

A Perspective on the Economy

October 10, 2008

Executive Summary

- These clearly are uncertain times and they feel bad. Downturns historically have been a normal part of the economic cycle. However, things have been worse before and we have survived.
- The real issue currently is that the credit markets are frozen. Banks are not lending money, even to each other. The Federal Reserve is making extraordinary efforts to restore free-flowing credit.
- Increased globalization means the U.S. economy is intertwined with economies around the world. We have seen unprecedented, coordinated action among the world's major central bankers to try to control what has become a global economic malaise.
- It is our belief that when the market turns, it will do so quickly and dramatically. Historically, the key to capturing the impressive gains that happen at inflections points is to be invested before the turn happens.

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Perspective

President Bush has signed into law Congress's economic-recovery program but financial news continues to be negative. Nevertheless, it's important to understand how now compares to "then." Times truly aren't as bad as they have been in the past. And you don't have to go back to the 1930s; in fact, things were worse in the 1980s.

How so?

- Commercial real estate was lagging.
- There was a \$100 billion deficit in the savings-and-loan equivalent of the FDIC; more than 700 savings-and-loans (S&Ls) went under.
- Virtually ALL money-center banks had negative book values after getting saddled with Third World loans that went bad.
- The prime lending rate peaked at 21.5 percent.

Our perception is our reality

All that said, things FEEL worse now than they did then. Why? We spoke with Todd McCallister, CFA, an Eagle portfolio manager with a doctorate in economics from the University of Virginia, who shared his thoughts:

He suggests that three main drivers helped get us to where we are today:

- The switch to "mark to market" accounting rules
- A near-exponential increase in leverage used by financial institutions
- The proliferation of hedge funds

"Mark to market" rules are fine – and perhaps even preferable, since they are designed to keep institutions "honest" about the value of their holdings – in normal environments but can create a negative spiral effect when certain segments of the market are broken.

Let's use an inexact example: You own a top-of-the-line, late-model, low-mileage luxury car that you want to sell in a slow car-sales

environment. "Mark to market" rules say your car's "value" is equal only to recent transactions. The last similar car was sold under distressed circumstances for \$1,000. Your car, under "mark to market" rules, is now valued at \$1,000 even though it clearly is worth well more than that by any rational measure.

It can get worse. Suppose you and two other people with identical used luxury cars decided to sell your vehicles at the same time. That has created a "glut" of those cars and so supply-and-demand laws dictate each of those luxury cars is now worth something less than \$1,000!

The Securities and Exchange Commission abolished the fixed-leverage rule in 2004 and financial institutions increased leverage from an historical average of around 12 times equity to up to 40 times! Leverage is a great way to increase profits but it can have just as significant consequences on the downside.

Not all hedge funds are bad but the proliferation of hedge funds – a trend in serious reversal this year as hundreds have closed – drives volatility. Many fund managers' rabid, typically momentum-driven pursuit of gains artificially, yet dramatically, have pushed stock prices up and down without much regard for fundamentals.

The fixes

We need to be clear: One, the stock market isn't the problem with our economy right now; the credit market is. Two, our financial system is huge on its own but increased globalization means our economy now is intertwined with the global economy. And it is like an aircraft carrier: It doesn't – indeed, it cannot – turn on a dime.

The first step in moving us through the current difficulties is freeing the credit log jam. Fear appears to be ruling the day. Banks are reluctant to lend to one another because they are afraid. They are afraid of what might happen in the market generally and they are afraid to let go of capital, even for short-term loans. When banks won't lend to each other, they are unlikely to lend money to any other kind of company, either. Short-term financing is, crudely, the gasoline that fuels much of our

economy and the ability to secure working capital is just as much an issue for otherwise solid, growing companies as it is for those who may be teetering on financial ruin.

How is fear manifesting itself in the credit market? Treasuries have nearly a precious-metal cachet to them right now. The “flight-to-quality” demand for Treasuries is nearly insatiable. Meanwhile, the Fed has instituted a plan to back 90-day asset-backed commercial paper in an effort to re-establish faith in that market.

Consider: It was possible on Oct. 8 to buy a 30-year Treasury paying 4.03 percent. Meanwhile, there was 30-day asset-backed commercial paper – now essentially with government support – on the market paying 4.00 percent. One can’t help but wonder how long those kinds of yields for short-term paper will exist before investors find the potential payoff too great to ignore.

The Paulson-Bernanke plan to buy distressed securities from financial institutions is a good first step. They have received Congressional approval to do so but, as always, the devil is in the details. The key – in addition to setting up infrastructure to carry out the plan – is determining the prices “we the people” should pay. Balance will be the objective. Offering banks too much for the so-called toxic paper saddles taxpayers’ with losses, which is – at the very least – a politically unpalatable idea. Offering too little for those securities won’t work, either, because banks will still be forced to take losses, will continue to hoard capital and remain disinclined to make loans.

Let’s go back to the car-sales example: Bernanke and Paulson are suggesting that the government buy the luxury car for something less than what the owner paid for it but an amount that is probably more realistic of its true value than the rate set by “mark to market” rule. Offering the luxury-car owner the distressed-sale price is, in all likelihood, only going to encourage him to keep his car.

Finding the right price – something closer to what the car would be worth in “normal” conditions but accounting for a slow car-sales environment – is the goal. A rational seller, especially a motivated rational seller, may decide accepting 30 percent less than what his car is worth in normal conditions outweighs having to wait for those conditions to return. He may accept that lower price,

even fully recognizing that the buyer may sell it later for a profit, simply to move on.

“Deleveraging” financial institutions, much like freeing the credit jam, is going to take some time. Some of the former Wall Street titans who used leverage to fatten earnings over the last several years are now, essentially, out of business (e.g., Lehman Brothers). Others, including Morgan Stanley and Goldman Sachs, have changed their stripes by becoming bank holding companies. The rules that govern traditional banks are much stricter in many ways, including the use of leverage, than those that govern investment banks.

We are heartened by the proactive and innovative moves Fed Chairman Ben Bernanke is making, not just with other U.S. leaders but in concert with his international peers. Oct. 8 marked an historic day: Six of the world’s major central banks, in a coordinated effort, lowered interest rates 50 basis points. (China separately lowered its rates also but to a lesser degree.) Further, the central bankers issued a joint statement outlining a clear message that the current situation is an international issue that must be dealt with globally.

We believe Chairman Bernanke still has other options at his disposal if the recovery plan in place falters:

- In addition to backing short-term commercial paper, the federal government could agree to guarantee the three-month loans that depository companies make to each other over the next year. That might be just enough confidence for banks to start lending to each other and that, in turn, would encourage banks to lend to businesses and individuals.
- The Fed could directly inject capital into the financial system by taking what would amount to quasi-ownership positions in existing banks. This is essentially what the Bank of England did early this week. Putting capital directly into banks allows the banks to turn around and loan money. But, this must be done carefully. Banks who are afraid of dilution from the government might hoard even more cash.

Further, the Securities and Exchange Commission (SEC), in conjunction with the Financial Accounting Standards Board (FASB), could suspend the “mark to market” rules for specific assets that are in “broken” segments of

the market where nothing is moving whatsoever. The economic-stimulus plan approved by Congress and signed by President Bush on Oct. 3 calls for the SEC to examine this issue and issue recommendations by early January.

In the meantime, the accounting-standards board has issued guidelines that would appear to allow companies to use internally generated values for certain assets in illiquid markets. Under those rules, companies could hold on to assets presumed to have much higher value in “normal” market conditions without having to raise extra capital. That is especially helpful for financial-services companies, which are obliged to keep certain levels of cash on hand to “balance” bad debts. Questions about a company’s liquidity have been a trigger for the death spirals we have witnessed among companies that otherwise may have had solid long-term fundamentals.

Outlook

Economies are cyclical. We appear to be in a recession, which is defined as two consecutive quarters of negative GDP growth. Third-quarter GDP numbers will be negative and fourth-quarter numbers likely will be, too. But that hardly means depression: a word that is, in our view, being carelessly bandied about.

The Great Depression happened primarily because the federal government and regulatory agencies were slow to respond initially and then made wrong decisions – e.g., raising tax rates, raising interest rates and imposing import tariffs – that exacerbated existing problems. As we already have discussed, the federal government, a strong Federal Reserve and other regulatory agencies – here and abroad – have proven to be more responsive. It took many years to get to where we are now so we likely won’t move away from here in a matter of weeks.

It’s important to remember that the stock market historically has served as a forward-looking, discounting mechanism. It has not been uncommon for the stock market to recover even while newspaper headlines continue to beat the drum of dismal economic news. In 1991, the U.S. economy was lackluster at best (one quarter of negative growth and flat to marginal growth

the balance of the year); we were still working through the S&L crisis; and average earnings for S&P 500 companies were down by 25 percent.¹ And yet the index returned more than 27 percent for the year!

That is why we believe long-term investors should ...

Stay the course

Investors should have a long-term plan and stay with it. It’s our belief that when the market turns, it will turn quickly and dramatically. But it’s impossible to predict when that will happen. Historically, the key to capturing the impressive gains that happen at inflection points is to be invested BEFORE the turn happens. Many investors wait until after they recognize a turn has happened but, by then, the large gains already are in the books.

There are still many quality companies that will weather this storm. Gains may not be as dramatic as they have been in the past 15 years but a more temperate environment may similarly help prevent dramatic losses. Small-cap companies historically have led coming out of recessions; indeed, small-cap stocks have outpaced their large-cap brethren by 15 percentage points since May.

The key to investing here is having confidence in a manager’s ability to pick stocks he or she believes will perform well on a risk-adjusted basis over the long haul. We here at Eagle believe we have a solid lineup of managers who have proven their ability to do just that.

¹ U.S. Portfolio Strategy, Morgan Stanley Research (Sept. 19, 2008)