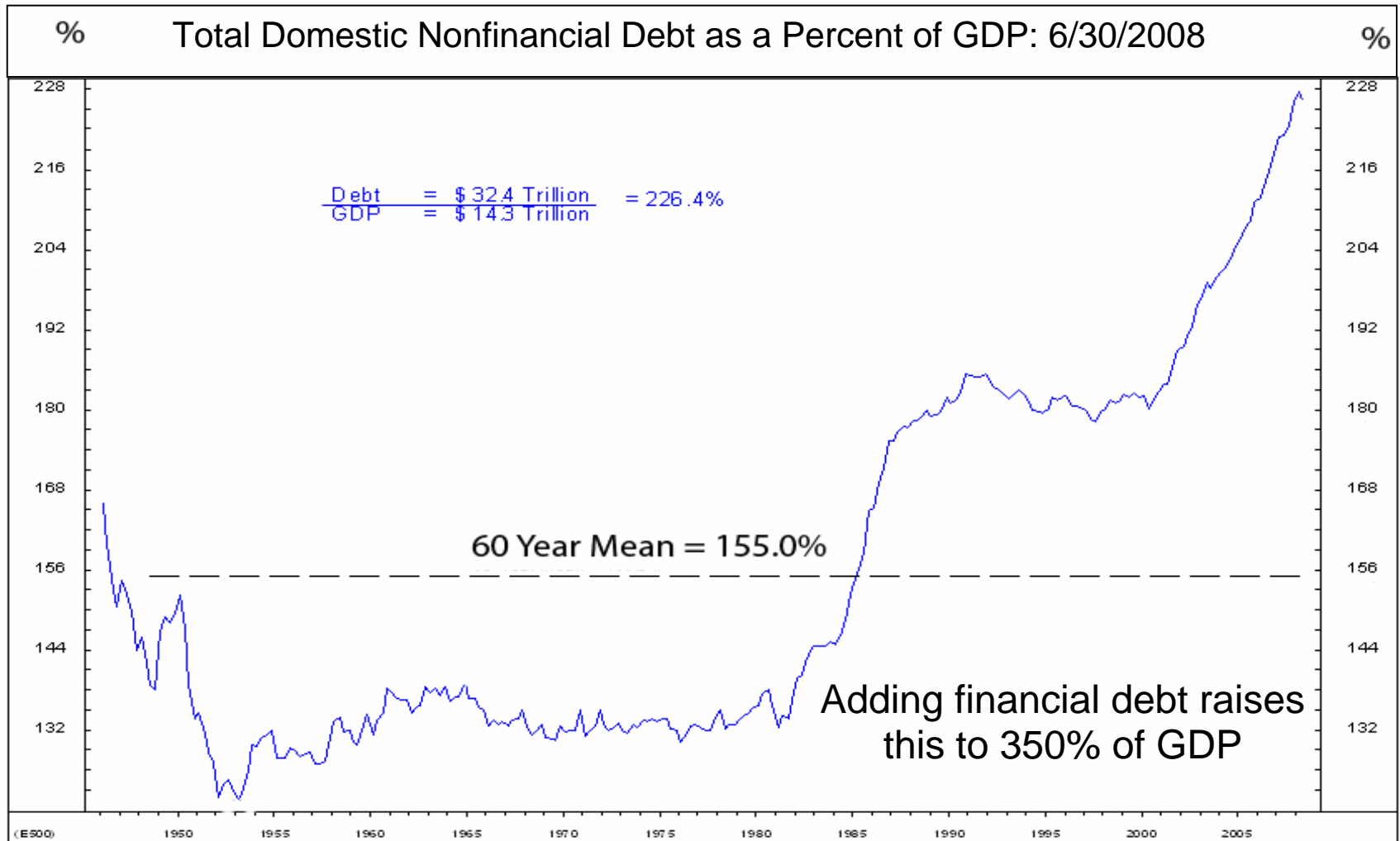
- **What happened and why?**
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# What Happened and Why?

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- We all borrowed much too much
- With deteriorating credit quality
- Leverage excess created the “spiral of doom”
- The Fed and Treasury have been trying to short-circuit the spiral

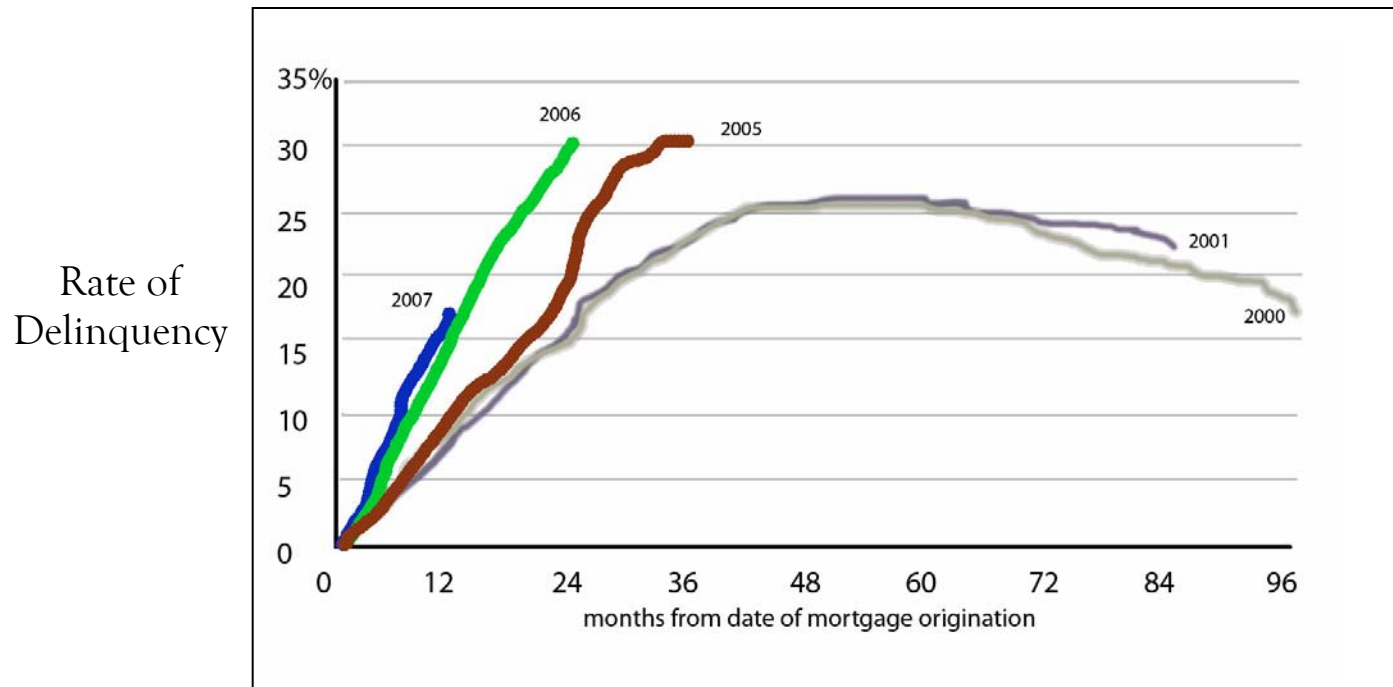
# We All Borrowed too Much



Source: Ned Davis Research

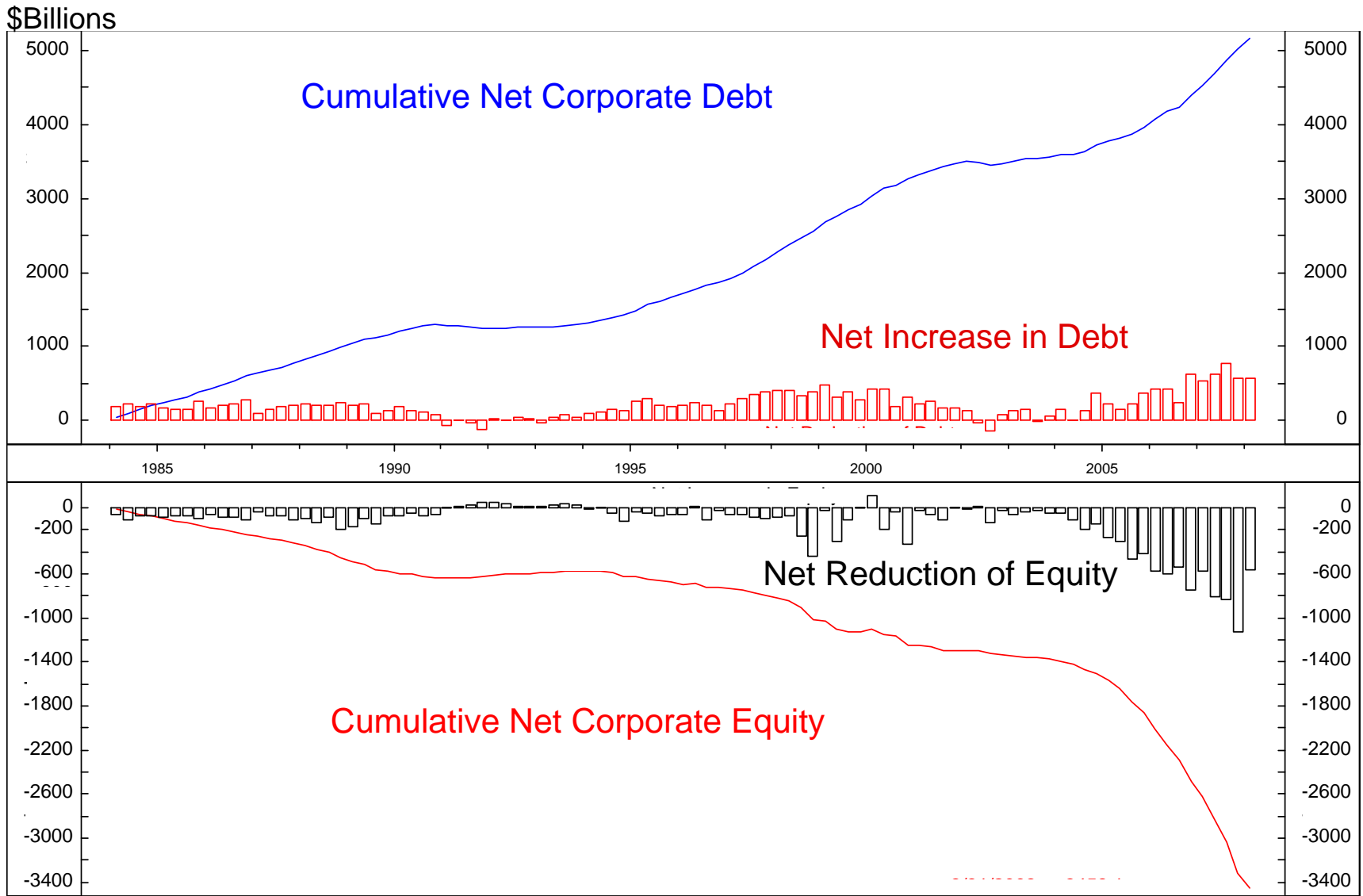
# With Deteriorating Credit Quality for Household Loans

## Subprime Mortgage Delinquencies



Source: *Wall Street Journal*, 5/5/08

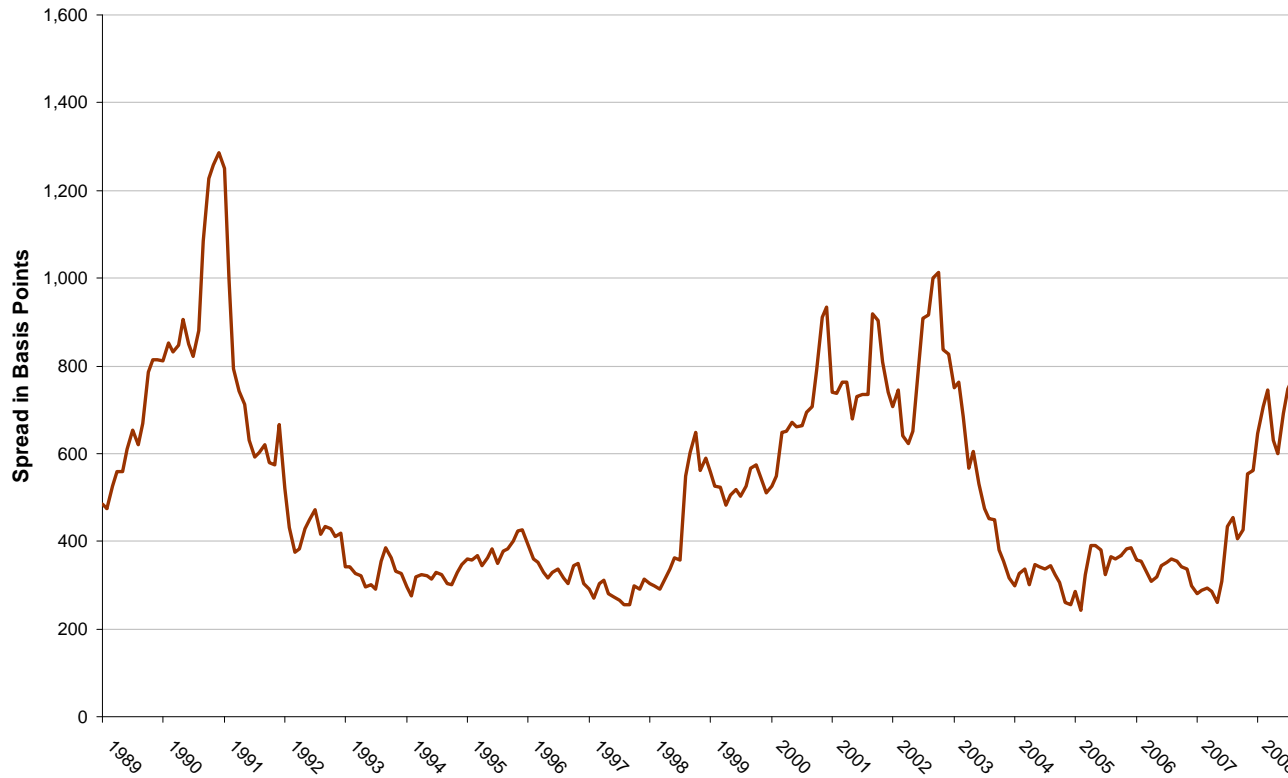
# While Companies Deteriorated Themselves



# Troubles Are Coming For Corporate Debt As Well

## Credit Cost and Default on Junk Debt . . .

Spread of Lehman Brothers High Yield Index over the 10-Year Treasury



Source: Bloomberg LP.

10%-15%  
default in  
next 12  
months!

## And for Other Debt Areas

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- ... And commercial real estate
- ... And consumer debt



# Short-Circuiting the Spiral

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- One at a time: Bear Stearns  
Dealer Loan Facilities  
Fannie/Freddie  
AIG
  
- Kill it with one hit:
  - Buy the illiquid, unwanted assets
  - Give the banks cash and rebuild trust in their solvency
  - Work out troubled assets over 5-10 years
  - Change the rules, somehow

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## A Couple of Ugly Years in Prospect

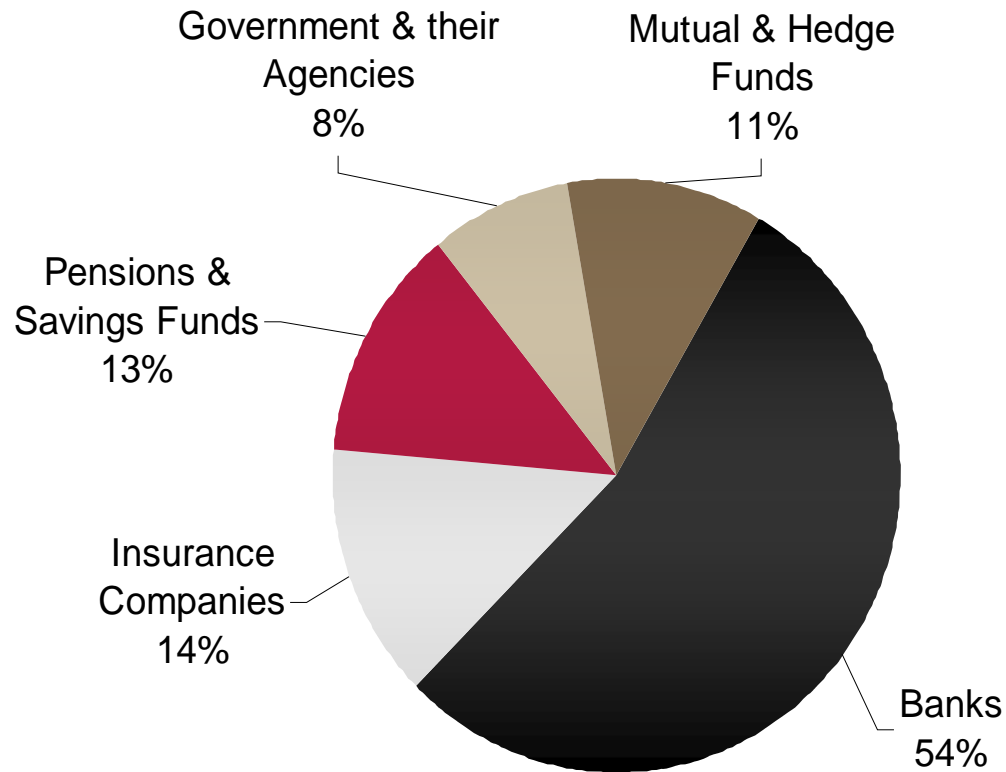
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- Large investor losses, especially for households
- We are in a recession caused by contraction of credit
- Largely by coincidence, so is the rest of the world (or at least slowing down)
- But this is for 2 years, not a lifetime!

# Large Investor Losses Merely on Credit

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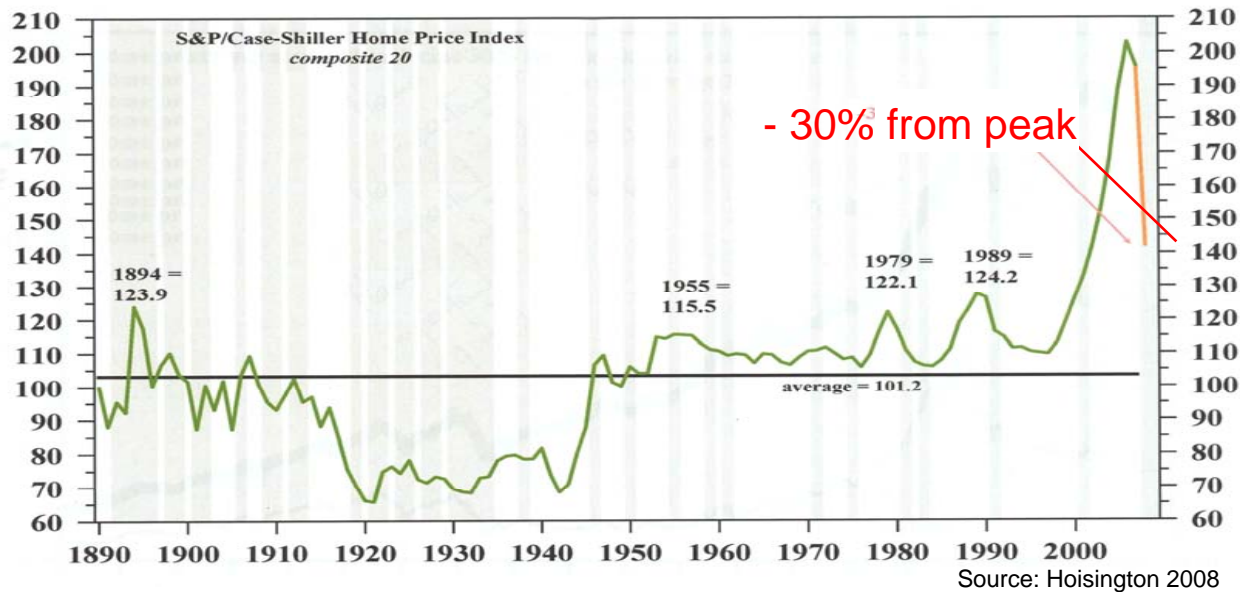
Total = \$1.5 Trillion



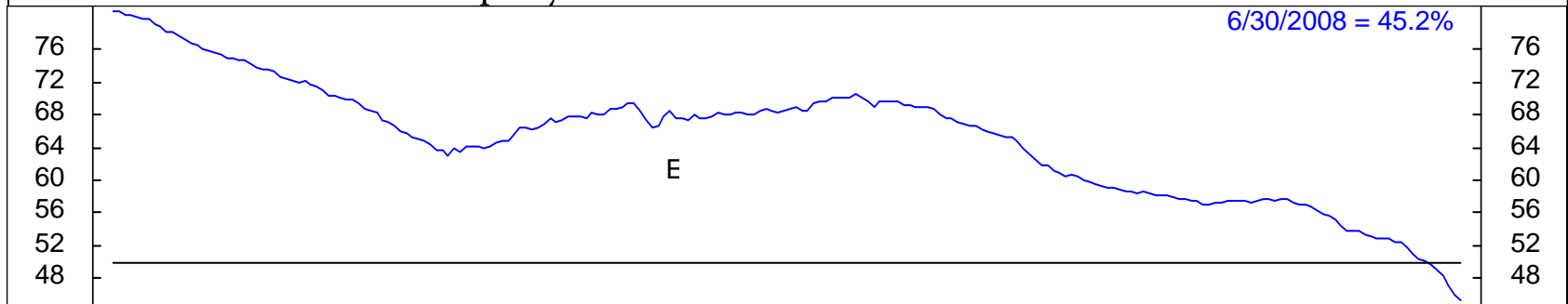
Source: *IMF Global Financial Stability Report*, October 08

# Households Will Be Worst Hit in Their Major Asset

**U.S. Real Housing Price Index 1890-2007**  
*annual, index 1890 = 100*



**Owners' Equity as a Percent of Household Real Estate**



Source: Ned Davis Research

# Financial Losses Are Even Larger

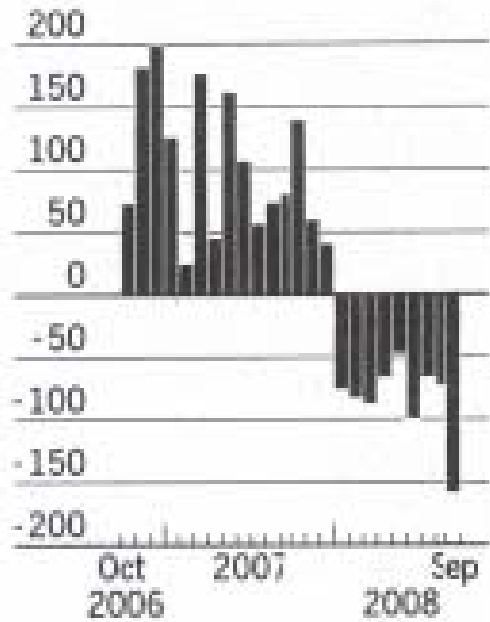
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- Trillions of dollars wiped off equity holdings
- 401(k)s, IRAs ravaged for boomers approaching retirement
- Similarly large losses for pension plans, insurance issuers of annuities: Will they all meet promises?

# We Are in a Recession ...

## US non-farm payroll

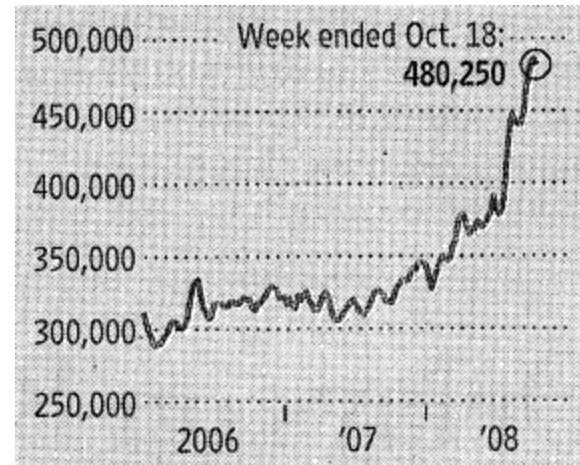
Monthly change ('000)



Source: Thomson Datastream

## Weakening Labor Force

Initial jobless claims,  
four-week moving average



Note: Seasonally adjusted

Source: US Labor Department

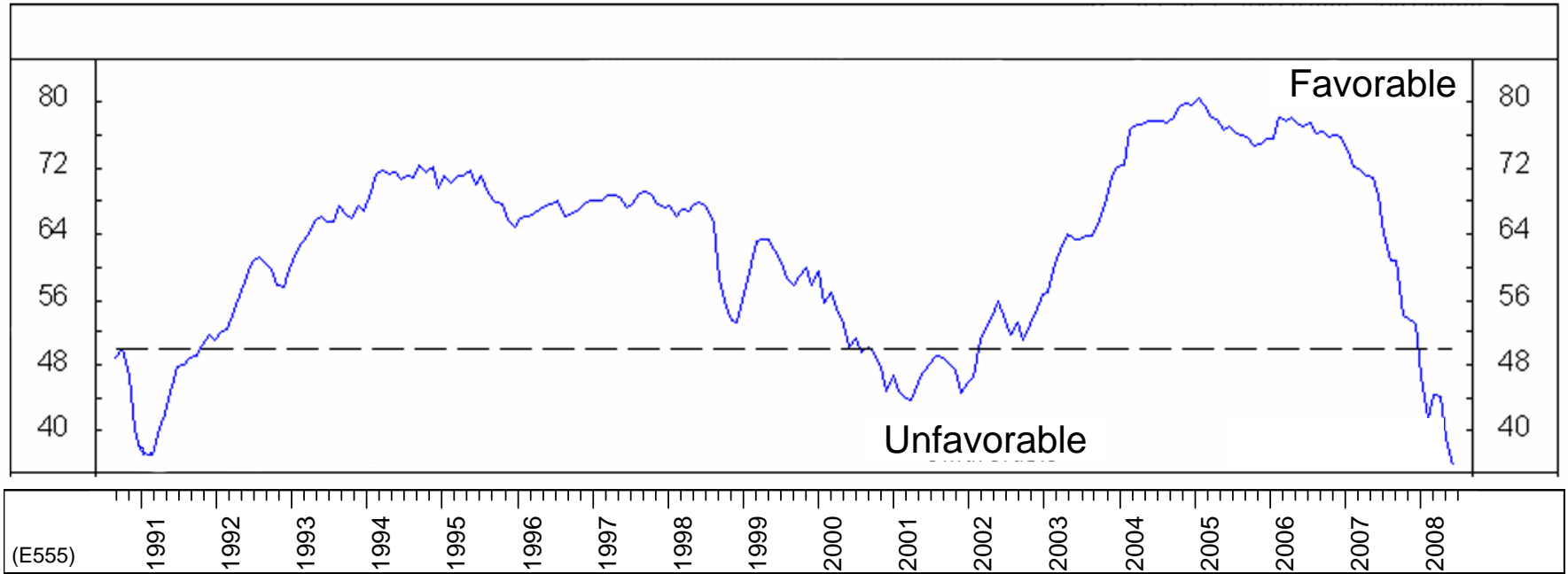
## ... Caused by Contraction of Credit

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- Eroding bank capital  $\Rightarrow$  banks can't lend more
- Higher loan standards  $\Rightarrow$  banks won't lend more

# Credit Is Harder to Get and More Expensive

## NDR Credit Conditions Index



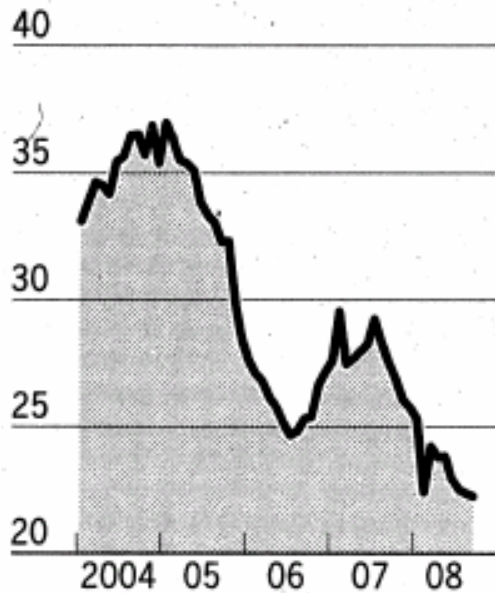
Source: Ned Davis Research

# Even the Chinese Dynamo Is Slowing Down

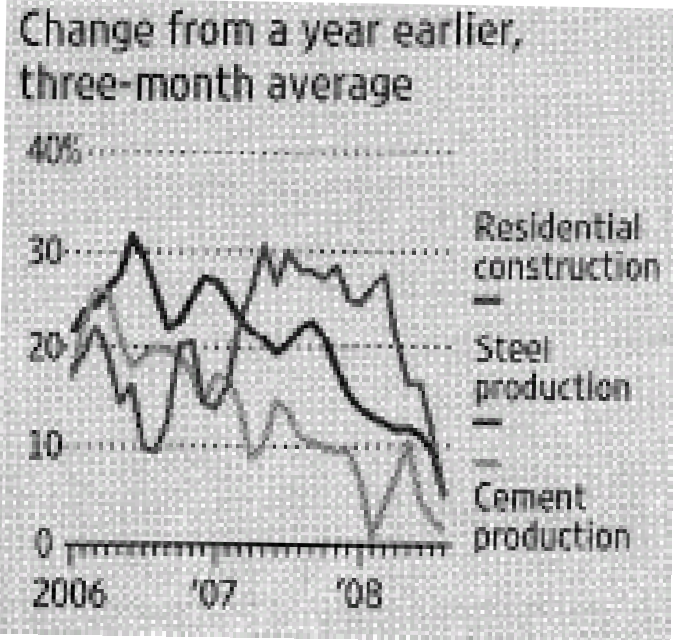
## China falters

### Exports

(annual % change, 12 month sum)



Source: Thomson Datastream



Sources: Rhodium Group (construction); National Bureau of Statistics; US Commerce Department (housing)

## Other Countries Are Harder Hit

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- EU moving into recession at least as bad as ours
- Eastern European “net borrowers” in deep distress
- Russia, India, Brazil, Middle East suffering accelerating inflation, falling export revenues, exploding government deficits.

## Two Years, Not a Lifetime

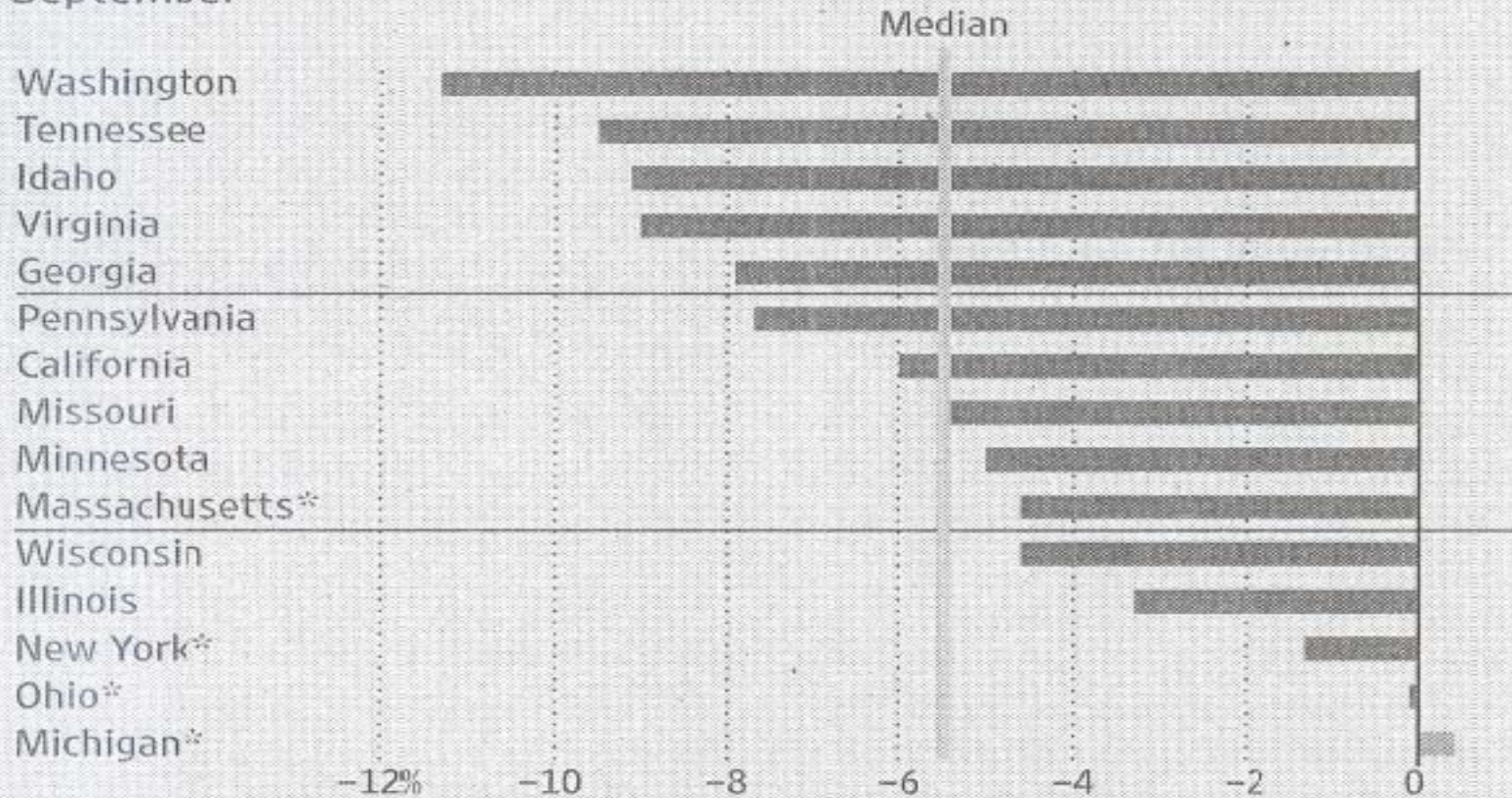
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- Credit markets will, ultimately, respond to trillions
- Equity markets in US are cyclical not terminal: Value will be written back
- As growth resumes in Asia, raw material and energy prices will rebound
- However: employment, construction, retailing, consumer durables, municipal finances will all deteriorate and start to repair in 2010/2011

# Locally Distressing

## Taxing

Change from a year ago in state tax revenue collections for July through September



\*Figures are influenced by enacted tax changes

Note: Figures are adjusted for inflation

Source: Center for Budget and Policy Priorities

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# Making Money Out of It All

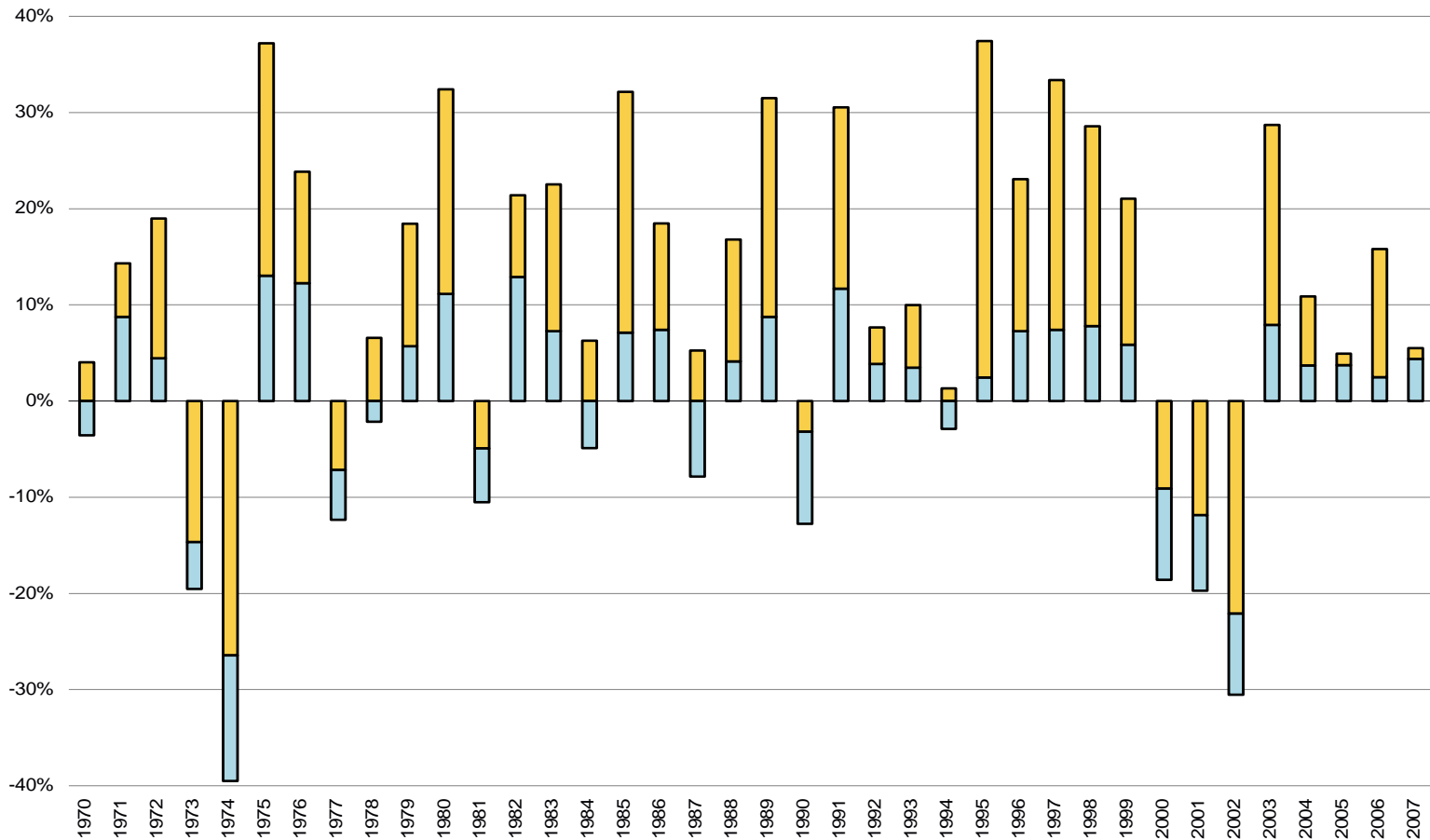
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- Don't lose money by getting out!
- There are extraordinary bargains, especially in the credit area, but follow the vulture rules ...
- Longer term, follow the *New Economic Order*

# Don't Lose Money by Getting Out

Annual Return
  Annualized Return Excluding the Best One-Month within the Calendar Year Time Period

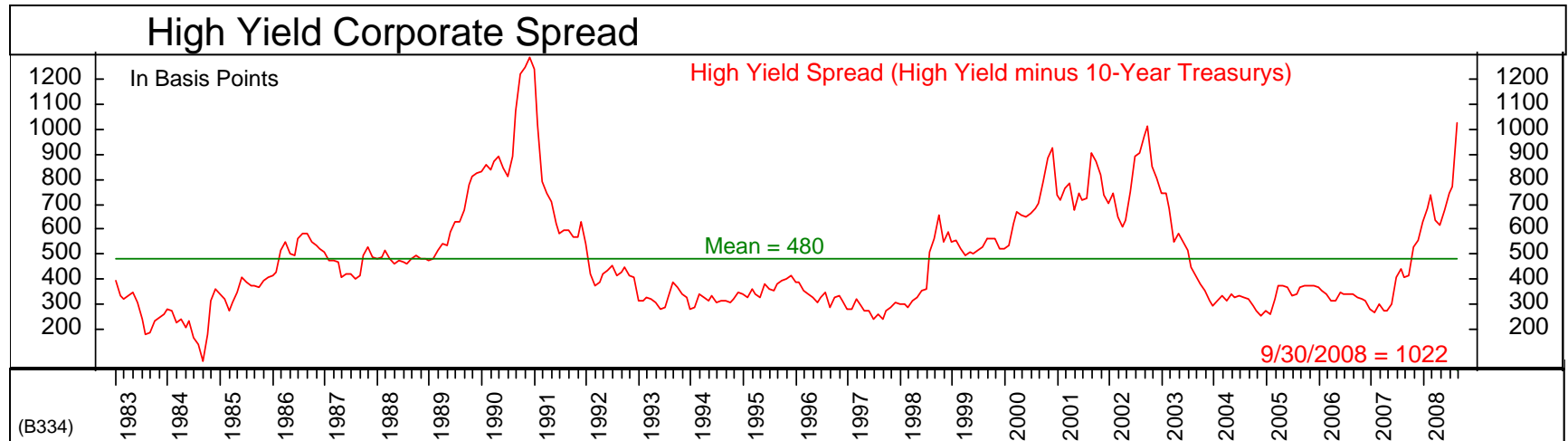
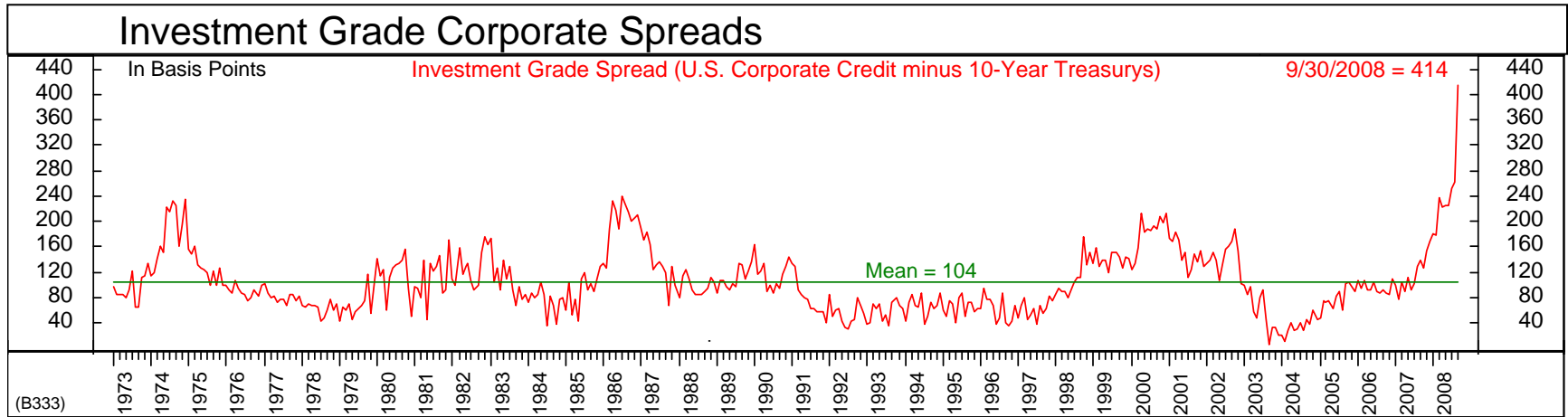
**S&P 500 Index Annual Total Return  
1970 – 2007**



**Note:** The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results.

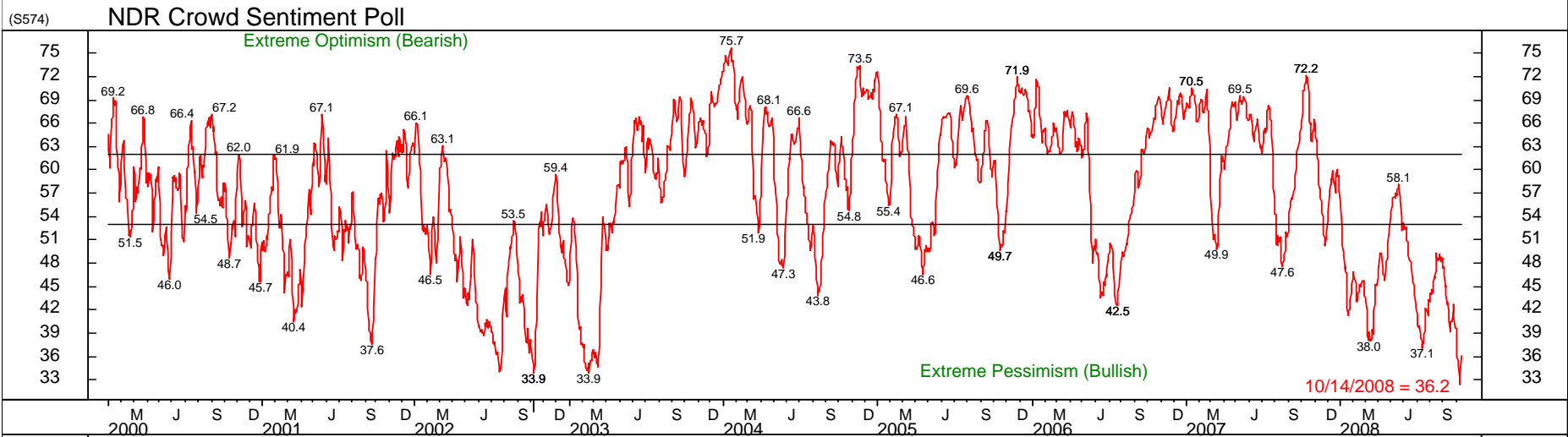
**Source:** Ibbotson Associates, Morgan Stanley Global Wealth Management Asset Allocation Group.

# Every Kind of Bond is Underpriced



Source: Ned David Research

# Stock Prices Represent Extremes of Fear

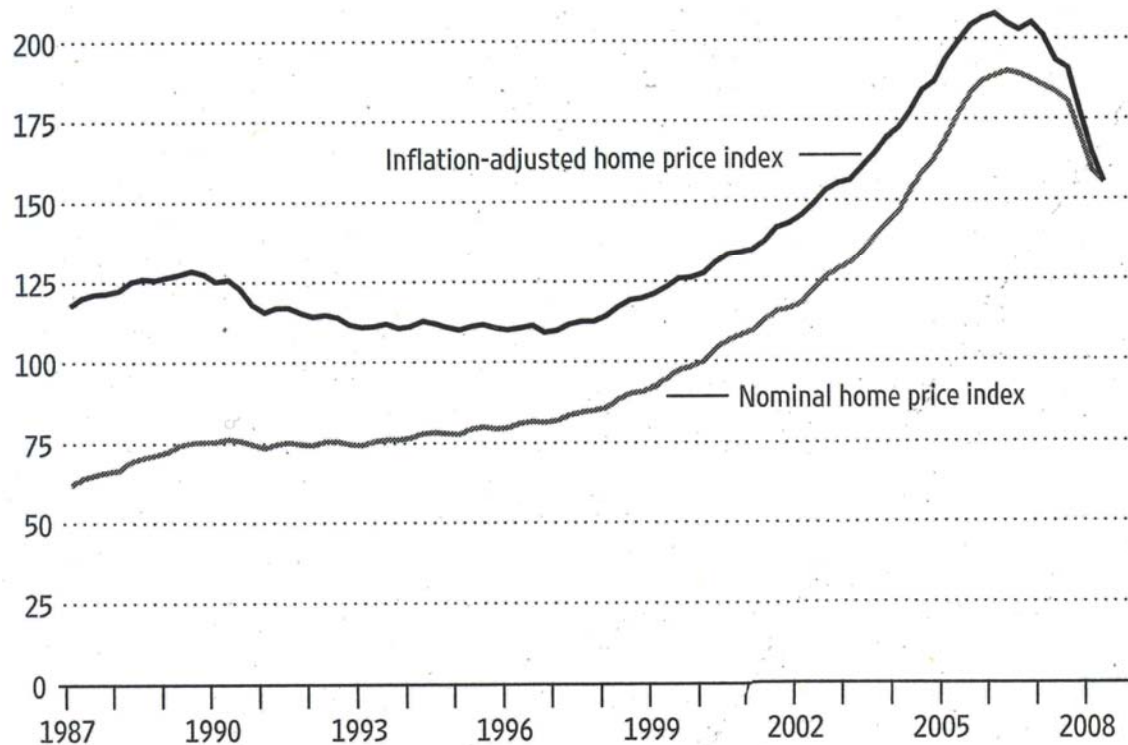


Source: Ned David Research

# But Do Sell Your House if You Can!

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S&P Case-Shiller National Home Price Index, 1987-2008



Source: Standard & Poors

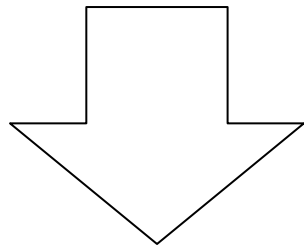
# To Make Money at Times of Distress, Follow the Vulture Rules

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- Dig Deeply
- Diversity
- Dither

## Dither, Because We Face a Few More Months of Falling Prices

- Investors demand redemptions
- Lenders make margin calls
- Retail investors panic



Forced sales triggering more forced sales

# New Economic Order

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- US: fall in share of consumption in GNP
- World economy in better shape than ever (if you look beyond the recession)
- Recession cycle will create a buying window

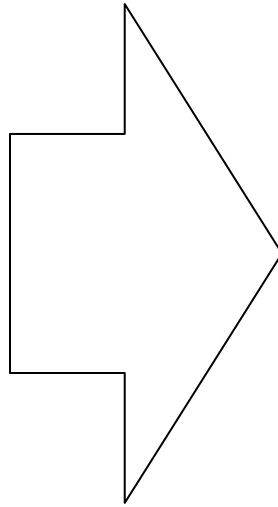
# Fall in Share of Consumption

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- 60%-65%  $\Rightarrow$  70%-75%  $\Rightarrow$  60%-65%
- We will need 10%-15% LESS
  - Retail space
  - Retail employees
  - Retail delivery & support systems
- We will have 25% MORE
  - Infrastructure
  - Business investment
  - Government activity

# World Economy in Better Shape Than Ever

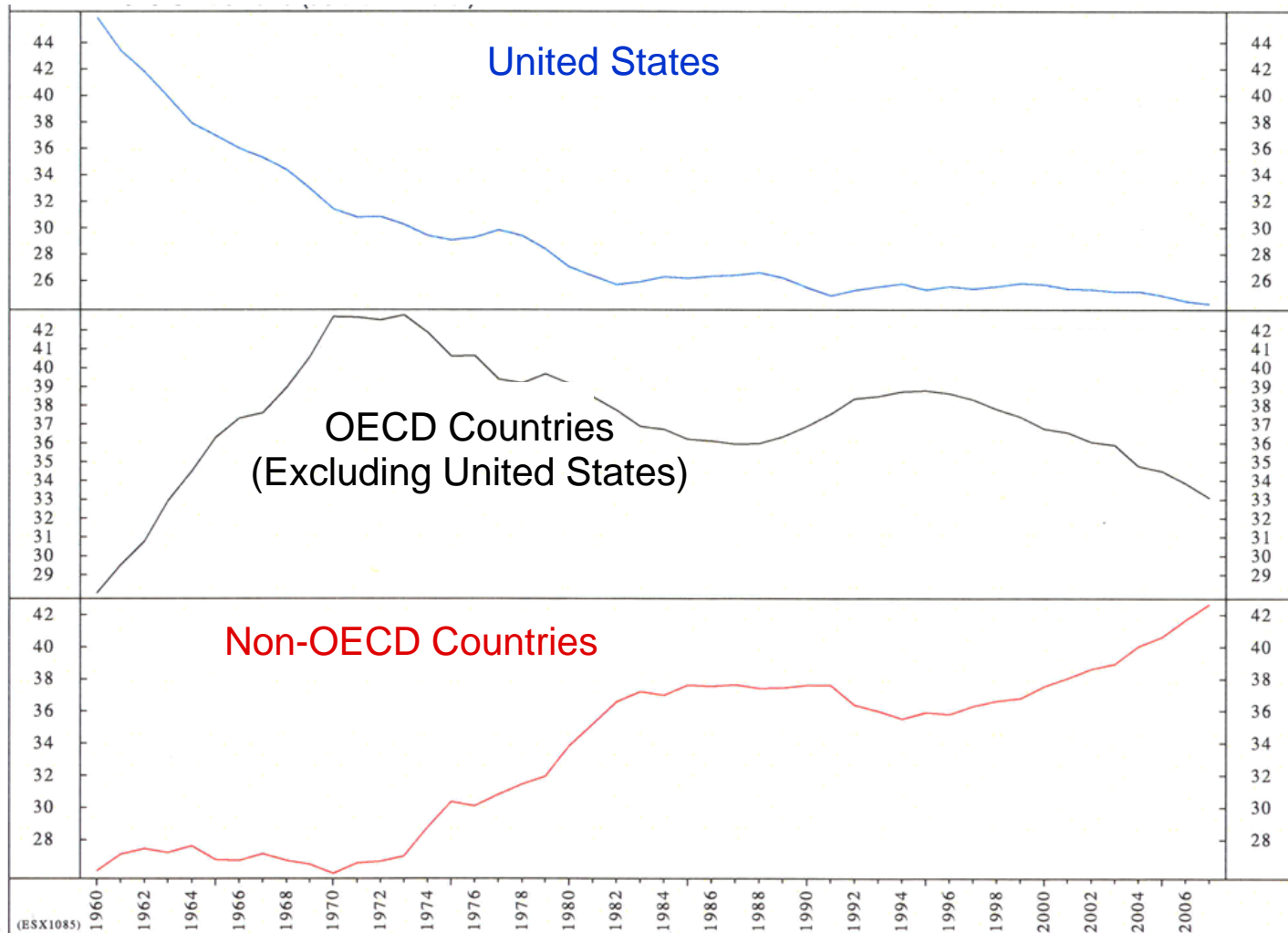
- Globalization/trade
- Fall of Iron Curtain/  
market processes
- Free capital mobility



- Rapid emerging market growth
- Rapid growth of middle class
- Increasing “decoupling”

# Energy Demand Driven by Emerging Countries

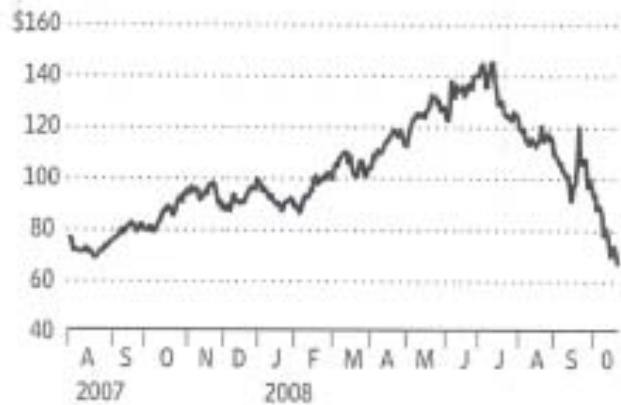
## Share of World Oil Demand (%)



Source: Ned Davis Research

# Buying Window

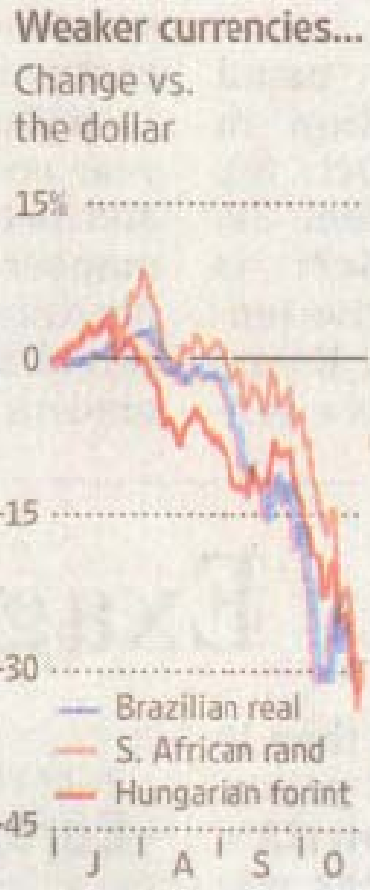
Daily oil futures price, August 2007-October 2008



Dollar vs. the Euro, August 2007-October 2008

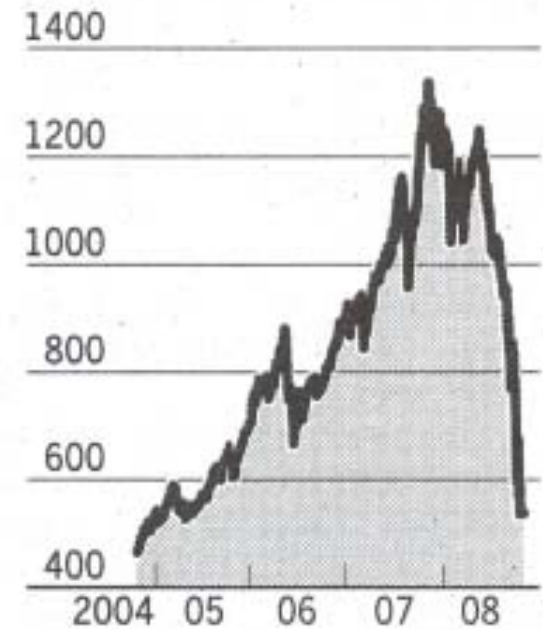


Source: WSJ Market Data Group



Sources: J.P. Morgan; WSJ Market Data Group; MSCI

Emerging market equities MSCI index



Source: Thomson Datastream

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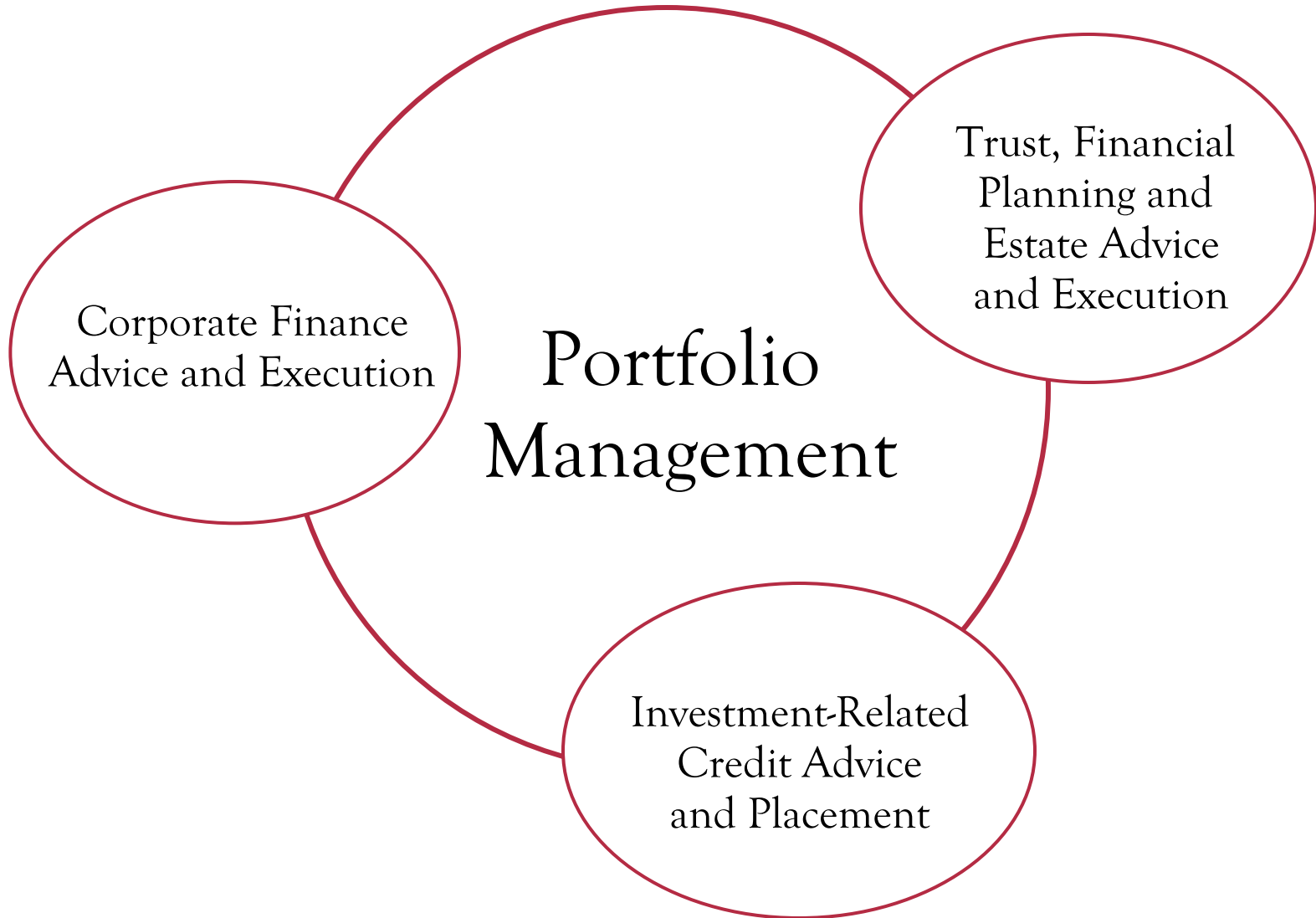


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