

Bianco Research L.L.C.

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Special Report

December 2008

Are We Bottoming?

December 2008 Conference Call

(This transcript has been edited)

James A. Bianco, President, Bianco Research:

Good morning, everybody. This is Jim Bianco. Welcome to our Monthly Conference Call.

Summary/Conclusion

Today's Conference Call topic is "Are We Bottoming?" The Conference Call is basically going to address a question that we have been posing since September, in arguing that the Market has been very close to hitting a bottom although the economy and the Credit Crisis would continue. If you look at the way that the markets have traded over the last couple of months, since October 10, what the technicians like to call "the internal bottom," the Market has been essentially unchanged. One could argue that the Market bottomed almost two months ago, and that it's been chopping around in a highly volatile range, but it really hasn't made any net progress. I think that is probably pretty close to being accurate – that the Market did bottom somewhere around mid-October, and it has been chopping around.

But what is more important than discussing whether or not the Market has bottomed is discussing where we are going to go next. I have said that it is a political argument that what we are going to see happen next is a long sideways action because we seem to want to reduce risk out of the system. We want to punish any kind of risk taking. This is because risk taking means that we could potentially lose money, and we don't want that to happen. Nothing is more egregious than in the Auto Bailout Bill, where they are getting down to such detail as that the CEOs of the auto companies have to fly commercial and, by law, will be prohibited from using private airplanes. The point is that people will then look at this as overkill by the Government, and how are we going to continue to go higher?

For all of you market people, if you were thinking about something else, then think about the argument between 1974 and 1982. The Stock Market made a big bottom in December of 1984, but the time to buy wasn't until August of 1982, when it was ready to

reassume risk taking and ready to start going higher. That is what we are going to argue now.

Now, we are not arguing that the Market is six years away from going higher. But there is a difference between the bottom and when we are going to start to go up. And I think that we are fairly close to the bottoming process in the Market now, somewhere around that November 20, October 10 low. And we are still many months away from any kind of net appreciation.

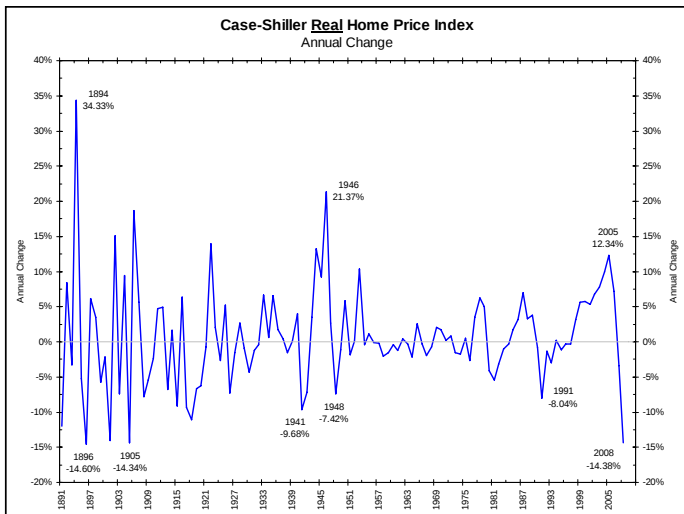
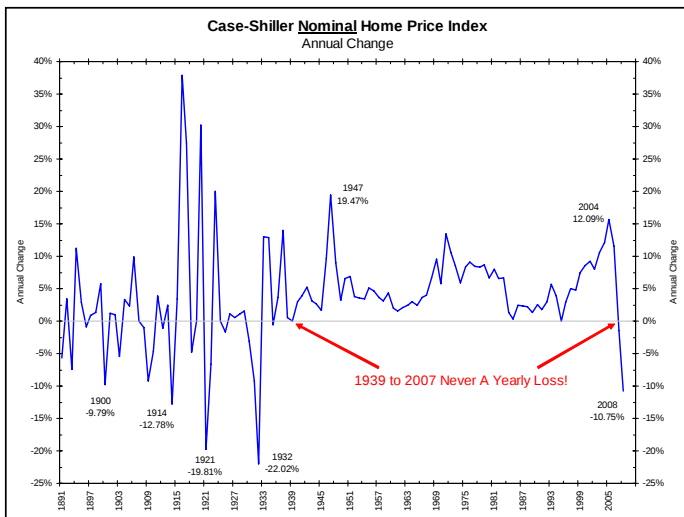
And, lastly, I would mention that we have argued that we would rather be a month late than a month early in this process. So I am in no hurry to say, "This is the time to buy, this is the time to buy." Maybe a better way to explain it is that this is a time to see that we won't be taking as much pain.

Home Prices' Historic Run Ends

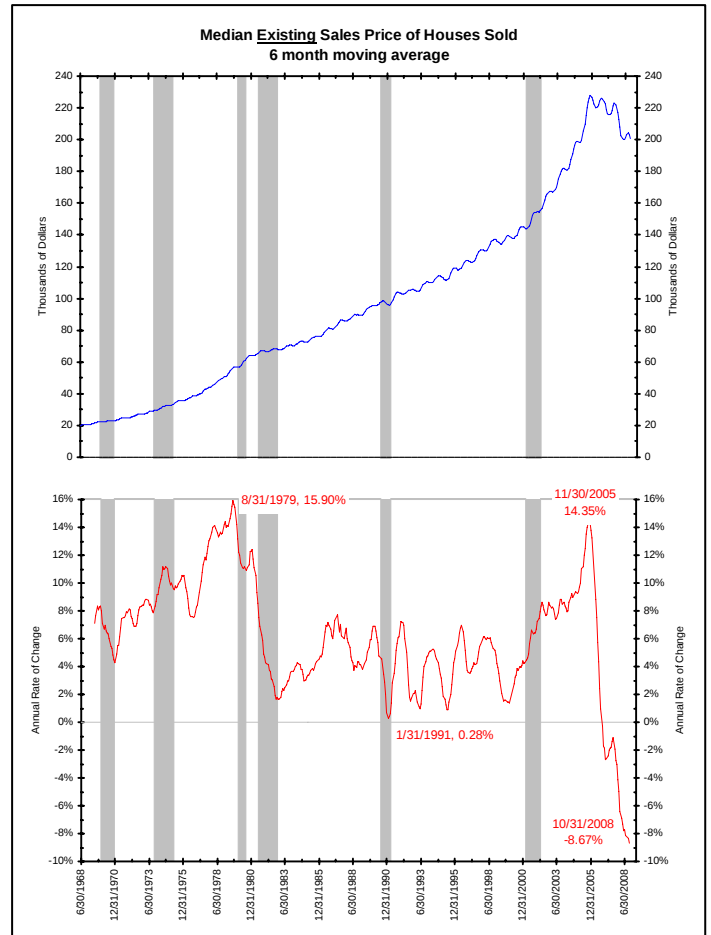
OK, let me jump into the handout now a little bit and take us to the chart on Page 2.

The first several set of charts are old charts. I want to go through this almost every time because I don't want us to lose sight of what has been happening in the Marketplace. That is that this is all about home prices. And home prices are the most important thing to keep in mind. Ultimately, home prices bottoming are what is going to end this problem.

The chart on the upper right of Page 2 is the year-over-year change in the Case-Shiller Index on a nominal basis, not inflation-adjusted. The chart underneath is inflation-adjusted. These charts go back to 1891 through current. And what I highlighted in the nominal chart in the upper left corner is that, from 1939 to 2007, there was never a yearly loss. How did we get so complicated with CDOs and with home mortgages? Why did we over-leverage the home price market? It is because all of the quants looked at the charts and said, "Look, there are 60 years of data where home prices never went down. You cannot be reckless in leveraging something that has a 60-year history of never going down."

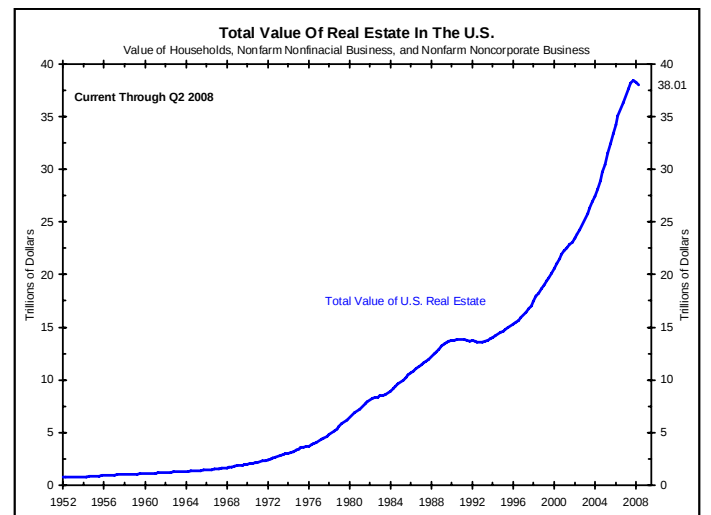


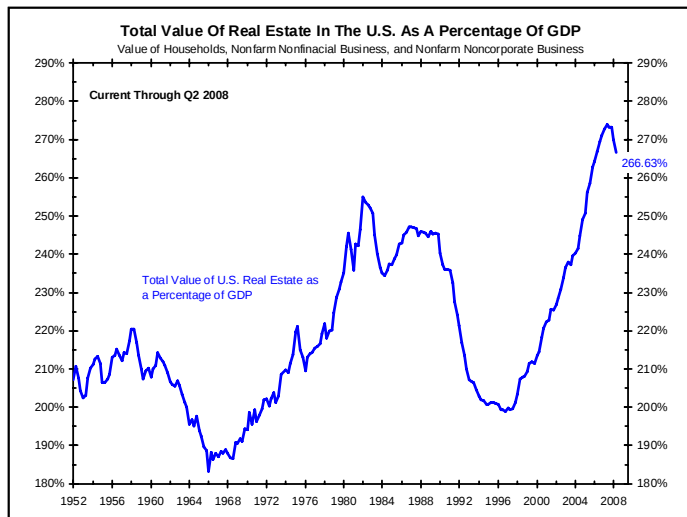
The chart on the right -- for all of the flaws in the Case-Shiller Index, which I won't get into -- shows the Commerce Department's median existing home sales. The actual price is at the top, which is around \$200,000, and the year-over-year change is on the bottom. The chart starts in 1968. It is the same thing -- from 1968 to 2007, there is never a negative year, even on a monthly year-over-year basis. It almost got there in January of 1991, but didn't quite as it was slightly positive. So keep in mind that this is all about home prices.



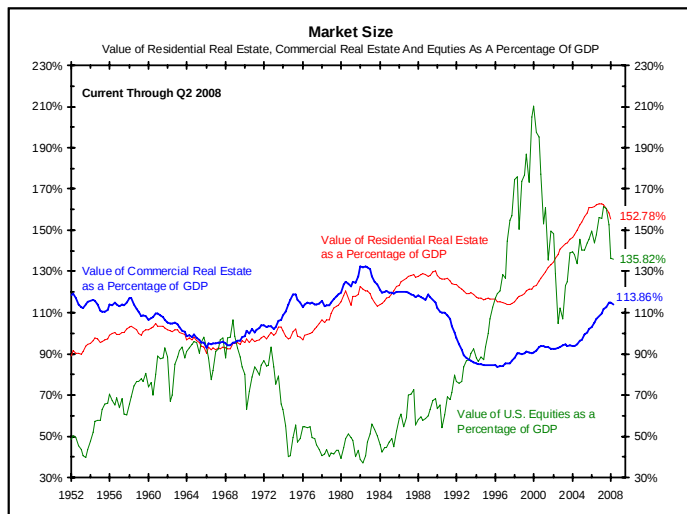
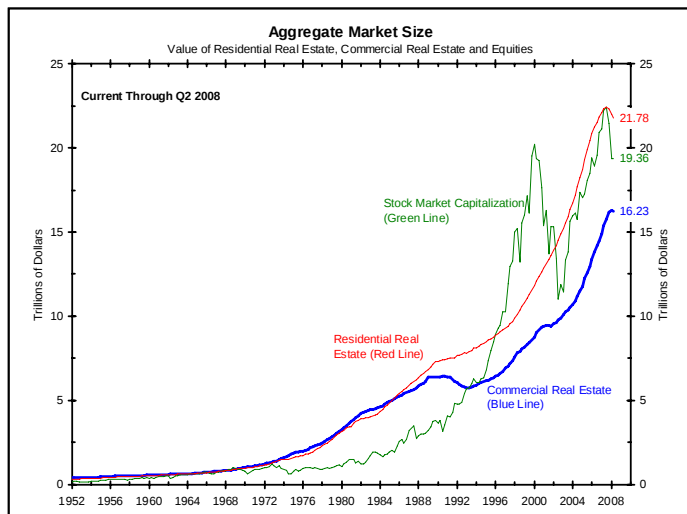
How Big Is Real Estate?

If you move to the chart on Page 3, when you look at home prices, here are some measures of home prices to keep in mind. Home prices are still the largest asset market in the world. If you look at the chart on the upper left, from the latest data that we have, the total value of real estate in the United States as of the end of the Second Quarter is \$38 trillion. The bottom left chart shows that is over two and a half times the size of the economy.





Breaking that down, in the upper right chart, we show aggregate market sizes. The Stock Market is in green. This is at the end of the Second Quarter.



We know that the Stock Market is some 30% lower now. That was \$19 trillion then, so it's probably more around \$13 trillion right now. Commercial real

estate was \$16 trillion. Residential real estate at the end of the Second Quarter was \$21.75 trillion. The bottom right chart shows it expressed as a percent of GDP. Residential real estate, the market that never went down, that you could not over-lever, is the largest asset market in the world. Mortgage-backed securities, which are made from residential real estate, are the largest fixed-income market in the world, twice the size of the U.S. Treasury Market.

So when we were leveraging the largest asset market and the largest fixed-income market, when they turned tail and fell precipitously south, then you should expect that we had many problems.

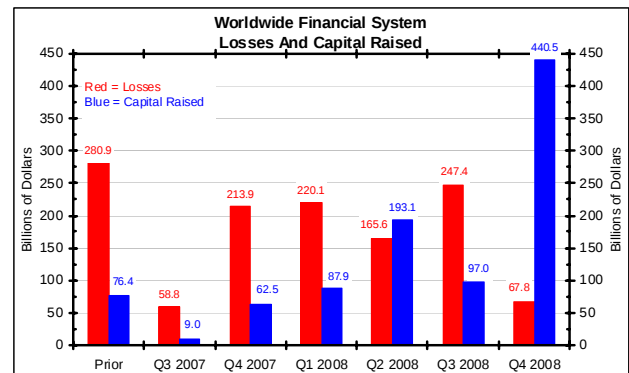
Almost \$1 Trillion In Losses

The problems came into the Banking System. That is the chart on Page 4. This is a chart that we have always used. It was always simply stated: home prices fell, they blew a giant hole in the Banking System.

Worldwide Financial System Losses and Capital Raised
As of December 10, 2008
In Billions of Dollars

	Total Losses	Capital	Q4 2008 Losses	Capital	Q3 2008 Losses	Capital	Q2 2008 Losses	Capital	Q1 2008 Losses	Capital	Prior Losses	Capital
Banks/Brokers	723.8	766.7	67.8	374.8	172.6	95.4	123.2	158.4	153.4	84.7	206.8	53.4
Insurance Cos	143.5	91.8	0.0	51.9	36.5	1.6	13.4	27.6	42.1	3.2	51.5	7.5
GSEs	114.5	36.4	0.0	13.8	38.3	0.0	29.0	7.1	24.6	0.0	22.6	15.5
Worldwide	981.8	894.9	67.8	440.5	247.4	97.0	165.6	193.1	220.1	87.9	280.9	76.4

Source: Bloomberg



On the table on the top right, we are currently at \$981 billion of losses. The expectations are that Citibank alone will push that over \$1 trillion when they report in January. And when all of them report in January, we should go well over \$1 trillion. The losses break down by almost three-quarters of \$1 trillion from the Banking System, almost \$150 from the Insurance Industry, and a little over \$100 from the GSEs. So we've got almost \$1 trillion worth of losses. We've raised \$900 billion worth of capital.

On the chart below, the red is the losses and the blue is the capital. I have argued that the problem is a capacity problem that the Banking System has shrunk. If you look at the difference between these numbers, then you know that they are about \$100 billion. I have been using the ratio of 14:1, about \$1.4 trillion, meaning that the Banking System can

hand out \$1.4 trillion less in loans than they could at the start of this crisis. But we know that the majority of that capital raised – that big blue bar in the Fourth Quarter – is Government-raised money. And we know from even yesterday's TARP hearings in Washington that we are not running up to 100 percent of capacity. So the shrinkage in the Financial System is far more than the \$1.4 trillion that these numbers would imply.

Moves Before Labor Day

This has caused unprecedented activity by the governments of the world and the central banks of the world. Before Labor Day, I count 22 major moves/major events that have occurred in the Market, from August 2007 all the way to Paulson's bazooka in July 2008.

Moves Since Labor Day

I thought that this was an unprecedented breakneck pace of major announcements coming before Labor Day but, boy, was I wrong on that. If you look at Page 6, the moves since Labor Day number 109. And we are still not done with these moves.

Major Financial/Economic Events <u>Since</u> Labor Day	
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 *Glininir 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 *DJA 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
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

Major Financial/Economic Events <u>Since</u> Labor Day - cont.	
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 buy CP from Money Market Funds
24-Oct	*Australian Banks Freeze Redemptions *Stock Futures Limit Down Before NYSE Open
27-Oct	*IMF Money To Ukraine *IMF Money To Hungary
28-Oct	*DJIA Up 890 Points *Volkswagen 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, Gets \$40 billion of TARP Money
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 Collateralized 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
20-Nov	*S&P 500 slumps 52% from all-time high, worst bear market in 60 years
21-Nov	*Fannie/Freddie suspend foreclosures through January 9
24-Nov	*Citi gets \$20 billion from TARP, \$306 billion in assets backstopped *\$800 billion TALF is announced *First "FDIC Bonds" (TLGP) Are Issued
25-Nov	*Stocks lose 8.93%, 6th worst day ever for the S&P 500
1-Dec	*NBER Officially Declares The Recession Started in December 2007
3-Dec	*Fed Extends PDCF, TSLF and ABCP Liquidity Until April 30
8-Dec	*John Mack, CEO of Morgan Stanley Will Take No Bonus For 2008

We're still talking about the Federal Reserve potentially issuing its own securities. We're still talking about moving mortgage rates to 4.5% through some kind of Government manipulation. There is still talk about asking for the other half of the TARP money. I don't even have these on the list because these are just talk. The list is actual moves, not just talk of moves, and yet it still numbers an amount more than anybody can understand.

The Credit Crisis: The Largest Outlay In American History

The chart on Page 7 details the amount of Government intervention. We have used this one before, and it has gotten some press away from us. There is \$8.7 trillion dollars of total commitments, almost \$3 trillion actually spent. As we point out here, if you look at the chart on the right, you could see that the amount of the bailout is much larger than most of the major programs that we studied when we studied about U.S. American History in high school. This is larger than the Marshall Plan, Louisiana Purchase, and all the way on down the

line. The only thing that is somewhat comparable might be World War II.

Measuring The Size Of The Bailouts

As of November 27, 2008

The Federal Reserve		
Program (Description)	Maximum Amount	Current Amount
Net Portfolio Commercial Paper Funding (Purchases ST Debt directly from corporate issuers)	\$1,800.0	\$270.9
Term Auction Facility (TAF) (Banks get loans for as many as 28 days by posting collateral)	\$900.0	\$415.3
Other Assets	\$601.9	\$601.9
MMIFF (Money Market Investor Funding Facility)	\$540.0	\$0.0
MBS/FHLM/Agency In Reverse Auctions	\$600.0	\$0.0
Term Securities Lending Facility (TSLF) (Allows primary dealers to borrow Tsys by posting collateral)	\$250.0	\$190.2
Other Credit Extensions (The AIG Loan)	\$122.8	\$122.8
Primary Credit Discount (Original Fed lending program for commercial banks)	\$92.6	\$92.6
Asset-Backed Commercial Paper (ABCP) Liquidity (Loans to banks to buy ABCP from mutual funds)	\$61.9	\$61.9
Primary Dealers and others (A discount window for all primary dealers and securities firms)	\$46.6	\$46.6
Net Portfolio Maiden Lane (Bear Stearns Assets)	\$38.8	\$26.9
Securities Lending Overnight (one-day loans to banks on collateral)	\$10.3	\$10.3
Secondary Credit	\$0.1	\$0.1
Federal Reserve Total	\$5,065.0	\$1,839.5
The FDIC		
FDIC liquidity guarantees (Guarantees bank-to-bank loans)	\$1,400.0	\$0.0
Loan Guarantee To Lending Arm of GE	\$139.0	\$139.0
FDIC Total	\$1,539.0	\$139.0
Treasury Department		
TARP	\$700.0	\$350.0
Fannie Mae/ Freddie Mac (bailout)	\$350.0	\$0.0
Stimulus Package (Spring 2008)	\$168.0	\$168.0
Treasury Exchange Stabilization Fund (Buys and sells Foreign currencies to moderate their fluctuation)	\$50.0	\$50.0
Tax Break For Banks	\$29.0	\$29.0
Citibank Asset Backstop	\$306.0	\$0.0
TALF	\$200.0	\$0.0
Treasury Total	\$1,803.0	\$597.0
FHA		
Hope for Homeowners (provides loan guarantees for struggling mortgage borrowers)	\$300.0	\$300.0
Other		
Auto Loans (via Dept. of Energy)	\$25.0	\$0.0
Grand Total	\$8,707.0	\$2,875.5

Sources: CNBC, Bloomberg, WSJ

So in looking at what has been happening, again, home prices never fell for 60 years, then they fell – and we have talked about that in previous Conference Calls, so we won't revisit that issue right now – it blew a \$1 trillion hole in the Financial System. The Financial System has been shrinking. The shrinkage in the Financial System has caused lending capacity to shrink. Shrinkage of lending capacity has meant what we call de-levering. But we have not been de-levering.

As the chart on Page 7 shows, as the Financial System has been de-levering, we know that needs to happen, but we don't want those deleterious effects. So the Government has been plugging the hole in the de-levering. They have been plugging the hole by de-levering. What does that mean? It means no more Commercial Paper Market. Well, we can't have that, so the Fed will now finance everybody through the Commercial Paper Market. "De-levering" – what does that mean? Well, that means potentially no more Citibank. No, we can't have that. We'll bail out Citibank in September, in October, and again in November to keep them going. De-levering means possibly no Auto Industry. No, we can't have that, so now we're talking about bailing out the Auto Industry.

So people have asked me the question, "Where are we in the de-levering process?" And I have answered the question, "If you're asking about the Financial System itself, if you want a baseball term, then it's somewhere between the fifth and seventh inning." If you're talking about the economy, we haven't thrown the first pitch because we don't want the economy to de-lever. And the problem then becomes that we've got a Financial System that is smaller than the real economy, and the Government is plugging the hole. We have to get the two back into balance. There are two ways that you can do that:

One way in which you can do that is to raise the Financial System size, which is to re-leverage it, and absolutely nobody wants to do that. The other way that you could do that is to shrink the real economy. That is why we keep hearing all of this talk about "the next Great Depression." We're talking about a contraction in nominal GDP, something that has not happened in well over 50 years, at least on a quarterly basis, and well over 70 years on a sustained basis. So the Government has been stepping in and plugging the hole. The most high-profile version of that is on Page Eight – "Who Gets TARP Money?"

Who Gets TARP Money?

This is our list right now. So far, there has been \$246 billion of known TARP money handed out among the 169 institutions. These are the institutions and the TARP money that are listed on this chart on Page 8.

I might add that we have something in the works that we're going to put out either today or, most likely, tomorrow is that we have been trying to say, "OK, here are 169 preferred stocks and warrants. Let's use FASB 157 accounting treatment on this and figure out what the market value of that is." And we come up with roughly \$201 billion, meaning that if we were to mark the TARP to market using FASB 157, then they would probably report about a \$44 billion loss for the First Quarter. Remember that this is mark to market, and all of the caveats and warnings that go with mark to market also apply. We could discuss that a little bit later.

Known TARP Money Awarded as of December 10, 2008		
Bank Name	Date Announced	Amount (in Millions)
Citigroup	10/12/2008	\$45,000
American International Group	11/12/2008	\$40,000
Wells Fargo	10/12/2008	\$25,000
JP Morgan Chase	10/12/2008	\$25,000
Bank of America	10/12/2008	\$15,000
Morgan Stanley	10/12/2008	\$10,000
Merrill Lynch	10/12/2008	\$10,000
Goldman Sachs Group	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
SunTrust Banks	10/12/2008	\$3,500
Regions Financial	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 & Isley	10/12/2008	\$1,700
Northern Trust	10/12/2008	\$1,500
Zions Bancorp	10/12/2008	\$1,400
Huntington Bancshares	10/12/2008	\$1,400
Freddie Mac	9/12/2008	\$1,000
Fannie Mae	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
M&T bank Corporation	11/20/2008	\$600
Colonial BancGroup	12/2/2008	\$550
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
Whitney Holding	11/26/2008	\$301
Tennessee Commerce Bancorp	11/25/2008	\$300
Susquehanna Bancshares	11/19/2008	\$300
Sterling Financial Corp	11/24/2008	\$300
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
Wintrust Financial Corp	11/26/2008	\$250
First Merit	11/13/2008	\$248
SVB Financial Group	12/3/2008	\$235.0
Trustmark	11/8/2008	\$215
Umpqua Holdings	10/12/2008	\$214
Washington Federal	10/12/2008	\$200
International Bancshares	10/8/2008	\$200
United Bankshares	12/3/2008	\$197.0

Known TARP Money Awarded - continued as of December 10, 2008		
Bank Name	Date Announced	Amount (in Millions)
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
National Penn Bancshares	11/26/2008	\$150
Boston Private Financial Holdings	11/19/2008	\$150
Western Alliance Bancorp	11/13/2008	\$140
Central Pacific Financial Corp	12/9/2008	\$135.0
CVB Financial	11/19/2008	\$130
Sterling Bancshares	12/2/2008	\$125
Banner Corp	11/12/2008	\$124
Signature	10/8/2008	\$120
Iberiabank Corp	11/18/2008	\$115
Taylor Capital	11/8/2008	\$105
Park National Corp	12/2/2008	\$100
Midwest Banc Holdings	11/12/2008	\$85.5
Sandy Spring Bancorp	11/20/2008	\$83.0
First Financial	10/8/2008	\$80.0
Dime Community Bankshares	12/5/2008	\$77.3
Columbia Banking System	11/12/2008	\$76.9
TowneBank	11/26/2008	\$76.5
Independent Bank Corp	11/24/2008	\$72.0
Virginia Commerce Bancorp	11/26/2008	\$71.0
Southwest Bancorp	11/20/2008	\$70.0
Flushing Financial Corp	12/3/2008	\$70.0
Superior Bancorp	11/18/2008	\$69.0
Nara Bancorp	11/14/2008	\$67.0
First Financial Holdings	12/1/2008	\$65.0
CoBiz Financial	11/8/2008	\$64.4
Wilshire Bancorp	11/20/2008	\$62.0
Great Southern Bancorp	11/17/2008	\$60.0
Gateway Financial Holdings	12/5/2008	\$58.0
American West Bank	11/8/2008	\$57.0
Center Financial Corp	11/24/2008	\$55.0
NewBridge	11/8/2008	\$52.0
Ameris Bancorp	11/21/2008	\$52.0
Home Bancshares, Inc	11/21/2008	\$50.0
Fidelity Southern Corp	11/24/2008	\$48.2
Capital Bank	11/17/2008	\$43.0
Southern Community Group	11/18/2008	\$42.8
First Community Bancshares	10/30/2008	\$42.5
Sterling Bancorp	12/9/2008	\$42.0
Bank of Florida	10/12/2008	\$40.7
Simmons First National	10/8/2008	\$40.0
Heritage Commerce	11/8/2008	\$40.0
Porter Bancorp	11/13/2008	\$39.0
Peoples Bancorp	11/13/2008	\$39.0
Cascade Financial	11/12/2008	\$39.0
Eagle Bancorp	11/21/2008	\$38.2
Financial Institutions	12/5/2008	\$37.5
TIB Financial Corp	12/1/2008	\$37.0
First Defiance Financial Corp	11/24/2008	\$37.0
West Bancorporation	12/8/2008	\$36.0

Known TARP Money Awarded - continued
as of December 10, 2008

Bank Name	Date Announced	Amount (in Millions)
HF Financial Corp	11/14/2008	\$35.0
MutualFirst Financial	12/5/2008	\$32.0
Bank of North Carolina	12/9/2008	\$31.3
BNC Bancorp	12/8/2008	\$31.3
StellarOne Corp	12/3/2008	\$30.0
Peapack-Gladstone Financial	11/20/2008	\$28.7
Bank of Marin Bancorp	12/2/2008	\$28.0
CenterState Banks of Florida	11/24/2008	\$27.9
Intermountain Community Bancorp	11/7/2008	\$27.0
Washington Banking Company	12/1/2008	\$26.4
LNB Bancorp	11/20/2008	\$25.2
Peoples Bancorp of North Carolina	12/9/2008	\$25.1
The First Bancorp	12/4/2008	\$25.0
VIST Financial Corp	11/24/2008	\$25.0
Horizon Bancorp	11/26/2008	\$25.0
Home Federal Financial	10/12/2008	\$25.0
First California Financial Group	12/2/2008	\$25.0
Crescent Financial Corp	12/8/2008	\$24.9
Heritage Financial	11/8/2008	\$24.0
Eastern Virginia Bankshares	12/8/2008	\$24.0
Seyern Bancorp	11/18/2008	\$23.5
Hampton Roads Bankshares	12/5/2008	\$22.3
Wainwright Bank & Trust	11/20/2008	\$22.0
Blue Valley Bancorp	12/9/2008	\$21.8
Indiana Community Bancorp	11/20/2008	\$21.5
Unity Bancorp	11/24/2008	\$20.6
Citizens South Banking Corp	12/1/2008	\$20.5
First PacTrust Bank	11/13/2008	\$19.3
HopFed Bancorp	11/20/2008	\$18.4
Redding Bank	10/27/2008	\$17.0
Bank of Commerce	10/12/2008	\$17.0
Valley National Corp	11/26/2008	\$16.0
First Financial Services	11/14/2008	\$16.0
The Bank Holdings	11/8/2008	\$15.0
LSB Corp	12/8/2008	\$15.0
Monarch Financial Holdings	12/4/2008	\$14.7
Bridge Bancorp	11/8/2008	\$14.3
Oak Valley Bancorp	12/3/2008	\$13.5
Wilbur Corp	12/9/2008	\$12.0
Pamrapo	11/8/2008	\$11.4
Mackinac Financial	10/8/2008	\$11.1
Center Bancorp	12/9/2008	\$10.0
Center Bancorp	12/5/2008	\$10.0
Coastal Banking Company	12/5/2008	\$10.0
Mid Penn Bancorp	11/26/2008	\$10.0
Southern Missouri Bancorp	12/9/2008	\$9.5
Elmira Savings Bank	12/9/2008	\$9.1
Broadway Financial Corp	11/14/2008	\$9.0
Central Federal Corp.	11/24/2008	\$7.2
Old Line Bancshares	12/5/2008	\$7.0
Fidelity Bancorp	12/4/2008	\$7.0
American River Bancorp	11/24/2008	\$6.0
The Connecticut Bank and Trust	12/3/2008	\$5.4
Commerce National Bank	12/3/2008	\$5.0
Capital Pacific Bancorp	11/8/2008	\$4.0
Seacoast Commerce Bank	12/1/2008	\$1.8
Manhattan Bancorp	12/9/2008	\$1.7
Saigon National Bank	10/12/2008	\$1.2
Total		\$246,603

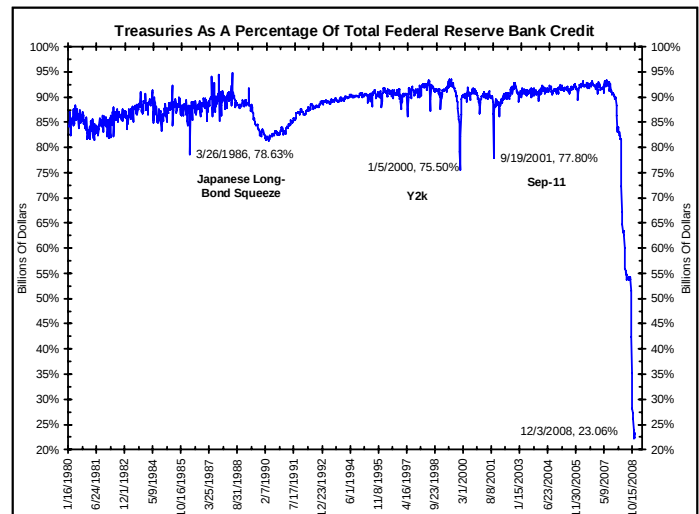
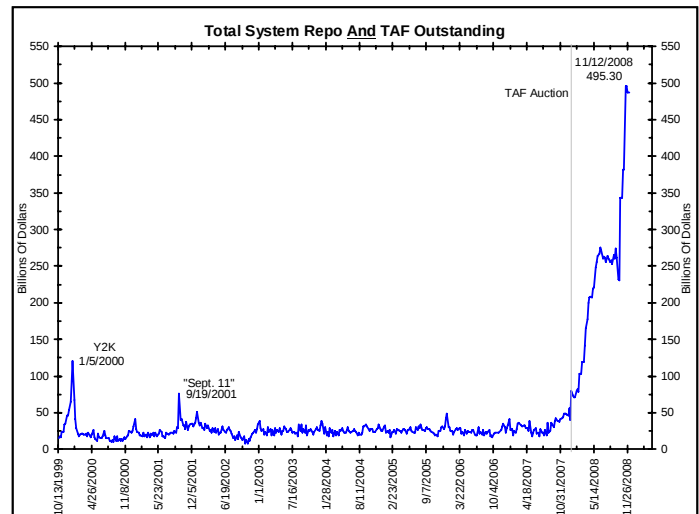
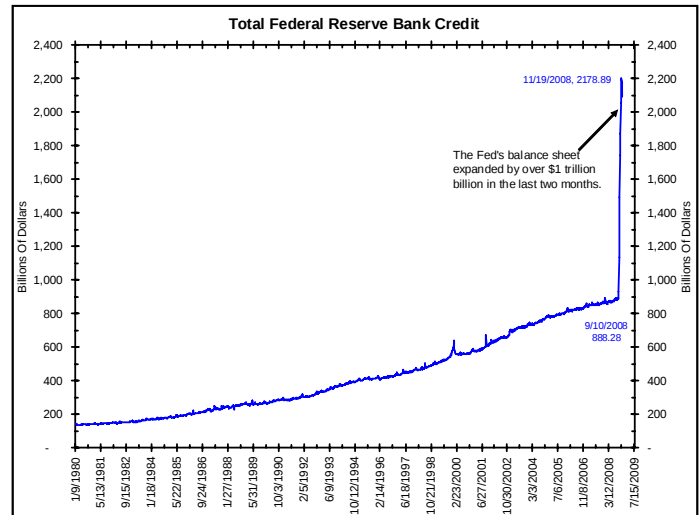
Compiled from various sources (but not the U.S. Treasury)

The Federal Reserve's Exploding Balance Sheet

I want to then jump into the markets as far as where they are going. The Federal Reserve is what I think that I will start with in terms of the markets. The Federal Reserve has been interceding in the markets in quite a big way.

Again, here are our charts on Page 9 of the Federal Reserve. The hockey stick chart of their balance sheet is in the upper left, which is now well over \$2 trillion and on its way, most likely, higher. Almost one-half trillion dollars of that alone, or 25% of their

balance sheet, is system repos in the TAF. Securities lending is another \$200 billion in the lower left.

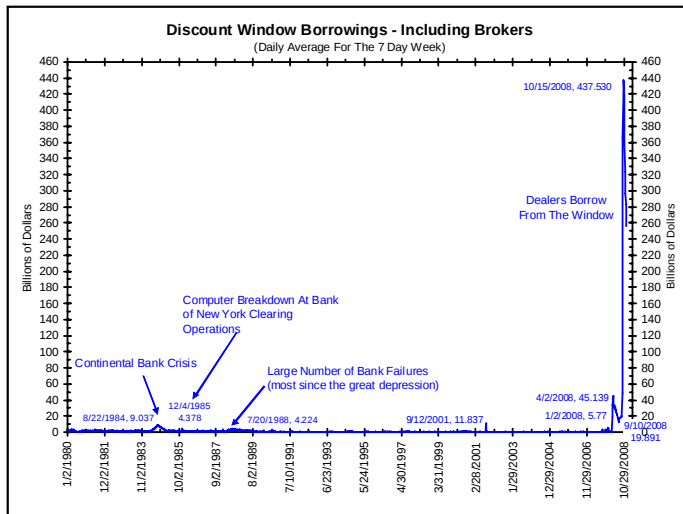


And the percentage of treasuries has fallen to about 23%. This is one of the reasons why the Fed is talking about issuing their own securities. Normally,

they could sell treasuries, but they don't have any treasuries to sell. So they are going to invent a new class of security to sell or issue called Federal Reserve bonds. So they are going through all of these machinations to continue to try and inflate the system.

The Federal Reserve's Exploding Discount Window

Finally, the charts on Page 10 – as far the Fed goes, it shows on Page 10 the discount window, which hit over \$400 billion at one point earlier this year, and now it has backed off to \$300 billion. Remember that the old record was \$11 billion set right after 9/11.



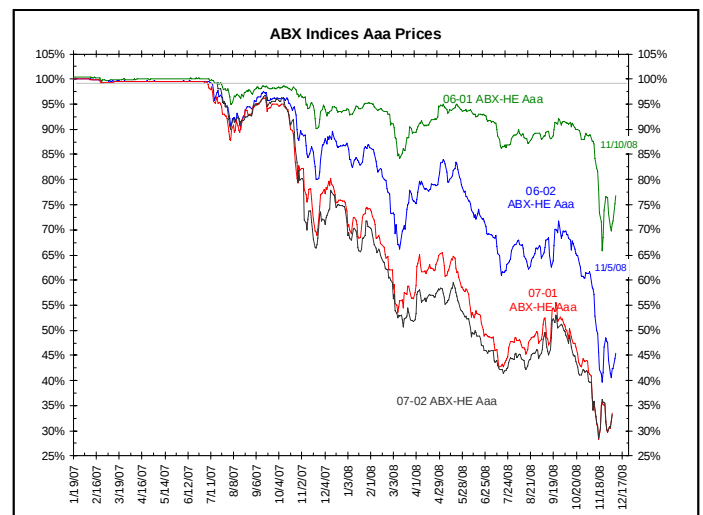
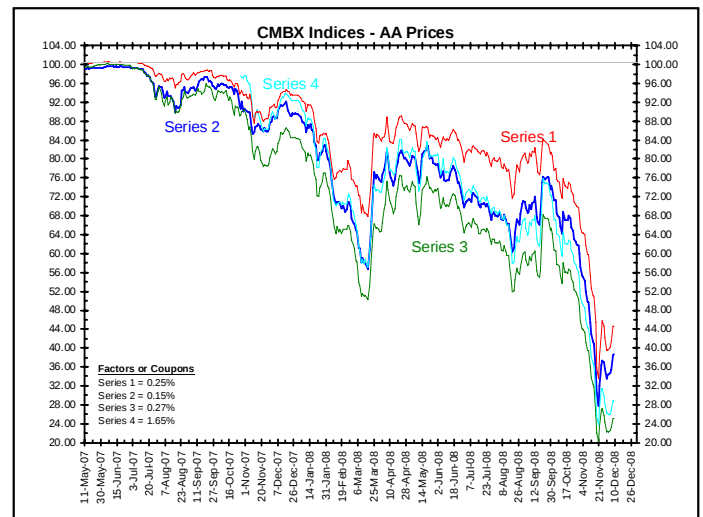
So what we have seen happen is that the Federal Reserve has been running extraordinarily inflationary policy. They have been inflating and inflating to try and prevent the deflationary deleveraging in the real economy. They have been plugging as the Financial System shrinks.

I have argued that there is only one way to interpret what the Fed is doing, and that is that it is running extraordinarily inflationary or hyperinflationary policy. The question is whether or not it's working. And it's not working, which is why we have deflation. But at some point, when it does work – whether that's three months down the road or three years down the road – we are going to have a bit of inflation to deal with. Today's worry is deflation. Today's worry in deflation is overwhelming any potential worry down the road about inflation's coming.

CMBX and ABX

But let's turn to the markets. Let's start on Page 11 and look at the CMBX and the ABX. These markets should lead any kind of a bottom in home prices because, as I have argued, it's bottoming home prices that will really end this crisis in a big way. Are we seeing any signs that these markets are

bottoming? Maybe. After a big tumble into late November, both on the CMBX, which is commercial real estate, and the ABX, they stopped going down for a couple of weeks. But it's way too early to say, "That's it. We've seen a bottom."

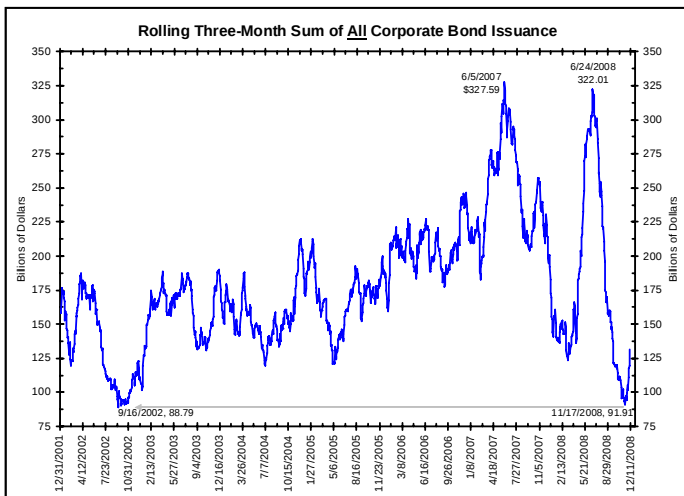
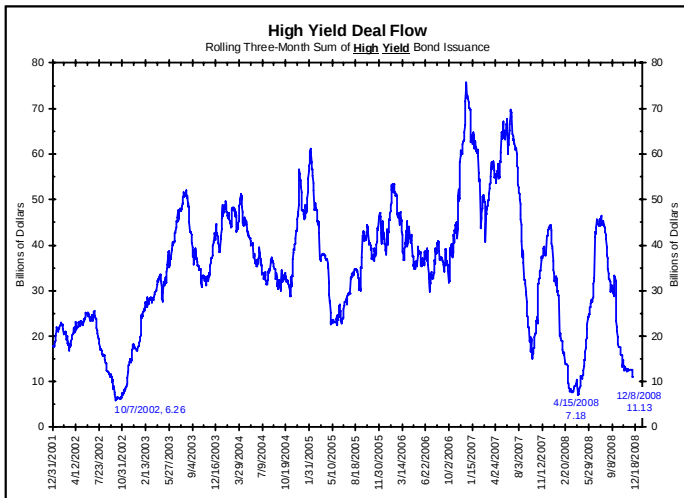
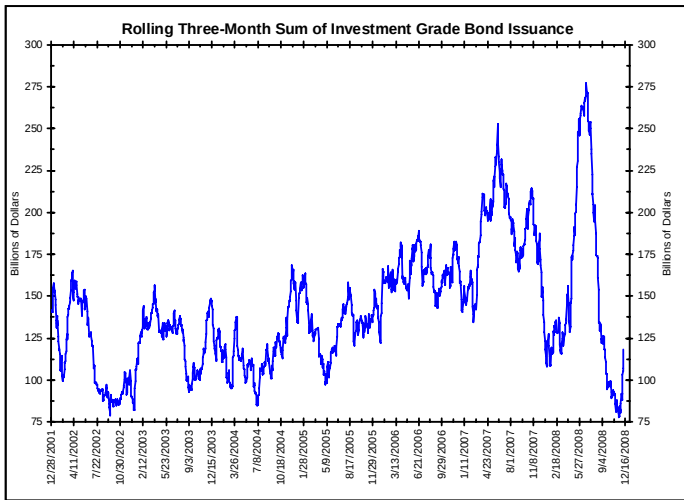


We have seen this happen again after the Bear Stearns crisis in March. We saw this happen again in early August when Paulson got his bazooka, and those bottoms didn't seem to be any more than just a pause in a larger downtrend. So this one is an open question at this point as to whether or not we are going to see a bottom in these. And without that bottom, we ultimately, I don't think, are going to see a bottom in real estate. Until we get that bottom, the markets are going to stay stressed.

Bond Issuance

The charts on Page 12 show bond issuance. This is corporate bond issuance, investment-grade, in the upper left chart, high-yield in the left chart, and the summation of the both together in the chart on the right. Corporate bond issuance, access to the capital markets has remained highly stressed. It has

been very, very difficult to get any kind of deals done.

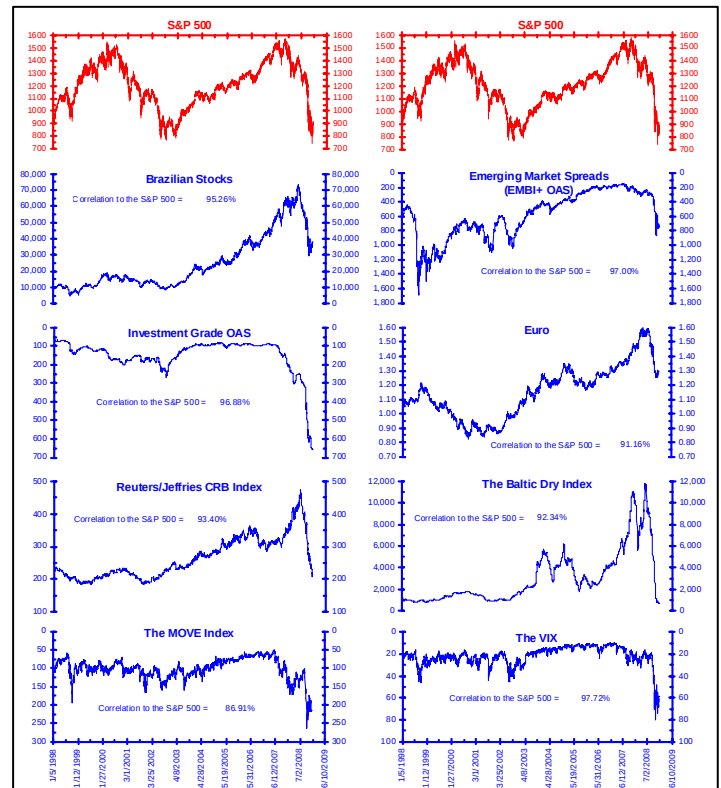


If you look at the high-yield chart, for one, as an example, rolling three-month – about \$11 billion worth of high-yield bonds have been issued in the last three months -- \$11 billion. There used to be a time when we used to have deals of almost that size; now that's how much we are issuing in a

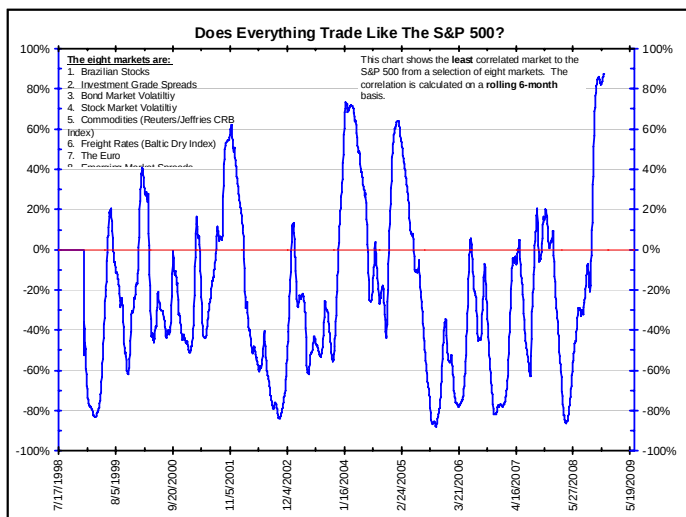
quarter. So the markets remain stressed. It's still very difficult to try and figure out what is going on.

It Is All The Same Trade

And if you jump to the chart on Page 13, a sign of the stress is what we have called on this chart "All the Same Trade." The red charts on the top are the S&P, the same chart repeated twice. As you look down the chart, in the panels on the left, you will see emerging market stocks, emerging market bonds, investment-grade OAS plotted inversely, the euro, the CRB Index, the Baltic Freight Index, Stock Market volatility, and Bond Market volatility. The point is that all of these were supposed to be markets that had nothing to do with each other. And since they had nothing to do with each other, the idea was that they should be zero correlated to each other.



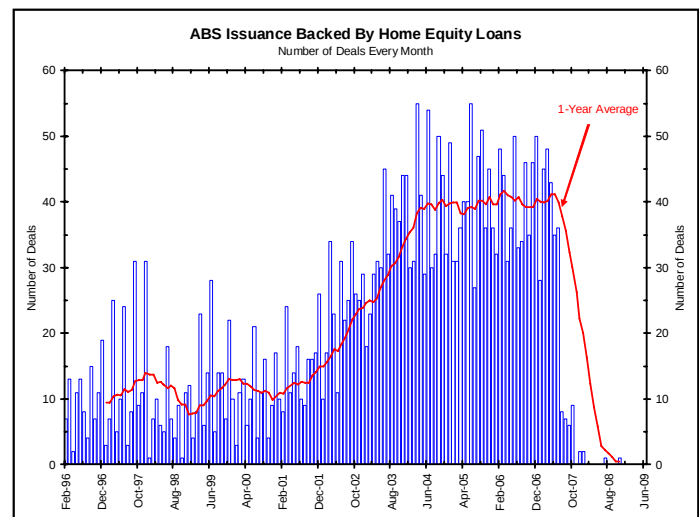
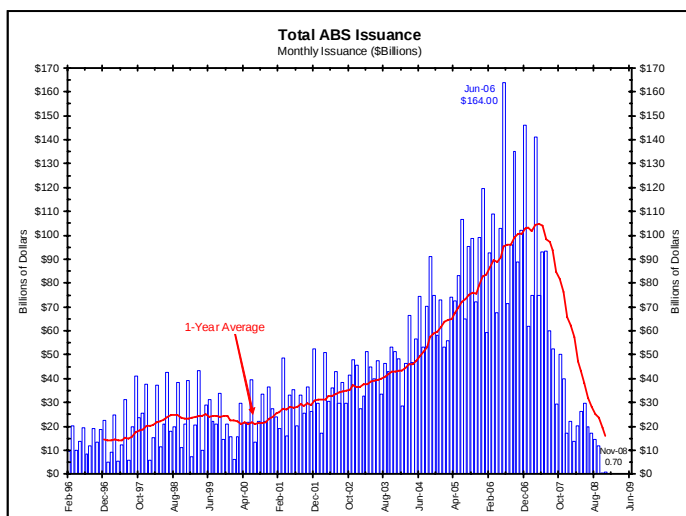
However, when we look at the chart on Page 13, on the right, what we see is that the least correlated market, which happens to be the MOVE, is 86 percent correlated to the S&P. So, in other words, all of these markets are trading the same. As long as we are in a crisis, I don't think that it's fruitful to discuss the fundamentals of crude oil, which I didn't have on this chart, or the CRB, or corporate credit, or Brazil, or volatility in the Bond Market. It's all the same trade.



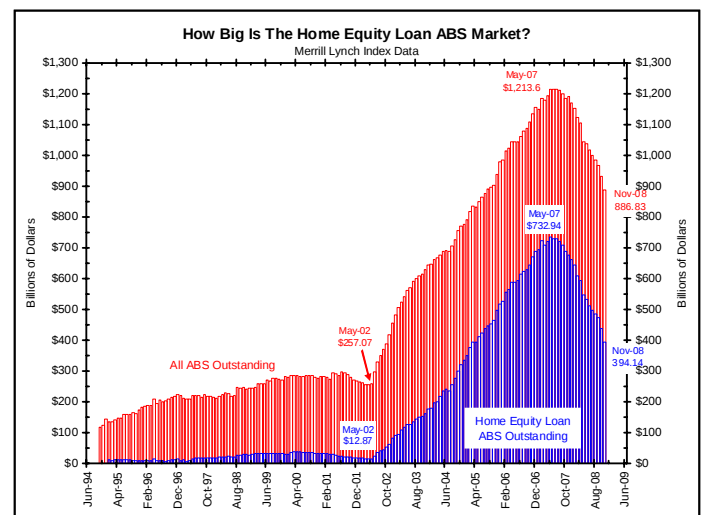
Actually, a sign that I think that we are returning to normal would be when these correlations break. And if you'll notice very closely on the chart, on Page 13, the highest plot was the last time that we updated this was on Tuesday. So we're the opposite of showing that these markets are ready to diverge; they are getting more in sync as we have been moving forward from here.

ABS Market Stops

Another problem with the Market – and this gets to the chart on Page 14 – is that there has been a lot of complaining that the banks are not lending. The numbers from the Federal Reserve actually suggest the opposite, that there is some lending going on from the banks. But, really, what we are complaining about is that access to credit is not really where it is. We want the banks to take up the slack, and the fact is they can't. As I showed you on the previous panel, access to the Corporate Bond Market is really a small fraction of what it used to be.



What about the Asset-Backed Market? The Asset-Backed Market is non-existent. The chart on the top left shows total asset-backed securities. We used to do well in excess of \$100 billion, almost \$200 billion-worth of securities a month. In November, we did less than \$1 billion-worth of these. In November, the Market essentially disappeared on us. It actually disappeared in October or November. Asset-backed securities backed by home equity loans have also fallen to zero and have been literally at zero for many months. The size of the market as measured by the Merrill Lynch indices – it's not a total measure of the Market but a good proxy – shows you that the overall size of the Asset-Backed Market is down by about one-third. The Asset-Backed Market has stopped.

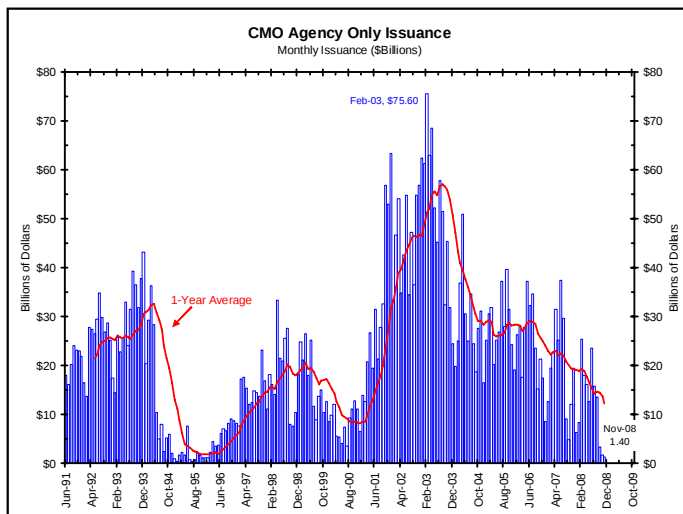
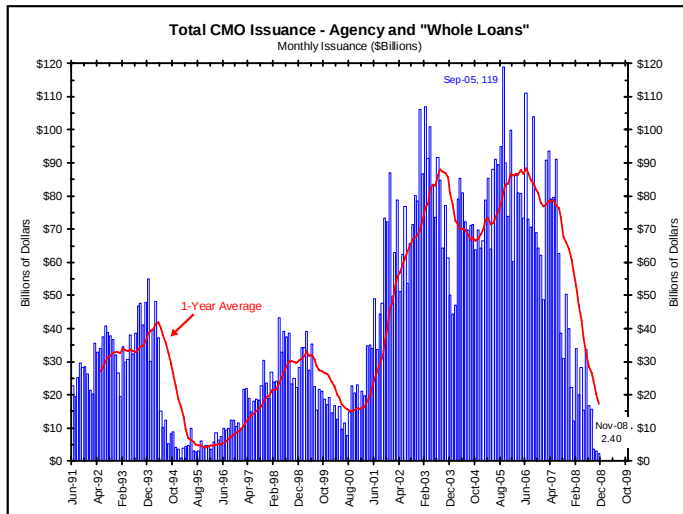


Almost all consumer lending flows through the Asset-Backed Market, whether you're talking about auto loans, credit cards, home equity loans, and of the like. That is what is making it very difficult in order to get a loan in a lot of those markets. Student loans also flow through this market. We want the banks to make up that difference. The problem with the banks making up that difference is that requires

them to have a balance sheet. They don't have the balance sheet that they are willing to commit to this and, therefore, we are seeing more and more problems in the Market.

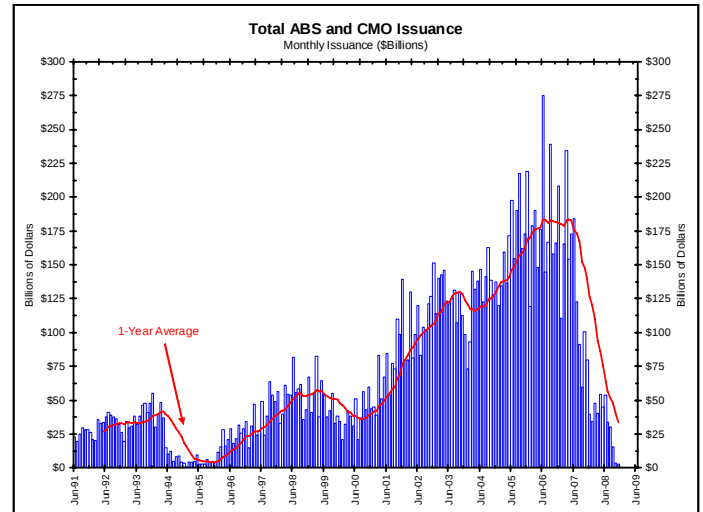
CMO Market Stops

If we go to Page 15, you could see that the same thing has happened with the Collateralize Mortgage Market. That market has also stopped. Whether or not you're talking about the issuance of whole loans or agency-only loans, they are essentially at zero, as well, for the last two months, or a number very close to zero like a nominal amount of \$1 billion. If you add in asset-backed and CMOs together, then it's only a couple of billion dollars.



At one point about 18 months ago, we were pushing out well in excess of \$200 billion a month; now we're pushing out two a month. This is why we have heard all of the screaming, "The banks aren't lending. The banks aren't lending!" Well, in some respects, they are. But we have made so many non-bank avenues to get loans and access to credit that the banks cannot possibly make up all of that loss. So we scream and yell that the banks aren't

making it easy for me to get an auto loan, for me to get a student loan, for me to get a mortgage, for a company to expand, for BCE to get its financing to do its LBO (which died today). We can't have the banks do all of that at the same time. We used to rely on the capital markets. The capital markets are not there. But the banks are, so the banks have been getting our ire. And I think that has been somewhat misplaced. The problem is much bigger than the banks.



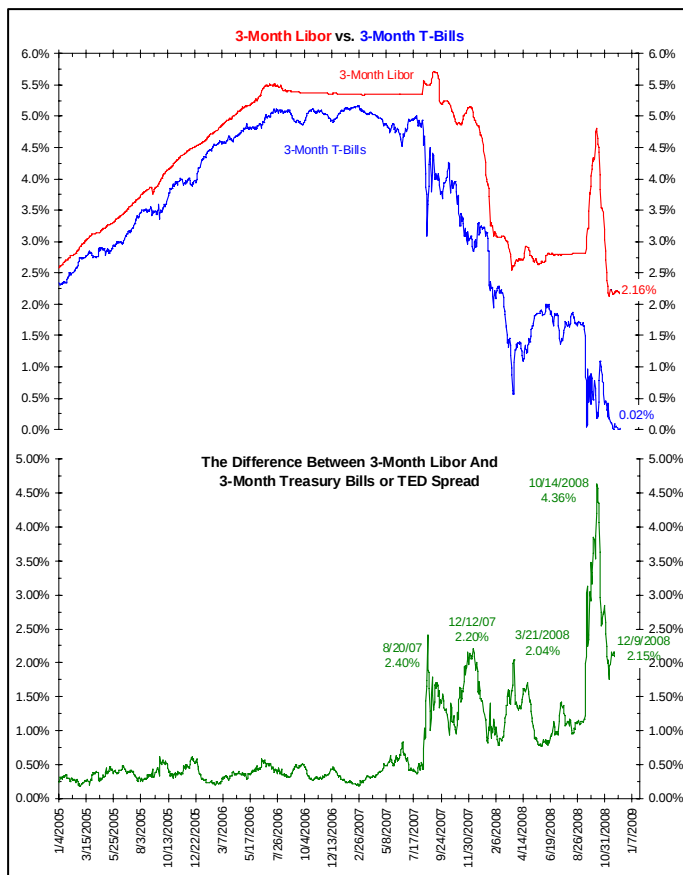
Medicated Market - LIBOR And The TED Spread

If we jump in at Page 16, again, are we at a bottom? I think that the best way to answer the question, "Are we at that 1974-type bottom, where maybe it just stops getting worse," I would argue, "Yes, we are very close to that if not right on it." So that means that you're going to go from a -40% return to a zero return.

Are we near that 1982-type bottom, where we're going to go from a zero return to a +20 return and keep going? In order for that to happen, I think that we need to see the Credit Market start to show some serious signs of getting better. If we look at the previous measures of the Credit Market – asset-back, CMO, bond issuance – they are not getting better. They are not getting better, and there is no other way to spin it.

The problem with looking at spreads is that we have defined the markets into two different groups. One is the medicated markets, which are the markets with heavy Government intervention. The first one is the chart on Page 16, which is LIBOR. LIBOR has got banks getting capital from their central bank and being told to do something about the high rates of LIBOR. And we've got a \$900 billion term auction facility, or TAF, in order to manipulate these markets.

T-bill yields have essentially hit zero. As a matter of fact, the other day, they briefly hit negative.



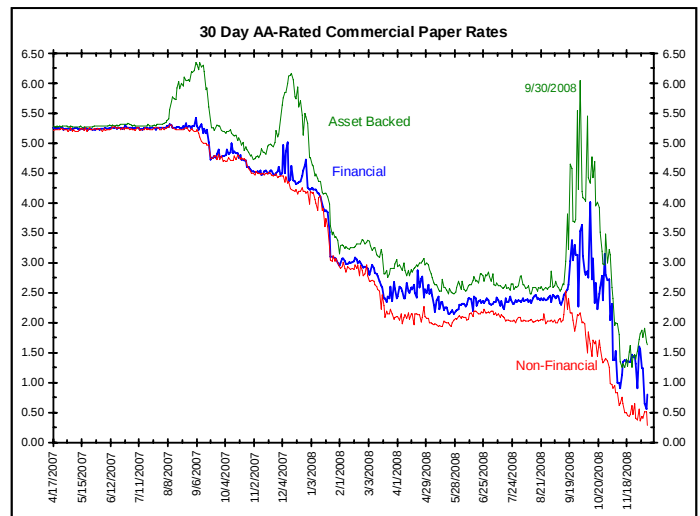
The three-month LIBOR has settled down at around 2.15%, 2.10%, 2.1%. The spread is still 200 basis points.

If you look at the green chart on the bottom panel, on Page 16, any other period except for October, a 200 basis point spread on LIBOR would be considered a crisis point. It was that when we were having a crisis in August, at the end of last year, and during Bear Stearns when it was at 200. Then it went to 436 in October, a number that nobody understands. But now it has settled into just normal old crisis level. I don't know how to interpret LIBOR. I have been arguing that the best way to interpret LIBOR is, "Let me see what this market does when we start reducing the size of the TAF, when we start reducing the influence in the markets." Otherwise, all that it has become is a government subsidy. And a government subsidy should not be confused with a market that is getting better.

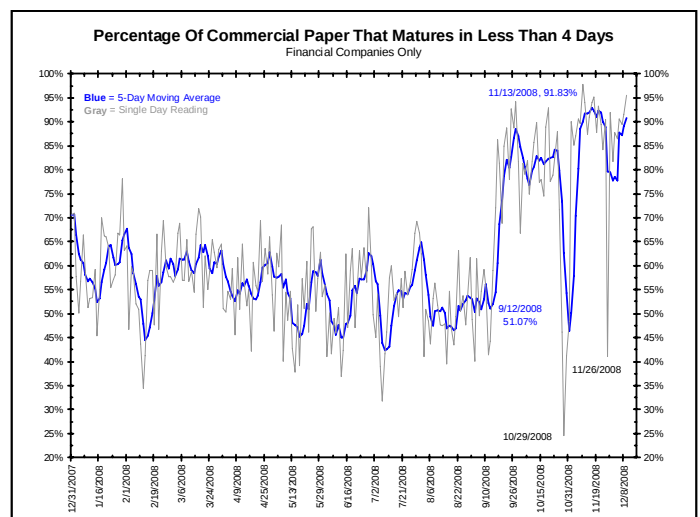
Medicated Market - Commercial Paper

The other government subsidy or medicated market, obviously, is commercial paper. The Commercial Paper Market doesn't exist except in very small terms in overnight money. The top left chart shows that 30-day commercial paper rates have fallen quite a bit. The chart on the right – let me take that one next – shows you that the amount outstanding of commercial paper has jumped a couple hundred

billion dollars over the last few weeks to the latest plot.

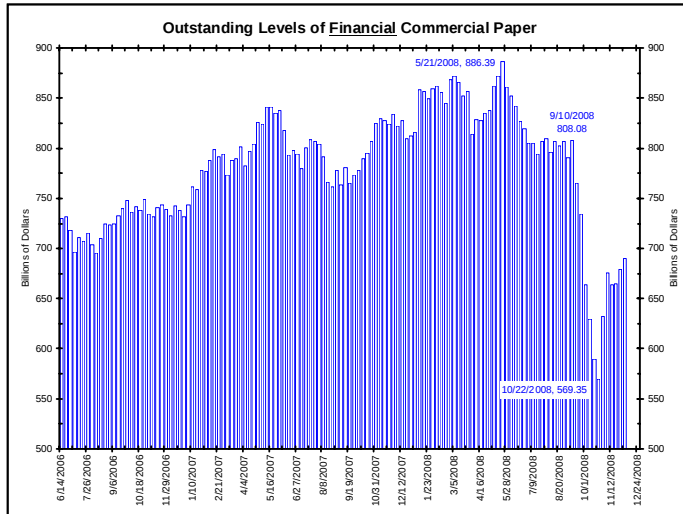


But if you look at this chart on the lower left, what it shows is the percentage of commercial paper that is overnight, less than four days. It was running at 50 or 60% until things got really bad in September, and it jumped up to about 90 percent. Then the Fed created their program to directly fund companies. In late October, it briefly jumped down to 20 percent, meaning that 80 percent of the commercial paper issued in late October had a term of greater than four days. We know that they probably had a term of 30 days because that is what the Fed was issuing. And what happened 30 days later? It dropped again as all of that paper rolled off. What happened in between? It was still 90%.



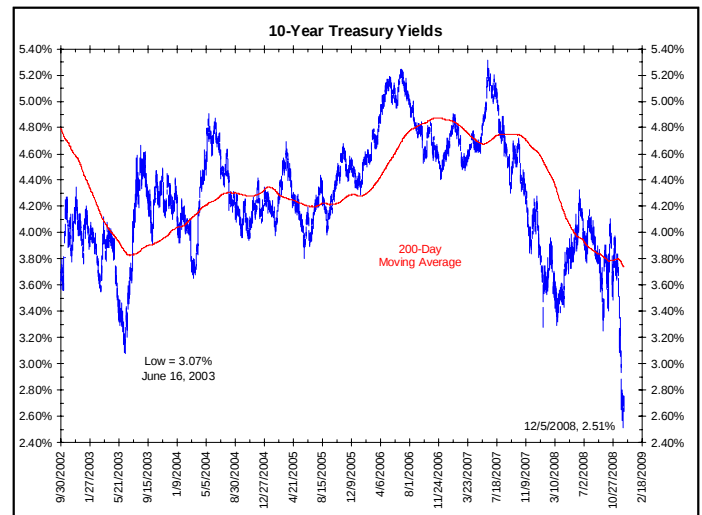
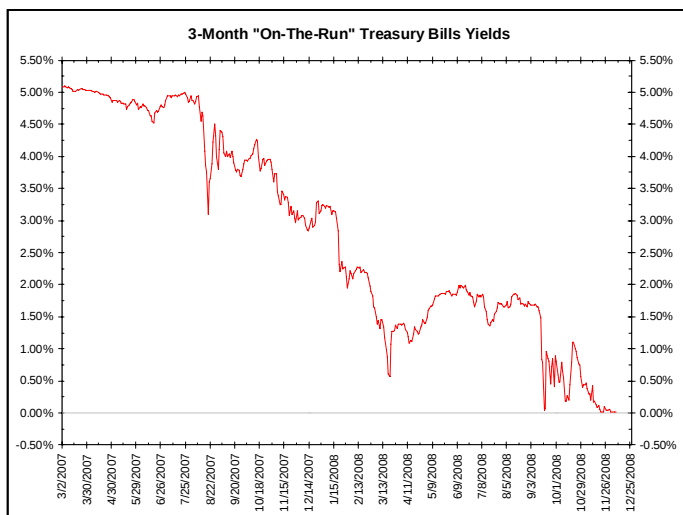
There is no commercial paper market outside of overnight. What there is is \$200 billion of Fed financing that gets rolled every 30 days. And so unless you can get a qualification from the Fed, this market essentially doesn't exist in any great degree. And, again, I don't know how everybody could be saying, "Well, look at those rates. They're coming

down.” It’s a government subsidy right now. And so, really, the sign to me that the Commercial Paper Market is getting better is, “Let’s cancel this government program, which is due to elapse at the end of April anyway, and see if these rates stay down here, or if they go shooting back up.” So in these markets, it’s really hard to say whether or not credit is getting better.



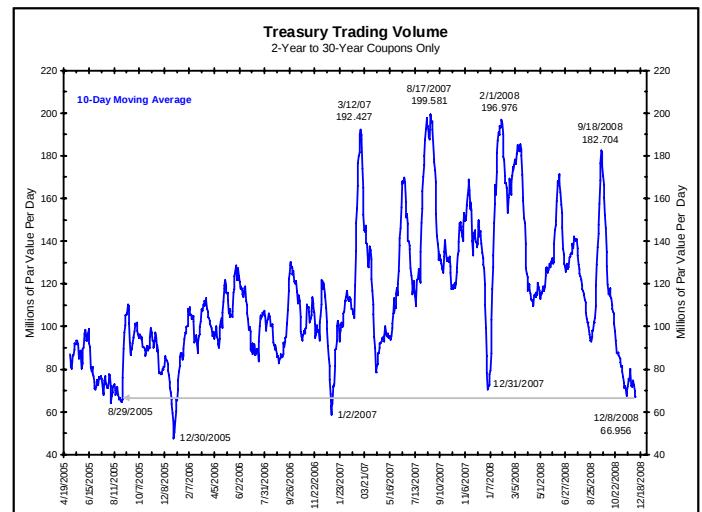
Treasuries Rally On Low Volume

Maybe a better place to look for short-term financing might be to look at the Treasury Market. The top left chart here on Page 18 shows three-month Treasury bills hitting zero as they have over the last several days. The bottom chart shows the dive to historic or 50-year lows in the 10-year yield down to as low as 2.5% last week, intra-day. And a couple of things about that – or the last chart, I should say, on the right shows broker tag volume for coupons, which is at a three-year low.



So what are these charts telling us in terms of telling us more about the medicated markets? If those markets were really getting better, and commercial paper were a viable market that was liquid for both investors to invest in and issuers to issue, then you wouldn't see T-bill rates running to zero. That is a sign that there is still stress. People would rather pay par for a T-bill and get par back in three months that invest in any of these other markets.

As for the idea that Treasuries are in a bubble – well, there are two problems with that. One, the volume numbers suggest opposite because volume is very low. Treasuries must be going into some kind of a strong hand and not being traded out if we're having this giant move in Treasuries on very, very low volume. That is the opposite of bubble characteristics.



Secondly, the only way that you could argue that it's a bubble is if you believe that inflation is the immediate concern. Now, what I find that is interesting is that there have been a number of people that have argued that Treasuries have bubble-like characteristics and then, in the next

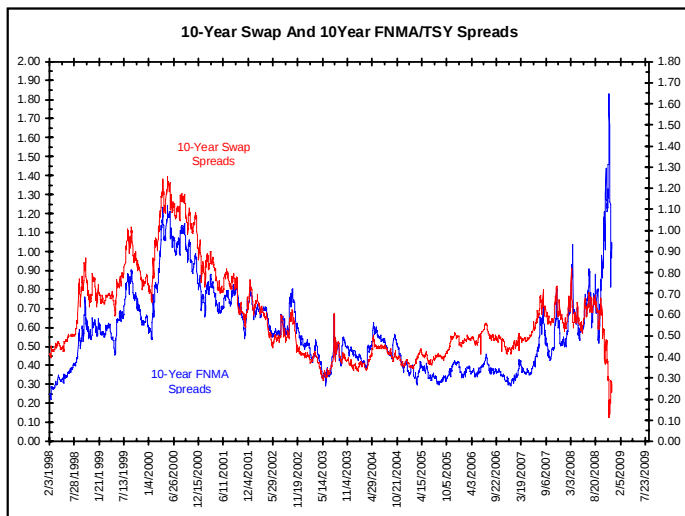
breath, say that we are in a deflation. Well, if we are in the deflation, then these yields are not out of line.

But if you believe that, ultimately, inflation is coming back, then these yields are out of line. So I have found that argument to be a little bit misleading or a little bit confusing. If you think that Treasuries are a bubble, then you must think that inflation is the immediate concern because if we are going to a period of negative CPI, then there is nothing wrong with a 2.5% Treasury yield at that point. But if we are going to see some traction from all of the Fed's inflating, then you have a big problem with a 2.5% CPI. The fact that these yields are at historic lows suggests to me that, when looking at the medicated markets, they are not that healthy; if they were, then we would be seeing Treasury yields moving higher.

Agency Spreads – The Fed Replaces The Chinese

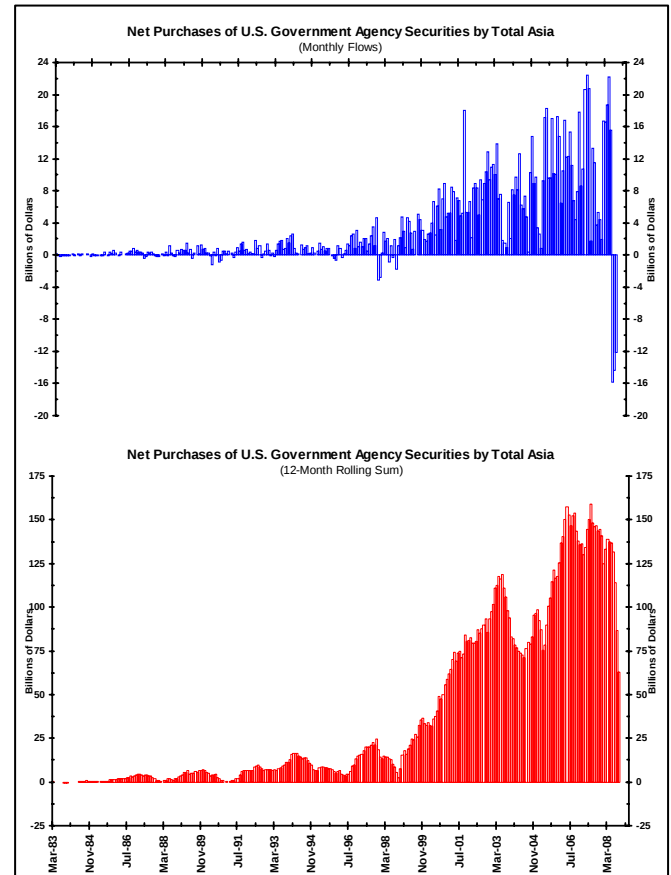
Let's look at some non-medicated markets or at least what were non-medicated markets:

Agency spreads – the chart on Page 19 – the top chart shows five-year spreads, the bottom chart shows 10-year spreads, and overlaid on them with the red line are 10-year swap spreads. The chart on the left shows purchases of agency securities by Asian accounts.



As we have argued, the agent accounts became sellers in July. I think that was the reason that Paulson asked to initially backstop the agencies, or his bazooka, if you will. He wanted to backstop them on the idea that we were going to try and regain the confidence of Asian buyers, and it didn't work. We then took the next step and nationalized them right after Labor Day, and that didn't work either. If you look at the 10-year swap spread chart in blue, that yield shot higher. But then it was only when the Fed announced that they were going to buy agency securities that we have seen a massive

collapse of almost 100 basis points in agency securities.



What is the takeaway? What is the lesson from that? The lesson is that nationalization backstopping does not work. What works better is that actual buying is what is needed. I think that the takeaway here is that we are just now understanding the extent that levered money was playing in these markets, that spreads had compressed down in their '06-'07 levels because there were a lot of hedge funds, a lot of levered closed-end funds, a lot of swap markets that were allowing us to buy these markets unleveraged. Why did we buy these markets unleveraged? They were AAA rated. We had positive carry. We were looking for ways to leverage them up.

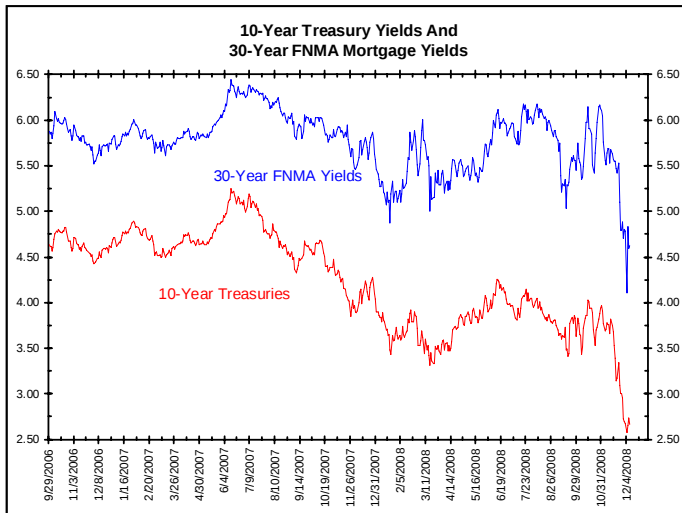
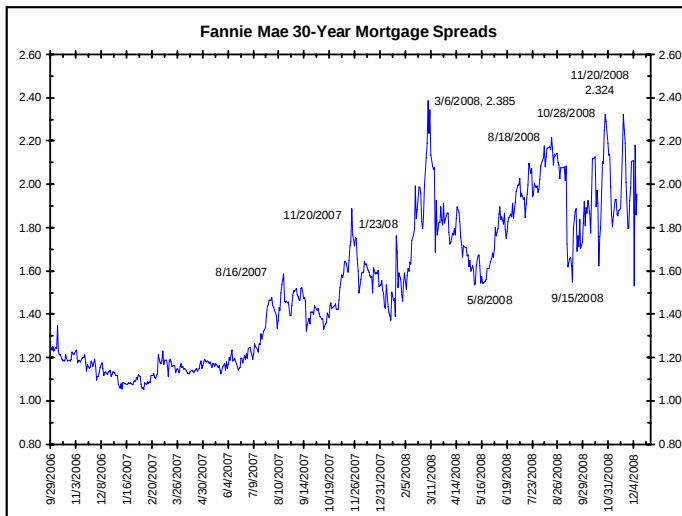
In the financial market de-levering, that leverage is gone. And it is not a problem that the credit quality is what we are scared about. So when the Fed nationalized Fannie and Freddie, and says that their credit is now as good as the U.S. Treasury, it doesn't stop their spreads from continuing to widen. The problem is that we need a buyer. When the Fed says, "We are going to be a buyer," then we see the massive decline.

So if you were to ask me the bailouts to date, I would say that nationalizations and backstops have been failures. Outright buying by the Fed or a

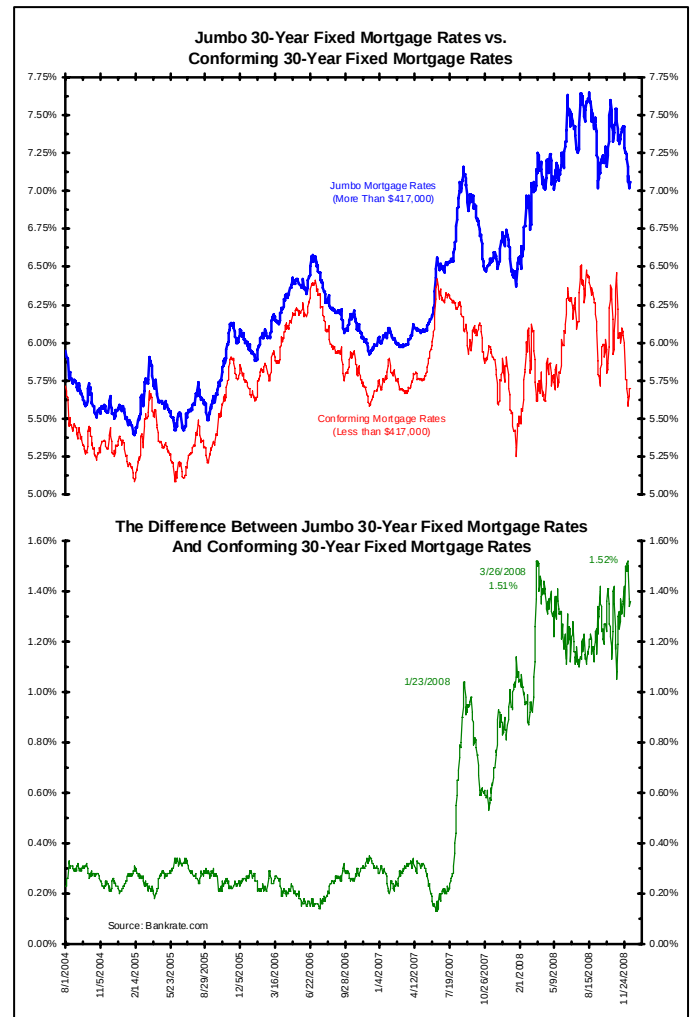
government agency has been the only thing that has worked. The problem with that, though, is that you are interfering with the Market. And how do you get the Fed out of that in the long run? That is a tough question that no one seems to have an easy answer for.

Mortgage Spreads – Not Getting Worse

Another great example of this is in the Mortgage Market, too. If you look at the chart on the lower left, mortgage rates have been heading down to an historic low. That is because they have been following Treasuries lower. The chart on the upper left shows you that mortgage spreads have largely done not much during this period, as well. Again, the loss of a buyer and what stabilized these spreads has been the potential that the Fed is going to come in.

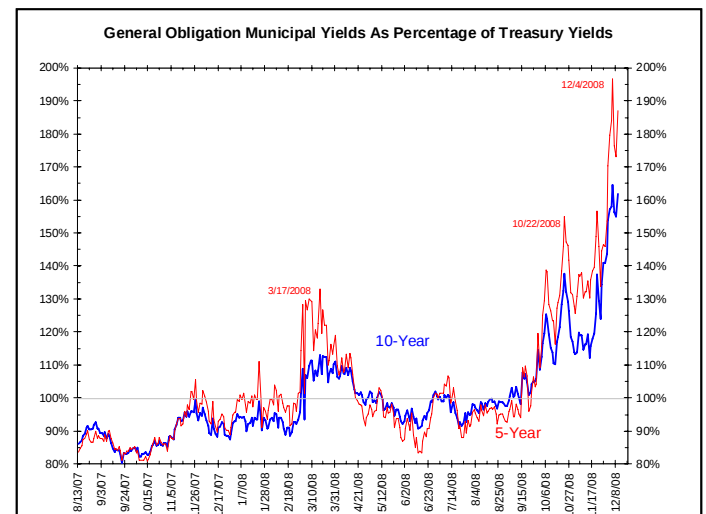


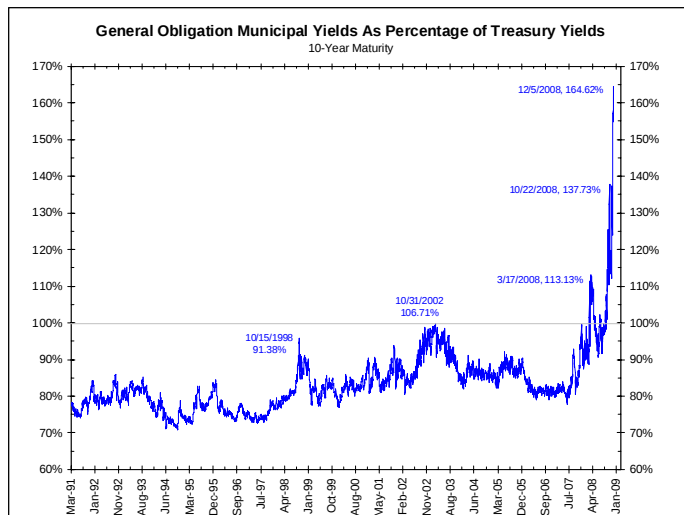
Jumbo-rate mortgages haven't been moving at all, either. The chart on the right shows jumbos in blue, their yield, and national average conforming mortgages in red by the Bankrate.com measure. And you can see that their spread has still been very high, too.



Muni Spreads – Still At Panic Levels

The chart on Page 21, though, I think, is more to the point – munis. Munis, I think, are really where I'm talking about, where it's the loss of the buyer that is causing the problem, not the credit quality.



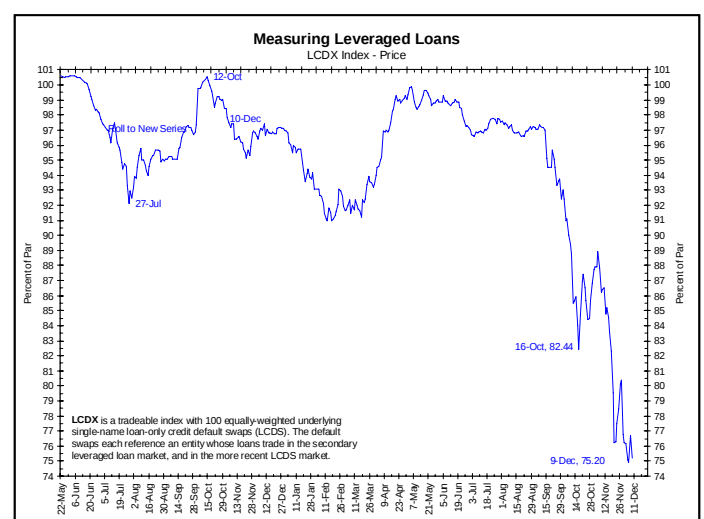
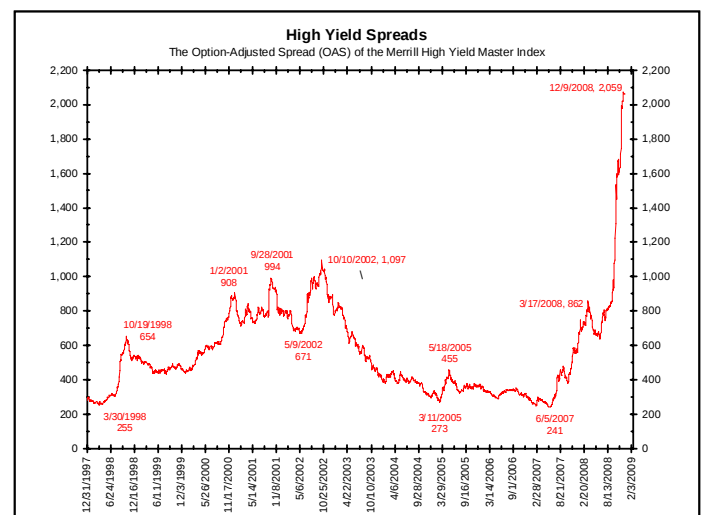
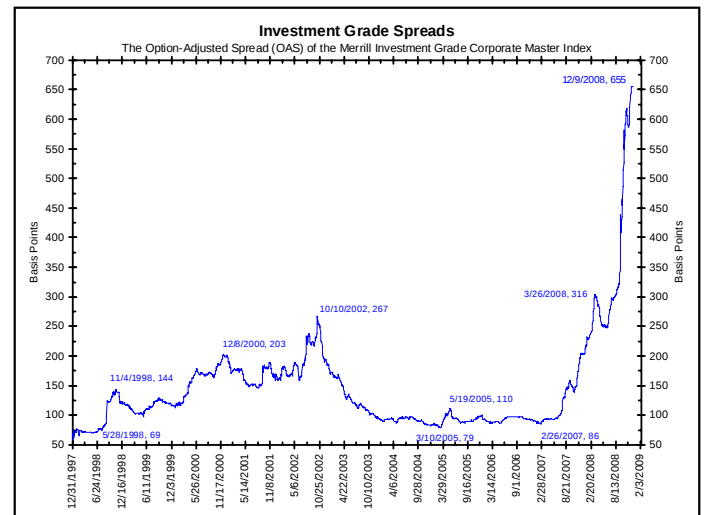


This chart here shows GOs as a percent of Treasury yields. The red line is five-years; the blue line is 10-years. The bottom chart is the same blue line, just going back for a much longer period of time. The muni yields as a percent of Treasury yields are off into a place that no one thought was possible. And one of the reasons that I think this is is not because we are worried about the credit quality of California or Florida, or of any other state or municipality. We know that they have the power of taxation. We know that they probably have the Government as a backstop.

But the Muni Market was levered, too, between: hedge funds, auction rate securities, variable rate debt obligations, and municipal swaps. We found ways to buy munis on multiples of leverage. All of those leveraged players are gone. We are now learning how big they were in the Market. It's the loss of the buyer that is causing muni spreads to continue to move higher. What we need is a buyer. So when you look at these non-medicated markets where you don't have direct government buying going on, you see that these spreads are still at their widest or very, very close to their widest.

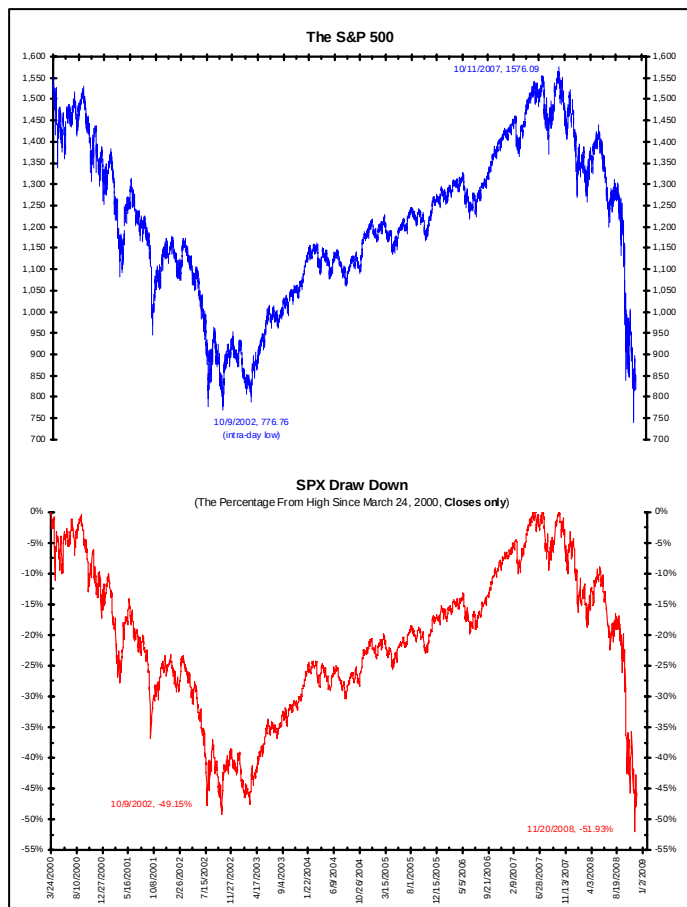
Credit Spreads Are At Their Worst Levels

Credit spreads on Page 22 – it's the same thing. In the last week or so, we have made a new wide. The upper left chart shows where we made a new wide in terms of investment-grade spreads. We have made in the lower left chart a new wide in terms of high-yield spreads. Leveraged loans have been making new lows in the last several days. And in addition to leveraged loans making a new low in the last several days, we have seen all of these markets -- even the iTraxx Crossover CDX Index, which is in the lower left chart, as well -- making new wides. This market is the opposite of getting better.

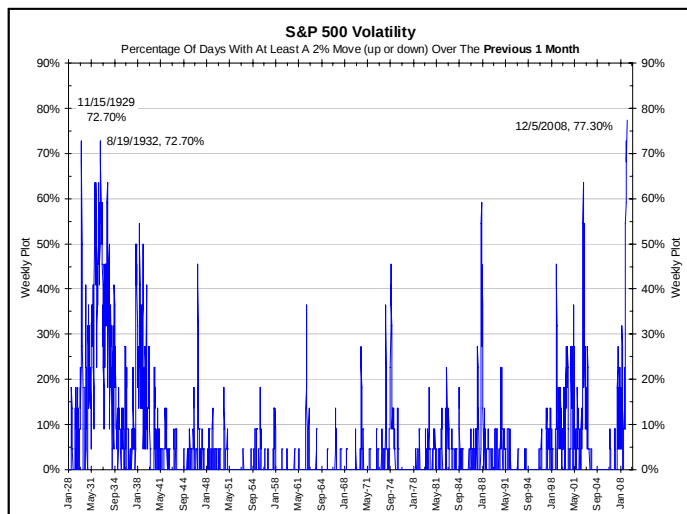


The Stock Market Decline Now Rivals The 1930s

Finally, the chart on Page 23, which shows the Stock Market decline, is now rivaling the 1940s. And one of the things that we have argued is that, if you look at the Stock Market on a relatively basis, it has been one of the better-performing markets.



That is because it has got the least amount of leverage. In fact, that we used to term this The Upside-Down Credit Crisis because the highest-quality instruments – municipals, agencies, mortgages – before the Fed stepped in were doing the worst. Those had the most leverage. High-yield was doing relatively better than investment-grade. Investment-grade had more leverage than high-yield. The Stock Market, relatively, is doing better than all of them because it's got the least amount of financial buying leverage. And it's not non-existent; it's just relative to the size of the markets.



The chart on Page 23 basically shows us where the markets have been. And that chart on the lower left shows that volatility – the percentage of days that we have had that have been 2% or greater is 77% over the last month. The S&P was started in 1928, and this is the highest that it has ever been.

Conclusion

So, in conclusion, are we at a bottom? I will give you a qualified “yes,” that I think that the worst pain is behind us. What we are going from is a severe downdraft to a sideways period of no return with extraordinary volatility. Look at that chart on the lower left. The media is going to have a problem with this. The move from November 20 to earlier this week was more than 20 percent, and it was their definition of a bull market. We are going to see five or six bear and bull markets, I think, in the period of the next few months so that they are going to have to come up with a new definition. Or to put it another way, if you look at the numbers that I have on Page 23 here, you will see that September was a negative month for the S&P, October was a negative month, December was a negative month, November was a negative month, December was a negative month, and last week was a negative month. Yet, in the middle of all of that, we somehow snuck out a bull market that you cannot even find in any of the numbers because of the extraordinary volatility that we have. So we are going from a downdraft to a sideways movement.

When do we get that August '82 parallel, when the Market goes up? There are two things that I think have to happen:

First, the credit markets have to show a sign of healing, which means that you can actually borrow in the credit markets. You can't do that right now or at least you can't do that at reasonable rates. What I think is happening in the credit markets is that they have to be priced to attract the unleveraged buyer. In other words, where does high-yield have to trade, where does investment-grade have to trade to get an equity manager to say, “You know what? I want to sell my holdings in healthcare, and I want to own corporate bonds.” What is that going to take? Eleven-percent investment-grade yields and 23-percent high- or junk yields, subtract out the expected default rates, and you've got a pretty decent return in those markets. The problem is that nobody can finance anything at 23 percent. It might be a good investment for some buyers of existing debt, but it's not good for the economy.

So the markets have gone from a severe downdraft to zero. It's one of the worst years that we have ever had. It's one of the worst sellouts that we have seen in the Stock Market in 60 years. Spreads are at record wides. In fact, I could argue that

investment-grade spreads are the highest/widest that they have been since the 1930s, in looking at some of the old Moody's data. So we have discounted a tremendous amount of economic damage in these markets. So now we trade sideways.

Only once the financial markets recover – not just getting more Federal Reserve assistance, which means more potential inflation down the road – and/or return risk-taking becomes acceptable could we get closer to arguing that we are near an August '82 period. So, right now, I think that the argument is that spreads are about to peak in high volatility, but you are not going to see much in the way of any kind of a collapse in those spreads or an up-thrust in stocks when you factor in the highest volatility that we have ever seen.

And the last thing that I will mention before I open up for questions is that I also want to warn that I would rather be a month late than a month early. I am not in a hurry to buy this Market. I am not in a hurry to see that this Market is going to get away from me. I don't see the potential of a 40-, 50-, or 60-percent return coming in 2009 because the risk-taking is simply not there. If companies are trading below cash values, if companies are cheap, then the private equity business cannot finance to do anything about it. The amount of outflows out of all types of investments – being hedge funds, mutual funds, endowments or trusts – is not there to take advantage of it. It's a zero-sum game. Do you think that stocks are cheap? You're going to have to sell something else to buy them. Therefore, the financial markets cannot recover until we get a positive flow coming from them, and I don't see that coming any time soon.

Questions And Answers

All right, let me stop there. Let me start taking some questions.

Let me start with the live questions. Our first question comes from George. George, are you there?

George: Jim, it was more of a comment rather than a question.

Bianco: Oh, those are good, too!

George: I was around during the investing during the 1970 period, and from 1974 to 1982 was not really a bad period. I wouldn't characterize it as flat. Small-cap stocks annualized at 33 percent a year from 1975 to 1983. The Dow Jones Utility Average doubled from the bottom of 1974 to 1982, and the S&P 500 went up 64 percent from the bottom of 1974 to 1982. I think that small caps in particular were particularly hard hit, so they had a tremendous bounce-back. And I remember several small-cap

funds – and I won't name any specific funds – did very well in that 1970 period.

So if you want to use an analogy, then I wouldn't use '75 to '82.

Bianco: Well, I understand what you're saying, and what you say makes a lot of sense. But what I was thinking was more along the lines that the Dow Jones hit 577 in 1974, it hit 776 in 1982 as its lows. When you adjusted for the inflation during the period, the inflation adjusted was actually lower in 1982 than it was in 1974. And so, therefore, on a real basis – I'm just using the Dow Jones Industrial Average – my thought process was that you made no net progress on a real basis.

George: OK.

Bianco: You're right. Within an (inaudible), and even within 2009, there will be places to make money. But whether or not we're going to get a broad rising of all tides is the question that I was trying to ask. And I was using that analogy to say that I think that, when calling a low, there is a two-step process: there is a low, and then when do we start going back up; and in this case, I don't think that they are the same date. It's not like October '02, which was the low and also the period when we started going back up at the same time. I think that this is going to be more disjointed, at least in terms of when the money is going to be made rather than the pain is going to stop, that those are going to be two different types of periods. That is what my idea was with the '74 to '82 period.

George: OK, I accept what you are saying about the real rate of return. But let me just make one other comment. It's that the amount of cash out there relative to the Stock Market, the amount of liquidity is very high. And I remember back in 1974 and also in 1982 that there were alternative places to put cash where you could get a good return. In money market funds, you could get close to a double-digit return in '74. And, also, real estate provided a good return, or certainly a better return, or a better-perceived return than what we have now. Now, if you look at alternatives to putting money particularly, say, in high-yield stocks and things like that, you're getting one to two percent in money market funds, and you're getting a negative return in real estate. So if people are convinced that the worst is behind us, and you have all of this liquidity and it's wondering where to go, then might the Stock Market not be a recipient of that?

Bianco: It would be except that now I guess that we'll get into another little avenue here -- and I'll try not to get myself in trouble by saying this -- but I think that Hank Paulson has killed that for a period of time. I have been a big critic of what he has been doing in that the haphazard approach has so

damaged investor confidence that nobody wants to invest in the Market, especially where it is needed the most, which is financials.

A lot of people would argue that Lehman Brothers was the mistake that they made that caused the System to fall apart. But I would actually argue that it was part of a larger hole. The week before Lehman Brothers, they nationalized Fannie and Freddie, and they bankrupted preferred shareholders. They made a political decision that preferred shareholders had to be bankrupted. They made a political decision to let Lehman go and see what happens. If they bailed out Lehman, then they probably would have done the same thing with AIG, let them go and see what happens two days later. If they bailed out both of them, then they probably would have let WAMU fail.

But the problem was that, over that period, they bankrupted shareholders and let shareholders fail. They bailed out some shareholders in AIG. And in the original terms of the deal at LIBOR plus 850, plus warrants for 80 percent of the company, I thought that it was nothing short of extortion.

In the case of WAMU, TPG owned WAMU and was trying to find a buyer for WAMU. And in the middle of the process, the FDIC stepped in and said, "You know what? This isn't going to work. We'll just give the company to JP Morgan," just out of the blue.

So the problem is the question of, "Will stocks give you a good return?" It's kind of like the argument that you have when investing in emerging markets. You have to trade off growth for rule of law. And the problem, I believe, is that we have so damaged rule of law, as to question, "If I buy into a financial firm, then what are my prospects that I am actually the owner of the firm?" This is why I think that Citibank was on its way to zero a couple of weeks ago before we had to bail them out again. This is because the minute that a financial firm runs into trouble, the perception is, "Uh-oh, the Treasury or Hank Paulson might step in and take the company away from me, and wind up giving me nothing. So I better get out now, even if the stocks hit \$4 from \$16, because it's still \$4. He could announce a deal over the weekend, where I get nothing. He's done that a couple of times already."

So we need to get past that. We need to have people say, "I am comfortable in investing in the Market, and I am comfortable that, as the owner of this company, I still have certain rights." We need that more in financial firms than anything else because only then can we really get the financial markets to expand and then get lending to come back. But we are well away from that right now. Investing in a financial firm is a minefield because

we don't know what the Government is going to do the next time that a financial firm runs into trouble.

The announcement of what they did with Citi was a better deal than the previous ones. But we've got a history over the last three months that we are not sure. So it's going to take some time before we can move forward.

So, yes, the Stock Market might provide some good places. But until we get the confidence to put our money in financials, then I think that that big cash hoard is going to sit on the sidelines.

A last thought for you – maybe the change of administration might do it.

George: Yes.

Bianco: Maybe a Geithner sitting in that chair instead of a Paulson might do it. I'm open to that idea, but we'll have to see how that unfolds.

George: Well, thank you for a great presentation.

Bianco: Thank you very much.

The next question is from Jack. Jack, are you there?

Jack: What were the points that you made that are preventing banks from lending, that it's not merely voluntary reluctance on their part but that they are being prevented from or delayed in lending?

Bianco: I'm not following.

Jack: In your presentation, just now, you were saying, you concluded so it's not entirely voluntary on the part of the banks that they are not lending, that there are elements in the economy or in finance that are delaying them from getting back into the lending business even though they have been pumped full of liquidity. Why is it sticking in the banks? You made a comment as to why that is happening, that it's not that they're just choosing not to lend.

Bianco: Yes, I think that the problem with the banks is a twofold thing. They cannot overcome the loss of the ABS, the CMO, the corporate bond markets, the commercial paper markets, and all of those markets that aren't functioning properly. The Banking System cannot expand fast enough to compensate for that. So we are asking too much from the Banking System.

The second problem that you have is that, of course, bankers are acting rationally. We've got arguably the worst – I was going to say depression, but worst recession since the 1970s unfolding right now. That's not a time to be handing out loans. And so they should be looking after their own best interests, which I think that they are, too.

And, third, even in adjusting for all of that, Federal Reserve numbers show that they are lending; they're just not lending in the massive size that we need to compensate for the first two. So it looks like they are not taking the money and doing anything with it.

So I think that the problem that, if you're waiting for the banks to start lending like drunken sailors in order to reflate the Financial System, it isn't going to happen. Really, what we've got to talk about is how do we get consumer-financed vehicles -- ABS, the Mortgage Market, the Commercial Paper Market -- back and running properly. Once we do that, then I think that you will see the markets return to normal. But if you're just waiting for Citibank or JP Morgan to expand their balance sheets into hyperspace, handing loans out to everybody left and right, they can't do it, and I don't think that we should expect them to.

Jack: Is it also a matter that they can't find qualified borrowers?

Bianco: Yes, I think that is the problem when the Government forcibly gives you money and says, "Go out and lend." Well, it's a recession. Now I don't want to lend to a lot of people in this environment. They're not good credits in this environment. And so, therefore, they have been pulling back on it.

You know, there's an example here that I mentioned the other day. I'm in Chicago, and this Republic Windows and Doors, where they have the workers sit because Bank of America pulled their lines of credit. If you look at Republic Windows and Doors' prospects over the last couple of years, they should have pulled their line of credit. That company has been teetering for a long time. And now we've got Government demanding that they continue to lend to this company. That's going to be write-off, is what it's going to wind up being. I just can't see how Republic Windows and Doors is going to miraculously turn around their operations and be able to pay those loans. So they are looking. And, yes, we have fewer qualified borrowers because of the downturn in the economy. When things turn up, more people would qualify.

Jack: Do you think that this latest bump in gold over just the past few days is the first whiff of inflation?

Bianco: It could be. I mean, I have always argued that we are going to end this with inflation, and then with the dollar weakness that we have also started to see unfold, too. I have leaned toward the idea that, while we are in deflation now -- and let me not confuse that -- inflation would be coming sooner rather than later. I know that some have argued that it's still two or three years away, but the Government created \$8 trillion-worth of bailouts in the last 12 months. When we do get Geithner, I don't think that

they are just going to throw their hands in the air and say, "You know what? None of this is working. We're not going to do anymore of this." They are going to keep doing it and keep doing it, and the Fed is going to issue bonds, and they are going to drive mortgage rates to 4.5 percent, and we are going to have a \$1 trillion-plus stimulus package in late January, and they are not going to stop until they reflate the economy; and with it could come inflation.

So while gold hasn't technically done anything to say that it's broken out, the dollar hasn't technically done anything to say that it's down. Yes, that definitely bears watching because those are the types of things that you would look for to say, "You know what? Maybe the reflation is going to start to work." And that means that the good news is that we will probably have no more negative GDP numbers. But the bad news is that we are going to flip back to inflation.

Again, I have argued that in this environment, we are operating on the extremes. We are operating in a deflationary environment now. For the last three months, we have had negative inflation to a tune of 12 percent annualized. You've got to go back to the 1930s to find, in a three-month period, where the inflation rate fell that much. But when this is over with, we're going to flip over to the big inflation side, the middle ground in which we used to operate, that low disinflation. Arguing the difference between two percent and 2.5 percent inflation -- that's gone for right now. So we're operating on one extreme; and then once all of these Government programs work, I think that we'll go to the other extreme.

Jack: Thanks very much.

Bianco: Thank you. Let me take one more live question. Jeff, are you there?

Jeff: Yes, I'm here, Jim.

Bianco: Hi, Jeff.

Jeff: I guess, going on from your comments from just a second ago, it seems that, if I've got my numbers right, the TIPS Market is discounting right now up to 10 years' worth of deflation.

Bianco: You're right. They are.

Jeff: It's now at 20.18 until it basically goes positive again and, like you said, it kind of hangs between one and two percent going forward. In terms of, as you just mentioned that you think it's going to go from one extreme to the next -- we don't know if that is going to happen in six months or three years -- in looking at the kind of risk-reward scenario, it seems somewhat illogical, in looking at all of the ways that one could place his bets in the markets right now, whether in equities, governments, or playing/praying the inflation/deflation camp, gut feeling is that this is

somewhat irrational, especially going out over 10 years. The risk-reward – would you think that it makes sense to dabble in the TIPS Market, in the deflation-linked market now, or to wait and see what the numbers bring in three to six months? What are your thoughts?

Bianco: Yes, it is somewhat irrational. And you can get in line with just about every other market in terms of irrationality. You know, like I was saying before, I still don't understand why munis are trading at 180 percent of Treasuries, or why we've got a 23-percent yield on high yield in the TIPS Market.

But let's consider a couple of things about that. Remember now, if the TIPS breakeven is negative out to 10 years, then that's mainly a function of the yield on the TIPS minus the yield on Treasuries. And when you have a massive flight to quality, everybody piles into Treasuries, Treasury yields decline, and that brings down the TIPS breakevens; and then when it declines through the yield on TIPS, you get negative. So it is an artifact of the flight to quality in the Treasuries, the measurement of the TIPS breakeven.

Do I think that we are going to have a negative 10-year rate of inflation? We barely did that in the 1930s. And it took a 46-percent decline in nominal GDP -- and, boy, we don't want that to happen again -- in order to have a negative 10-year rate of inflation in the 1930s. Yes, they do look attractive just like a 23-percent high yield looks attractive, too. But if the Market is irrational, which is what it is, then it can stay irrational longer than you can stay solvent. And in this environment, I would bet that these markets are going to stay irrational until the Banking System starts to regain its normalcy.

There is no real arbitrage out there in the Market, in any great way. It's hard to borrow, and it's hard to operate in the markets. As one quanttrator said to me, "What has happened in the markets is the end of math." Anything that you invest on that has to do with a mathematical equation, like a TIPS breakeven being one of the simpler ones, isn't working right now. And so these tend to start to take on the view of a random walk. Everybody is piling in the Treasuries.

Treasuries are the place to be right now, though I think that they ultimately won't be. TIPS look like a very good investment if you can buy and hold them for an extended period of time like many years, waiting this out. Yes, you could probably do that and have a good return. But if you're thinking about buying and holding TIPS to help improve your performance in the first part of 2009, then that's a different question because that irrationality could stay for a while longer.

Did that give the answer to your question, Jeff?

Jeff: Yes, it did, I guess. And the other comment that I was going to make, too, was that, when you had mentioned about the thirties and high yield, and Moody's ratings, if my knowledge is correct, they rated only non-financials at that time, not financials, as well, which could skew the comparison a bit. We don't know, obviously, because we don't know what it would have been like at that particular time.

I don't know, but if you strip out the current high yield into different industries, obviously, the spreads would still be very high; but they might be quite as high. It's an open-ended comment. I'm not sure what the answer is.

Bianco: Yes, again, I think that the problem is that, when you talk about high yield or any of this other stuff, we are learning how much of the buying was unleveraged. When I say, "leveraged," everybody thinks hedge funds. Yes, that was a big part of it; but it was also in leveraged closed-end funds, in the swaps, and in the derivatives desk that would turn the stuff into total return derivatives or in the swaps markets, too. All of that is gone. And now that we are finding that all of that is gone -- that's what I meant by the end of math -- all of these relationships were based on the idea that we had that giant pool of liquidity, those levered buyers, and they're not there. All of these relationships have gone haywire. And they are going to stay haywire until we get some kind of an equilibrium point in the Marketplace.

Jeff: Yes, OK, thank you very much.

Bianco: OK, thanks, Jeff. Let me move on to a couple of email and IM questions, just to run few of those. The first question comes from Matt:

"What do you make of recent developments in the rising cost of default insurance for Treasuries and states. Is hedging at the core of capital structure a sign of unwarranted fear, a real sign of default risk, or something else entirely different?"

It's with a caveat here. Again, we are talking about a derivative market that is based a lot on math in an illiquid environment. Yes, you are right that the rising cost of default insurance -- for all the Treasury, for states, for companies as solid as Berkshire Hathaway -- has been rising and rising quite substantially. We are up to around 75 basis points for the default cost insurance of the United States Treasury right now. That default cost insurance at 75 basis points is pretty much what a single A-rated company was getting at the beginning of the year. And now the United States Treasury is getting that at the end of the year.

I think that it is right for those markets to show some fear because of the trillions of dollars of commitments that the Government has made, so that you have to start to worry about that.

It's the instrument itself that I've got problems with because, if you buy CDS on the Treasury, it's payable in euros. It should be payable in gold. If the day comes that the Treasury defaults, then, trust me, if they give you a bunch of euros and say, "Good call. Here are you euros. Good luck," that's not going to do you much good because they're going to be pretty much in the same position. This is true because, if you look at the CDS on most of the European countries, they rise in kind with us. They're probably all going to go at the same time. So, as Howard likes to say, it's a little bit like betting on raindrops going down windows with these markets. Nevertheless, the bigger picture there is that, yes, the Government is taking on more risk, and that should be going higher.

Is it unwarranted? Nobody knows if it is unwarranted because we have never seen the Government do anything like this before. But we need to understand that we have got a tremendous amount of borrowing, and we've got a tremendous amount of risk.

One quick statistic for you – yesterday, the Treasury Statement came out. For the first two months of the fiscal year – those are October and November, just the first two months – the deficit was \$400 billion.

This was for just two months. Remember when \$200 billion used to be the sign of a deficit's being too large on a yearly basis. We did \$237 billion alone in October and another \$160 billion in November. And \$100 billion of that was all of these bailout programs. When you are talking about a massive deficit like that, massive amounts of borrowing, and massive amounts of backstops, guarantees, and commitments, then it makes a lot of sense that Treasury CDSs should be rising. How much? That is the difficult question to really get out arms around.

I'll tell you what I am going to do since we are at 64 minutes right now. I've got some other emailed and IM-ed questions here. I will put those in the transcript that we put out on Monday. I try to limit this Monthly Conference Call to an hour, and I'm now a little bit over an hour. So I am going to end the Call right now. A lot of these other questions address what I think that I've talked about in one form or another already.

So let me thank everybody for joining us. Let me wish everybody a Happy Holiday. And our next Conference Call will probably be in early January. So thank you and goodbye.

END

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