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Special Report

November 2008

The Latest On Credit And Deleveraging

November 20, 2008 Conference Call
(This transcript has been edited)

James A. Bianco, President, Bianco Research: Good morning, everybody. This is Jim Bianco. Thanks for joining us on our Conference Call.

Summary/Conclusion – The Beginning of the End

Our topic today is "The Latest on Credit and Deleveraging." If you turn to Page Two, I will talk a little bit about the summary and conclusion upfront.

"The Beginning of the End" – I wrote this back in September and have been repeating it ever since. I still believe that we are in the final capitulation process that is the beginning of the end. In September, I wrote, "Within the next three months, the low price and the high spreads should be in place." I still think that right now. Now, does that mean, technically, that we are within days of it? I don't know if we are within days of it or a couple of weeks of it, or a couple of months. But I do think that what we are seeing now is the final capitulation process.

There are a couple of interesting notes here. Let me use the Stock Market as a measure. If the Stock Market closes here at 783, which is where it is as I am talking, with the Dow down 166 points and the S&P 500 at 783, it's only six points above its 2002 low, which was 776. And being that it is only six points below its 2002 low, it's also more than 50 percent off of its high, which would make this is largest high-to-low sell-off in the Stock Market since the Great Depression, or since the 1930s. That has an enormous amount of damage being done, at least to the equity valuations. To cut the Stock Market in half – more than cut it in half – for the first time since the 1930s. We went down 49 percent both in 1974 and again in 2002. If we close at current levels, then we would be more than 50 percent off of the highs right now. That is why I think that we might be in the process of the final capitulation, the beginning of the end, where we are going to put in the low price and the high spread.

But as I have also tried to argue, too, over the next several months, I do not think that the Market is going to have much in the way of a recovery, no V bottom. Why no V bottom? I have argued that this is a political argument more than anything else. If we are going to punish risk-taking, if we are going to cap salaries, if we are going to make nationalized whole swaps of the financial industry, maybe the auto industry, and continue on down the line, then we are going to take risk-taking out of the system. We don't want people to lose money, so we don't take a risk. And if there is no risk, then there is no reward, so that really limits the ability of the Market to recover. So I think that we make the low here because I think that we have done so much damage to the Market.

The last warning that I would give you is that I have also been saying, too, that I would rather be a month late than a month early. So even though we might be a few weeks or a few months from the low, ultimately – because I think that what we are going to have is a big capitulation – I don't want to buy now. I would rather buy a month after the low. I would rather say, "That was the low." It's now being confirmed by some technical indicators and is now going higher. In the trader parlance, it's a better buy at higher. Let the Market bottom out; let the Market go back up. And then, at that point, I could then consider trying to buy the Market and looking forward to move higher along the way. So that's kind of where I am as far as where the Market is.

The three other topics that I want to address with this are: the amount of Government intervention and how everything stopped in October; how horrifically bad the Fourth Quarter is shaping up to be economically; and then I want to give an update on where the credit markets stand in the deleveraging. And the answer is that it is really hard to make a case that the credit markets were getting better. We were looking at some markets that were being manipulated through heavy government intervention, namely commercial paper and LIBOR, and convincing ourselves that we were getting better. But the fact of the matter is that, beyond those markets, it's really hard to make that case.

And, finally, as far as deleveraging goes – I know that's a big popular question that everybody tries to ask – I don't think that there has been a lot of deleveraging that has been happening. What has been happening is that the private sector has been delivering, and the Government sector, or the public sector, has been trying to take up the slack. The great example of that is the auto companies. Deleveraging means that people go out of business. Deleveraging means that people stop borrowing. If you want a great example of deleveraging, then close the auto companies. "No, we can't close the auto companies, so we're going to have the Government give them a loan." So, overall, we're not deleveraging at all; we're just switching some of the leverage to the Government. And that gets back to my thesis that, as we switch it to the Government, there will be a need to put laws in place so that we don't take risks. And that is going to prevent any kind of a decent rally in the Market.

The Credit Crisis: The Largest Outlay In American History

So let's start on Page 3 and talk a little bit about the Government's intervention.

FINANCIAL CRISIS BALANCE SHEET	
Government Entity	**Sum in Billions of Dollars**
Federal Reserve	
(TAF) Term Auction Facility	900
Discount Window Lending	
Commercial Banks	99.2
Investment Banks	56.7
Loans to buy ABCP	76.5
AIG	112.5
Bear Stearns	29.5
(TSLF) Term Securities Lending Facility	225
Swap Lines	613
(MMIFF) Money Market Investor Funding Facility	540
Commercial Paper Funding Facility	257
(TARP) Treasury Asset Relief Program	700
Other:	
Automakers	25
(FHA) Federal Housing Administration	300
Fannie Mae/Freddie Mac	**350**
Total	4284.5

Note: Figures as of Nov. 13, 2008

Here is a table that I found on CNBC that looked right to me -- "How much money has been thrown at the Financial Crisis to date?" We are fond of saying that this Financial Crisis has always been about numbers so large that nobody understands them.

And, right now, if you look at this table on Page 3, what you will see is that the total number is $4.2 trillion. That's $4.2 trillion. The earliest that all of these things listed on this sheet came into play was the discount window lending.

The first set of rules were moved in favor of the commercial banks back in August of 2007. So in a little bit over 15 months, we have spent $4 trillion. How do I put that number in context? On the right, I show a bunch of big-budget items. And the amount of outlays that we have is larger than all of these combined – the Marshall Plan, the Louisiana Purchase, the Race to the Moon, the S&L Crisis, the North Korean War, the New Deal, the Gulf War, the Vietnam War, and NASA without the Race to the Moon combined.

We have outlaid more money than all of that combined. All of those items collectively total $3.92 trillion in inflation-adjusted dollars versus $4.28 trillion. So you would have another $359 billion left after all of that.

Now, it is important to note that what we are doing is largely loans. We should get paid back. The recovery rate is not zero in a lot of these cases. The recovery rate is something a little bit higher than zero.

But, nevertheless, the outlays are greater than all of those. The only comparable thing that we have seen in American history – I was going to say human history, but let's just go with American history – is the cost of World War II, which, on an inflation-adjusted basis, was $3.6 trillion. These are numbers that are so large that we have a very difficult time understanding them.

The amount of money thrown at this crisis is unprecedented in American history for anything that we have ever done. And anytime that you see statements where people say, "Well, we need to thrown another $500 billion there" or "maybe it will cost another $1 trillion here," they are making them up. These numbers are so big that nobody understands them to begin with. And it shows you the amount of push by the Federal Government or World governments – but in particular, the U.S. Government in this case – in order to stem this Crisis.

This chart on Page 3 is my example that I also like to use to talk a little bit about how we are not levering. You could look at this table and say that all of these numbers in total are the amount of private sector delivering that was about to occur, but the Federal Government wouldn't allow it to occur, so they stepped into the breach where people couldn't

get loans -- not getting loans is another definition of delivering – and then started handing out those loans to somebody else.

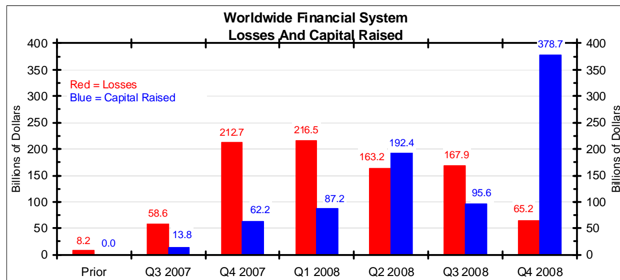
Almost $1 Trillion In Losses

Before I make some more qualitative comments, let me go to the next page. So far, the amount of losses to date – and, hopefully, those of you on the webcast can read these numbers – that the banks, insurance companies, and GSEs have written off is $967 billion, almost $1 trillion.

Worldwide Financial System Losses and Capital Raised
As of November 19, 2008
In Billions of Dollars

	Total		Q4 2008		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	Losses	Capital
Banks/Brokers	709.3	717.3	65.2	328.5	167.9	94.0	120.9	157.8	149.9	84.0	159.2	44.1	42.1	8.9	4.1	0.0
Insurance Cos	143.2	90.0	0.0	50.2	36.4	1.6	13.3	27.5	42.0	3.2	42.2	4.6	9.3	2.9	0.0	0.0
GSEs	114.5	22.6	0.0	0.0	38.3	0.0	29.0	7.1	24.6	0.0	11.3	13.5	7.2	2.0	4.1	0.0
Wordwide	967.0	829.9	65.2	378.7	242.6	95.6	163.2	192.4	216.5	87.2	212.7	62.2	58.6	13.8	8.2	0.0

Source: Bloomberg



The chart on Page 4, in red, shows the losses and, in blue, shows capital raised. The total amount of capital raised has been $829 billion. I have argued that the losses minus capital raised is the measure that you want to look at as far as delevering goes. And if you look at these numbers nominally, then you say, "OK, we are net down about $150 billion." The number that I have been using all along has been a leverage ratio of about 14:1. So if you're net down $150 billion times 14:1, then that means that the Financial System, by this measure, is about $2 trillion smaller than it was about a year or 18 months ago.

However, if you look at the Fourth Quarter, $378.7 billion was raised. That's the big blue bar on the chart. That means that we have had almost $400 billion of capital injections come into the financial system in the Fourth Quarter. The majority of that number -- $221 billion of it – has come in through TARP money. The table that is on the left there – and I tried to lay it out so that it was large enough to read – on the printed copy, shows you all of the banks and AIG being the only non-bank right at the top of the list – AIG at the top – that have received commitments for TARP money and have publicly stated it. It is 92 financial institutions totaling $221 billion.

Known TARP Money Awarded
as of November 19, 2008

Bank Name	Date Announced	Amount (in Millions)
American International Group	11/12/2008	$40,000
Citigroup	**10/12/2008**	**$25,000**
Wells Fargo	**10/12/2008**	**$25,000**
JPMorgan Chase	**10/12/2008**	**$25,000**
Bank of America	**10/12/2008**	**$15,000**
Merrill Lynch	**10/12/2008**	**$10,000**
Goldman Sachs Group	**10/12/2008**	**$10,000**
Morgan Stanley	**10/12/2008**	**$10,000**
PNC Financial Services Group	10/12/2008	$7,700
US Bancorp	11/12/2008	$6,600
Capital One Financial	10/12/2008	$3,550
Regions Financial	10/12/2008	$3,500
SunTrust Banks	10/12/2008	$3,500
Fifth Third Bancorp	10/12/2008	$3,400
BB&T	10/12/2008	$3,100
Bank of New York Mellon	**10/12/2008**	**$3,000**
KeyCorp	10/12/2008	$2,500
Comerica	10/12/2008	$2,250
State Street	**10/12/2008**	**$2,000**
Marshall & Ilsley	10/12/2008	$1,700
Northern Trust	10/12/2008	$1,500
Huntington Bancshares	10/12/2008	$1,400
Zions Bancorp	10/12/2008	$1,400
Fannie Mae	9/12/2008	$1,000
Freddie Mac	9/12/2008	$1,000
Synovus	11/14/2008	$973
Popular, Inc	11/18/2008	$950
First Horizon National	10/12/2008	$866
E-Trade	11/8/2008	$800
Associated Banc-Corp.	11/8/2008	$530
Webster Financial	11/12/2008	$400
City National	10/12/2008	$395
Fulton Financial	11/8/2008	$375
TCF Financial	11/12/2008	$361
South Financial Group	11/14/2008	$347
Wilmington Trust	11/14/2008	$330
Valley National Bancorp	10/12/2008	$330
Citizens Republic Bancorp	11/14/2008	$300
UCBH Holdings	10/12/2008	$298
Whitney Holding	10/12/2008	$282
Cathay General Bancorp	11/18/2008	$258
First Merit	11/13/2008	$248
Trustmark	11/8/2008	$215
Umpqua Holdings	10/12/2008	$214
Washington Federal	10/12/2008	$200
International Bancshares	10/8/2008	$200
First Midwest Bancorp	11/12/2008	$193
Pacific Capital Bancorp	11/12/2008	$188
First Niagara Financial	10/12/2008	$186
United Community Banks	11/18/2008	$180
Old National Bancorp	10/12/2008	$162
Provident Bankshares	10/12/2008	$157
Boston Private Financial Holdings	11/19/2008	$150
Western Alliance Bancorp	11/13/2008	$140
Banner Corp	11/12/2008	$124
Signature	10/8/2008	$120
Iberiabank Corp	11/18/2008	$115
Taylor Capital	11/8/2008	$105
Midwest Banc Holdings	11/12/2008	$85.5
First Financial	10/8/2008	$80.0
Columbia Banking System	11/12/2008	$76.9
Superior Bancorp	11/18/2008	$69.0
Nara Bancorp	11/14/2008	$67.0
CoBiz Financial	11/8/2008	$64.4
Great Southern Bancorp	11/17/2008	$60.0
American West Bank	11/8/2008	$57.0

Known TARP Money Awarded - Continued
as of November 19, 2008

Bank Name	Date Announced	Amount (in Millions)
NewBridge	11/8/2008	$52.0
Captital Bank	11/17/2008	$43.0
Southern Community Group	11/18/2008	$42.8
First Community Bancshares	10/30/2008	$42.5
Bank of Florida	10/12/2008	$40.7
Heritage Commerce	11/8/2008	$40.0
Simmons First National	10/8/2008	$40.0
Peoples Bancorp	11/13/2008	$39.0
Porter Bancorp	11/13/2008	$39.0
Cascade Financial	11/12/2008	$39.0
HF Financial Corp	11/14/2008	$35.0
Intermountain Community Bancorp	11/7/2008	$27.0
Home Federal Financial	10/12/2008	$25.0
Heritage Financial	11/8/2008	$24.0
Severn Bancorp	11/18/2008	$23.5
First PacTrust Bank	11/13/2008	$19.3
Redding Bank	10/27/2008	$17.0
Bank of Commerce	10/12/2008	$17.0
First Financial Services	11/14/2008	$16.0
The Bank Holdings	11/8/2008	$15.0
Bridge Bancorp	11/8/2008	$14.3
Pamrapo	11/8/2008	$11.4
Mackinac Financial	10/8/2008	$11.1
Broadway Financial Corp	11/14/2008	$9.0
Capital Pacific Bancorp	11/8/2008	$4.0
Saigon National Bank	10/12/2008	$1.2
Total		**$221,040**

The Treasury does not make this data available. The banks that borrow this money eventually make it public either through a press release or through their financial statements. So I have totaled this up from several sources that have been trying to count up these numbers, and this number pretty much agrees with everybody else's source, though mine is a little larger because I'm combining everybody's source.

So $221 billion of the $378 billion is TARP money. And what have we heard about TARP money? We have heard that the banks aren't lending that out. So where you look at this difference of $967 billion in losses versus $829 of capital raised, bear in mind that a couple of hundred billion dollars of that capital raised is TARP money that is not being lent out. So there has been a massive shrinkage in the Financial System, a massive shrinkage that has led to the Financial Sector delevering. But the Government won't allow the consequences of delevering because those consequences, again, are, "Auto companies, you cannot get a loan. You have to go out of business," to, "Well, no, we're going to give them a loan." "Commercial Paper Market, you can cease to exist, so, GE, you cannot rollover your commercial paper," to "Oh, hold on a minute, the Fed will take care of that and will continue to let them borrow from the Fed." So that is what deleveraging means, and we are not allowing that to happen.

Three Months To Remember

On Page 5 is the update of the three months to remember. We have been keeping track of what I subjectively thought that, in a normal year, would be events that would each be one of the bigger financial events of the year in a normal year. And I have been tracking them since Labor Day and have now got 101 entries since then.

It is unbelievable what the Government has been doing. And I think that this has been somewhat counter productive. Not all of these are Government moves, but most of them are. And I think that it has been somewhat counterproductive that, at this point, I think that we should step back and argue whether or not the Government's moves to date have been effective. We are not sure whether or not they have been effective.

Paul McCulley, in his latest, said that he doesn't know whether or not the Government's allowing Lehman Brothers to fail made the situation worse. I will agree with that. We don't know what it would have been had they (inaudible) what would have happened. We don't, so we are left to guess. But if the answer is, "We don't know what happened, we are not sure," then let's stop changing the rules every five minutes with these 101 types of things. I think that has done more damage than anything else.

Major Financial/Economic Events Since Labor Day

Date	Events
7-Sep	*Fannie Mae, Freddie Mac put into conservatorship
14-Sep	*Bank of America buys Merrill *Lehman files for bankruptcy
17-Sep	*AIG Bailout *Lloyds buys HBOS in UK government-engineered deal
18-Sep	*FSA announces short selling restrictions *Liquidity added through record system repos of $110 billion
19-Sep	*Treasury guarantees money market assets *SEC announces new short selling rules *TARP plan unveiled *FTSE has biggest one-day gain ever
22-Sep	*Goldman Sachs and Morgan Stanley convert to banks *Fed loosened rules that limited buyout firms and private investors to take big stakes in banks from 25% to 33%
23-Sep	*Berkshire Hathaway invests in Goldman Sachs
25-Sep	*Washington Mutual (WaMu) taken over by JP Morgan
27-Sep	*Bradford & Bingley nationalised *Fortis bailed out by Dutch, Belgian, Luxemburg governments
28-Sep	*Hypo Real Estate bailed out by German government-sponsored lenders *Glitnir bailed out by Icelandic government
29-Sep	*Citigroup takes over banking business of Wachovia with FDIC guarantees *Ireland guarantees all deposits *House rejects TARP plan *DJIA falls a record 777 points
30-Sep	*Belgian government bails out Dexia *South Korea, Taiwan, Indonesia Ban Short sales on all stocks temporarily *Fed pumps a record $630B of liquidity into swap lines with foreign central banks *Senate passes revised TARP plan
1-Oct	*Berkshire Hathaway invests in GE *UK lifts depositor guarantee to £50,000 from £35,000, *Well Fargo takes over Wachovia despite Citigroup deal 4 days earlier *Fortis bailout amended, Dutch government buys Dutch businesses
3-Oct	*TED spread hits record of 340 bps, House passes revised TARP plan
5-Oct	*BNP buys rest of Fortis *Germany guarantees all individual savers *Hypo Real Estate bailout re-negotiated *Denmark and Sweden guarantee deposits *Unicredit bailed out in Italy
6-Oct	*FTSE has worst day in over 20yrs, Dow trades down over 800pts at one stage, *Federal Reserve boosts TAF auctions to $900bn (last Dec started with $50bn as a "temporary measure") *Iceland takes control of banking system, *UK government meet with bank CEOs to discuss capital injection *RBA cuts rates by 100bps
7-Oct	*RBS trades down 40% on talk of UK government injection into banks *Federal Reserve to buy commercial paper direct from companies
8-Oct	*UK bank bailout plan *Coordinated rate cuts with Fed, ECB, BoE, BoC, Riksbank, SNB and PBOC * SEC lifts restrictions of short selling *Dow completes worst 6 days in history *European stocks endured worst 3 days since 1987
9-Oct	*The DJIA falls 7.33% for its 13th worst day ever *UK announces plan to recapitalize banking system

As far as the Lehman situation goes, I would argue that it is a much larger situation than Lehman. During the first half of September, the Federal Government – either the Treasury or the Federal Reserve – put Fannie and Freddie into conservatorship and then made the decision to bankrupt the preferred holders. So we gave the death penalty to some preferred stockholders. Then we gave the death penalty to some firms, as in the case of Lehman Brothers. But we extorted other firms, as in the case of AIG. The Fed gave them a loan, but they had to give the Fed warrants for 80-percent ownership of the Company. The Fed is the lender of last resort, not the extortionist of last resort. I have never heard of the Fed giving out a loan and demanding ownership in a company before.

Major Financial/Economic Events Since Labor Day - cont.	
10-Oct	*Stock markets complete their worst week since 1933 *The G-7 holds emergency meeting in Washington *Corporate spreads reach widest levels since the Great Depression
12-Oct	*EU countries agree to capital injections into banks *Guarantee deposits and inter-bank loans *UK offers details on capital injection plan takes major stakes in HBOS, Lloyds and RBS
13-Oct	*MUFG agrees to $9 billion capital injection into Morgan Stanley *S&P 500 up 11.08%, its best day since 1933 *TED spread hit record wide of 436 basis points *World central banks offer "unlimited" liquidity to banking system
14-Oct	*U.S. Treasury agrees to inject $125 billion of capital into nine banks *Increases guarantee on bank deposits and bank debt *Iceland stock market re-opens and falls 76%
15-Oct	*The DJIA falls 7.87% for its 11th worst day ever (and worst since October 1987) *ECB expands collateral framework , accepts lower-rated credit instruments and also instruments denominated in $, £ and yen .
16-Oct	*Swiss government injects $5 billion in UBS and could own 9% It will also acquire $60 billion of illiquid assets *Credit Suisse raises SF 10bn *French President Sarkozy calls for a "revamp of capitalism" *Bank of England eases rules for borrowing at the discount window
20-Oct	*The Netherlands Government injects $13.4 billion into ING Groep NV *EU loosens mark-to-market rules on European Banks *South Korean Government Guarantees Up To $100 Billion in Bank Loans
21-Oct	*France Injects $14 billion into top 6 banks *Pakistan discusses with IMF a $10bn-$15bn support package to stabilise its economy
23-Oct	* Fed Announces $540 billion facility to but CP from Money Market Funds
24-Oct	* Austrialian Banks Freeze Redemptions * Stock Futures Limit Down Before NYSE Open
27-Oct	* IMF Money To Urkaine * IMF Money To Hungray
28-Oct	* DJIA Up 890 Points * Volkswagon Short squeeze - Stock up 500%
29-Oct	* Bank of China Cuts Rates * Norway Cuts Rates 50 Basis Points * Fed Cuts the funds rate 50 basis points to 1.00% * Fed Announces $120 billion swap lines with Brazil, South Korea, Singapore and Mexico
30-Oct	* Fed Increases AIG Loan $21 Billion
	*Japan cuts Interest Rates to .03 % cut in 7yrs
3-Nov	*Auto Sales dropped 30 % in October, Worst Since 1945
4-Nov	* Obama is elected President
5-Nov	* Fed Raises rates it pays on reserves (equal To target rate)
10-Nov	* AIG deal renegotiated
11-Nov	* China announces $586 Billion stimulus package * Fannie Mae announces $29 Billion loss
12-Nov	* Fed changes role of Tarp to Capital Injection Fund
13-Nov	* CIT converts to commercial bank
14-Nov	* Bloomberg Sues The Fed For Disclosure on Collaterizled Loans * Deadline for publicly held banks to apply for TARP money
15-Nov	* G-20 Meeting
17-Nov	* Goldman Senior Executives Will Not Take A Bonus For 2008
18-Nov	* UBS Senior Executives Will Not Take A Bonus For 2008

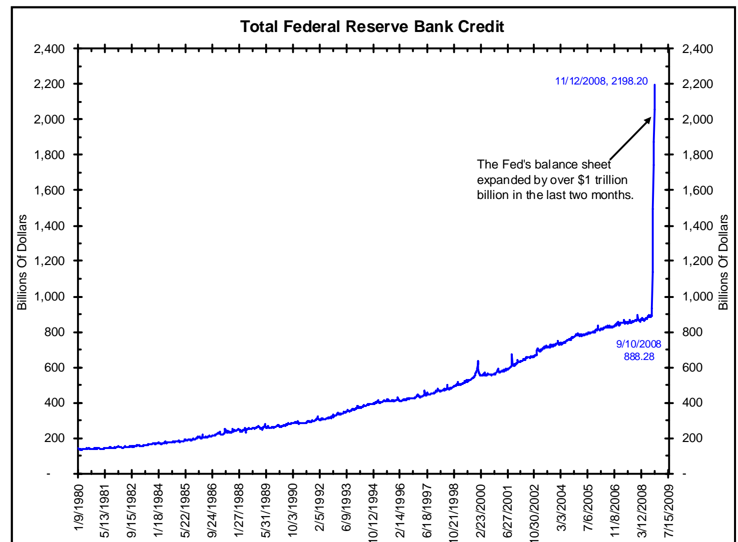
Then if you want to throw in the FDIC, then WAMU, which was owned by TPG, was in the process of trying to find a buyer. In the middle of that process, the FDIC said, "You know what? This isn't going to work. You're not going to find a buyer here. We're just going to give the Company to (inaudible)." So we've bankrupted firms. We've picked winners. We've picked losers. We extorted firms. And we have forcibly taken firms and given them to other people.

Why do you think that the markets panicked in the first half of September and haven't stopped since? It's because we have been treating the owners of financial firms as badly as anytime in, probably, capitalist history in this Country. And owners of financial firms don't know whether it's their firm or it's the Government's firm. They don't know if the Government is going to bankrupt them or leave them alone, or if the Government is going to give their firm to somebody else because they don't like the way that they are operating it, as in the case of WAMU. They don't know if the Government is going to forcibly give them capital, as they did with the top nine firms, and then maybe demand that they run their businesses in a certain way, like restrict the bonuses that they give. This is why these financial firms have been under such tremendous stress, I think. And, if anything, we could call a timeout on what they have been doing as far as everything is concerned.

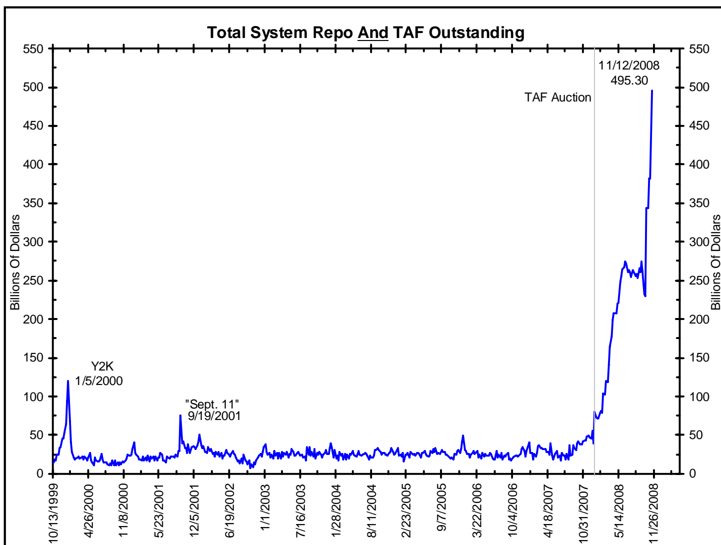
And I think that, to some extent, after Paulson's latest blunder, where he all but admitted that the original TARP Plan to put a reverse auction, to put a floor on mortgage securities, is not going to happen. We are seeing the consequence of that in the ABX and CMBX markets. I will talk about that in just a second.

The Federal Reserve's Exploding Balance Sheet

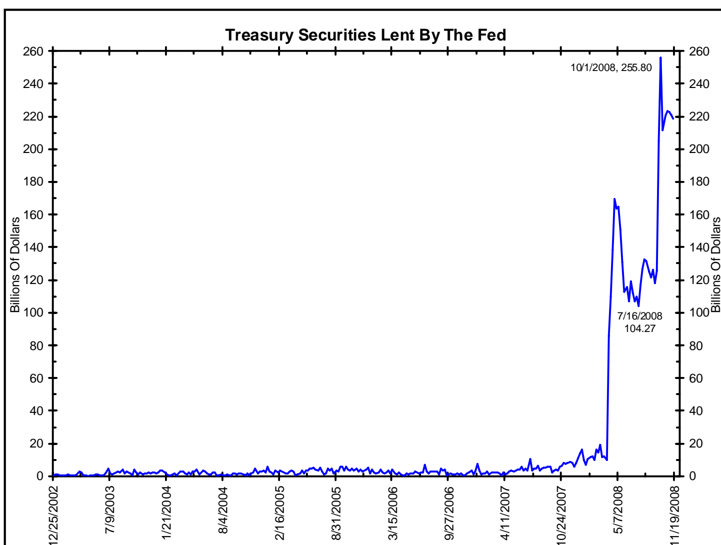
But if we go to Page 6, just to finish off with the Government's extraordinary involvement in the markets, I want to detail here what the Fed has been doing to its balance sheet. In the upper left corner of the chart, it shows that the Fed's balance sheet has gone from $880 billion to almost $2.2 trillion in the space of a little over two months, an unprecedented move at any time since the Fed was created in 1913. Now, how did the Fed explode their balance sheet that much?



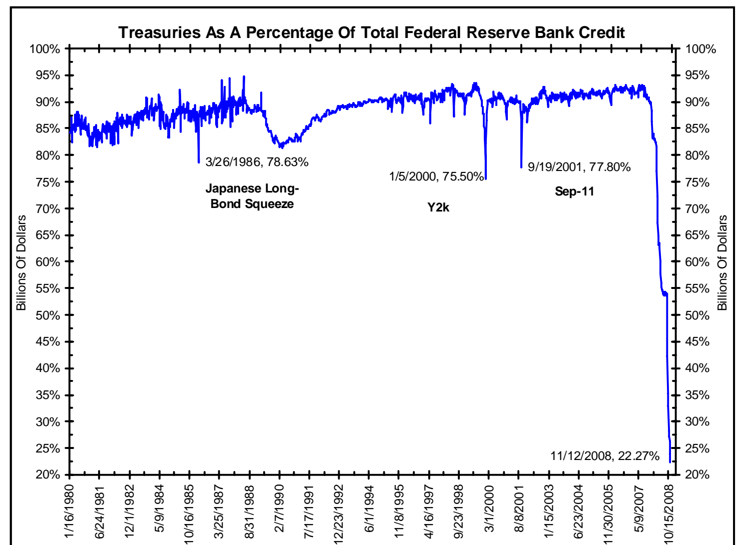
The upper right chart shows the total system repos and term auction facilities, or TAFs outstanding. The TAF only came into existence in late December, and we are now up to almost $500 billion -- $495 billion to be exact – so that is a quarter of the Fed's balance sheet right there.



Another big part of the Fed's balance sheet, in the lower left, is Treasury securities lent by the Fed. That used to be a nominal amount of $5- or $6 billion but is now $220 billion.



The Fed has also been trying to sterilize these operations. Back when their balance sheet was $880 billion, if you look at the lower right chart, 90-plus percent of their balance sheet was Treasury securities, and now it is down to 22 percent as Treasury securities.



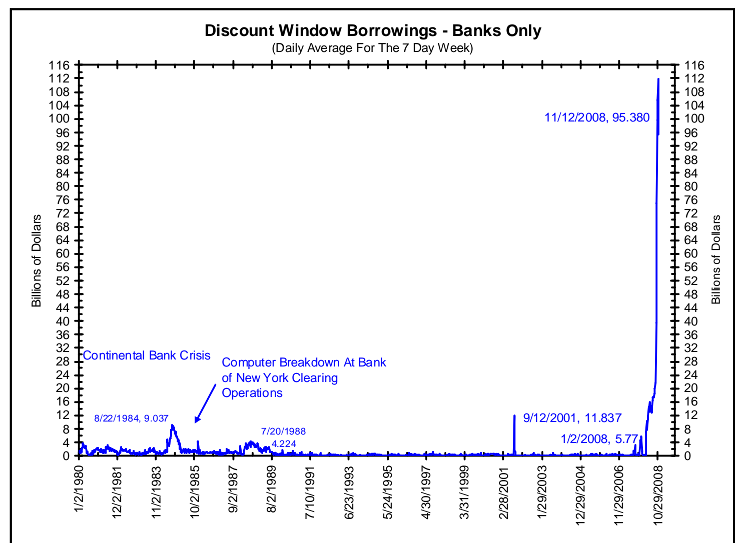
The Federal Reserve's Exploding Discount Window

Let's jump to the next page. On Page 7, you will see a detailed breakdown of discount window borrowing by the Fed.

Breaking Down Discount Window Borrowings

Weekly Average For November 12, 2008

Type of Loan	Total (Billions)	Chg. From 10-Sep
Primary Loans (Traditional Bank Borrowings)	$95.38	$75.58
Primary Dealer Credit Facility (PDCF)	$64.93	$64.93
ABCP MMMF Liquidity Facility (New This Week)	$80.24	$80.24
Other Credit Extensions (Primarily The AIG Loan)	$82.28	$82.28
Seasonal Credit (Traditional Bank Borrowings)	$0.10	$0.01
Total	**$322.93**	**$303.04**



The banks borrowed $95 billion in total. If you look at the table, $322 billion has been borrowed through the discount window through all of these various facilities that are being listed. So $500 billion from the TAF, $220 billion through the Treasury securities operations -- $322 trillion has been borrowed through the discount window. Now, remember that

all of these are collateralized loans. This means that they have put collateral up there, at the Fed of some kind of security, and got a loan back of well over $1 trillion.

Some of you have been following this – Bloomberg is suing the Fed in trying to get disclosure as to what this $1 trillion of collateral is that has been put up. The Fed is not relenting. They don't want us to know what the collateral is. The fear is that a lot of this collateral is worth a lot less than the face amount, and that the Fed could be sitting on sizeable losses. Look at what CMBX and ABX have done in just the last couple of weeks. That kind of stuff is the collateral that is being put up at the Fed. They could be sitting on huge losses.

Remember Maiden Lane, which was the entity for the $30-billion loan to get J.P. Morgan to buy Bear Stearns. There is $30 billion-worth of collateral. They have already marked that collateral down by about nine percent. But they still won't tell us what that collateral is. Well, if you take it and market through all of this stuff, the Fed could be sitting on another $90-ish billion worth of losses just by that measure. And that is before the big dive that we had in the last couple of weeks.

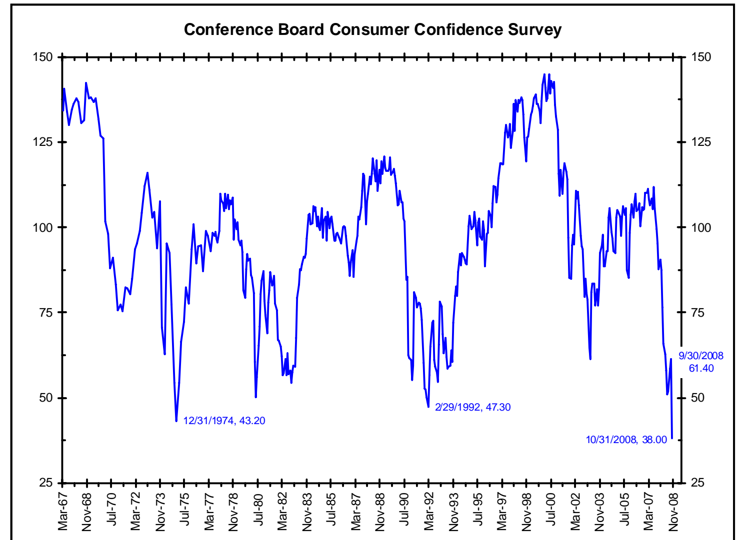
But the bottom line with all of this first set of charts is just to detail the extraordinary amount of Government intervention that has been going on. The takeaway – these numbers are too big to understand. When anybody says that we need to have another $1 trillion or something like that, we've already got more than World War II committed to this in just the last year.

These are numbers that are being made up. You could say to $1 trillion or $100 trillion – it doesn't mean anything to anybody as far as these numbers go. What we are seeing happen is extraordinarily inflationary. But because it's not working, what we are having is deflation. I have always like to kid around to be careful if the Fed ever did work and we ever did see traction being taken, and we ever did see that we were getting behind the Credit Crisis because, if we did, we would see these markets take off, and we would see inflation come back in a big way.

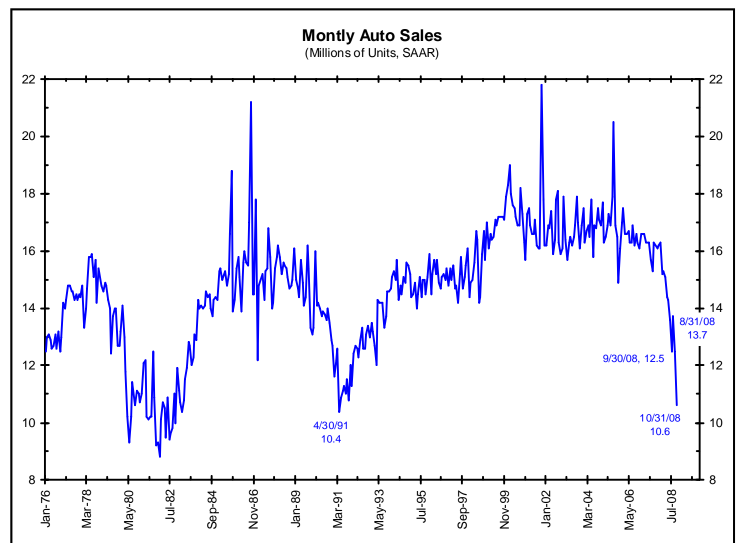
But we are not seeing inflation come back in a big way; rather, what we are seeing happen is deflation in its place. So all of these moves combined with the Stock Market sell-off, which has now reached epic proportions have had a tremendous impact on the economy.

The Economy Stopped In October

Page 8 – what I show here are just a couple of measures of the economy. In the upper left corner, I show consumer confidence. This chart goes back to 1967. It is a 40-year chart. We have the lowest consumer confidence ever recorded. The dive between September, at 61.4, to October, at 38, is the biggest one-month decline in consumer confidence in history. So consumer confidence is in the tank.

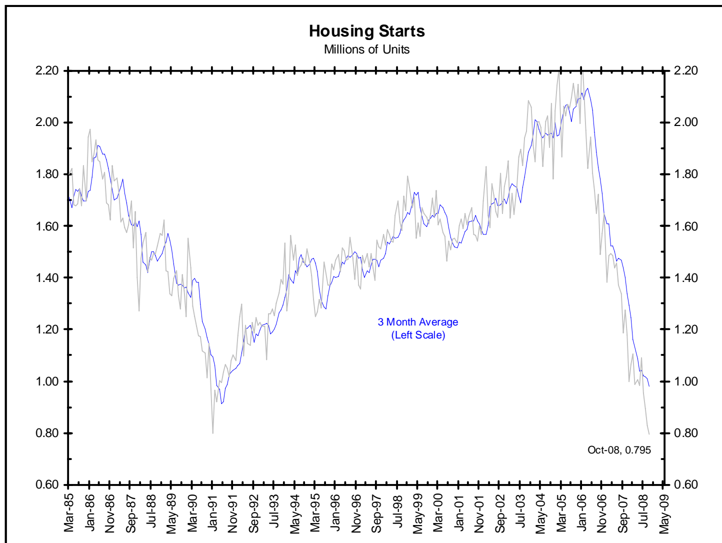


Underneath it, auto sales took one of their biggest dives, too. They are 30 percent down between September and October. That is the biggest monthly decline in auto sales in the post-World War II period. And auto sales are now at the lowest levels that they have been in 18 years. And when we get November's numbers, from every indication from the auto companies, they are going to be far worse.

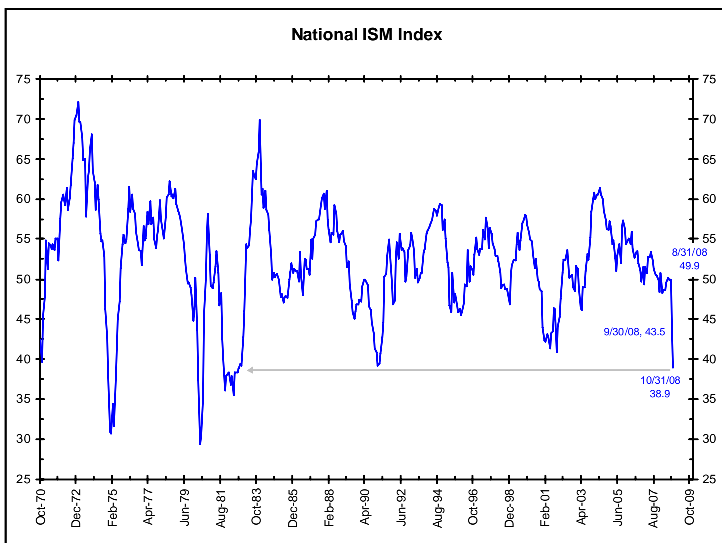


Housing starts are in the upper right. Housing starts came out yesterday morning at 791,000 or 791,500 units. That is the lowest monthly rate of housing starts ever…ever. We have the highest number of households in the Country. There are 122 million households in the Country. If you go back 40, 50,

60 years when we had 70- or 80 million households in the Country, you still had a higher number of housing starts going on. This is the lowest number ever. And the dive between September and October was one of the biggest ever.



ISM is in the lower right corner. The Institute of Supply Management's national index – from 49.9 to 39.9 – a 26-year low and one of the biggest dives ever. You could add into these numbers initial unemployment claims, which have taken a sharp move higher, up to 542,000, up 37,000 today, as well. And when you look at all of these numbers, what you are looking at is an economy real GDP growth, which could be nothing short of a disaster for the Fourth Quarter.



Now, why a disaster? It has been apparent. I have written a number of times in our *NewsClips* product that it seems like around the time that the TARP was passed and we had the Stock Market fall 3,000 points in the week ending October 10, which was its worst weekly loss since 1932, the worst week in 75 years, it scared the hell out of everybody, and everything stopped. People that had the capacity to buy things or conduct business activity decided to stop around the first week of October because they wanted to wait and see what was going to happen. In other words, they are looking for a sign that things are getting better.

We were thinking that maybe that sign was going to be Obama's acceptance speech on November 4. But in the three days after that acceptance speech, the Stock Market lost another 1,000 points, so that kind of put a kibosh on that idea.

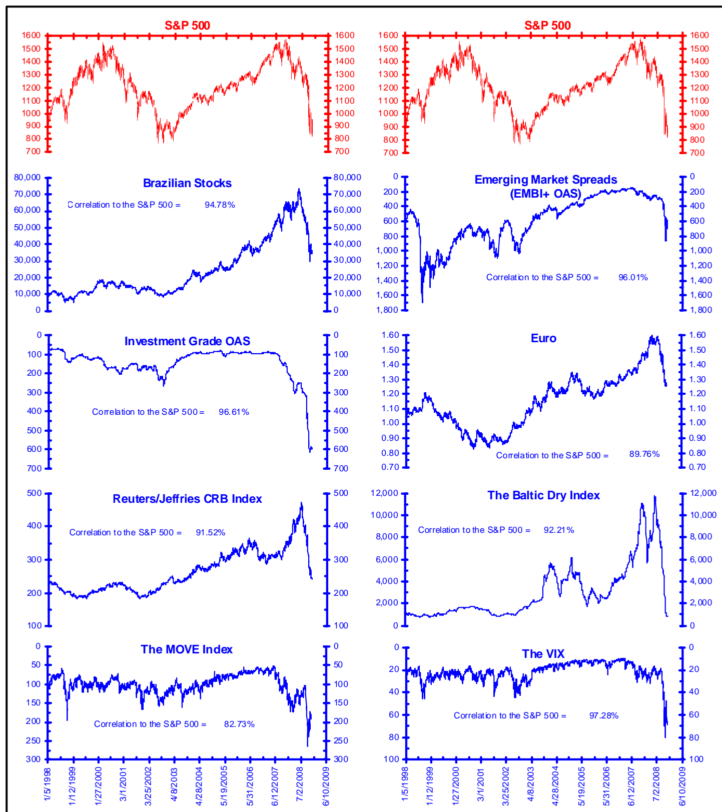
So it seems like where the economists are having problems with the economy in the Fourth Quarter is that people have the capacity to spend the money, and they have elected to not spend the money, and these economic numbers and a lot of others are just showing that everything stopped in October. When you look at economic numbers, if it has "September" or "August" on it, then you can forget those because that was the Old World.

We want to look at economic numbers that have "October" and "November" on them, and those are very bad. And economists have a problem in getting their arms around this because they think that, at any moment – and it's true – these people could start spending again because they have the capacity to do it. But I don't think that they are going to do it until they are given some kind of sign that things are better. I don't know what that sign is right now that things are going to get better. And, yet, we wait.

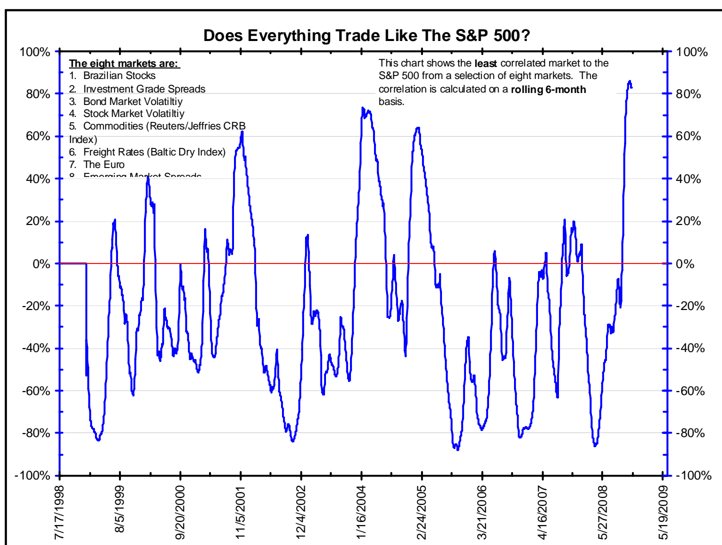
The newest argument that I have heard is that it might be January 20 with the acceptance speech. The problem with that is that we've got two more months to go through with this. That means that we will have one of the worst GDP numbers in the Fourth Quarter if we continue through the rest of the year like that. We'll have a terrible Christmas selling season. And, by January 20, we'll be in the midst of year-end financials and fourth quarter financials that are going to be scaring everybody to death. And then, at that point, I don't know if an acceptance speech is going to be able to turn it around.

It Is All The Same Trade

The consequence to all of this is the chart on Page 9. This chart is something that we have been highlighting about that it's all the same trade. On the top panel on Page 9, you've got the S&P 500 repeated twice. As you move down the panel, you've got emerging market stocks on the left, in the second panel, in Brazil; emerging market bonds next to it; investment-grade bonds, and investment-grade OAS plotted inversely underneath that; the euro next to that; the CRB Index; the Baltic Dry Freight Index; Bond Market volatility and the MOVE; and Stock Market volatility and the VIX.



I could have picked a whole bunch of other markets. I could have picked gold. I could have picked crude oil. I could have picked the yen. I could have added, added, added. But I randomly chose these markets because they covered a broad cross-section of what I was looking for: emerging markets, developed markets, stocks, bonds, and commodities. And listed on the chart is the correlation to the S&P 500 over the previous six months.



The chart on the right shows the market that is least correlated to the S&P. So everyday, I think about it in the spreadsheet – a min calculation, what markets least correlate to the S&P -- and I plot that. Right now, the least correlated markets of the S&P over the last six months has been the MOVE Index at 83 percent. That is the highest that we have seen in 10 years. And if you look at the way that these numbers are unfolding, it looks like it is going to stay that way for a while.

All of the markets are trading the same. So when we look at crude oil trading below $50 a barrel today – at least on Brent Crude Oil, at $51 on WTI – and then we try to make the case that crude oil was a bubble at $147, that inventories are growing, it's all the same thing. If the Stock Market were to make a V bottom and rally sharply higher, then crude oil is going up with it, too.

As long as the Market slumps and stays low, then everybody is going to stay afraid, and crude oil is going to go down. The good news is that you can buy cheaper gas. It's coming soon at the gas station at the corner. The bad news is that, hopefully, you'll still have a job to be able to pay for gas. That's kind of what the crude oil argument is. It is all the same trade. And trying to differentiate what is happening with the euro, what's happening with crude oil, the Baltic Dry Index, Stock Market volatility, Bond Market volatility – at this moment, you don't need to differentiate it because we are all operating on whether or not this credit crisis is going to get worse or going to get better, and it's driving all of the markets the same.

And, right now, the fear is that it's going to get worse because of the very bad Fourth Quarter economic numbers. And all of that massive Government intervention, which is collectively greater than World War II, has really been working so far.

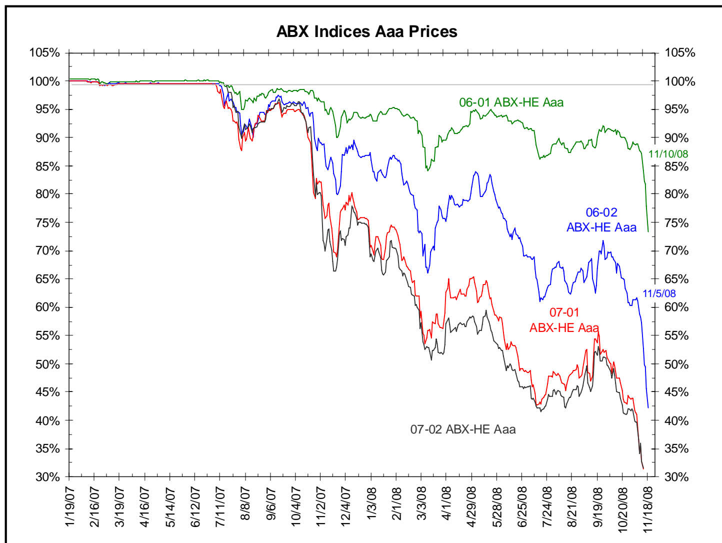
ABX/CMBX Get "TARPed"

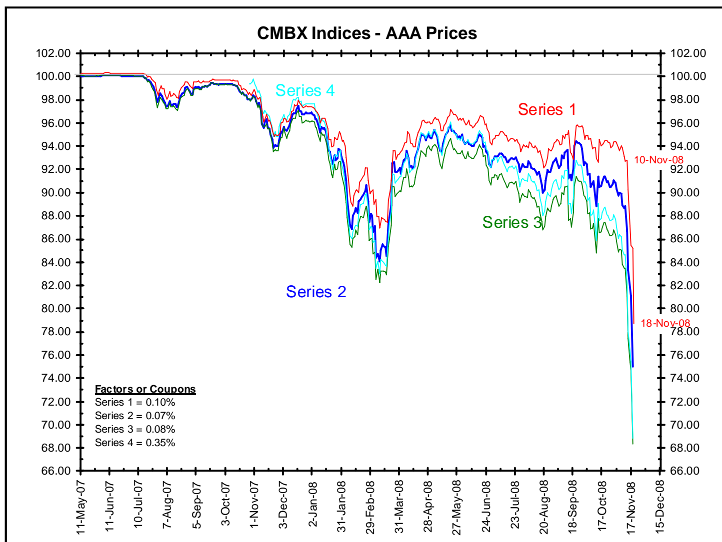
Page 10 – let's talk about where we are in the Credit Crisis.

These charts here are of the ABX and the CMBX. On the upper left of the chart is the ABX Index. The lower right on the chart is the CMBX Index. These are the AAA prices on these indexes. What I tried to highlight on a couple of these charts on the ABX Index, in blue, I got November 5 and November 10.

And on the CMBX Index, in red, I highlighted November 10 and November 18. I wanted to show you how badly these prices have gone down in just the last two weeks, that this move down in the ABX and in the CMBX is greater than any other move that we have seen in the history of these indices. And you can see that these charts go back – in the ABX's case, back to January of 2007, and in the CMBX's case into May of 2007 – and the worst move down in securities backed by mortgages and commercial real estate mortgages has been in the

last two weeks. This market is getting worse; it is not getting better.

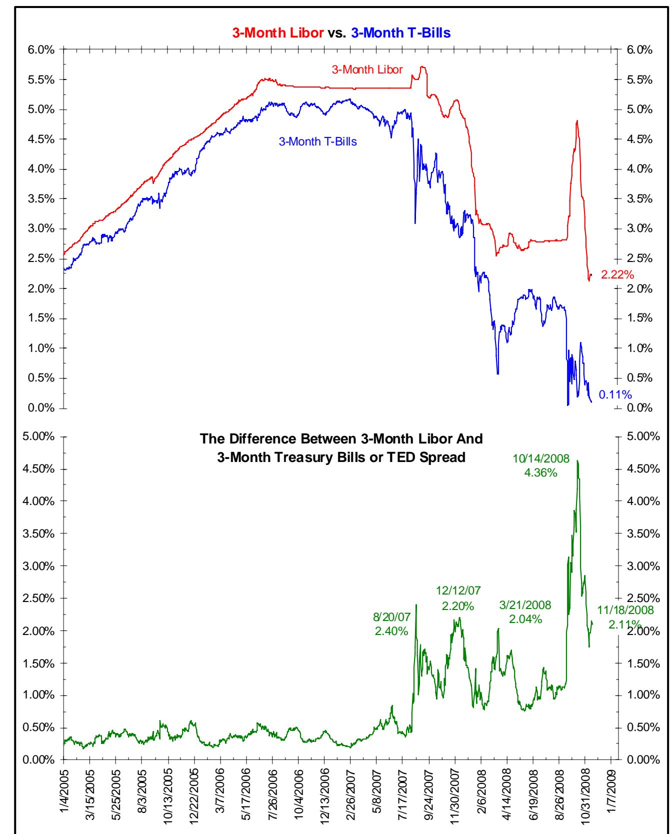




What happened in the last two weeks? It appears that these guys believed that there was a program called TARP that was going to do reverse auctions, that was going to put a floor on their prices. And while the initial move in TARP was to put some capital out to the banks, they were eventually going to get around to doing that. When Paulson announced at the beginning of last week, “No, we’re not going to do that,” these prices fell apart. They were artificially inflated with the hope that Government money was coming. And when he changed his view that we weren’t going to do this program, these markets took another dramatic turn downward. And so it shows me a couple of things:

One, Paulson still has a tin ear as to what has been happening in the Marketplace. He had no idea how much these prices were being held up by the hope that TARP money was coming and the original plan of the reverse auction. And when he pulled it back, he made the situation much worse. That is why, like I said earlier, let’s just call a timeout. No more new plans because all of these plans, collectively, aren’t doing anything. And in a case of this, sometimes they make things worse. So I don’t think that these situations are definitely going to help. So when we talk about whether credit is getting better, the original ground for credit is real estate, securities backed by commercial and residential real estate. These markets are decidedly getting worse.

Medicated Market - LIBOR And The TED Spread



But wait. There are markets that are getting better. And I like to call those markets the medicated markets. One big thing that you will hear and read every day is that the signs that the Credit Crisis is getting better is that LIBOR is coming down. The chart on the top left, in red shows that LIBOR peaked at 4.81% in early or mid-October, and it’s gone all the way down to 222. On the bottom, in the green chart underneath, that shows the difference between three-month LIBOR and three-month Treasuries, or the TED Spread. That got to an unbelievable record of 436 basis points by October 14.

But now, at 2.11%, while we want to say that’s better, other than the last two months, that’s right where we were at every other panic point during this crisis. Two hundred and eleven basis points was considered a panic on the TED Spread up until two

months. Then we went to 436, and I guess that we redefined what the definition of panic is.

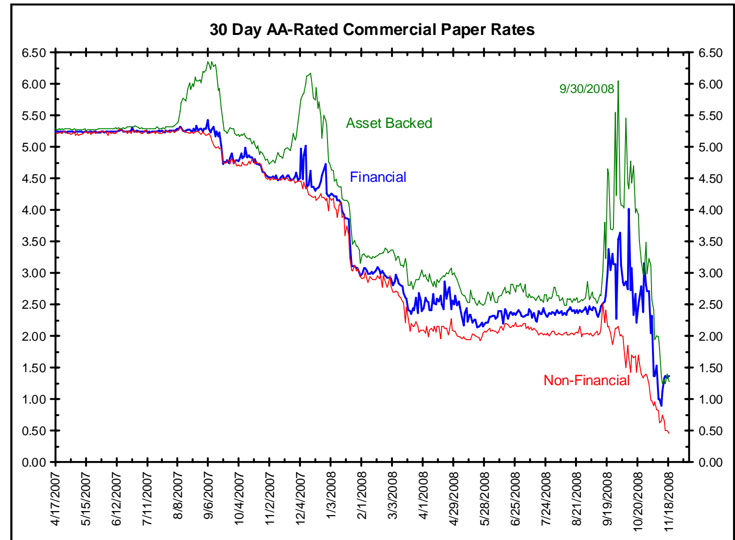
What I am trying to say here is that LIBOR is still telling us that there are big problems. You can see that, especially if you look at the blue line on the top, which is three-month Treasury bills. That is something that everybody can watch every day. Three-month Treasury bills – you don't need to get as complicated as watching something like LIBOR. They were at 11 basis points on Tuesday's close. They are at six basis points now. They are effectively zero. When these markets are getting better, three-month bills are going to move dramatically higher, more toward the targeted funds rate of one percent.

This market has come down. As I have talked about in the text on the right, nine of the 16 banks that report to LIBOR have received Government money. Some of them are UK banks and European banks, and they have gotten money from their governments, as well. There have been public statements that they want these banks to do something about LIBOR.

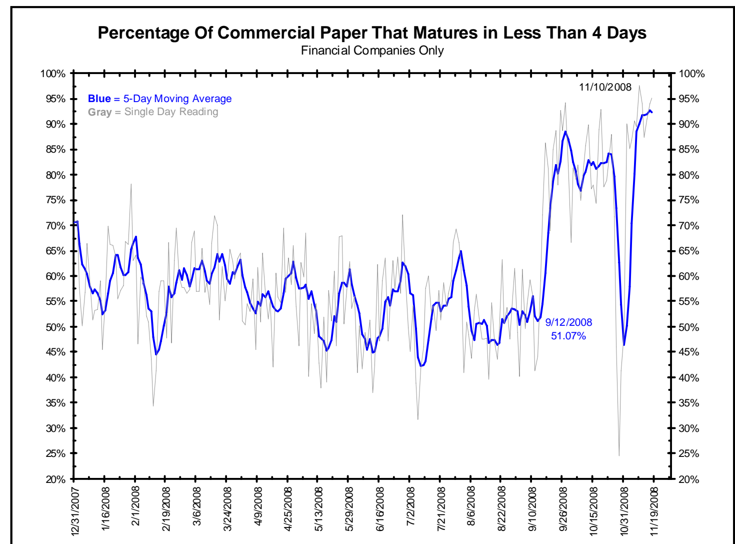
In fact, I linked it in the piece where you can access it by clicking on the link about doing something about LIBOR. Well, they did; they brought it down. You wanted it down, so they brought it down. A lot of these banks aren't lending at these rates, so it's LIBOR, the level that you cannot get a loan at -- now, it's 2.22%; it used to be 4.81% – and they are using other measures now like CDS spreads and stuff to price new loans. But their new capital injection came from the Government. The Government wanted it lower, and they got it lower. That's why I was calling these medicated markets. If I am in excruciating pain, and you shoot me up with morphine, then, OK, I'm not in pain anymore; but that doesn't mean that my problem has gone away. That is what we have done with markets like LIBOR.

Medicated Market - Commercial Paper

And if you look at the chart on the next page – commercial paper – we've shot these markets full of morphine, and they don't feel any more pain, and we have decided now that they are getting better. No, they're not getting better. The definition of "getting better," to continue with my metaphor, is when you withdraw your medication, that the patient doesn't go back into convulsions. So if you want to know a sign of when does LIBOR get better, it's when they start reducing the size of the TAF, when they start reducing the size of Government involvement. In terms of commercial paper, if the commercial paper, right now, you can borrow 30-day commercial paper directly from the Fed once you are approved to borrow – that program is supposed to end in April. Well, end it in April, and let's see if the private market steps in and continues to let corporations borrow at that rate; and, if they do, then the Commercial Paper Market is getting better. But if they extend it in April, well, then they answer the question with, "It's not getting better." We won't know until that happens.



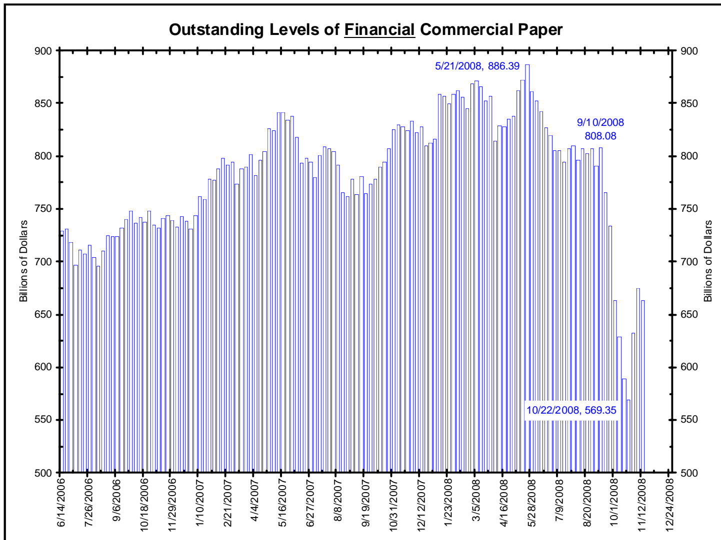
As the chart on the upper left shows, nominally, rates are coming down because they are Government-set rates. Commercial paper rates are now no different than the Targeted Funds Rate.



The bottom left chart shows the percentage of commercial paper that is being financed four days or less, that was running at around 80 or 90 percent. Then they started the Program, and it shot down to 20 percent, meaning that during late October-early November, 80 percent of all commercial paper was longer than four days. Eighty percent of commercial paper was not overnight commercial paper.

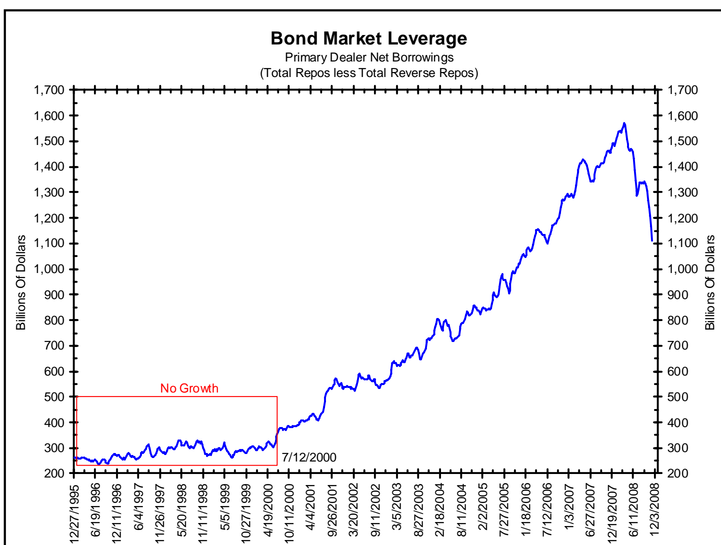
But now we're back to 90-plus percent of commercial paper being overnight. Nobody wants to give an extension of a loan beyond four days

because of the environment that we're in. The only lending that they got was the initial burst of lending that we saw when people borrowed 30 days from the Government. And I suspect that, in 30 more days, you'll see another move down as this paper gets refinanced.



The result of commercial paper has been that, yes, as the chart on the right shows, you've had an uptick in the levels of outstanding financial commercial paper. But we are nowhere near where we were back in September or even earlier this year when these markets were still considered healthy. We have had somewhat of a rebound, and all of that rebound could be attributed to the Government. So are commercial paper and LIBOR showing us that these credit markets are getting better? I don't think that we could make that case.

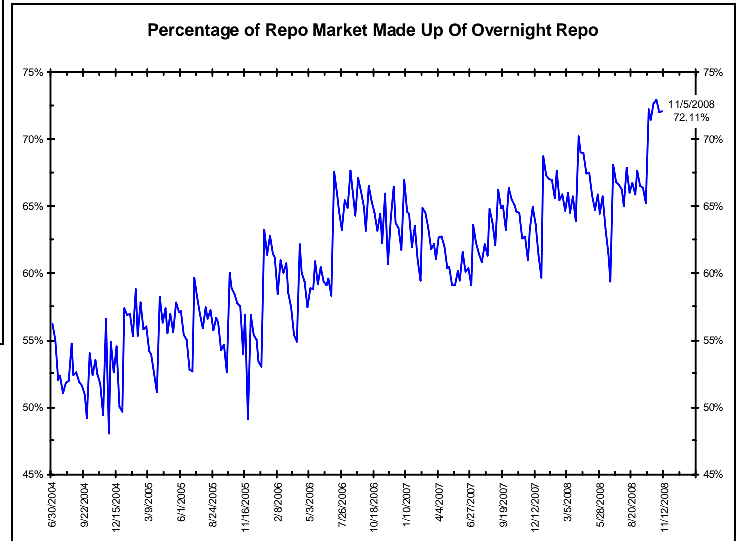
Repo Still Not Healthy

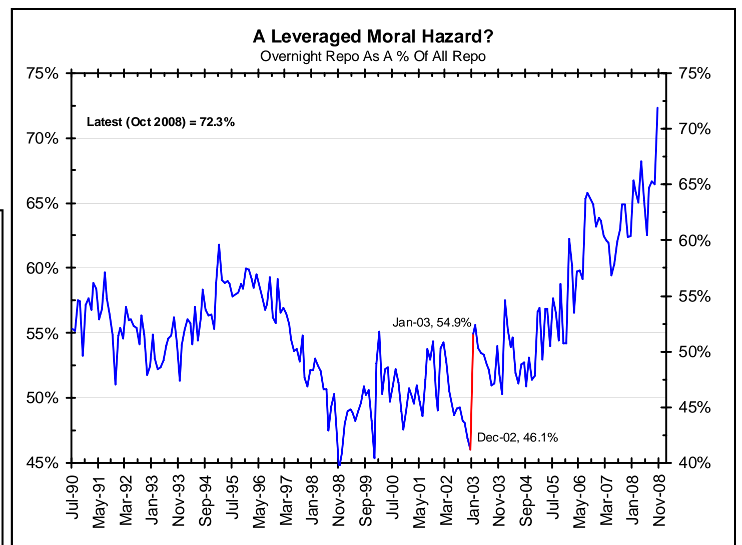


Repo is definitely not getting better. And there is not as much in the repo market as everything else.

If you look at the charts on Page 13, specifically the upper left chart, again, what is happening is that Bond Market leverage is coming down. The amount of repo in the Market has been shrinking from about $1.6 trillion to $1.1 trillion.

Five hundred billion dollars has come out of the Market. The percentage of that repo that is now overnight versus term is the highest that it has ever been. Both charts on the bottom show the same thing over different timeframes. I wasn't sure which one to use, but I had room and so decided to stick both of them in there.





What is this telling us? First of all, I think that a lot of people are looking at the repo number and saying, "Ah, there's your delevering. You've gone from 1.6 to 1.1." Yes, Wall Street is delevering. But the consequence of that delevering – a bunch of people that were getting loans that shouldn't have been getting loans, they are getting them from the Government now. They are not getting them from

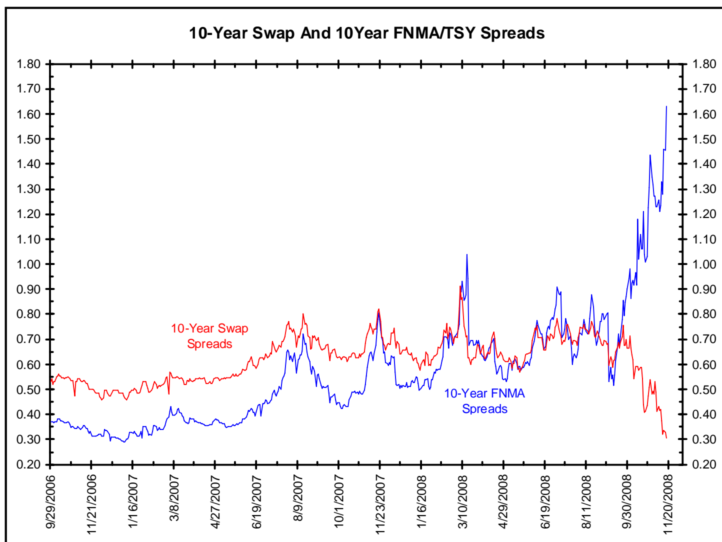
Wall Street. So while Wall Street is delevering, the economy is not delevering.

If you want to think of it in these terms, then consider the stylized example that I have been using: we have an economy that requires, worldwide, something along the lines of about $25 trillion in loans every day. We are now providing roughly $21 trillion-worth of loans through the private sector, through the banking system, meaning that there is a hole of $4 trillion. If we were delevering, we would have to have $4 trillion-worth of borrowers go away; but we're not. That $4 trillion is being plugged by the Government. They are providing the financing for that $4 trillion.

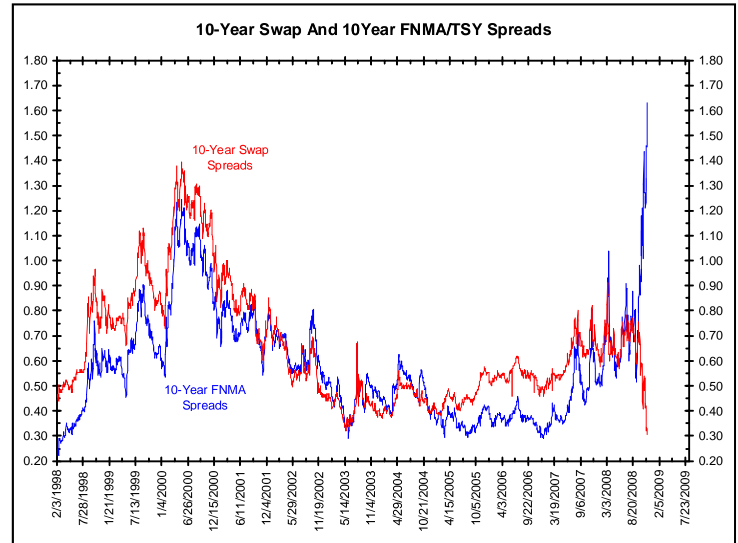
Here is the problem: we now have a $21 trillion financial system. It can provide loans for $21 trillion. We have a $25 trillion economy. How are we going to get this in balance? We've got the Government standing in the middle, trying to hold everything together. Either we need to have investors pump more capital back into the financial system in order to bring their size up so that we can have them be big enough to provide $25 trillion in loans, or we need to shrink the economy. Or we can kind of stay in this sort of stasis in the middle, where we are right now, hoping that things get better. And as we do, the problem is that the damage done by Paulson with all of his changes in plans and treating the owners of financial firms so badly is that it has extracted a huge toll on the Market.

Let's move on a little bit more as far as credit goes.

Agency Spreads – All About The Chinese



Agencies – let me start with the chart on Page 14, in the upper right. Ten-year swaps spreads, which are in red and is moving down; 10-year Fannie Mae spreads – Fannie Mae 10-year minus Treasuries has been dramatically widening. The reason that I express it this way is because, normally, Fannie Mae spreads and swaps spreads would trade on top of one another, but now we have opened up a dramatic difference. The bottom chart is five-year spreads showing something very similar, too.

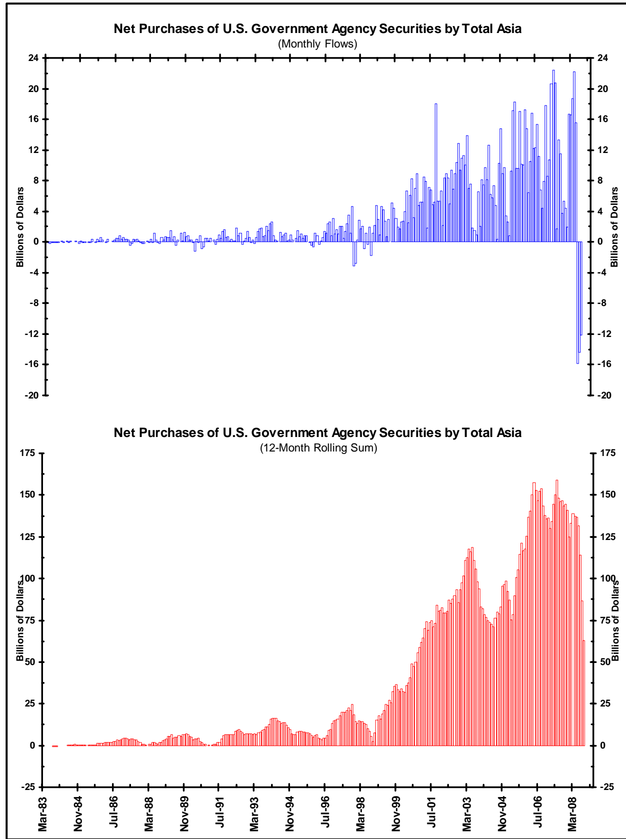


Why is this happening? First of all, we gave Paulson his so-called bazooka to try and quell Fannie and Freddie in July, and then we put these companies into conservatorship in early September, and that was supposed to make their creditworthiness the same as the U.S. Government's. So why is it that they are getting worse even though they have gone into conservatorship?

The chart on the left, which was from the TIC update that we did earlier this week, shows U.S. Government and agency securities purchases from Asia. In July, August, and September – the last three bars – out of Asia and, particularly, out of China, you have seen dramatic selling of agency securities. They have turned tail and have run away from the agency market. And they were a big buyer of these securities. They are not only not a buyer anymore, but they are now a big seller of these securities. I'm talking about Asia in particular. This is through September. We haven't seen the data yet for October, which was that horrific month that we've got coming up yet.

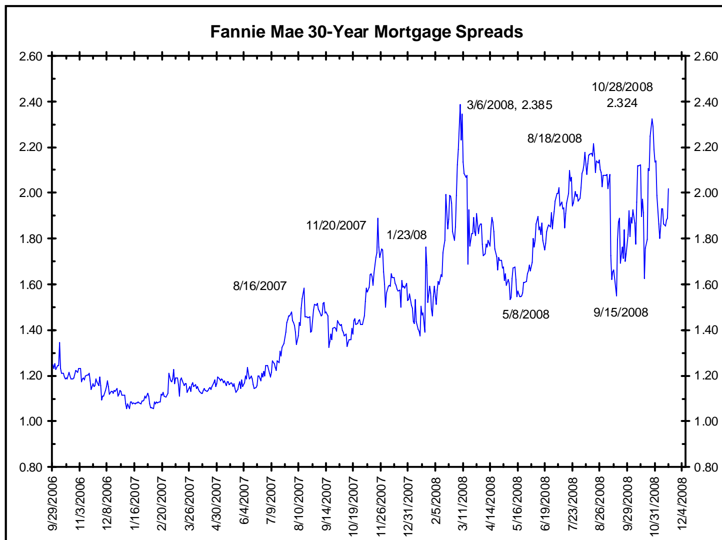
We have lost a big buyer. The spreads for agencies are compensating for that loss of buyer. And even conservatorship doesn't change it because the buyer ran away not because he feared the credit risk of the agencies. Conservatorship increased their credit risk, and it is not changing his view. Foreigners have left this market. They are not coming back to this market. It is part of the delevering process. And instead of letting Fannie and Freddie be delivered, we are now putting them into conservatorship, and it is making the situation worse. And the Government is preventing them

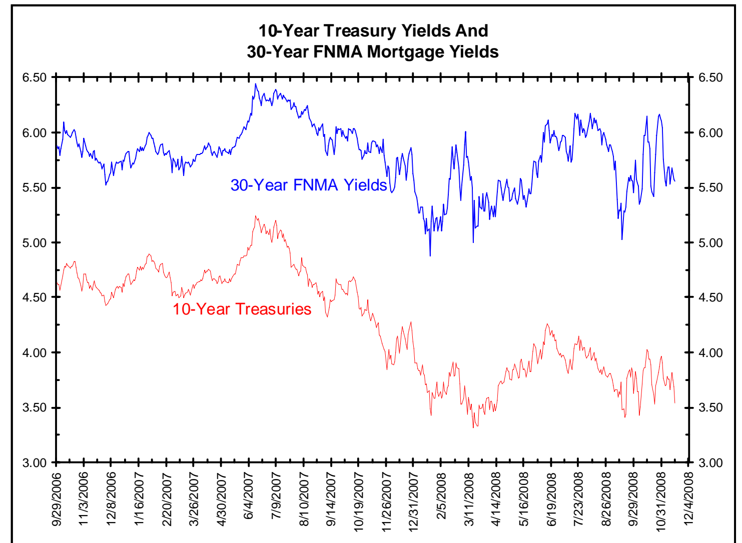
from delevering by trying to step in and trying to keep them afloat.



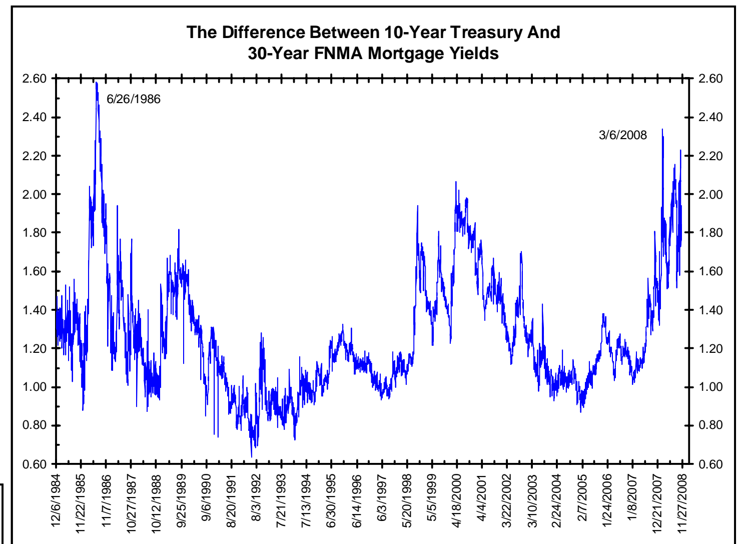
Mortgage Spreads – Not Getting Worse

Go to the next chart – "Mortgage Spreads." I suspect that, if you look at this chart, it's all essentially the same thing. The upper left chart is 30-year Fannie Mae minus 30-year Treasuries. They are spread at their current level at around 200 basis points. It is still fairly wide, but this is one of the few markets that is not a record spread.





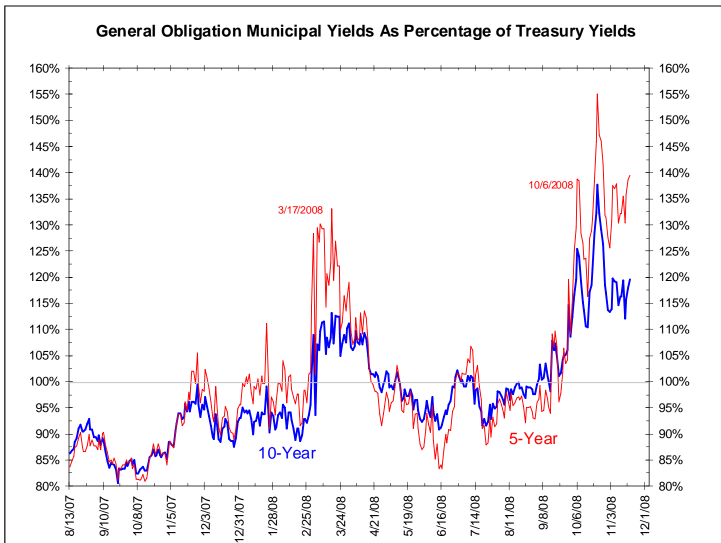
The bottom chart shows you have you get there – 30-year Fannies and Treasury yields. And the chart on the right is just a longer version of the upper left chart to show you that these levels are the highest levels that we have seen in two-plus decades.

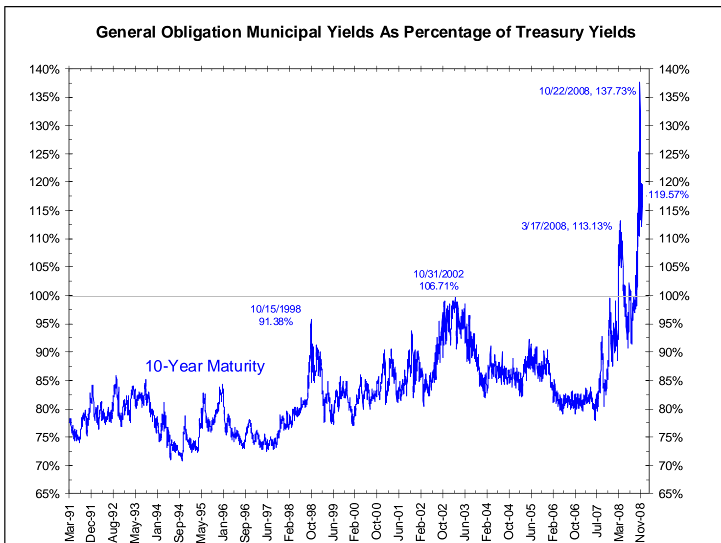


I suspect that, in the next couple of days as we update this chart, you are going to see mortgage spreads dramatically widen out because of the huge drop that we have had in Treasuries. Treasuries are plummeting lower – down to 315 on the 10-year and down to 372, which is a record, on the 30-year. And what we will see is that mortgage spreads have not been plummeting to that degree, and that they are going to widen their spreads back out. Again, a lot of these spreads, when you look at them, are not getting worse. But there is still definitely at a panic level, and it's still way to early to say that things are getting better.

Muni Spreads – Still At Panic Levels

Muni spreads are shown on Page 16, using the same chart again. I like to do this a lot with differing timeframes.





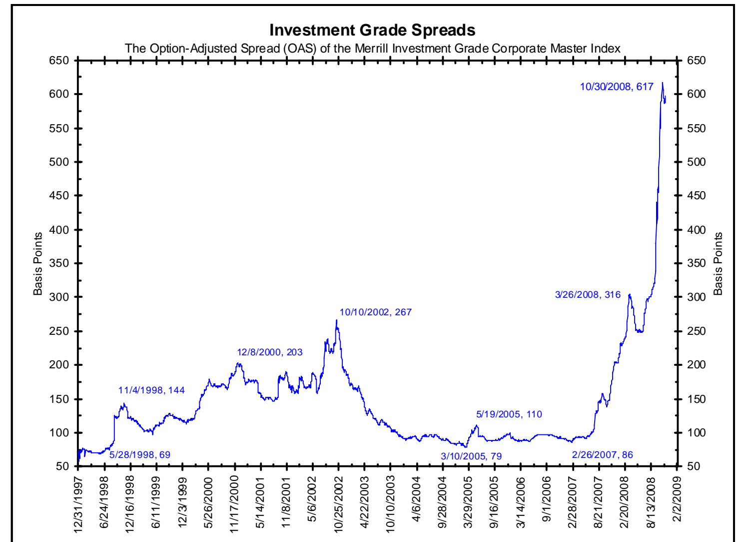
The red chart on the top is five-year general obligation munis as a percentage of five-year Treasuries. At 100, that means that their yield is the same as Treasuries. Well above means that at 137, which is where they are right now, means that they are yielding 137 percent of Treasuries. The blue line is the 10-year GOs versus the 10-year Treasury at around 117 percent. And the bottom chart is 10-year GOs as a percent of Treasuries, going back 18 years to show you, truly how unprecedented what we have seen happening has been.

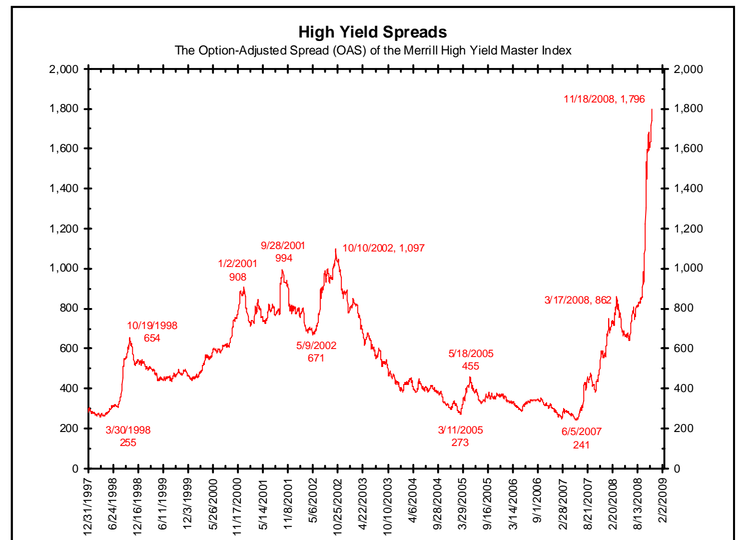
A couple of things about this chart for foreigners to keep in mind is that municipals are tax-free. They should, as the bottom chart shows, trade at a much lower yield basis Treasuries because of their tax-free status. And in normal times, we can use them to try and guess where people think that the tax rate is going to go. But in this environment, they are still wider now – if you look at the top chart – then we were when the Auction Rates Security Market was blowing up in March, when Bear Stearns was going out of business. Five-year – the red line – is higher than it was in March. The blue line is also higher than it was in March.

Munis are still at panic levels. There is no other way around it. Now why is it that agencies, munis, and mortgages are still at panic levels? I have argued that part of the problem is that a big buyer in these markets has always been the levered buyer. And to some extent we have delivered him out, "him" meaning the hedge fund. And by delevering the hedge fund out of the Market, we have had a lot of these players being unable to buy, and it has been really hurting their prices.

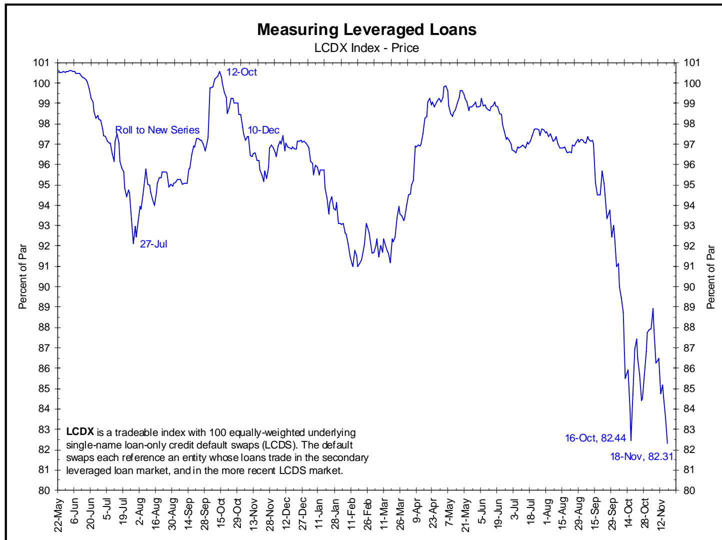
Credit Spreads Are At Their Worst Levels

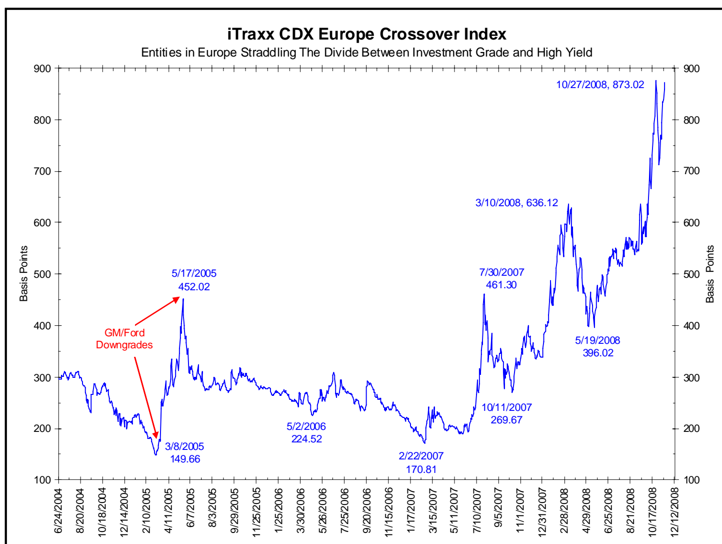
In wrapping up here, Page 17 – "Credit Spreads" – they are not getting better, either.





Here are various measures of credit spreads. The top chart shows that investment-grade credit spreads peaked at 617 back on October 30. We were at 608 last night. We're just a few basis points off of it. If you look at the bottom left chart, on November 18, we hit the wide in high-yield spreads at 796. We were 1818 or 1900, or something like that yesterday – new records on high-yield spreads.



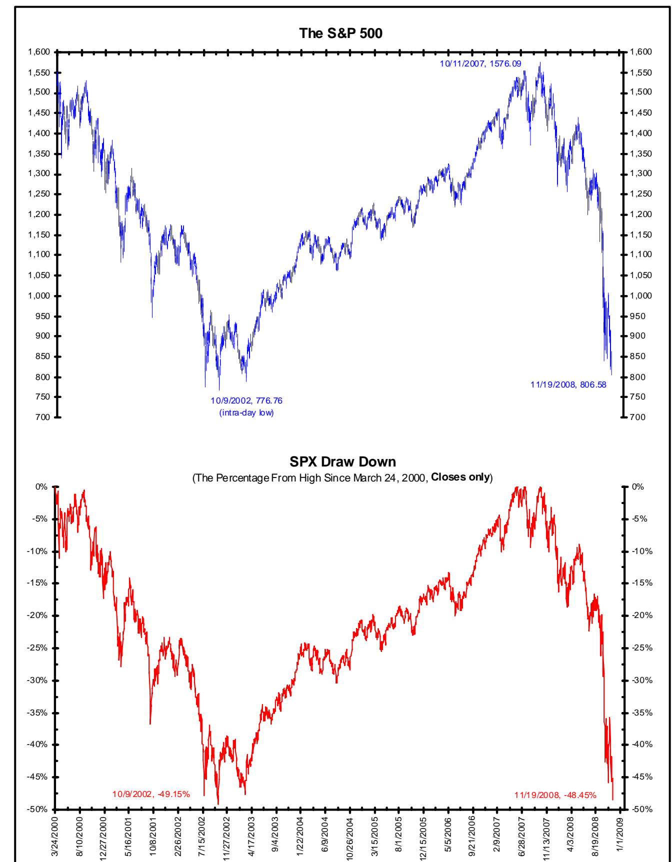


If you look at the upper left chart – "Measuring Leverage Loans" – new low price in the LCDX Index. And if you look at the lower right chart, this is the iTraxx Crossover Index. The iTraxx Crossover Index was just about at records, and then it shot way over 900 today, so it would be up off of the top of the scale right now.

When were the worst level in credit spreads? I have been saying this on these Conference Calls for a few months now – "Today was the worst level in credit spreads." We have the opposite of getting better when it comes to the corporate bond and level loan markets.

The Stock Market Decline Now Rivals 2000 to 2002

And then, finally, in looking at the chart on Page 18, the Stock Market, as of yesterday, its decline was double bottoming off of the low of 776 from October of 2002. It was 48 percent off of its high, whereas, in 2002 -- it took two years versus one this time – when we were 49 percent off of the high.



Conclusion

So let me sum all of this up for us. We have had an extraordinary amount of Government intervention, numbers so big that no one can understand them, and larger than the outlays of World War II. This Government intervention that we have seen happen here is largely not working, which is why all of these credit spreads are getting worse, and the Stock Market continues to crumble. This has led to scare the hell out of everybody that economic activity all but stopped around October 1 and we are looking at horrifically bad economic numbers for the Fourth Quarter. People, yes, have the capacity to buy and to conduct business, but they have elected not to because they are waiting for a sign that things are going to get better.

That is what has tripped up the economists. They used to think that, if it was this bad, then it was because unemployment had skyrocketed, because wealth was destroyed (though we have had some of

that), or because incomes were down, and you did not have the capacity to spend the money. But this time around, you do; you just don't want to spend the money, and you're not going to until there is a solid sign that things are getting better. We don't have that solid sign that things are getting better. And because of that, people are not spending as well.

The credit markets can be broken down into two different groups – the medicated markets, which are those with heavy Government intervention like LIBOR and commercial paper. Nominally, they look like they are doing better. But you cannot borrow at those rates. You have to use the Government as your borrowing partner in terms of the Commercial Paper Market. And we don't know if that is a sign that things are getting better because we only know that once the Government withdraws from those markets and the markets can stand on their own, and the Government is not yet withdrawing from those markets.

Looking away from the non-medicated markets – whether you look at three-month T-bill rates at 11 basis points, mortgage spreads, agency spreads, muni spreads, corporate spreads – they are all terrible. They are all still at panic levels. And the ABX and the CMBX, which are where everything started in real estate loans packaged as securities, they have taken their worst hit throughout this entire crisis in the last two weeks, right about the time that Paulson said that they are not going to use the TARP for its original plan.

This has all been priced in. This is why we've got levels in markets that we don't understand. Most high-yield managers would tell you that they never thought that we would see a high-yield index at 1800 basis points. That's a 21-percent borrowing rate right now. The Stock Market is 49 percent off of its high. We have seen world-record rates, whether it's muni spreads on down the line. So to some extent, we've got a lot of this priced in. And that is why I will continue to think that a lot of the damage is about to be put into the Market.

I still look for one more capitulation move in this Market that really gets everybody to move from greed to fear. Normally, what I have been worried about is, every time the Market sells off, I hear people say, "Oh, this is a buying opportunity," as opposed, to every time the Market sells off, you better get out before you have no money left. That is when you get to the fear phase, and I think that we are very close to that.

At that point, I think that we will largely have found a bottom in the Market. And yet, with all of the Government involvement, and with the idea that we are going to have heavy regulation coming, we are going to regulate out risk-taking. And I don't think that we are going to have much of a bounce after that.

But I am going to warn that, even though I am kind of saying that we are very close to a low, one, you're still not going to like what it is going to take to get to that low. A great example of that is financial stock. A lot of people thought that financial stocks were a great buy. By the end of September, were 41 percent off of their high, and a lot of wise sages said, "Financial stocks are a great buy." They went down 22 percent in October, and people were floored. It was one of the worst months that financial stocks had ever had. And of financial stocks around November 1, they said that these represent the most extraordinary value that they have ever seen in the Market. I heard this a lot on CNBC. That was after a 22-percent down in October. They are down 36 percent this month, and it's only the twentieth of the month right now.

And what has happened with a lot of these wise sages now is that they are in the paper and laying off staff because they have lost so much money as far as these markets go. So you're not going to like the process of making the low. And I am going to say that, even though I think that we are very close to the low, I am going to rather be a month late than a month early. I am not interested in picking a low. I am more interested in saying, "I think that was the low a few months ago" or "last month" or something along those lines. So the good news is that we might be having the damage about over with. The bad news is that it is probably going to be sideways, and you're still not going to like the process that is going to come before us.

The big problem that we have is that we say that we want delevering, but we don't want delevering. We are delevering the private sector with the losses. But the Government is stepping into the breach because delevering means that GM goes out of business. Delevering means that GE can't get commercial paper, but we don't want that. So we're going to give GM a loan. We're going to let GE borrow from the Fed.

How do we get out from underneath this? Well, we need for people to start having faith in the financial system and start investing in banks and brokers again. The problem there is that we have done so much damage with the loose cannon at Treasury – Hank Paulson – changing the rules every three minutes that no one wants to touch these companies, which is why their stocks are down 36 percent again this month. It is going to take some time before we can get this problem undone.

Questions & Answers

I'm going to open up for questions after this last thought for you. There is this belief in the Marketplace that we haven't found the right deal. And I keep watching everybody and what Paulson is doing. Paulson is an investment banker. He is looking to do a deal. And everybody still has this mentality that somebody is going to come up with a flowchart and a big Magic Marker and show us how we could structure our way out of this deal, and we are all going to collectively slap our hands on our foreheads and say, "Gosh, I didn't think of that. That's how we get out of this problem!" But that doesn't exist. There is no easy way to get out of this problem. There is no way to get out of it.

I was on the phone with a reporter yesterday, and he was saying, "If I put you as czar, what would you do to fix this problem?" And I said, "In large part, you really can't," and he wouldn't accept that as an answer. We could do these deals all that we want, and we could argue about whether or not we should be modifying mortgages and whether or not we should be refinancing this, allowing that, or creating a new facility here or a new facility there, and that will stall off the problem for a while, but it's not fixing the problem. That is really all that we can do in this Market.

All right, as usual, I ran a little bit longer than I thought. It's seven, pound if you want to ask me a question directly. Otherwise, if you want to email a question to me, or if you are on the webcast and want to IM a question, you can do that, too. Remember now that we take questions anonymously, so when I answer the questions, I will answer them all by first name only. So it is seven, pound to ask a question online, or you can IM a question, or you can email me the question.

The first question that I will take today is from Ryan. Ryan, are you with us?

Ryan: I've got so many questions, but I will just pick one. Do you think that the Market wanted the automotive bailout without any real strings attached, almost like a blank check? And is that one of the big reasons for the pain that we have experienced in just the last few days?

Bianco: That's a good question. Let me answer the question a little bit more generically. I think that one of the problems that we have been facing is another mistake that we have made, which is that we have been trying to both bail out companies and punish them at the same time. AIG is a great example. "We'll give you a loan, but you've got to give up 80 percent of the Company."

And then what happens is that we give AIG a loan, and then to show that we drive a hard deal, we give it to them at LIBOR plus 8.50, and then they can't pay it back, so our $85 billion goes up to $135 billion, and then the Fed becomes part owner of the Company.

If you want to bail out GM, then give them the money to bail them out and forget bellyaching about how much private jet mileage that the CEO puts on or what he gets paid. If you want to punish them, then don't give them the money and punish them. But to try and do both at the same time – "Here is $25 billion, but we don't want for you to use your private jet, and we want to restrict your pay" – we showed with AIG that doesn't work. We showed with Fannie Mae and Freddie Mac, in putting them in conservatorship and then blowing up the preferred shareholders, that doesn't work. We have proven that doesn't work, and that is what we are doing again.

So to answer your question, yes, if you want to bail them out then bail them out. If you want to punish them then punish them. But you cannot pull off both at the same time. So I do think that that is what is bothering the Market. This is because, by attempting to punish these firms and give them money, they are going to be back in six months for more money, and they are going to be back a year after that for more money because we are not going to go about fixing the problem.

Ryan, does that kind of get at it? Did you have a followup to that question?

Ryan: No, that's a good answer. I appreciate it.

Bianco: Sure, thanks. Let me jump to the next question. Harold, are you there?

Harold: Can you explain a little bit just what is going on in the Interest Rate Swaps Market? We've got negative spreads on the 30-year, almost down a substantial narrowing in there that is somewhat unprecedented. What is causing this? You didn't really comment on that. I'm just curious.

Bianco: Yes, you know, about the Swaps Market, the answer is, "Can I explain it?" (Laughter) No, I can't really explain it. Negative swaps spreads – and they are severely negative now by, what, -20 basis points or something, not just –1 or something – I can't really explain it other than that you used to pay a premium for fixed, and now you're paying a premium for floating, I guess, is what it really suggests. You could nominally look at it and say that the Market must think that these rates are going to plunge. But beyond that, that one has really been a headscratcher.

Harold: Theoretically, I can buy long Treasuries and swap them, and pick up spread.

Bianco: Yes, exactly!

Harold: If it's in the Repo Market, then I can earn it on the other side, too, assuming that somebody will lend to me.

Bianco: Yes, assuming that somebody will lend to you is a good example. The simple answer is that this is yet one of these in a long line of things that, when markets get stressed like this, they start doing things that you don't quite understand. And I don't understand it. That is really the best answer that I can give you, is that it takes an environment like this to get something like negative swap spreads. And why do they exist? They probably exist because those are rates and at levels that you cannot understand and that you probably cannot do the trade at anyway. And so it could also have something to do with derivatives backfiring. It could have to do with lack of liquidity, all of the above. That is kind of the best answer that I can give you as far as swap spreads go. But that is one that I have been really scratching my head at.

Do you have a followup or anything else to add?

Harold: Can I just follow up on something that you said just a little while ago?

Bianco: Yes.

Harold: On the whole idea that TARP now is something that theoretically just put capital into programs, one of the things that you said is that, when they basically eliminated Fannie and Freddie preferred dividends, they took huge amounts of capital out of regional banks because, basically, they are the big holders of Fannie and Freddie preferred, so they depleted capital, making them an FDIC problem. Why couldn't they, right now – or is there anything that prevents them from reinstating the dividend on Fannie and Freddie preferreds, and, all of the sudden, capital would reappear on the balance sheets of most of the regional banks all across the Country?

Bianco: There is nothing to prevent them from doing that, as far as I know. The problem now is that, once you've gotten two months on, some of these preferreds might have been sold for residual value so that the regional banks don't own them anymore.

Harold: It could be.

Bianco: Yes, but you're right. This gets back to what I said before. Do you want to bail them out or do you want to punish them? You cannot do both at the same time. And that is what they tried to do, and that is why it was such a spectacular failure. And that is why I think that this auto thing is going to be a failure, too, because we are trying to do both at the same time.

Harold: But in the case of the banks, it is going to be a Government problem one way or the other, either through the FDIC if it is a problem or the other. Wouldn't it be cheaper to reinstate the dividend, pay it, and have the capital reappear except for those who have already sold it? I'm completely baffled.

(Laughter)

Bianco: No, I think that you're right. It is something that, if they wanted to reinstate the dividend on the preferred, then it is something that they could do that would maybe help for those regional banks that still own it. They were supposed to put together a program through the FDIC to help those regional banks. I think that we now call that…

Harold: But that's an expensive way to do it. You turn around and give it to them so that they can merge with a bunch of (inaudible)…?

Bianco: Well, everything that they have done – you know…

Harold: Never mind. I'm on a soapbox. Forget it.

Bianco: And you're on a soapbox that I get on, too, that everything that they have done to date has not worked. We know that because of the state of the markets. And part of it has not worked because it is very obvious that it is not thought through. There isn't a plan in action. Early on, I do think that, going all the way back to Bear Stearns, they really thought that the plan was that if we try and remove moral hazard by extracting punishment, then that was going to fix the problem. Why do you think that the original deal with Bear was $2? That two was meant to be a symbolic gesture. That eventually turned out to be 10, but the original $2 per share that they were going to give was supposed to be a symbolic gesture that you were going to get punished. The problem is that, if you've got firms that are reeling, then punishing them makes it worse. And they haven't yet found a way to both punish and save at the same time.

So they are still not quite figuring it out. Even if you go to last week's announcement, I don't have the access that the Treasury Secretary has, and I'm not going to say to you that I could have predicted that the ABX and CMBX markets were going to fall apart if I make an announcement that says that I'm not going to do it.

Harold: Yes, of course.

Bianco: But if I were the Treasury Secretary, I would have found out how people thought that those markets were going to behave. And unless they completely misjudged those markets, I don't think that Hank even thought of asking the question. And

because he hasn't thought of asking the question, I think that is why he got so blindsided by its answer.

Harold: Yes, they ought to be able to ask the question, "What is business as usual" before taking an action. "If I take it, will people be able to do business as usual?" If the answer is "no," then (inaudible)…

(Crosstalk)

Bianco: Right.

Harold: I've used up my time, so….

Bianco: Yes, thanks, Harold. But just as a concluding comment again, I think that the problem here is that we are almost arguing about what they could have done to at least mitigate their damages, not necessarily make things better.

Let me jump to the next question. Thanks again, Harold.

Our next question is from Dan. Dan, are you there?

Dan: Yes, I am. I am wondering if you have a view on mark-to-market accounting. And while I'm not a fan of changing accounting rules, it seems like we have put ourselves in the position where we are shoving a fat elephant through a keyhole, as banks have to pare off some of these assets that they have to write down.

Bianco: Mark-to-market accounting, by the way, is also going to hit Mr. Buffet in a big way, too, with some of the derivatives that he has written, which is why his stock is under extreme pressure. I think, though, to answer your question, we are past it right now.

Let me back up two steps. The reason that mark-to-market accounting came into being was that it was an outgrowth of the old way that we used to do things. Let's call it the old way was the Enron way. When Enron was doing everything with its special purpose vehicles and was doing all of its shady accounting in cahoots with Arthur Andersen and got themselves into big trouble, we said that the old way of hold-to-maturity, available for sale, and the trading account wasn't working. There were too many examples like Sun Trust, that was massaging those accounting rules to manipulate their earnings. So we recognized that the old way wasn't working.

We went to mark-to-market as a means to try and fix the old way. But then we went to mark-to-market and got into this problem where it is the diving market, and now it is creating all of these paper losses.

I think that the time has come and gone where we could have changed it. If they were to change mark-to-market accounting now, then I think that it would be terrible for the markets because what you would essentially be saying is, "OK, mark-to-market accounting has made it bad, so let's give you less transparency, not more transparency." And in this environment, with the mentality that we have in the markets now, that, I think, would make things worse, not make things better.

Dan: You'd see more of just throwing – just changing the rules yet again and blindsiding people is what you're saying?

Bianco: Yes, I think that it would definitely be some of that, as well. A last thought for you about mark-to-market – let's define where the problem is -- the problem with mark-to-market accounting is with the accountants, with their auditors and their financial statements -- the PriceWaterhouseCoopers, the Deloitte & Touches of the world. The Level III assets are what we are talking about. The rule is management-judgment. And the accounting professionals and the SEC have already put out letters a couple of times this year, saying that does not necessarily mean that you have to mark these at distressed mark prices. You can use management-judgment.

The problem is that, when you get to your auditor, if you want an unqualified statement, they want to use a market measure. And the reason that they want to use a market measure is that, while they won't say it out loud, the answer is that we know what happened with Enron. Enron was using shady accounting. And before we figured out what the accounting was, we sought out their auditor, which happened to be Arthur Andersen, and liquidated the entire accounting firm as a death penalty for the sins of what they did with Arthur Andersen. So no accountant of a financial firm wants to be caught in that situation again. They are going to go with the most extreme measure to protect themselves. So this, in some respects, is a legacy from the accounting standpoint that we have seen from Arthur Andersen.

And if I could throw in one other kind of anecdotal item, I remember that after Bear Stearns went down, a lot of people were saying, "You know what? Their book value was $83 a share, and they went to zero. We ought to be looking at the accountants and beating up the accountants. How could they have been carrying them at $83 a share?" Well, you're driving the accountants more toward using distressed market prices for Level III assets across the entire industry when you start kicking them in the teeth like that because they are just trying to protect themselves because every time that a firm gets into trouble, we blame the accountants. So if you wanted to really put where the blame is, then you put it on the accountants. And I understand why they are doing it, which is because history has shown that if they don't, then they could be making

career decisions that their firms may not survive because one of them didn't already, and so that is why they seem to be wanting to do it in terms of that.

So it's too late, I think, to change mark-to-market rules right now. They have been trying to ease up with them and say, "Look, why don't you use more management-judgment. It's just us using panic levels on the ADX to price this stuff." But you can't get it past the accountants. And the accountants probably fear for their lives that they actually have to value this stuff because of the downside risks that they face.

Dan, did you have a followup question to that?

Dan: Yes, I did. Really quickly, on the final money, on the unspent portion of the TARP, do you think that it should be used for what it was originally intended to do, then, which was to pare off distressed assets from banks?

Bianco: So we'll flip yet again back to the – I was never a fan of the original plan, that buying – reverse auctioning these securities to try and put a floor on them was actually a plan that was going to work. But I do think that kind of the flip-flopping around all over the place and selling the TARP – remember that we like to laugh internally that there was an email that went around with a picture of somebody holding a gun to a dog's head, and said, "Pass the TARP or this dog dies," and your way of life ends as you know it – they sold it to us that way, and then they decided not to do it. Flipping back another way, I think, would almost be as much damage as to any good that could come of it. Besides, I am not a big fan of it in terms of going back to putting a floor on prices.

They seem to be committed to using the rest of the money for capital injections. I'm not sure how they're going to do it. They're not sure. Paulson is not going to ask for the other 350 until the Obama Administration comes in. And then we're going to have a whole new Treasury Secretary who is going to be in charge of that 350, and we'll see what he winds up doing with it.

Dan: Who do you think that is going to be?

Bianco: Oh, if I had to guess right now, I would guess Geithner would be it. That is just a pure guess. And if they did put Geithner in as Treasury Secretary, then there is still another problem along the lines. And that other problem is that the President of the New York Fed is one of the integral players in this game. Geithner, as the New York Fed President, negotiated the AIG bailout. You're going to have to find somebody to replace him at the New York Fed, and that person could be almost as important as the Treasury Secretary.

But he is just my guess right now. I don't think that they are going to be able to get Summers through from everything that I have read regarding problems that he had back at Harvard, talking about women in science.

All right, let me move on to the next question. Jack, are you there?

Jack: Yes, what data tells you that the economy, even though it doesn't want to, has the capacity to spend an invest, but, in converse, that it's not too much in debt and really doesn't have that capacity?

Bianco: The only argument that I would give you is that the ability of people to spend and invest did not plummet by 30 percent during the month of October.

Jack: Well, what measures that ability – savings, etcetera?

Bianco: Yes, savings. Income would be the big one. I mean, yes, stock valuations did fall by 22 percent in October, and they have taken another hit this month. The S&P 500 is down another 17 percent in the month of November, so they did take a hit. But if you look at the way that the economy is supposed to work, the big one is income. We did not go from five percent to 12 percent unemployment in one month. We did not have a –700, or –800, or a million jobs lost for the October payroll report. That would tell you that people don't have the capacity to spend. What we have is that they voluntarily stopped. The economy did not decelerate that fast. That is why there is this big debate about how bad the Fourth Quarter is going to be. Everybody stopped. I have heard this anecdotally from people – that people have cancelled vacations, didn't want to buy a car, or stopped looking for a house even though they could probably still qualify for a mortgage and have the capacity to buy the home but decided not to because of all of the uncertainty in the world.

Jack: But the only measure is that we didn't go to 25 percent unemployment (inaudible)…

(Crosstalk)

Bianco: Well, income is definitely the big driver of a lot of these decisions. It is not necessarily savings, at least by the measures that we see. Now, there should have been a downdraft because of the hit in savings. But the huge deceleration that we have seen since October 1 over September was really more of a confidence issue.

Now, I'm not suggesting by any stretch of the imagination that, if everybody spent to their capacity, then the economy would be OK. But what I am suggesting is that the numbers – right now, I have seen some estimates of –4 to –6 percent GDP numbers of the Fourth Quarter 2008. Now, half of

the quarter still has to go. But if we have numbers in that range, then it will be among one of the worst quarters that we have ever seen in our career in terms of economic growth for the Fourth Quarter. It is that bad. And a lot of it is because of this voluntary stoppage.

Now, if we didn't have this voluntary stoppage, then we still probably would have a terrible quarter, somewhere around zero. But we wouldn't have it 400 or 600 basis points worse than that. That is what I am arguing about, is that we needed the TARP passed because our way of life depended upon it. And then the Stock Market responded by going down 3,000 points, and everybody said, "That's it. I'm not going to buy a car. I'm not going to buy a house. I'm not going to expand my business. I'm not going to do anything. I'm going to wait until a sign tells me that everything is OK." And here it is November 20, and we're still waiting for that sign. And everybody is still just kind of standing there, doing nothing, and waiting for something to happen.

Jack: Well, my point is that you can still have a job, so you have employment. There's going to be so hocked up that you can't get into any economic activity – buy, invest, or anything. And so unemployment may not be a good enough indicator to tell that we still have the capacity to spend and invest.

Bianco: Right, but what you are arguing is more of a longer-term thing. And I'm not disagreeing with you that that could be a sign that things are getting worse. But I would argue to you that it did not change from September 29 to October 14, that fast.

Jack: Maybe private debt would be a good measure, whether that has gone up so high.

Bianco: Well, it is and it was. But the problem with private debt is that Stan Salvicson was correct when he was pointing out in the 1980s that it was too high. And it kept going higher for the next 20 years. So, yes, the problem with a lot of those measures is that they were measures that told us that, when we got into trouble, they were going to show us that we had a huge decline coming. And now that we've gotten into trouble, they are showing us, indeed, that we've got a huge decline coming.

Jack: Yes.

Bianco: All right, let me jump from there, Jack. Thanks a lot. Let me just conclude here with a couple of the questions that came in on the audiocast side. I've got a lot of emails with questions – 42 of them, to be exact – so I will try to answer those questions afterwards, via email. And as I always do, I will include them in the transcript that we will put out on Monday.

But for some of these audiocast questions, the first one if from Milton:

"Can we not consider the trade below 776 as a breakdown similar to the breakdown in October of 1930, which led to a further bear market?"

He wrote that early on when we were under 776, and we are now at 800. The answer is possibly, if we were to seriously break through 776, then you could be looking at that from a technical standpoint and say, "Hey, this is the first lower low that this market has had in many, many decades," and that might be a sign that we've got a 1930s-style Depression coming. Otherwise, I'm sure that, with our trading at 798 right now, you're going to hear the double-bottom talk.

The next question is from Jeffrey:

"With lower CMBX marks, what is the impact on year-end marks from any financial institutions. Does it wipe out the new capital injected into these markets?"

It is going to be bad if it stays down at these levels. There is going to be another round of losses, especially on CMBX. I don't think that ABX is going to be as big of a problem because so much of that stuff has been written down already, and so much of that stuff has been sold off. But I think that your question is right. There is going to be another round of write-downs because, if the CMBX Market continues to stay as weak as it has in those charts that we showed, then I think that we've got a real problem on our hands, and it could be somewhat of an issue.

Your followup question to that was:

"What are the chances that we see mark-to-market reform?"

Boy, we've got to be very careful if we want to start to do mark-to-market reform because of the dive in the CMBX Index. This is because, if we did mark-to-market reform now, then it would be viewed as a sign that we are trying to cover up a loss, and I don't think that would be taken over very well.

Bob has a question:

"What will it take for the Leverage Loan Market to stabilize and not continue to move lower?"

The Leverage Loan Market is going to stabilize when all of the other markets stabilize. All of these markets are going to peak at the same time. All of these markets are going to trough at the same time. It gets back to that one slide that we have had, that is on Page Nine, that it is all the same trade. Everything is moving together. I could have stuck so many other indicators underneath that 10-panel

chart, including leverage loans, that would have shown a very similar correlation to the S&P 500.

What is going to make it return in general is re-lending. The banks get capitalized. Confidence comes in enough that people want to invest in the banks, they get recapitalized, and they start lending, and the Market starts to bottom out and starts to move forward. But is something specific to leveraged loans going to stop it? No, I don't think so. I think that they are all going to turn at the same time.

Andy has a question:

"Where do you see investment-grade corporate spreads peaking? And are we there yet?"

Well, we're at a little over 600 basis points right now on the Merrill Investment-Grade Index. I think that we are very close to it. But, you know, in this environment with this volatility, that could still be another 150 basis points higher. That used to be what we considered wide for junk just a year ago, and now that's investment-grade.

But I still would contend to you that 600 basis – and I have seen some measures using Moody's – that these are like the widest spreads that we have seen in something like 60 years, in terms of corporate spreads have discounted a lot of the damage, and we could still see further moves. So when we get to the wide – and that's why I was using that 150 basis point number – you may not like the final move to get to the wide, but it still could be coming.

Finally, the last question that I will take here is from Phil:

"What do you think about gold as a play on the global lack of faith in the U.S. Treasury, and, at the other end of the extreme, back-end inflation that actions may bring late next year?"

The problem with gold is that gold, in generic terms, is a good play on all of the problems. That is why I think that it has held up relatively well – "relatively well" meaning that, while a lot of commodities like crude oil are down by more than half, and copper is down by more than half, gold has gone from $1,000 to $750, so it is down by a third or a quarter. It is down, but it is not nearly down as much.

The problem with gold is that it is as much a financial asset as it is a physical asset. And as a financial asset, it is being caught up in a lot of this, too. One case in point is that one of the buyers of gold is the GLD – the Gold ETF. At one point earlier this year, it would have been the fourth largest central bank holding of gold in the World because it had nearly 700 tons of gold. We are relying on financial buyers to buy gold ETF. And if they are being battered around by the Credit Crisis, then it helps to hurt gold, as well.

As far as the second half of your question goes – back-end inflation – I have been a big proponent of that argument, that what you see in the Federal Reserve chart and what you see that the Federal Reserve has been doing with their balance sheet -- that upper left chart on Page Six, going from $800 billion to $2.2 trillion – that number is nothing short of Weimar Republic-type inflation, which is what you are seeing there. But it's not working, so we have deflation. But boy, oh, boy, the day that some of this stuff ever starts to work, we're going to have an inflation problem. The Fed will try and withdraw this liquidity before inflation gets out of hand, and that is going to be a big high-wire act that I just wonder how they are going to be able to pull off.

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