

CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

The Bottom?

March proved to be a turning point for equity markets as a strong rally from new multi-year lows left the major indices at more respectable levels for the year. Following a dismal January and February, the equity markets bounced back strong after the first week of March on positive news from the banking sector. Markets were further bolstered by the Treasury's announcement of its bank rescue plan and the month concluded with an upbeat meeting of the G20. The major indices finished the month of March strong with the DJIA finishing +7.94%, the S&P 500 +8.76% and the NASDAQ Composite +10.94% for the month. Despite a strong rally, the indices are still -12.48%, -11.01% and -3.07%, respectively.

In early February, the freshly appointed Treasury Secretary, Timothy Geithner, prepared for his first major press conference and primed the market for the mother of all announcements. Investors were eagerly expecting his first major announcement regarding the financial crisis with the hope that Mr. Geithner would present a solution to the bad assets plaguing under-capitalized banks. Unfortunately, Geithner's announcement fell well short of expectations, leading many to question his qualifications and ability to rise to the challenge of stabilizing the economy. Geithner was previously the President of the Federal Reserve Bank of New York and was extensively engaged in many of the government interventions during 2008. It was expected that his prior employment at the Fed would put him in prime position to jump right into the Treasury job on day one and provide the detailed plan the markets were looking for. The furor over the payout of bonuses at AIG from taxpayer monies brought Geithner further into the public crosshairs. Having been intimately involved throughout the AIG bailout, he clearly should have been aware of the bonuses that were to be drawn from government funds.

Geithner was fortunate enough to get a second chance to present his plan, despite many in Congress and across the country calling for him to resign after just a couple weeks on the job. On March 23, he finally announced the details, or rather, more details of his bank rescue plan. Equity and debt markets responded favorably, extending their rally from early March. Geithner's plan in many ways is the realization of the initial intention of the TARP program. The TARP plan was originally structured to purchase "bad assets" from troubled banks

but quickly turned into a bank recapitalization structure under Henry Paulson. Geithner's new plan goes back to the original design for TARP, albeit with private investors participating alongside with the government. The Treasury is hoping to incent private investors to bid on troubled assets, namely securitized products such as MBS, CMBS and CDOs, by offering investors the ability to co-invest with the Treasury. To sweeten the pot, the Federal Reserve will provide cheap loans and the FDIC will provide debt guarantees.

Ideally, the plan will work like this. A private institutional investor, such as a mutual fund, hedge fund or private equity fund, will bid on a pool of assets, let's say, a mortgage backed security. Prior to the bids, the FDIC will review the pool and determine what ratio of debt to equity it is prepared to guarantee. For the purpose of this example, let's say they agree to a leverage ratio of 6 to 1, offering debt guarantees for 6 dollars of debt for every one dollar of equity put up by the private investor and the treasury. If the highest bid for our example MBS is \$84, the FDIC would provide guarantees for \$72 (\$72 of debt / \$12 of equity = 6 to 1 leverage ratio) worth of financing. The private investor and the Treasury would split the equity component of the investment, putting in \$6 each. The private investor is putting up \$6 for the ability to share total profits 50/50 with the government. The risk reward potential is attractive for the investors that have the liquidity and expertise to participate in the trade. Is it a good deal for the taxpayer? That is yet to be seen, but it doesn't look good, as tax dollars are levered further.

As with everything, the devil is in the details, and there are many key aspects of the plan that are unknown. While this allows Geithner the flexibility to adapt to changing conditions, the markets have continued to view that as weakness and uncertainty, leading to higher volatility. Some of the details still to be worked out include: borrower's eligibility for FDIC guarantees, lending rates, minimum loan sizes and loan durations. The biggest question continues to be whether the banks will sell at all. The banks holding many of these troubled assets could have sold them already, but were unwilling to take haircuts on assets they considered to be worth more than a stressed marketplace would offer. Conversely, how much transparency is going to be offered to private investors who are expected to bid competitively on the pooled assets? Despite the

participation of the government, there is still a good likelihood that the bid / ask spread during the auction will not be tight enough for assets to be sold. Many of the banks have held out this long without selling, perhaps they think they can drive a harder bargain if they wait longer. Furthermore, in light of the AIG bonus payouts, the negative public perception of private investors generating returns with taxpayer money could be too much for some investors to overcome and, therefore, could limit the private market's participation. Finally, the plan may not be large enough in scope to deal with the problem. The Treasury is hoping to lever \$100 billion of TARP funds to potentially purchase up to \$1 trillion in bad assets. However, as the financial crisis has progressed, the amount of bad assets has increased dramatically as credit card debts, auto loans and commercial mortgages are now being aggregated into the bad assets pool. Given the severity of the current recession and his recent past performance, Geithner's plan has little room for error.

The end of the month was highlighted by the meeting of the G20, the world's leading industrial nations. In past years the meeting has been mostly ceremonial with few real commitments emerging. However, the recent meeting was different, namely because the urgency of the current crisis has forced the participating countries to address issues that can be put off no longer. The resulting agreement to provide an additional \$1 trillion of funds to the IMF (International Monetary Fund) was by far the most positive development from the meeting. Many emerging market countries, namely in Eastern Europe and Latin America, will have trouble rolling over their debt and need access to the IMF for credit. Europe and Japan have already promised to commit another \$100 billion, while the US has offered a credit line to the IMF for another \$500 billion. Even China has decided to chip in \$40 billion now but is posturing for a reform of IMF voting power before it commits more capital. Many emerging countries have been reluctant to commit or draw capital from the IMF, which is often viewed as "Western" organization due to its leadership monopoly by Europeans and Americans. Although the additional capital is needed to help shore up emerging economies that don't have the fiscal capacity to stimulate their economies, it only adds to the debt burden for countries like the US who are already running huge budget deficits.

The sub-plot of the G20 meeting was the debate regarding additional fiscal stimulus and regulation. The US and UK, in one corner, continued to push for more public spending to help bank balance sheets while the overhaul of regulation is put on the back burner. France

and Germany, on the other hand, believe they have committed enough public money to the crisis and see regulation of banks and hedge funds as the most critical next step in the process. Unfortunately, the meeting provided few details despite the lofty rhetoric concerning coordinated global regulation. For example, the meeting provided very little guidance as to how banks should mark down assets to saleable levels. Subsequently, FASB (the Financial Accounting Standards Board) loosened mark to market accounting standards in the US, igniting another rally in bank shares. This may prove shortsighted as there is a lack of global consensus. It is important to support the banking system at the present time, but an earnest discussion of bank regulation has to come sooner rather than later to avoid a repeat of the current crisis. More importantly, the task of reform should under no circumstances be left to bankers themselves who have clearly failed to self regulate.

March may prove to be a turning point for markets world wide, but many risks still remain. The panic of January and February has passed, but fundamental economic conditions continue to deteriorate in many regards, ensuring that the road to recovery will not be straight up. According to Moody's, a ratings agency, March had the largest number of corporate bond defaults (35) since the Depression. The default rate is likely to continue to increase, with Moody's predicting a 14.6% default rate by the fourth quarter. Commercial property markets are also showing stress as consumers and businesses have cut back leaving many spaces open for rent. Earnings continue to deteriorate and the price to earnings ratio of US equities is still high compared to prior recessionary periods. The actions of the Treasury and central banks across the world have stopped the financial system from unraveling, but the future repercussions of massive public spending has received little attention. The massive inflationary effects and subsequent debt load for the US, in particular, will be an albatross hanging over an economic recovery. The long-term effects on the dollar and the US taxpayer have led the Chinese to question the US dollar's status as a reserve currency. The reflation of the economy through public funds has prevented a Depression-like collapse, but it will take years for banks, businesses and consumers to pay off their debts. Will Asia continue to finance those debts? The Chinese appear to be less enthusiastic about buying US Treasuries (perhaps prompting the US Treasury to come in and purchase Treasuries last month) and are looking at diversifying their reserves. As the recessionary cycle continues to unfold, the next meeting of industrial giants may no longer be called the G20, but may be renamed the G2, with the US and China sitting down face to face.