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The Credit Crunch Part II: Waiting for the Other Shoe to Drop

Introduction: The Credit Crunch Part I



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In the August 20 edition of *Strategic Insights*, we analyzed the causes of the escalating crisis in debt markets, a crisis the media has dubbed “The Credit Crunch.” We concluded that investors had underestimated the risks of certain Collateralized Debt Obligation securities (CDOs). By underestimating the investment risks of these complex securities, investors were willing to pay too much for these bonds. Since loans are the “collateral” within the CDO, overpriced CDOs created an artificially high demand for loans of every description. High loan demand led to a sharp decline in underwriting standards for almost every type of loan. This decline in lending standards was particularly pronounced in sub-prime mortgages, the mortgages extended to borrowers with poor credit histories.

Rapidly escalating sub-prime mortgage defaults rates alerted investors to the leveraged risks within CDO securities. With losses escalating in their sub-prime CDO portfolios, many investors suddenly went from overpaying for CDOs to being unwilling to buy a CDO at any price. The collapse in demand for CDOs resulted in subsequent collapse in demand for loans. Suddenly, even qualified borrowers found it almost impossible to obtain a loan, and a credit crunch began.

We made three predictions concerning the credit crunch in our August 20 publication:

1. The Fed will need to act aggressively to counter the impact of the credit crunch.
2. If the Fed acts aggressively, the economy can avoid recession thanks to the relatively sound balance sheets of banks and other major corporations.
3. The bull market in equities will continue, but future gains will likely come at a less exuberant pace.

In this follow-up to our earlier publication, we examine each of these predictions in light of subsequent events and revelations. We then craft an outlook for the markets incorporating what we have learned over the past few months. Our primary conclusions are:

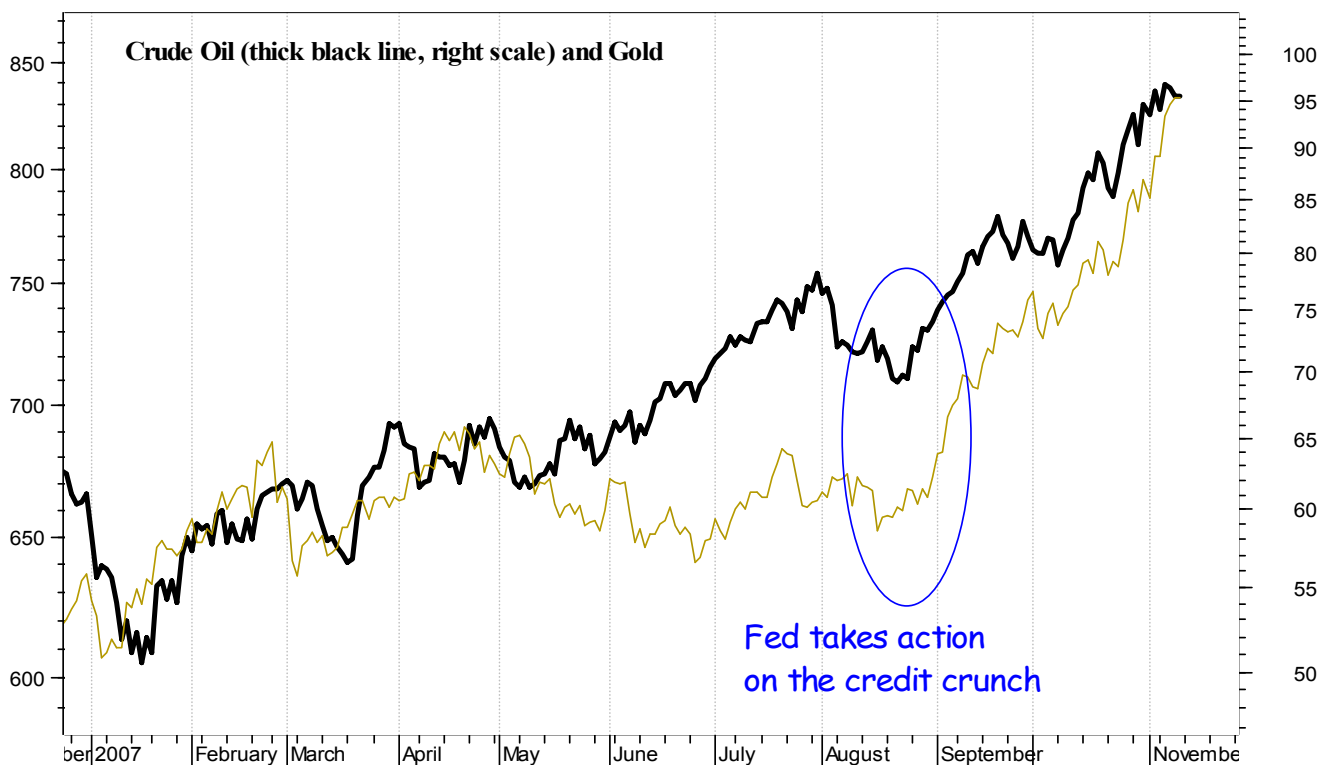
1. While the Fed has aggressively lowered interest rates to counter the impact of the credit crunch, it would like to see current inflationary pressures ease before lowering rates any further.
2. Financial institutions are weaker than we originally thought, primarily because they used CDO technology to leverage risks rather than sell off those risks. In our opinion, the weakened banking system increases the risk of recession and could require the Fed to continue lowering rates irrespective of the inflation outlook.
3. Based on our assumption regarding future Fed policy, we believe that the bull market in equities will continue over the next year, but with relatively modest gains (“Boring but Up” markets). However, our confidence in this relatively benign forecast has declined somewhat since our August 20 analysis.

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Prediction 1: The Fed will likely need to act aggressively to counter the impact of the credit crunch.

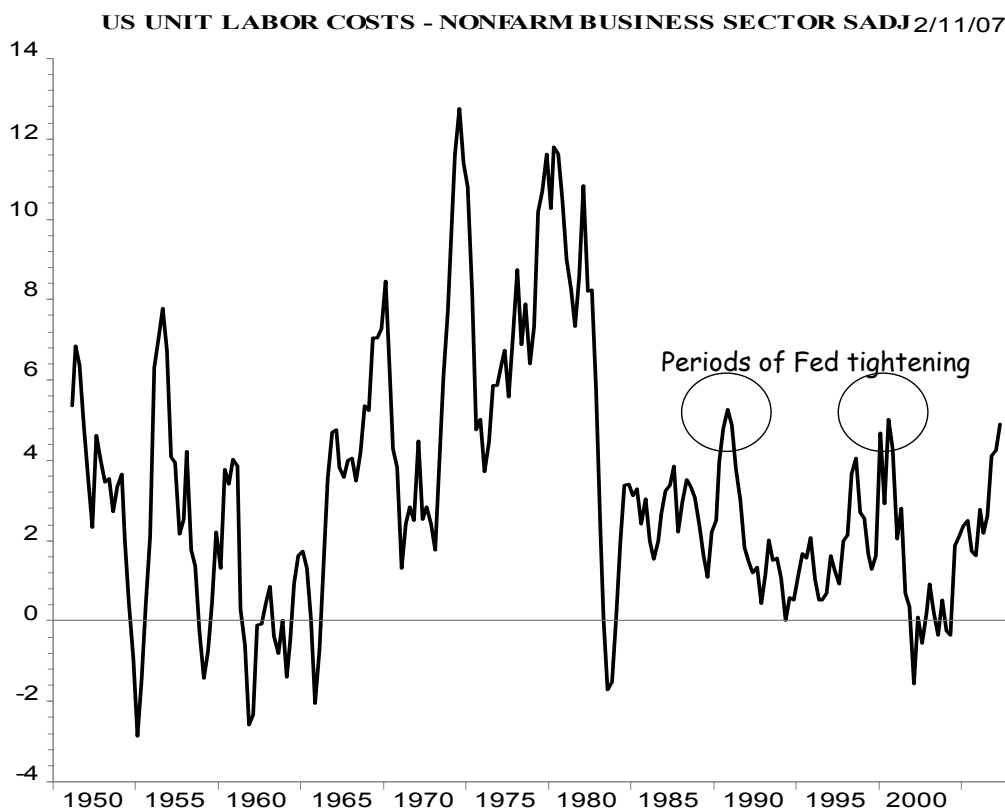
Federal Reserve Board Chairman Ben Bernanke and his fellow policy makers apparently concurred with our assessment of the action required by the Fed. Since the publication of our *Strategic Insights* paper, the Fed has lowered interest rates 75 basis points (0.75%), from 5.25% to 4.50%, starting the easing process with a dramatic 0.50% cut on September 20. The Fed clearly understood the risks posed by the credit crunch and was willing to act boldly to counter those risks. However, the Fed strongly suggested that the market should not anticipate further rate reductions in the statement accompanying its 0.25% cut in rates on October 31. In the Fed's view, the risks to U.S. economy are now roughly equally balanced between the risk of slower economic growth and the risk of additional inflation. Despite this statement and the inflation concerns implicit within it, we believe that the Fed will soon be forced to resume its course of lowering interest rates (as discussed in the November 5 edition of *The Week*).

Most Americans probably don't have any problem understanding the Fed's concerns about inflation. Oil price spikes and the resulting pain at the gas pump tend to be a primary inflation gauge for many Americans. When, as now, gas price hikes are accompanied by sticker shock at the grocery store, inflation perceptions in the economy become disconnected from the financial market's obsession with inflation measures that exclude food and energy. The markets generally ignore price spikes in these two volatile categories because these spikes can be caused by temporary supply shocks or weather-related demand. The current price pressures, however, appear to stem more from increased demand in emerging markets than any temporary factors. As China, India, Brazil, etc., continue to grow, their rapidly expanding middle class demands the amount of food and energy consistent with a middle-class lifestyle. The Fed's concerns about the inflation implications of these developments cannot be eased by the sharp rise in gold, copper, grains and other commodities that followed on the heels of their recent interest rate reductions.



Source: Wachovia Securities; Past performance is not indicative of future results.

Financial markets are also typically willing to discount the impact of food, energy and commodity price rises on potential inflation because labor costs have a far more significant impact on inflation. Unfortunately, the recent news on that front also doesn't look good. As shown in the chart below, unit labor costs have risen sharply over the past year. This means that employers are facing higher costs for every dollar of revenue they generate. While unit labor costs currently remain well below the levels that sparked hyper-inflation in the 1970s, costs are approaching levels that, in the past, have prompted the Fed to raise interest rates to fight inflation.



Source: DataStream; Past performance is not indicative of future results.

With companies facing rising input material costs and rising labor costs, they must either:

1. Lower unit labor costs by cutting wages or improving productivity;
2. Pass cost increases on to their clients through higher prices; or
3. Absorb cost increases in their profit margins and see their earnings growth fall.

Cutting wages lowers the ability of homeowners to meet their mortgage payments, and could further undermine the housing market. A wave of big price increases by major corporations, such as Procter & Gamble's recently announced price hikes, could spark an inflationary spiral. Of the three options cited above, we think the Fed would prefer to see companies absorb higher materials and labor costs in their profit margins. Given the Fed's mandate to fight inflation, we believe it would normally hold off any further rate reductions until economic growth decelerates enough to undermine the ability of companies to charge higher prices, but not enough to tip the economy into a recession. In our opinion, the Fed is attempting to walk a tight rope between the implications of the credit crunch for economic growth and the implications of cost pressures on inflation. As with every tight rope act, even a small misstep can result in a nasty fall.

Prediction 2: If the Fed acts aggressively, the economy can avoid recession thanks to the relatively sound balance sheets of banks and other major corporations.

On Balance Sheet Problems

In our original analysis of the credit crunch, we explained how the CDO market allowed financial institutions to securitize their loans and therefore remove the associated credit risks from their balance sheets. The recently announced charge offs at many major financial organizations is evidence that just because you **can** get rid of your risks does not mean that you **will** get rid of your risks. The frenzy of CDO creation and the resulting fees that were generated apparently caused some firms to relax their risk disciplines. In our August analysis, we stated that we

expected banks to be caught with loans that they had not yet had time to package into CDOs. We did not expect the magnitude of these so called “pipeline” exposures to be nearly as high as they have subsequently proven to be.

Even more surprising to us was the extent to which financial institutions retained the riskiest pieces of the CDO structures. These highly leveraged pieces were often the most difficult to sell. Rather than slowing the CDO machine to clear out this slow moving inventory, some firms allowed a significant number of risky CDO securities to pile up on their balance sheets. When the CDO market collapsed, the risky pieces became almost worthless, and have caused significant losses at major financial institutions.

A final unexpected balance sheet exposure for financial firms is the surprising number of banks and insurance companies that have used CDOs extensively in their investment portfolios. While many of these securities were highly rated when purchased (AAA or AA), the highly leveraged nature of CDOs (especially the so-called “CDO²”) means that ratings can change significantly in a short period of time, unlike “traditional” AAA or AA ratings. In the current market environment, prices fall even more dramatically than credit ratings. Write-downs of these investment portfolio positions are just starting to be announced, and we will need to see how pervasive this problem proves to be.

Off Balance Sheet Problems

For all the on balance sheet risks that have been revealed in recent weeks, the most alarming CDO exposure for financial institutions does not formally appear on their balance sheets. In recent years, Structured (also Securitized or “Special”) Investment Vehicles (SIVs) have been set up to invest in various types of assets, with CDOs typically comprising a high percentage of the portfolio. To fund these CDO purchases, the SIVs issue commercial paper. Traditional commercial paper is issued to fund short-term inventories or receivables. As the inventory is sold or the receivables repaid, the commercial paper is paid off. The commercial paper issued by SIVs, known as “asset backed commercial paper” (ABCP), does not typically have the automatic repayment source of traditional commercial paper. The securities SIVs purchase often have maturities of more than 10 years, while their commercial paper obligations typically mature every 90 days. To repay existing holders of commercial paper, the SIV either has to issue new commercial paper obligations or sell some of its assets.

The exhibit to the right shows the structure of Beta Financial, a fairly typical SIV sponsored by Citigroup. Buying longer term assets and funding with short-term commercial paper at 21x leverage, as Beta Financial did, can be profitable, but the strategy clearly carries significant risks. The worst-case scenario for SIVs is the current market environment, in which no one wants their commercial paper and no one wants their underlying CDO assets either. Holders of the commercial paper would like to be repaid when it comes due, but the only source of repayment is to sell CDOs. With an estimated \$370B¹ in SIVs potentially looking to sell their CDOs, most investors are understandably very reluctant to be the first to step up and buy these assets.

Structured Investment Vehicles



Example: Beta Financial



Assets		Liabilities/OE	
AAA	\$12B	ABCP	\$21B
AA	\$7B	Equity	<u>\$1B</u>
A	<u>\$3B</u>	Total	\$22B
Total	\$22B	D/E	21x

Source: Wall Street Journal, October 26, 2007 (Figures rounded)

¹ Source: Reuters News Service, October 15, 2007

The SIV structure has resulted in many commercial paper investors wanting their money back, but finding no ready source of repayment. That fact alone creates significant pressure on the financial markets. Some of this commercial paper is backed by letters of credit issued by the major banks. If the SIVs fail to sell their commercial paper, then they will draw on these letters of credit. Back in August, the market was concerned that banks did not have sufficient reserves to meet these potential obligations. Fortunately, one of the Fed's first actions to address the credit crunch was to modify the policies governing discount window borrowings, thereby ensuring that banks have the funding to meet their letter of credit obligations. However, these potential obligations could result in banks having to accept billions more in CDOs as collateral for these letter of credit draws. The prospect of owning more of this distressed asset class cannot be a happy one for these institutions.

The implications of the funding problems at SIVs go beyond simply the contingent liability at certain banks, in our view. Hundreds of billions of dollars in long-term assets are sitting in structures that face a daily scramble to secure funding. Unless confidence returns fairly quickly to the ABCP market, these assets will likely have to be sold to long-term investors who can fund them until they mature. The need to transition such a large block of assets hangs over the CDO market and all of its participants. Citigroup and Treasury Secretary Henry Paulson are attempting to structure a "super" SIV designed to make this transition as smooth and painless as possible. The difficulty they are having in pulling this structure together illustrates the problems faced in transitioning such a large block of assets. With a substantial number of motivated sellers, buyers are offering very low prices for the SIV assets. SIVs are understandably reluctant to sell at these distressed levels. Potential buyers are apparently content to wait until funding pressure forces the SIVs to meet their terms.

Implications for Fed Policy

CDOs were supposed to allow banks to manage their risks better than the traditional lending model. By securitizing credit risk, banks were supposed to be better protected from the ups and downs of the credit cycle. Clearly the theory did not work out in practice. In our original analysis of the credit crunch, we underestimated the extent to which financial institutions used CDOs to leverage their risks rather than reduce those risks. Until the SIV assets begin to transition into the hands of long-term investors, the CDO market is effectively frozen and very few securities are being traded. This means that financial institutions holding CDOs cannot accurately assess the current market value of their holdings and therefore the extent of their losses. Such uncertainty concerning the ultimate extent of their losses could potentially prevent banks from extending new loans, even to qualified borrowers. As a result, it appears that the credit crunch is likely to be deeper and more painful than we originally suspected.

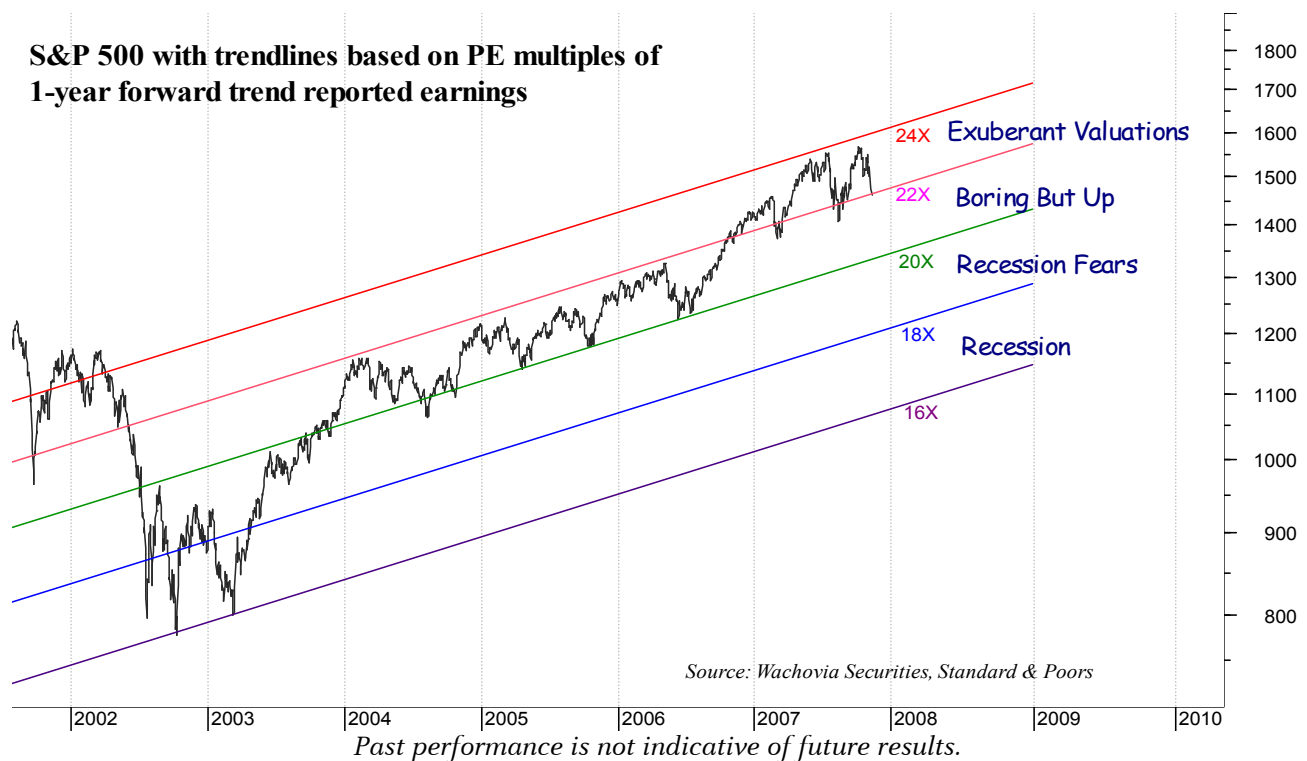
Unless decelerating economic growth in the U.S. quickly abates inflationary pressures, the Fed will be forced to choose between protecting the economy from inflation or protecting the economy from the credit crunch and a potential recession. We believe that the Fed would rather risk accelerating inflation than risk the potential deflationary bust of a global credit meltdown. As Greenspan indicated during a 2002 speech to the Economic Club of New York, the Fed is more comfortable fighting inflation than deflation because it has won battles with inflation, but has little experience in successfully fighting deflation. If the credit crunch remains as intractable as we expect, then the weakened state of our banking system is likely to push the Fed into additional rate reductions in the months ahead.

Prediction 3: The bull market in equities will continue, but future gains will likely come at a less exuberant pace.

Our assessment of the equity markets back in August was premised on an assumption that the market would be caught in a tug of war between bad news and good news. The bad news was that the housing market would continue to deteriorate and that leveraged buyouts would be harder to fund. The good news was that the Fed must lower interest rates. Our prediction was that the good news would outweigh the bad, but that the bad news would cause the market to rise at a slower pace during the second half of the year.

Market action since our report confirms that the bull market is still intact, but the markets waited until the past few trading days to validate our caution about exuberance. As shown on the chart below, when the S&P 500 is trading above about 1490 we consider valuations exuberant and the market to be pricing in optimistic assumptions regarding earnings growth. After testing this key level several times, the market finally broke below 1490 a few days before this

report was published. Breaking 1490 does not, in our view, signal the end of the bull market. Rather, the market is simply repricing for a less than perfect economic and earnings outlook.



As we suggested in August, we believe that the market will return to the “Boring but Up” trading band that characterized market behavior for much of 2004 through 2006. Now that the market has fallen out of the exuberant zone, we believe investors should be prepared for the market to test further lows as it establishes its new trading range. We believe that the next test will be at 1440, a level approximately equal to the middle of the “Boring but Up” zone. If this level fails to hold, we would still not be questioning the long-term bull market. Only a break below 1370 would force us to call into question our “Boring but Up” forecast.

The primary risk to our “Boring but Up” forecast is the Fed’s signal that it is uncomfortable with the inflation environment, and would like to see companies absorb higher material and labor costs in their margins rather than increase prices. Lower margins and a normal, cyclical decline in earnings are not a threat to our forecast, because we believe “Boring but Up” valuations anticipate just such an earnings decline. However, recent economic data remain consistent with positive economic growth, and the Fed could be tempted to delay further easing until it sees some reduction in inflation pressures. We believe that offsetting the economic impact of the credit crunch will require additional Fed action in the near future and that the Fed will take that action as needed. If we are wrong and inflationary fears keep the Fed from taking action for an extended period of time, equity markets could be vulnerable to a more painful correction into the “Recession Fears” zone.

Implications for Portfolio Strategy

Given the threat posed by the credit crunch, we believe that the Fed will not be able to keep policy on hold for long. In our opinion, any delay in taking action will simply increase the ultimate magnitude of the interest rate cuts. Accordingly, we believe the best strategy for investors going forward remains the strategy that was articulated in the September 24 edition of *The Week*. In that publication, titled *Setting Policy for the “Weakest Link,”* we noted that Fed action to fight a financial crisis has not historically made the weak parts of the market strong. Whether fighting the collapse of emerging markets in 1998 or the tech wreck in 2001 and 2002, the Fed’s easing policy did not have much immediate impact on those troubled markets. Rather, Fed action tended to take the stronger parts of the market and send them into a bubble. Technology bubbled after the Fed’s action in 1998, and housing went into a bubble after

2001 and 2002. The key to setting portfolio strategy, we believe, is understanding those parts of the market that are strong and are therefore likely to get stronger as a result of future Fed action.

If our analysis is correct, then the Fed would rather risk some inflation than a deflationary collapse of the debt markets. The primary beneficiary of an accommodative Fed remains China, Hong Kong, and other economies that explicitly or implicitly peg their currencies to the dollar. By tying their currencies to the dollar, these economies effectively “import” the Fed’s monetary policy. The last thing that China’s economy needs is additional monetary stimulus, in our opinion, but unless they allow their currency to appreciate far more than has previously been the case, that is precisely what they are likely to get. We are suspicious of valuation levels and accounting standards within mainland China, but we continue to invest in the Asian economies that directly benefit from the China boom. Valuations in these “satellite” markets are no longer cheap but, in our opinion, these markets are not at the bubble valuations seen in China. *Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.*

Continued Fed easing will place additional pressure on the dollar, and as the dollar declines commodities are likely to rise. A continuation of the China boom could provide the fundamental demand to support these rising prices. Many commodities have spiked in recent weeks, and these markets appear technically due for a pull back. However, price levels relative to long-term trend continue to suggest reasonable returns over the next decade, and we think commodities continue to offer attractive diversification benefits within an overall asset allocation strategy. In particular, commodities are one of the few asset classes that offer protection from a “reflation” scenario, in which the Fed fights the credit crunch by allowing a temporary rise in inflation. *Buying commodity-based investments allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in these markets. Any investment represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual’s portfolio.*

Our current domestic equity strategy is to overweight large cap companies with a significant international presence. We believe the international diversification of these companies helps protect them from any slowdown in the U.S. and allows their revenues to rise as the dollar falls. Furthermore, their large cap status helps ensure access to funding no matter how severe the credit crunch. Finally, large cap companies with consistent, predictable earnings growth remain cheap relative to their historical valuation levels. If the economic environment becomes more uncertain, we think investors should be willing to pay more for predictable earnings.

From a fixed income perspective, we continue to underweight credit risk. Agency backed mortgage securities offer the yield and credit quality we are seeking, and prepayments are likely to be depressed by continued problems in the mortgage industry. Despite our fears concerning the credit crunch, we are cautious about the long end of the yield curve. If inflationary pressures are not eased by the economic consequences of the credit crunch, we believe that the Fed will choose to fight the credit crunch rather than inflation. This would suggest a further steepening in the yield curve. Finally, we are exploring whether Treasury Inflation Protected Securities (TIPs) make sense at current levels. Headline inflation is likely to remain high over the next several months, in our view, given the sharp rise in energy prices. This spike in headline inflation could potentially add substantial incremental yield to TIPs over the next several months.

Conclusion

When the Fed lowered rates 0.50% in September, the markets breathed a sigh of relief. The Fed’s dramatic action offered the promise of a quick end to the scary conditions in the credit markets. Based upon subsequent events, we believe that resolving the credit crunch will take longer and be much more complicated than we first thought. The nearest historical parallel that we can draw to the current crisis is the collapse of the savings and loan industry back in the late 1980s. That credit crisis took years to work its way through the economy and required strong action from both the Fed and Congress. We believe the current credit crunch will require a similar investment of time and effort before it is resolved.

Important Disclosures

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