Bianco Research L.L.C.

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Independent · Objective · Original

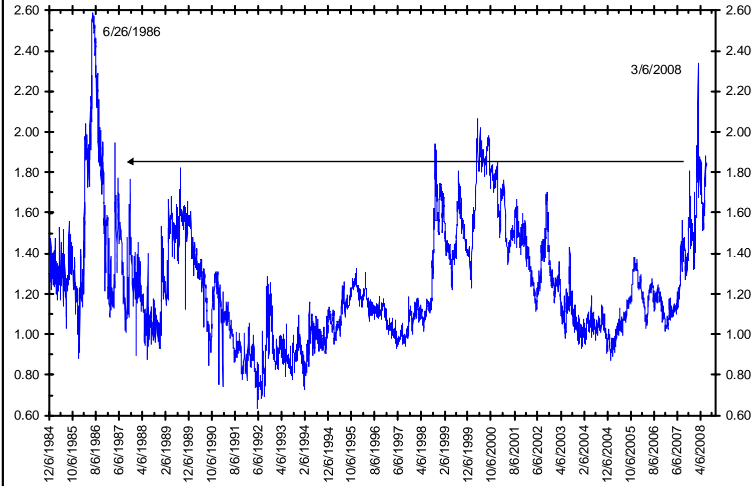
Credit Or Inflation, The Fed's Dilemma

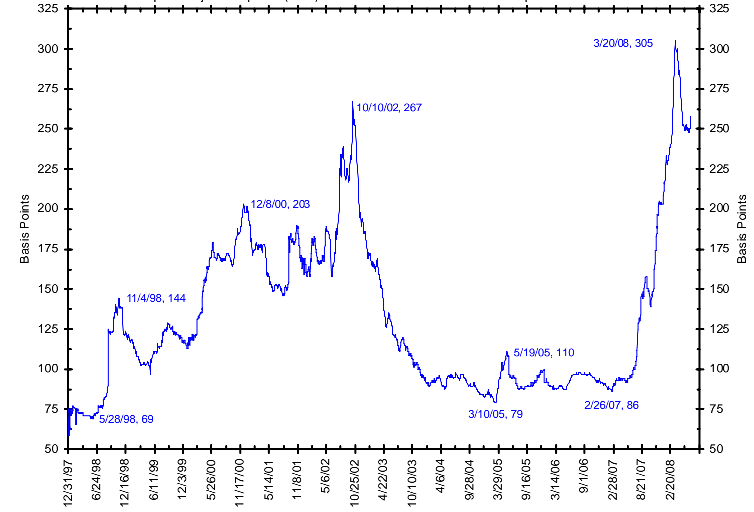
InCapital Presentation Package

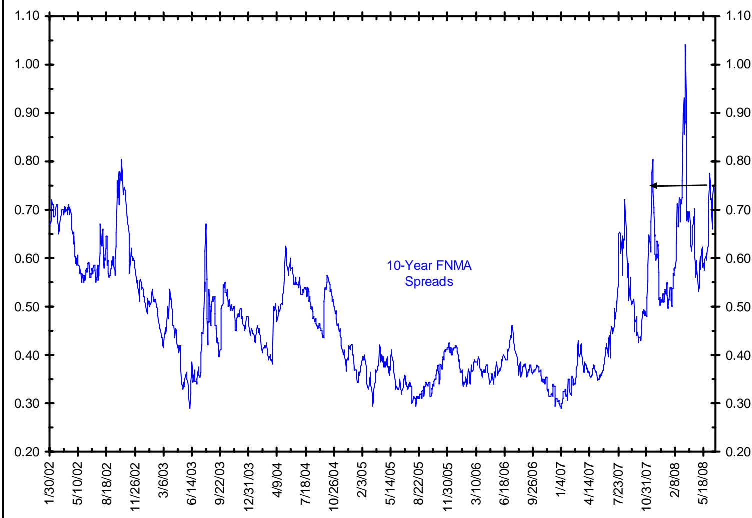
June 26, 2008

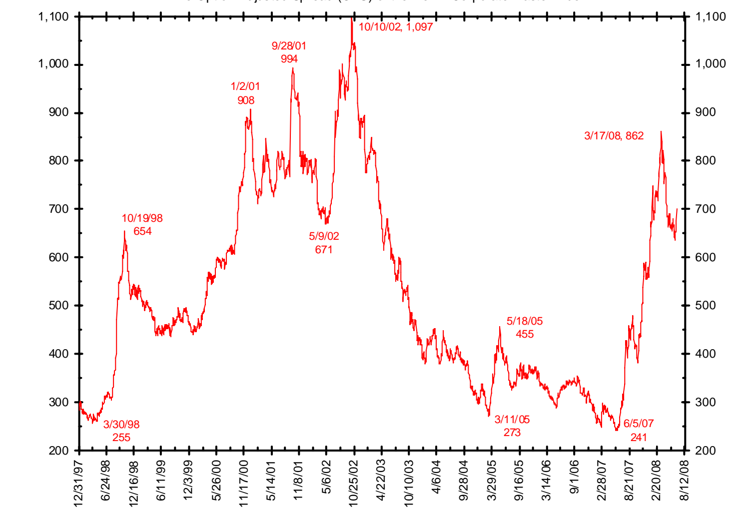
Long-Term Interest Rates - 1900 to 2007

The Upside Down Credit Markets









Banking Losses And Capital Raised

Total Banking System Losses & Capital Raised
As of June 10, 2008
Billions of U.S. Dollars

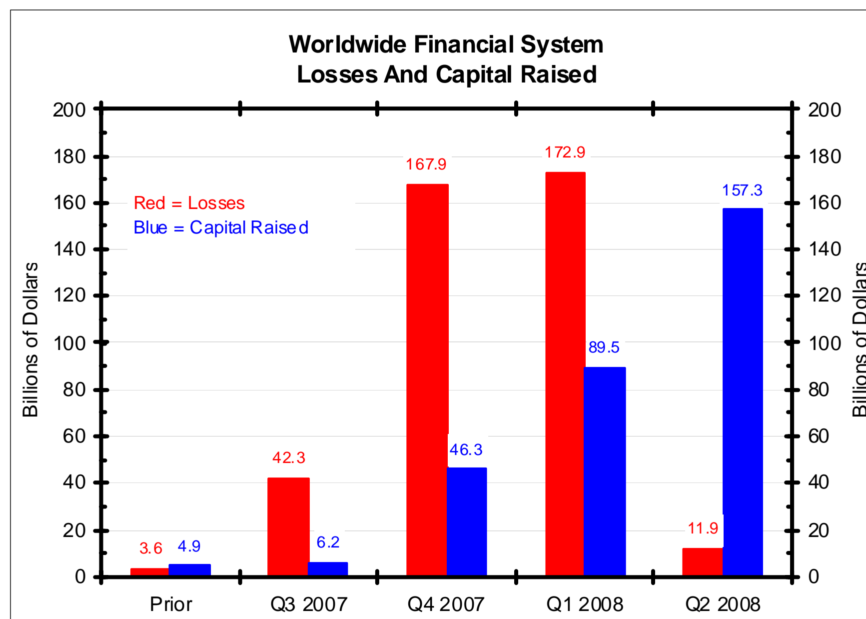
Firm	Loss	Capital Raised	Difference
Citigroup	42.9	44.1	1.20
UBS	38.2	29.0	(9.20)
Merrill Lynch	37.1	17.9	(19.20)
HSBC	19.5	3.5	(16.00)
IKB Deutsche	15.9	13.1	(2.80)
Royal Bank of Scotland	15.2	24.0	8.80
Bank of America	15.1	20.0	4.90
Morgan Stanley	12.6	5.6	(7.00)
JPMorgan Chase	9.8	7.8	(2.00)
Credit Suisse	9.6	1.5	(8.10)
Washington Mutual	9.1	12.1	3.00
Credit Agricole	8.2	9.1	0.90
Lehman Brothers	8.2	13.9	5.70
Deutsche Bank	7.6	3.2	(4.40)
Wachovia	7.0	10.5	3.50
HBOS PLC	7.0	7.8	0.80
Bayerische Landesbank	6.7	0.0	(6.70)
Fortis	6.6	1.0	(5.60)
Canadian Imperial (CIBC)	6.5	2.9	(3.60)
Barclays	6.3	9.7	3.40
Societe Generale	6.2	10.1	3.90
European Banks Not listed	6.1	2.1	(4.00)
Mizuho Financial Group	6.0	0.0	(6.00)
ING Groep	6.0	3.1	(2.90)
West LB	4.9	7.7	2.80
LB Baden Wuerttemberg	4.0	0.0	(4.00)
Dresdner	3.4	0.0	(3.40)
Natixis	3.4	0.8	(2.60)
Etrade	3.3	1.8	(1.50)
Wells Fargo	3.3	4.1	0.80
Bear Steams	3.2	0.0	(3.20)
National City	3.1	8.9	5.80
Goldman	3.0	0.0	(3.00)
Other Asian banks (excluding Mizuho, Nomura)	2.8	0.6	(2.20)
Lloyds TSB	2.7	0.0	(2.70)
BNP Paribas	2.7	0.0	(2.70)
Landesbank Sachsen	2.7	0.0	(2.70)
HSH Nordbank	2.5	0.0	(2.50)
DZ Bank	2.5	0.0	(2.50)
Nomura Holdings	2.4	1.2	(1.20)
ABN Amro	2.4	0.0	(2.40)
Other Canadian banks (excluding CIBC)	2.4	0.0	(2.40)
Bank of China	2.0	0.0	(2.00)
Commerzbank	1.9	0.0	(1.90)
Bank Hapoalim	1.7	2.6	0.90
Royal Bank of Canada	1.6	0.0	(1.60)
Mitsubishi UFJ	1.6	0.0	(1.60)
Unicredit	1.6	0.0	(1.60)
Alliance & Leicester	1.4	0.0	(1.40)
Other US Frims	1.3	1.7	0.40
Dexia	1.3	0.0	(1.30)
Caisse d'Epargne	1.2	0.0	(1.20)
Hypo Real Estate	1.0	0.0	(1.00)
Gulf International	1.0	1.0	0.00
Sumitomo	0.9	3.1	2.20
21 Taiwanese banks	0.9	0.0	(0.90)
Rabobank	1.7	0.0	(1.70)
Sovereign Bancorp	0.9	1.9	1.00
Sumitomo Trust	0.8	0.0	(0.80)
Aozora Bank	0.6	0.0	(0.60)
DBS Group	0.2	1.1	0.90
Shinsei	0.2	0.0	(0.20)
Total*	**391.9**	**288.5**	(103.40)

Source: Bloomberg L.P.

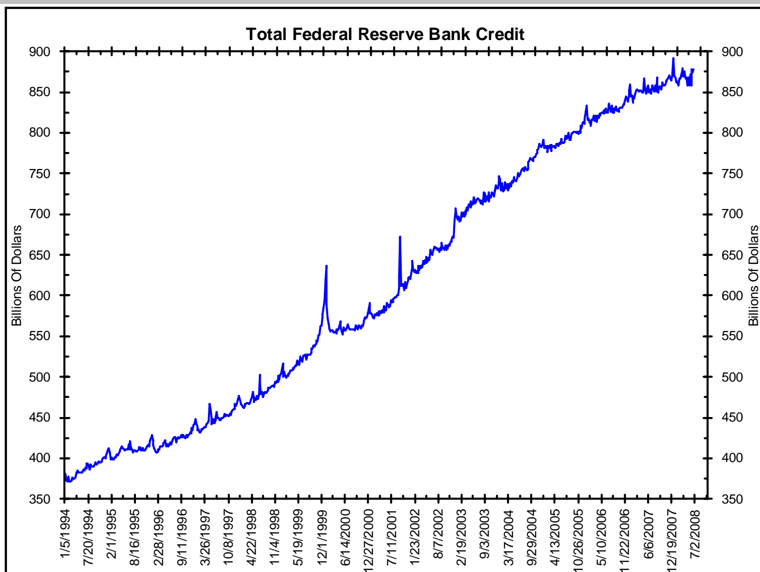
Worldwide Financial System Losses and Capital Raised
As of June 24, 2008
In Billions of Dollars

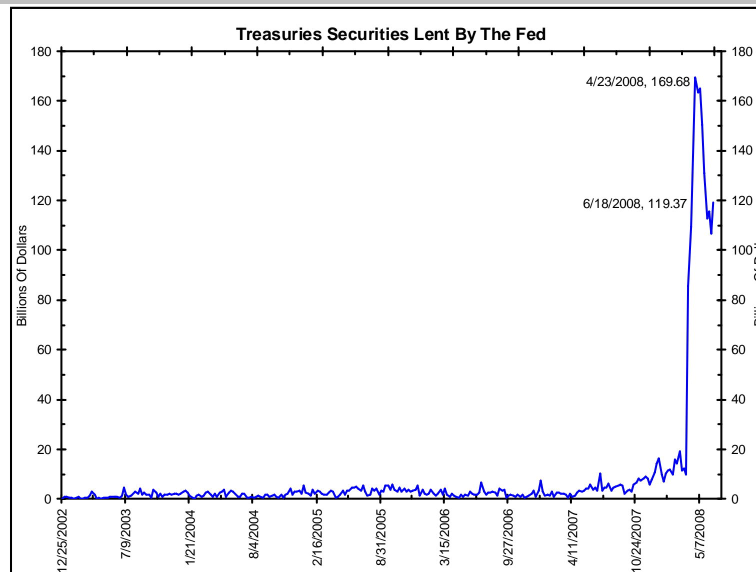
	Total		Q2 2008		Q1 2008		Q4 2007		Q3 2007		Prior	
	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital
America	176.1	159.0	11.0	68.3	66.5	60.1	71.5	29.8	26.4	0.8	0.7	0.0
Europe	201.5	128.9	0.4	76.1	96.9	26.0	85.7	16.5	15.6	5.4	2.9	4.9
Asia	21.0	16.3	0.5	12.9	9.5	3.4	10.7	0.0	0.3	0.0	0.0	0.0
Worldwide	398.6	304.2	11.9	157.3	172.9	89.5	167.9	46.3	42.3	6.2	3.6	4.9

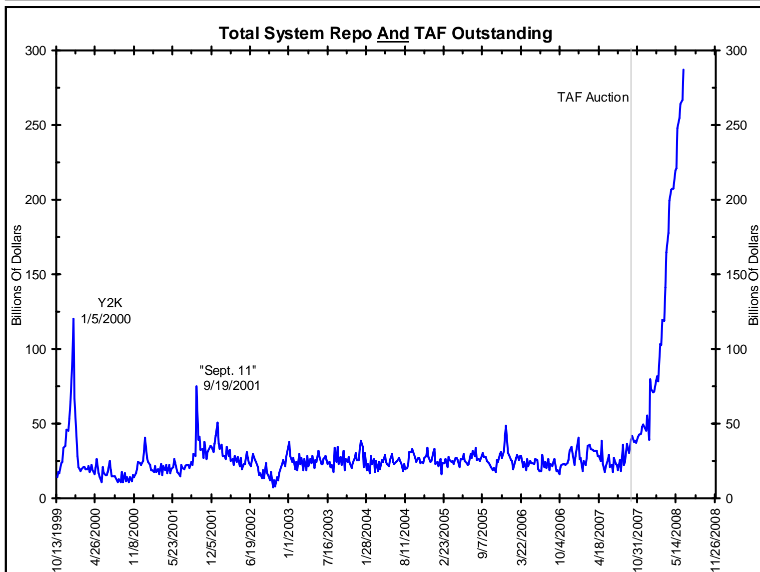
Source: Bloomberg

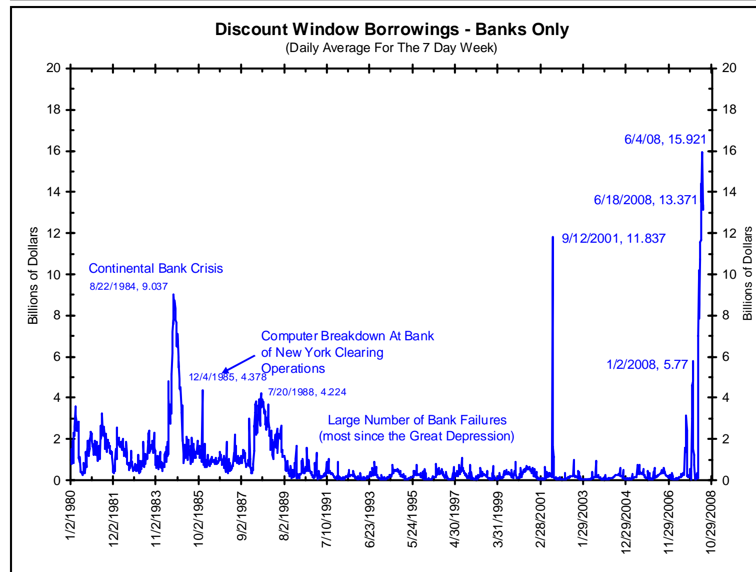


The Fed's Balance Sheet









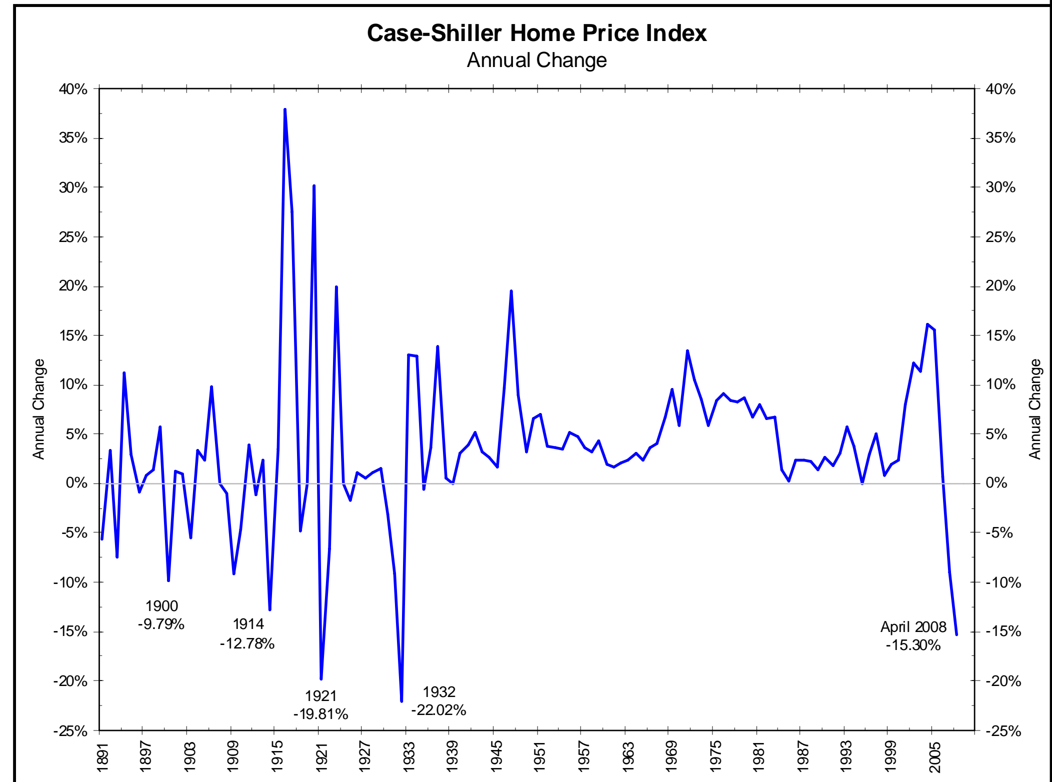
Worst Home Market Since The Depression

Unfortunately, severe home losses are now a reality. The next chart comes from data compiled by Yale professor Robert Shiller and shows home prices are plunging at a rate not seen since the Great Depression 75 years ago. Virtually no one alive has a memory anything like the current home price market.

The consequences of this continued decline in home prices can be seen in the next set of graphs on the following page. They come from Citigroup's 2008:Q1 investor presentation (page 10). The bottom chart shows that home equity loans (second mortgages) 90 days past due (blue line, "90+ DPD") and the non-conforming loan ratio (red line, NCL ratio) have skyrocketed in recent quarters.

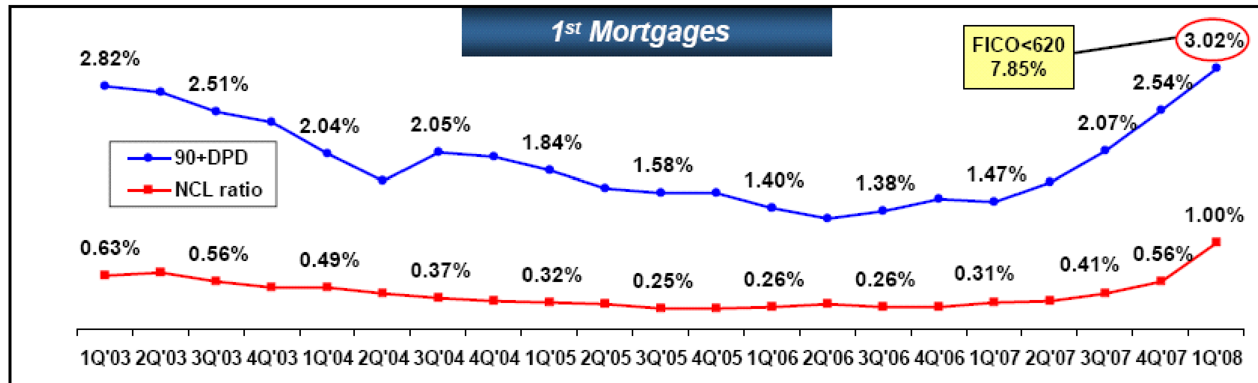
Two years ago (2006:Q1) these ratios were extremely low at 0.15% and 0.14% respectively. Further note that these “near-zero” rates were commonplace in the years leading up to 2006. This history drove to the belief that homeowners simply do not default on home equity loans and investors in securities backed by these loans need not worry.

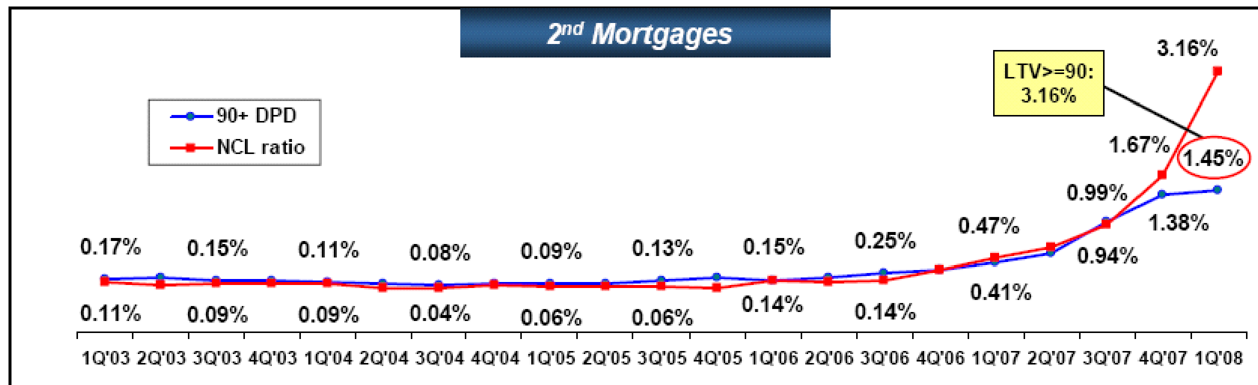
Fast forward to 2008:Q1 and late payments and loans that are not performing have skyrocketed to levels thought not possible just two years ago at 3.16% and 1.45% respectively. More worrisome is that these ratios are accelerating higher.



2nd Mortgage Losses Skyrocket

90+ Days Past Due, NCL ratio





Note: 1st mortgage portfolio: comprised of the Consumer Lending and U.S. Retail Distribution (Citibank) 1st mortgage portfolios and the U.S. Retail Distribution (CitiFinancial) Real Estate portfolio. It includes deferred fees/costs and loans held for sale. 1Q'08 90+DPD based on EOP balances of $154.6 billion.
2nd mortgage portfolio: comprised of the Consumer Lending and U.S. Retail Distribution (Citibank) Home Equity portfolios; 90+DPD rate calculated by combined MBA/OTS methodology. 1Q'08 90+DPD based on EOP balances of $62.5 billion.

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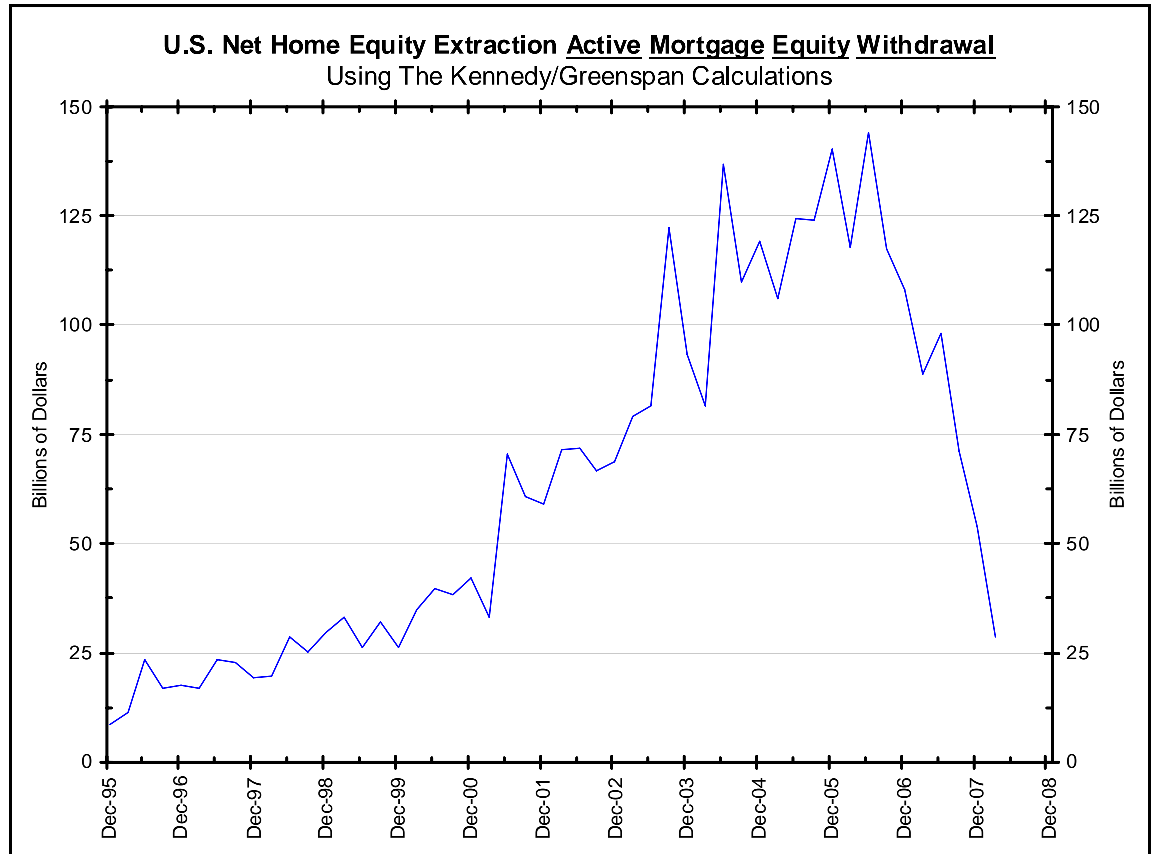
MEW No More

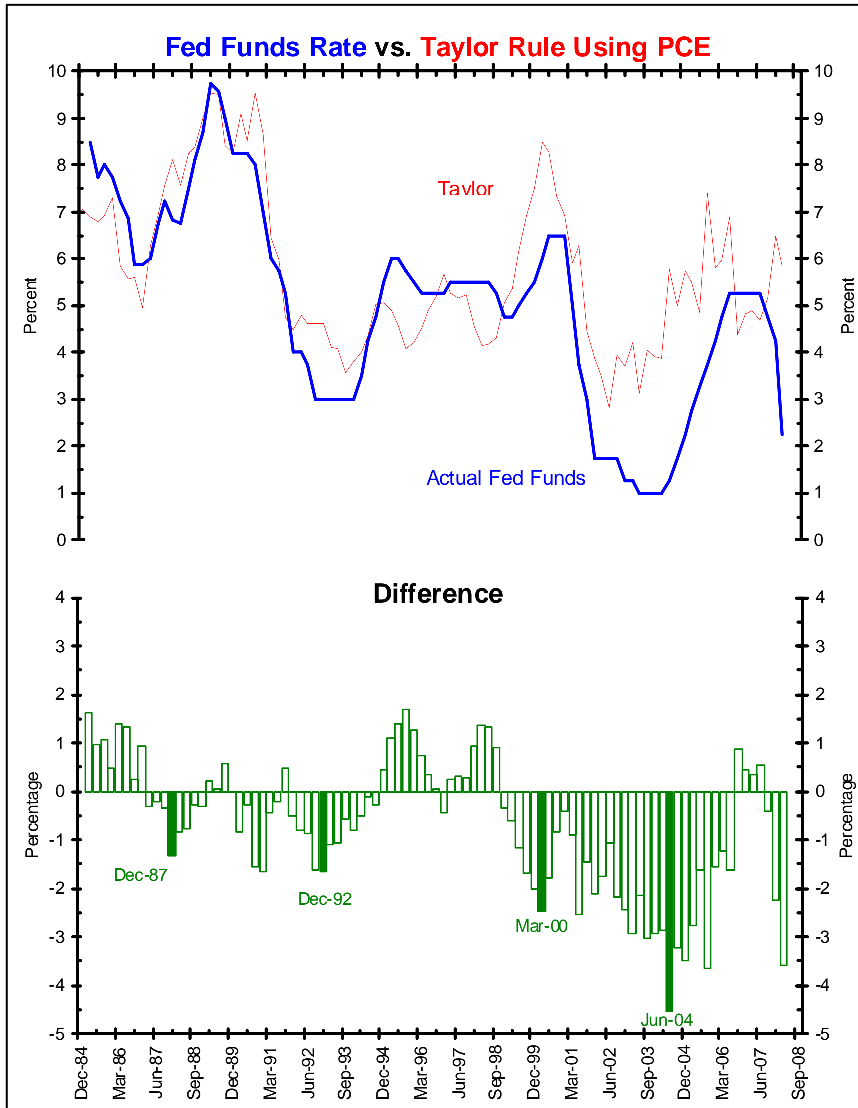
The final consideration is the concept of mortgage equity withdrawal or MEW. This was popularized by none other than Alan Greenpsan a few years ago.

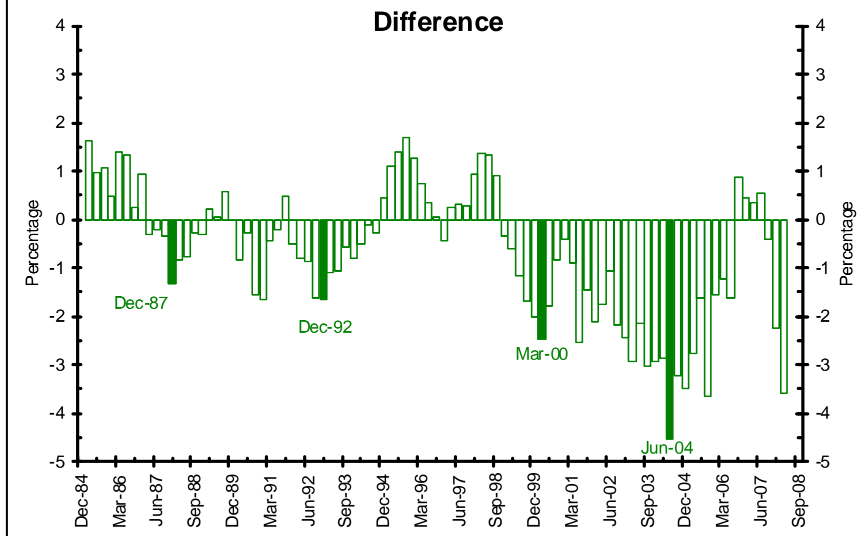
The idea is that home owners will use HELOCs to borrow against their homes, effectively using their homes as an ATM. It was argued by Dr. Greenpsan that this form of borrowing was supporting the entire economy by increasing the consumption ability of homeowners. While direct evidence that this is actually the case is spotty, many believe this to be true. How big is this activity? The next chart details net equity extraction or MEW.

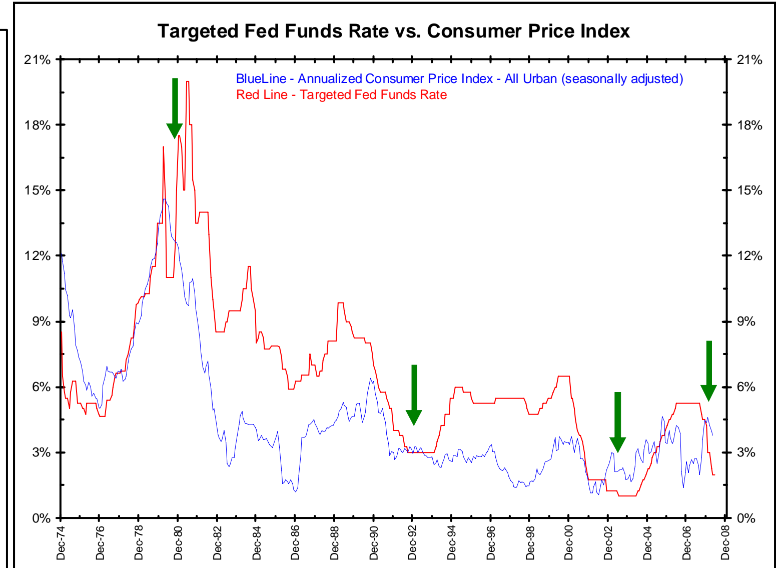
Given the decline in home prices and the recent bankruptcy ruling, it should not come as a surprise that home equity lenders are pulling back in a big way. HELOC's are being canceled but not on a case-by-case basis. Rather, certain lenders are cancelling their programs in entire cities like Las Vegas, Cleveland and Los Angeles. If MEW was a driving force for the consumer, this support is now completely gone.

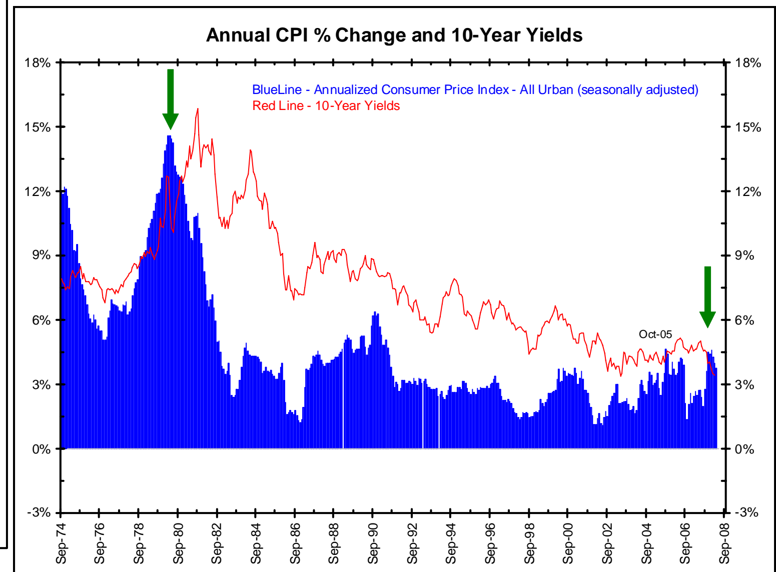


The Federal Reserve Is Too Easy









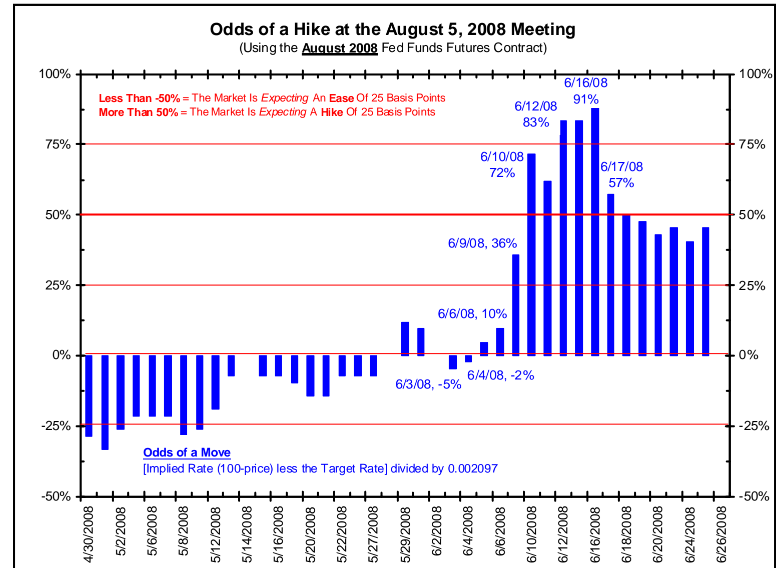
The Market Wants The Federal Reserve To Hike

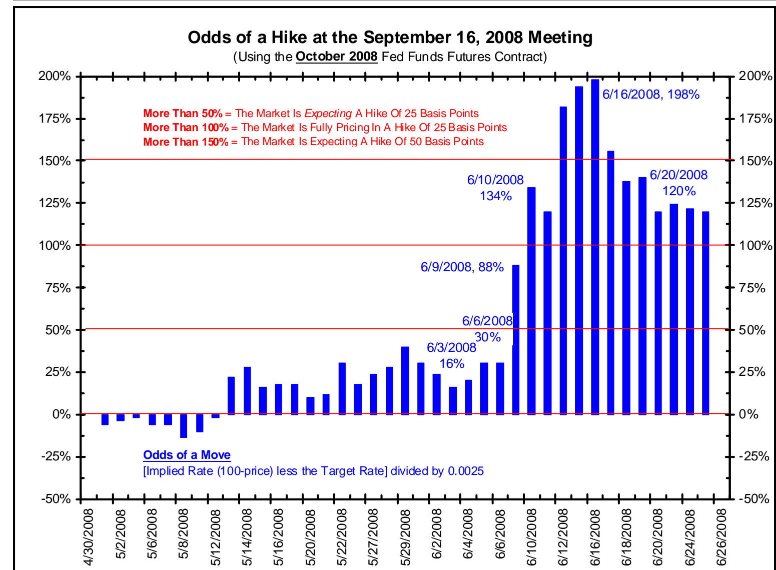
What is bothering the market in the last three days? If we had to guess, Lehman Brothers. Prior to Lehman's problems of the last week, the market was worried that the Federal Reserve was already too easy and stoking inflation. Lehman's stress is now concerning the market that Bernanke and Co. will become even easier and stoke even more inflation fears.

This marks a sea change in the credit crisis. Until last week, the Federal Reserve and the ECB were allowed to operate without consequence in dealing with the credit crisis. Whatever extraordinary means and new facilities they invented, the market always saw them as a positive. Now there are consequences to fighting the credit crisis with easy monetary policy. The Federal Reserve now has to weigh dealing with financial stress against raising inflation expectations.

Restated, the marketplace may be telling the FOMC it has done all it can in dealing with the credit crisis. From here on out, all attempts to soften the blow for financial firms will not work and only serve to heighten inflation expectations. So, sick financial firms are "on their own" and should be allowed to fail. They had their chance. If they do not have their house in order by now, it is not going to happen, so "let them go" Ben. Otherwise the Federal Reserve will be pumping liquidity into the financial system and keeping the funds rate well below the inflation rate for years. The market is now viewing this as unacceptable because the inflation it will create will be worse than the chaos in the financial markets prevented.

This brings us to the economic statistics. If our interpretation of the situation is correct, then weak economic statistic will also make the situation worse. The market wants the Federal Reserve to tighten. Any economic release that gives it a reason not to, like the 0.5% jump in the unemployment rate, worsens inflation expectations. The market thinks inflation is coming back and it does not want to hear arguments and/or statistics to the contrary right now. So, a benign inflation report Friday morning (CPI) could backfire. The markets may be better off with a bad report which forces the FOMC to hike.





Long-Only Funds And Monetary Policy

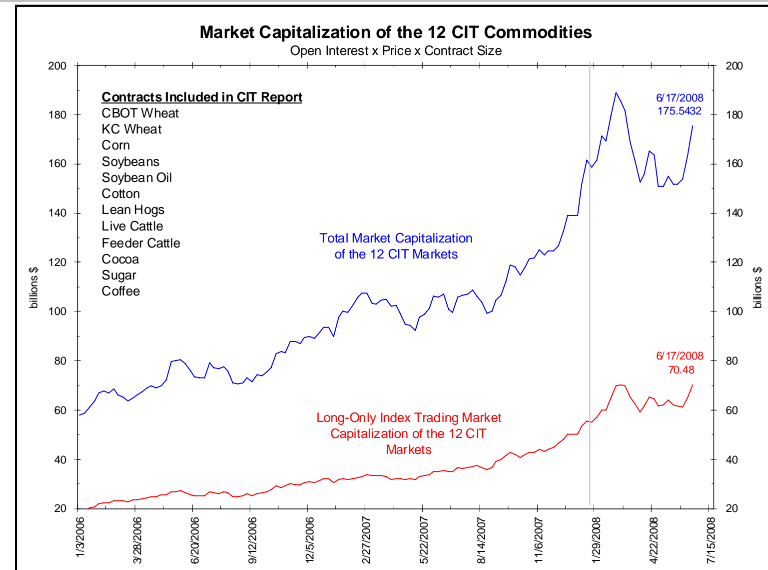
Easy monetary policy means the central bank is trying to stimulate demand, or keep consumption high. Higher prices are supposed to slow down consumption. Therefore, easy monetary policy is offsetting higher prices or "monetizing" them. This means monetary policy is encouraging even higher commodity prices.

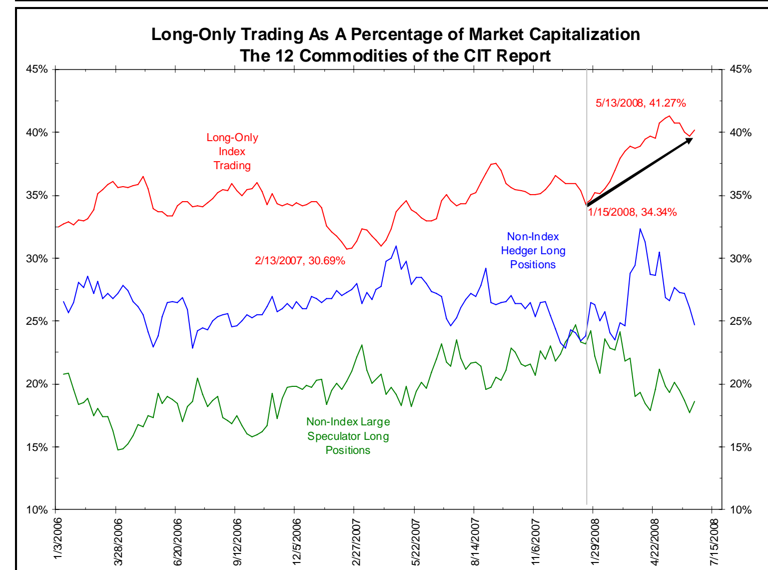
Under this interpretation of current monetary policy, the rational thing for investors to do is run, not walk, to investments that benefit from higher inflation. So the easier monetary policy becomes, thanks to Lehman's recent woes, the more investors are "inspired" (word carefully chosen) to rush into investments like long-only commodity funds and the higher those prices go. We believe this is how Federal Reserve policy is pushing crude oil higher.

Under this way of looking at things, if the Federal Reserve is viewed as just talking and not getting ready to act, then the markets will react badly and interest rates will soar. That is what they have been indeed doing in recent days.

If the market really believed that Bernanke was going to act and hike in August, in the middle of the presidential campaign, and continue to hike throughout the campaign to reign in inflation, then interest rates would not be soaring.

Rather, the markets fear Bernanke is merely talking tough because he believes that is what he must do and when the time comes to actually raise the federal funds rate, he and Don Kohn will give speeches with tortured logic arguing why they can wait another six months or more. The market is not convinced they can wait until December. So, that tortured logic of why the Federal Reserve can wait to hike better be convincing or we will have a real problem in the bond market in the weeks ahead.





This Is Also A Long-Only Commodity Fund

From A Recent Commentary

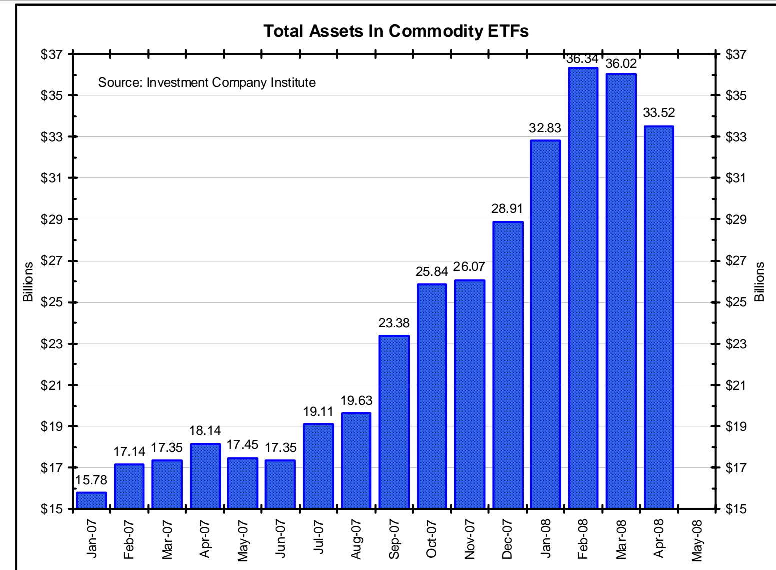
So far we have described long-only commodity funds in the abstract. How about a hard example of one or two?

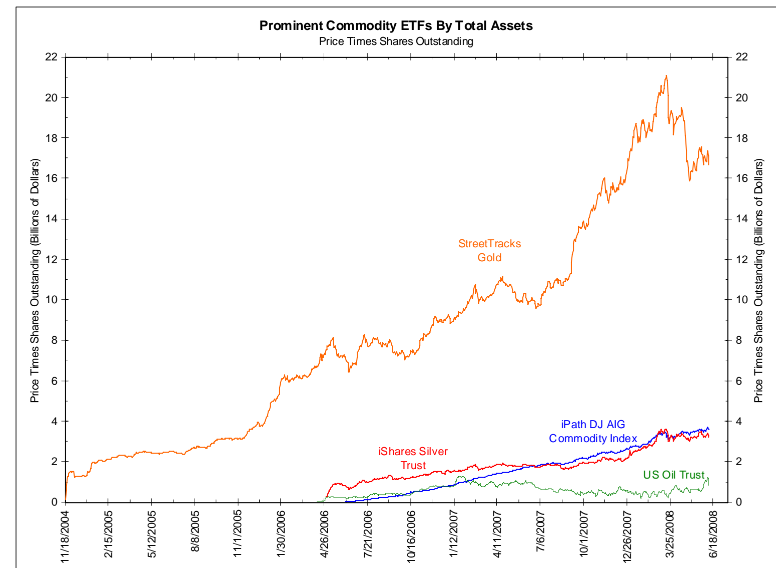
Those familiar with these funds will often think of the massive $220 billion California Public Employees Retirement System (CALPERS) and its 8+% investment ($17 billion) in natural resources and commodities. Many other institutional investors and retirement systems have similar types of investments. However, there is a relatively new category of exchange-traded fund (ETF) that also invests in commodities. These funds have exploded in growth in recent months, more than doubling in the last year and showing no real signs of slowing.

The next chart shows some of the more prominent commodity ETFs. The five funds shown make up $24 billion of the $36 billion total shown above.

While these numbers look small, remember that these markets are not that big to begin with. The total market capitalizations in all the components of the major indices like the Reuters/Jefferies-CRB or the S&P-GSCI is about $650 billion. So ETFs alone are about 5% of this size, up from nothing a few years ago.

If you want an analogy, the U.S. stock market is about $15 trillion in size. Imagine a new buyer that intends on purchasing $750 billion in stocks (5%) over the next few years. Do you think their activity would affect prices?





Is Inflation A Problem?

The hot debate in the marketplace today is whether inflation is a problem. Two often-heard arguments as to why inflation is not currently a problem are that CPI is not at 1980 levels and core inflation is not confirming the headline move. Let's look at these one at a time.

The first chart below comes from shawdowstats.com. They calculate CPI using the weighting and methodologies used in 1980. Using the same methodology that existed when inflation peaked above 14% in 1980, inflation would be near 12% today.

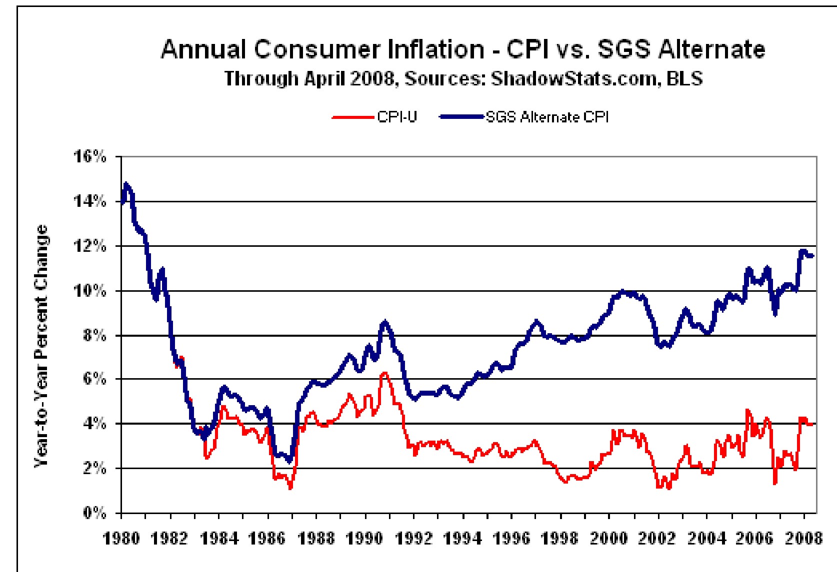
The second set of charts compares headline inflation to core inflation. The chart on the left is the 1970s and the chart on the right is the last 18 years.

Can we take comfort that core inflation is not confirming the rise in headline inflation? Take a look at the rectangle on the left hand chart. It covers the April 1972 to August 1973 period. During this era the divergence between core and headline inflation was much greater than now. Headline was driven by booming gas prices, as it is now, and the Fed was accommodative, as it is now.

It was precisely this divergence that inspired the Fed to create core inflation to argue the rise in headline inflation was not worrisome. And, right after this period, core inflation shot higher.

We believe that inflation fears are rooted in a negative real funds rate, a 2% funds rate in a 4+% headline inflation world. This situation present in 1980, 1993 and 2003. In all of those cases, borrowing money below the inflation rate led to speculative bubbles. In 1980 it was commodities. It was assets in 1993 (bonds) and 2003 (real estate). All these periods ended badly.

The Fed wants us to look at core inflation not confirming a 4% headline inflation rate and take further comfort that is well below the 1980 peak. We believe the market is more worried about a negative funds rate and that history.



The CPI on the Alternate Data Series tab here, reflects the CPI as if it were calculated using the methodologies in place in 1980.

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