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Commentary

Market Opinions and Topics of Interest

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How Big Are The Banking System's Losses Now?

A version of this report was part of last Friday's Newsclips

Each quarterly earnings announcement for financial firms over the past year was accompanied by a spate of analyst announcements proclaiming the worst was behind us. This again happened this Monday with Merrill's announcement that they are selling their CDO portfolio and raising more capital.

Are the people who have been wrong every three months now correct?

Worldwide Financial System Losses and Capital Raised

As of July 29, 2008

In Billions of Dollars

	Total		Q3 2008		Q2 2008		Q1 2008		Q4 2007		Q3 2007		Prior	
	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital	Losses	Capital
America	**251.3**	**178.2**	**5.7**	**17.5**	**68.6**	**70.1**	**70.0**	**60.0**	**76.0**	**29.8**	**29.8**	**0.8**	**1.2**	**0.0**
Europe	**202.1**	**156.1**	**0.0**	**17.4**	**0.6**	**84.9**	**97.4**	**26.8**	**85.7**	**16.6**	**15.6**	**10.4**	**2.8**	**0.0**
Asia	21.0	19.1	0.0	2.8	0.5	12.9	9.5	3.4	10.7	0.0	0.3	0.0	0.0	0.0
Worldwide	**474.4**	**353.4**	**5.7**	**37.7**	**69.7**	**167.9**	**176.9**	**90.2**	**172.4**	**46.4**	**45.7**	**11.2**	**4.0**	**0.0**

Source: Bloomberg

U.S. Losses, As Bad As Ever

Highlighted in blue above are U.S. (including Canada) losses and capital raised. In Q4 2007, these banks reported $76 billion in losses. In the first quarter, they reported $70.1 billion in losses. So far in the second quarter they have reported $68.6 billion in losses. Some smaller firms and IndyMac, placed into FDIC receivership shortly after the quarter ended, have yet to report, and both Countrywide and Bear Stearns have been relieved of further obligations to report. When second quarter losses are totaled, they should equal first quarter losses and approach the record set in Q4 2007. If the worst is over, we are having a hard time finding it in these numbers.

Europe Losses To Come

Highlighted in red above are European losses and capital raised. The sharp-eyed reader will note that European financial institutions have reported larger losses than America in Q4 2007 and Q1 2008. This illustrates the credit crunch has been more of a European problem than an American problem. However, they have reported only $600 million in losses so far in the second quarter. Why so low?

The answer is only a few of nearly 60 European financial institutions that reported losses previously have released Q2 financial statements at this juncture. If the America experience continues to be a good guide, European financial institutions should report some $90 billion of losses when the second quarter earnings statements are released. Combine this with the $10 billion in losses from the 20 Asian financial institutions that have yet to report (green line above) and **total financial system losses will near $600 billion.**

Who Is Not On the List?

Keep in mind these losses are for financial intermediaries (banks and brokers) only. Not included on this list are "*Other financial firms*" such as:

- Fannie Mae and Freddie Mac,
- Monoline and other insurance companies (AIG),
- Finance companies (GE Capital and CIT),
- Hedge funds

- Private equity firms and,
- Other financial institutions such as pension managers and endowments.

These firms are excluded because reporting is either not available, as in the case of hedge funds and private equity, is inconsistent because some firms such as monolines FSA and Assured Guaranty are privately held, or are buried within larger corporations, such as GE Capital.

The list populating the table above has been restricted to financial intermediaries for purposes of consistency over time. Those firms not accounted for do not change the directional conclusion:

Combine the financial sector losses of $600 billion with another $200 billion for the *other financial firms* and **we estimate that $800 billion of losses have been booked already.**

The Trillion Dollar Guess Club

Bill Gross projected in his [latest monthly] commentary these losses could top $1 trillion. Bill now tops the $945 billion estimate by the IMF and joins Frank Veneroso ($2 trillion), Bridgewater ($1.6 trillion) and hedge fund manager John Paulson ($1.3 trillion) in the "trillion dollar guess club."'

This sounds bad until one considers $800 billion has been recognized already without attenuation. It would be bigger news if losses stopped **before** reaching $1 trillion.

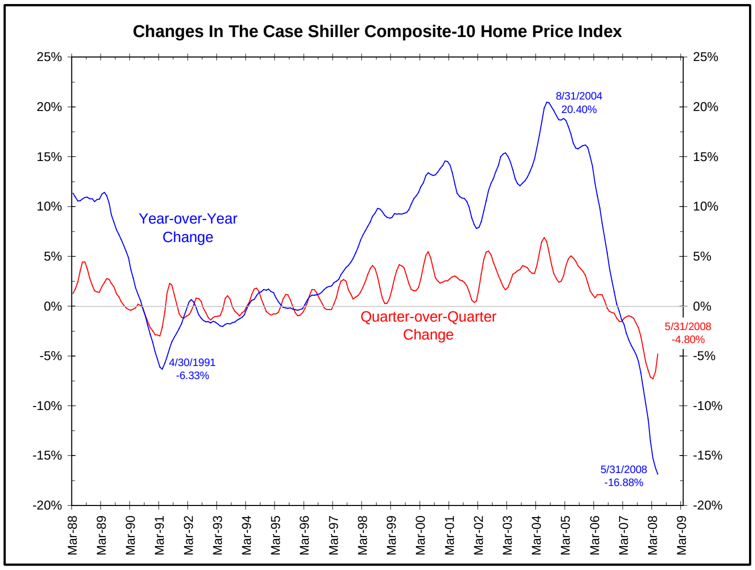
Why did the market act "stunned" at Gross' prediction of $1 trillion in losses? We believe the answer is "they still don't get it." How many really understand losses are at $800 billion now? It is worrisome that after a year the statement of facts and reasonable projections are taken as stunning news.

Is The Worst Over?

In the wake of the Merrill news, many are suggesting that the worst is almost over. What else is left to write-off? We believe that two things need to happen before the worst is truly over.

First, home prices need to bottom and stop creating more losses. This is why second quarter losses rival first quarter losses. Home prices have continued to decline and create more losses. As the chart to the upper right shows, the Case/Shiller index is still falling and the futures markets forward curve is inverted, as we should expect for a "commodity" whose cheapest storage remains with the seller.

Also, as we detailed in a June Commentary, further declines in home prices can create more losses in other areas such as home equity loans.



Second, once the losses stop, the financial system needs to be recapitalized to a massive extent. The typical financial intermediary is levered around 14:1. For every dollar in capital, they can hand out $14 in loans. As the table on the first page shows, financial firms have losses in excess of capital raised by $150 billion. This means there are some $2 trillion less of credit available in the world than there was a year ago thanks to balance sheet impairment. Simply put, the financial system is shrinking, and there is not enough credit available at current interest rates.

That is why we see exotic financial products blow up. They all relied on massive amounts of leverage, and the shrinking financial intermediaries no longer can supply it. This is also why banks have been accused of lying about LIBOR - we'll quote you a rate, but don't expect a loan at that rate. Until capital is raised to offset these massive losses, we will continue to see these kinds of problems.

So, please raise your hand if you have **at least** $150 billion or so to invest in financial firms. The problem is likely capital sources such as sovereign wealth funds and private equity firms have invested and taken huge losses already. They are not interested in repeating the experience. As Merrill showed, equity offerings can be done only on dilutive terms.

Conclusion

Deleveraging is a painful process. It has come about because home prices were too high. This process is not quite complete. Home prices have yet to bottom and massive amounts of capital have to be raised for it to end. Otherwise, economies and markets have to shrink to realign with a smaller financial intermediary system.

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