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March 2008 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Special Report

March 2008

The Latest On The Credit Crisis

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

James A. Bianco, President, Bianco Research: Good morning, everybody. This is Jim Bianco. Welcome to our Conference Call.

Today's conference call is "The Latest on the Credit Crisis." I'm sure glad that we're having the conference call this week as opposed to last week because there have been so many changes that it would have been obsolete just a week later. But I think that, at this point, while touching upon some of the changes of the last week, let me still try and fly at 5,000 feet to give you a better view of the bigger picture.

Summary & Conclusion

The problem is the following. The banking system is taking losses and is shrinking. The real economy is still trying to expand. Those two are incompatible with one another. You cannot have a shrinking financial system and an expanding real economy.

The consequence is we don't have enough credit to go around, so we're rationing it. That is why we bounce from one crisis to the next. Borrowers are trying to find a way to get credit. And, usually, when some problem because of a lack a credit rises to the attention of all, it seems to get "solved" by denying another sector credit.

What is the fix for this? Simple, stop the losses. This is a nice way of saying that reserves become great enough so financial firms don't continue to have write-downs every quarter. Unfortunately this seems unlikely because the write-downs are now so great that financial firms are not in a position to reserve for the eventual bottom. Another way to fix this is to have the cause of the losses, home prices, stop falling. Unfortunately this too doesn't look likely to happen anytime soon.

The most likely way to fix this problem of a shrinking financial system is to offset the losses by raising capital. This has become in the vogue more in the last couple of weeks as I have seen more and more stories suggesting this should be done. Right now only about half of the capital lost has been covered through capital raising efforts. Financial firms will tell us that "the market is not there" to raise more capital. This is a nice way of saying that it's not there on their terms. But we might be getting to the point where they will have to take whatever terms that they can get, somewhat analogous to what the monolines had to do to preserve their AAA rating. They will just have to raise equity, dilute existing shareholders, and watch their stock price tank. But at least they stop the shrinkage of the financial system.

Finally, let me lump all of the government efforts at a solution together. There has been this constant whine in the market for the last several months of, "What are *they* going to do? How are *they* going to fix the problem? What is *their* solution?"

I believe there is no solution that the government can implement to fix this problem. The answer is that capital has return to the banking system, as it has to stop shrinking. The Fed and the government, along with the Treasury offered several ideas along the way, and we will try to discuss a couple of those. I think that, at the end of the day, they can help to ease some of the pain, but they cannot fix the problem.

For instance, Fannie Mae and Freddie Mac buying more mortgages is nothing but an artificial support to mortgage prices. The upcoming Fed's Securities Lending Program is also an artificial support to prices. If there purpose is to buy time, to wait for home prices to bottom, we believe they are not a good idea. Investors will see through this attempt to manipulate prices as they have with jumbo mortgages. If they are an artificial support to buy time so that Citibank et al. can raise more capital, then they might help. But if they are to buy time while hoping for something else to happen, then I think that they will ease a little bit of the pain but not ultimately fix the problem. So I think that, while the Government is doing what it can, we are not necessarily going about fixing the problem.

Finally, I do think that what the Fed has done in the last, say, two weeks or so between: the increase of the TAF, the New Securities Lending Program, the new 28-day System RP, the Bear Sterns bailout, and letting the dealers to the window is truly historic. Fed scholars will write about and discuss for decades. But it is also a bit of a line in the sand. The Fed has thrown everything it has in trying to stop the credit crisis. The Fed has "shot its bolt" – or whatever metaphor that you want to use – if these moves do not work and in a week, a month, or three months the credit markets are back to their panic point of earlier this week, what does the fed do next?

So with this summary let me start us on Page 2 and put some flesh on these bones.

Banking Losses And Capital Raised

"Banking Losses, Capital Raised" -- these tables on Page 2 come from Bloomberg. The table on the left shows the losses at major financial institutions. Last month, I had a more comprehensive list from Deutsche Bank. But I was unable to get an update of that list, so I was going to go with the more current list of only the major institutions from Bloomberg.

Total Banking System Losses
As of March 14, 2008
Billions of U.S. Dollars

Firm	Writedown	Credit Loss	Total
Merrill Lynch	24.5		24.5
Citigroup	19.9	2.5	22.4
UBS	18.1		18.1
HSBC	3.0	9.4	12.4
Morgan Stanley	9.4		9.4
IKB Deutsche*	8.9		8.9
Bank of America	7.0	0.9	7.9
European Banks Not listed	7.7		7.7
Credit Agricole	6.5		6.5
Washington Mutual	0.3	5.5	5.8
Credit Suisse	4.9		4.9
Other Asian banks (excluding Mizuho, Nomura)	4.1	0.7	4.8
Wachovia	2.7	2.0	4.7
Canadian Imperial (CIBC)	4.2		4.2
Societe Generale	3.8		3.8
SachsenLB	2.8		2.8
JPMorgan Chase	1.6	2.1	3.7
Mizuho Financial Group	3.4		3.4
Barclays	3.3		3.3
Royal Bank of Scotland	3.2		3.2
Bayerische Landesbank	3.0		3.0
Dresdner	2.7		2.7
Bear Stearns	2.6		2.6
Other Canadian banks (excluding CIBC)	2.5	0.1	2.6
Deutsche Bank	2.4		2.4
ABN Amro	2.4		2.4
Fortis*	2.3		2.3
Natixis	1.9		1.9
NSH Nordbank	1.7		1.7
Wells Fargo	0.3	1.4	1.7
Lehman Brothers	1.5		1.5
DZ Bank	1.5		1.5
National City	0.4	1.0	1.4
BNP Paribas	1.0	0.3	1.3
Caisse d'Epargne	1.2		1.2
Nomura Holdings	1.2		1.2
Gulf International	1.0		1.0
Total**	**168.9**	**25.9**	**194.8**

Source: Bloomberg L.P.

The table above shows asset writedowns and credit losses, including reserves set aside for bad loans, at more than 20 of the world's largest banks and securities firms this year. The charges stem from the collapse of the U.S. subprime mortgage market. The figures, from company statements and filings, include charges the firms have said they expect to report for the fourth quarter.

All figures are in billions and are net of financial hedges the firms used to mitigate their losses.

It shows that, if you round it off, the losses right now, to date have been about $200 billion. They are sorted by size of loss. Merrill Lynch leads. Citibank is in second. UBS is third. HSBC is in fourth place.

This cannot be emphasized enough, this is the problem – the banking system is losing money. They are losing capital.

Remember that the typical bank is levered around 14 or 15 to one. For every dollar that they have in capital, they can hand out $14 or $15 in loans. I'm keeping it very simple and generic. They have lost $200 billion, just rounding it off with the table on the left.

Now, if you look at the table on the right, rounding it off again, major financial firms have raised around $100 billion.

Total Banking System Capital Raised
As of February 25, 2008

Firm	Infusion ($blns)	Investor	Stake
UBS (a)	$ 10.00	Government of Singapore Investment Corp.	10.00%
	$ 1.80	Unidentified Middle Eastern Investor	2.00%
Citigroup	$ 6.80	Government of Singapore Investment Corp.	3.70%
	$ 7.70	Kuwait, Prince Alwaleed, Capital Research, Capital World, Sandy Weill, Public Investors	4.1%*
	$ 7.50	Abu Dhabi Investment Authority	4.90%
Bank of America	$ 13.00	Public Investors	5.50%
IKB Duetsche	$ 12.50	German Gov't; Banking Association	**
Societe Generale	$ 8.20	Public Investors	13%*
WestLB	$ 7.40	State of North Rhineland Westphalia, savings banks associations, regional governments	**
Merrill Lynch	$ 4.40	Temasek Holdings	9.40%
	$ 6.60	Korean Investment Corp, Kuwait, Mizuho	10% - 11%
	$ 1.20	Davis Selected Advisors (U.S.)	2.60%
Morgan Stanley	$ 5.00	China Investment Corp.	9.90%
Wachovia	$ 3.50	80 U.S. Investors	***
Canadian Imperial	$ 1.50	Li Ka-Shing, Manulife, Caisse de Depot, OMERS	6.1%*
	$ 1.30	Public Investors	5%*
Barclays (b)	$ 3.00	China Development Bank	3.10%
	$ 2.00	Temasek Holdings (Singapore)	2.10%
Bear Stearns (c)	$ 1.00	Citic Securities Co. (China)	6%*
Gulf Int'l	$ 1.00	Gov'ts of Bahrain, Kuwait, Oman, Qatar, Suadi Arabia, UAE	**
Total****	**$ 105.40**		

Source: Bloomberg

So that means that the banking system is net-down $100 billion. If it's $14 or $15 to 1 leverage, in keeping it simple again, then that means that there are $1.5 trillion less of loans now than there were a year ago. And the economy needed every single dollar of those loans a year ago. The economy is attempting to expand, so we're short credit.

Further, we are going to get another big wave of write-downs starting in April, when we get first-quarter numbers, this situation only gets worse. We have already started the parlor game of guessing what Merrill's and Citi's losses are going to be. We threw in Credit Suisse again today and the rumor that HBOS has problems

So this is the problem – the banking system is losing capital that is levered 15 to 1. For every dollar in capital that financial firms lose, they shrink their balance sheet by $15.

Although I believe the economy started a recession on December, the economy is still larger than levels a year ago. The need for credit has increased as the availability of credit is decreasing. We don't

have a financial system that can meet those needs, so we're rationing credit.

Agency And Swap Spreads

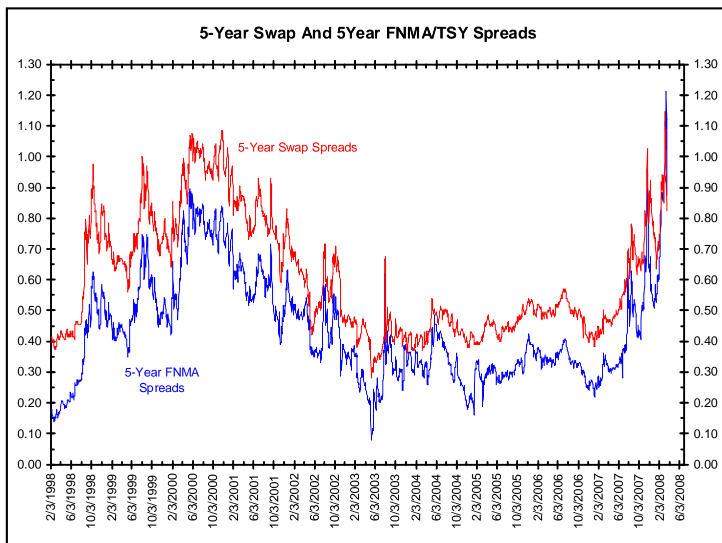
Let's turn to Page 3 and for the next several pages, I want to emphasize the result of that rationing credit. We now have a kind of an upside-down set of fixed-income markets. What do I mean by that?

Normally, when you have a recession the lowest credit quality instruments – and that would be equities or high-yield bonds – do the worst. As investors pile into the safety of the highest credit quality instruments, the lower quality does poorly. Treasuries are not the only high quality instruments; mortgages, agencies, and munis would also qualify.

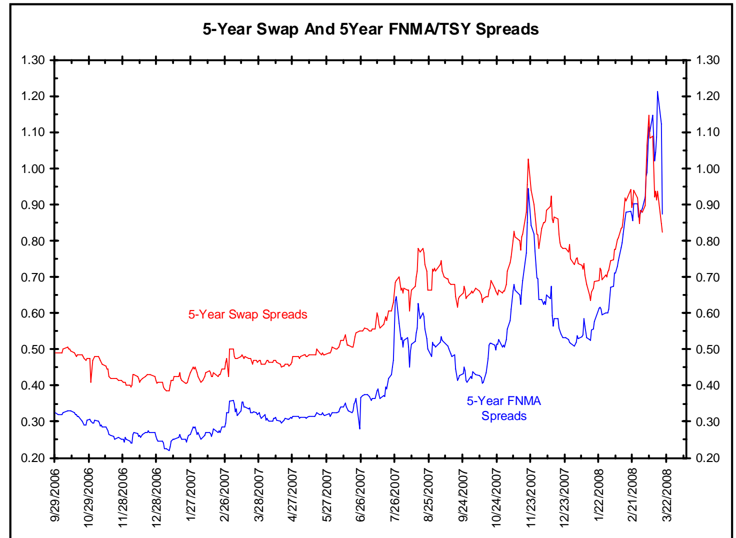
Treasuries are seeing a flight to quality as we saw this morning with three-month T-bills at 54 basis points; lower than T-bills in Japan for the first time since July 1993. So the U.S. now has the lowest short-term interest rates of all of the major industrialized countries. Japan no longer holds that distinction as it has for many, many years.

But away from treasuries, the highest credit quality instruments are doing, on a *relative* – and the keyword is "*relative*" – worse than the lower credit quality instruments.

Let's take a look at the charts on Page 3. Starting with what are among the highest credit quality instruments, agencies securities because they have an implied government guarantee. If you look at the chart on the lower left, you will see that the agencies and swaps spreads are at the highest levels in at least 10 years.



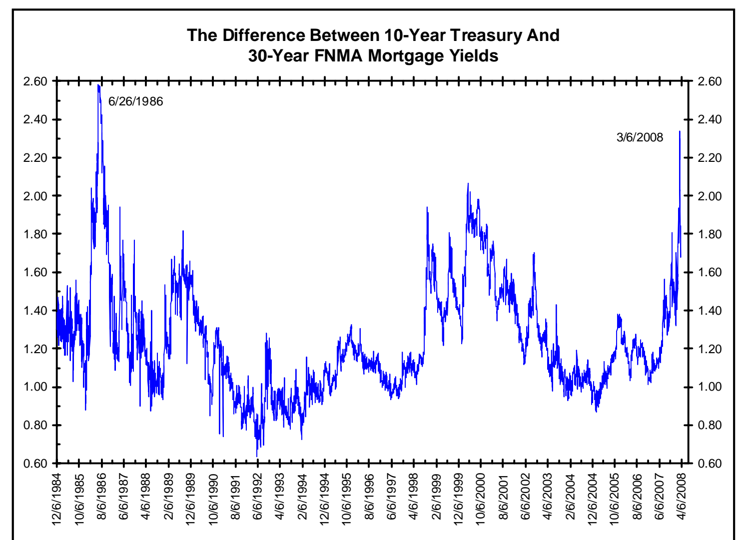
Agency spreads have widened out relative to treasuries, to a level that we have not seen in at least 10 years. Agency spreads narrowed over the last few days by about 25 to 26-basis points. As one agency trader yesterday remarked to me, "That used to be a good year." You can see that, in the bottom left chart. The top left top chart shows the same thing as the bottom chart with a shorter time horizon to see more recent detail.

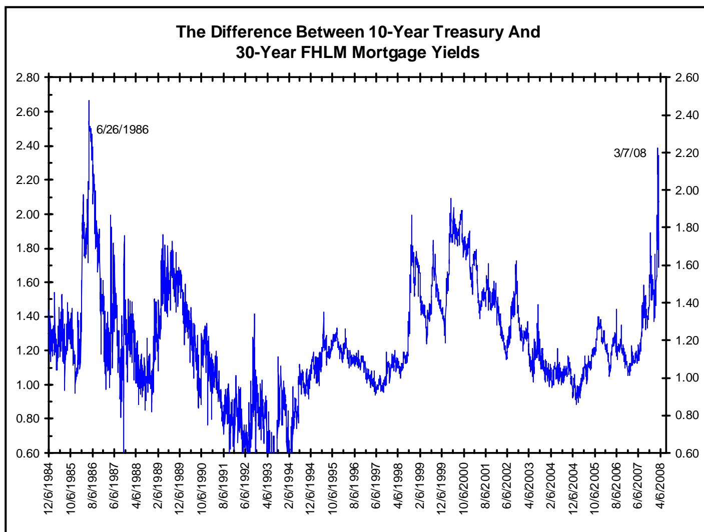


So relatively speaking, agency securities are in their worst position in the past decade. They have had some of the biggest one-day moves that we have ever seen in this market.

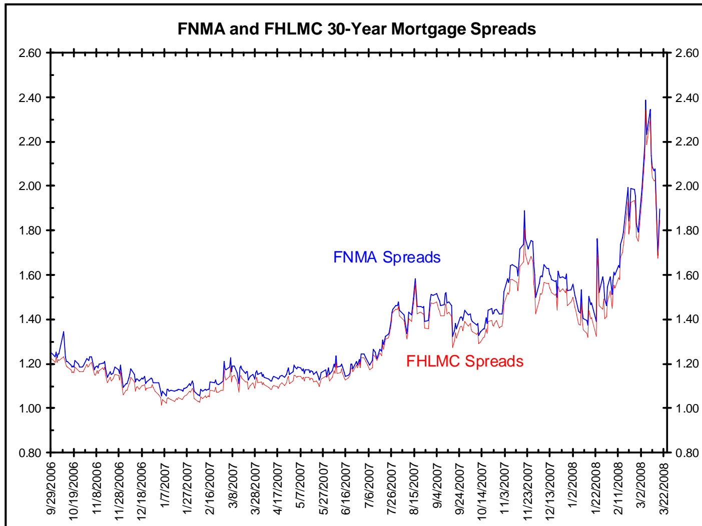
Mortgage Spreads

Keep this idea in mind and turn the page, to Page 4 – Mortgage Spreads. Here is the difference between 10-year Treasuries and 30-year Fannie Mae, and 30-year Freddie Mac mortgages. On the charts on the left, they go back 24 years, almost a quarter of a century. What they show is that mortgage spreads have been among the widest that we have seen since 1986; the widest levels in 22 years of mortgage trading.





The chart on the right just shows those spreads overlaid on the same chart with each other. And you will see that there has been a dramatic tightening of those spreads over the last couple of days.

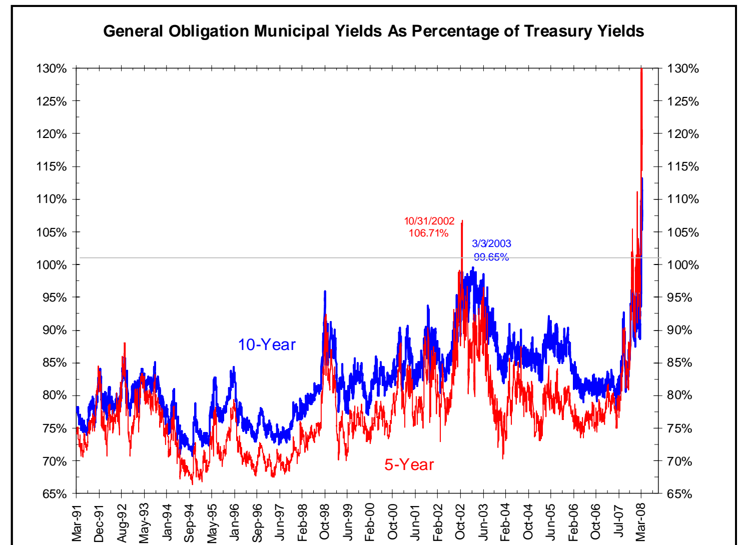


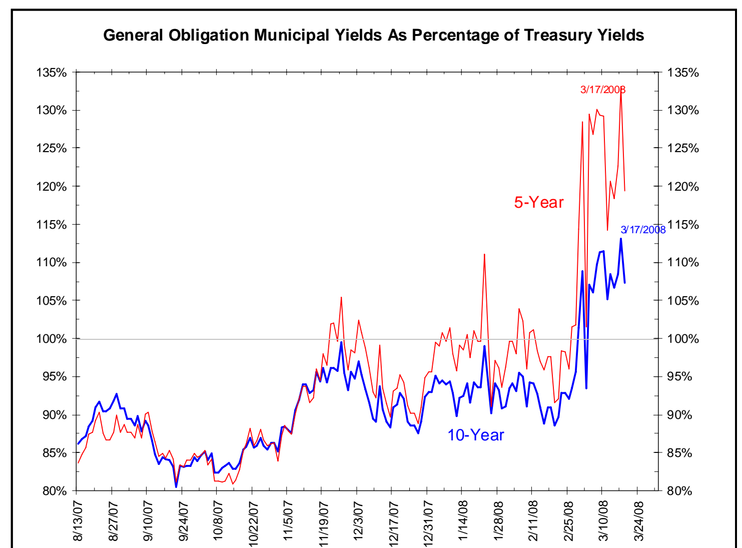
There is no doubt that the story that Fannie and Freddie are getting ready to buy $200 billion-worth of mortgages is coming into play with the tightening over the last few days. More on this later.

Muni Spreads

So far we have seen that the highest quality instruments are *relatively* getting hit the worst. Continuing with this thought, please turn the page to "Muni Spreads."

These charts show the Bloomberg General Obligation Municipal Bond Market Index. So this is an index of GO bonds relative to treasuries. The scale shows Muni yields as a percentage of treasury yields. Because of the tax-exempt status of municipals, they should always trade at a lower yield relative to treasuries. That would be signified – I'm looking at the chart on the left as a reading below 100%. There is a thin gray line at 100% as well. Both of these charts, again, are the same thing; it's just that one chart shows a longer detail while the other chart shows shorter time frame to see the more recent trading.



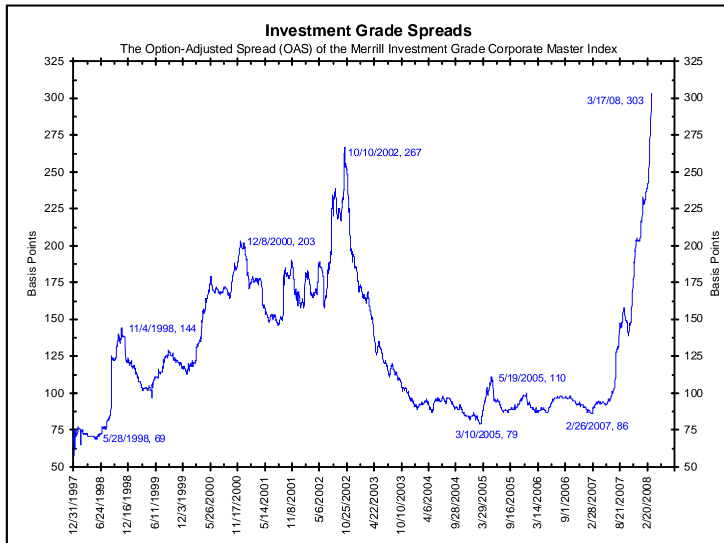


Starting in early March, what you saw was that municipal yields – GO yields – shot up way above Treasury yields. Again, in the early weeks of March, we had among one of the worst days ever in the history of the municipal bond market. And as of yesterday, we are still well above Treasury yields.

Everybody has said, "This is an extraordinary buying opportunity in municipals," yet as everybody has supposedly made a headlong rush to get into these municipal bonds, their spreads have not been coming down much. So the bottom line is that municipals, again, are showing the most extreme moves in two decades, the most extreme days ever.

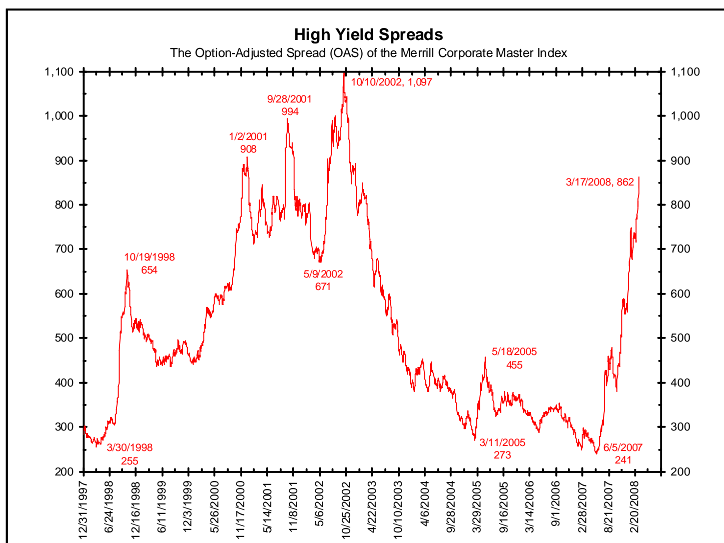
Corporate Spreads

Let's move further down further down the credit quality spectrum. Page 6 shows corporate spreads. Let's start with investment-grade corporates on the upper left.



This chart shows, in blue, the Merrill Lynch Investment-Grade Corporate Master Index. At 303 basis points on March 17, it is wider now than it was at the panic peaks of October 2002.

Now let's go further down the credit spectrum. High-yield spreads are still a few hundred basis points away from their 2002 panic levels. Relatively speaking, they are doing much better than investment-grade.



There is no "worst day in the history of investment grade," at least not yet. That is definitely not the case in high-yield. We are not even back to the 2002 levels. Yet, as we have been saying that about the higher credit quality markets of agencies, mortgages and munis, they are have historic moves.

Finally, if you go to the end of the credit quality spectrum, which would be equities – and I don't have a chart of this because I couldn't figure out a good measure, so I thought that I would just say it.

Stocks have been off 17% or 18% from their October highs. Let's just go with the media definition of a bear market because it is as good as any other made-up definition, and that is that 20% decline is a bear market. We have not quite hit that with the S&P.

The stock market has not had its worst day in 20 years. It hasn't gone down 22% like it did in October 1987. It has not had the most extreme and wild movements of our generation like agencies mortgages and munis. It is not flirting with its 2002 lows like investment-grade and high-yield corporates.

Rationing Credit

You see the pattern? The better the credit quality, the worse it has been doing, on a relative basis. Why is that? The answer is that the financial system is shrinking. There is rationing of credit.

I'm going to be very basic here because I think that basic will better help explain the argument as we have a very widely diverse audience. Everybody says that municipals offer value, agencies offer value, and mortgages offer value. Who is ready to sell their equity portfolio and buy a portfolio of agencies that yield 100 basis points more than treasuries? And if you want to put that in raw numbers, the five-year Treasury is yielding 2.35%. Who wants to sell S&P 500 stocks to buy a portfolio of agencies that is yielding 3.35%? The answer is, "Nobody without leverage."

What they want to do, like Carlyle was doing, is buy these high quality instruments on 33:1 leverage. That same 33:1 leverage number, coincidentally, is what Fannie and Freddie are now using. The announcement yesterday that their minimum capital requirements have been lowered allows them to go from 30:1 leverage to about 33:1.

Everyone recognizes that agencies, mortgages and munis have value. But the drivers of these markets are leveraged buyers. Although, there is leverage in the stock market, it is not the dominant force like it is very high credit quality instruments. These markets depend on leverage. In fact, we are heralding the savior for the mortgage market as a 33:1 levered buyer in the case of Fannie and Freddie.

The problem is that you can't get the loan with enough leverage to make it worth your while. Because the financial system is shrinking. That is why the highly levered end of the financial system, the highest credit quality instruments that are bought

with the most leverage, are relatively doing worse than the lower credit quality instruments.

This is why the arguments that the Federal Government explicitly guarantee municipals or agencies, or guarantee some mortgages completely misses the point of this problem. It is not a problem that the asset quality is bad, or perceived to be bad. I agree, too – munis, agencies, and mortgages present great opportunities. But if you can't get a 30:1 arrangement to buy these instruments, then you might not do it because it might not be worth your time. Financial firms might offer you only 10:1 leverage, in which case the returns after leverage, given the risks and potential rewards, might not be worth it. So the buying power isn't there to push these markets back into line. This is why they remain stressed despite everyone saying they are a "buy." Simply, you cannot get the leverage.

The financial system is shrinking while the real world and a lot of the high credit quality instruments want to continue to expand. These two facts cannot co-exist without problems.

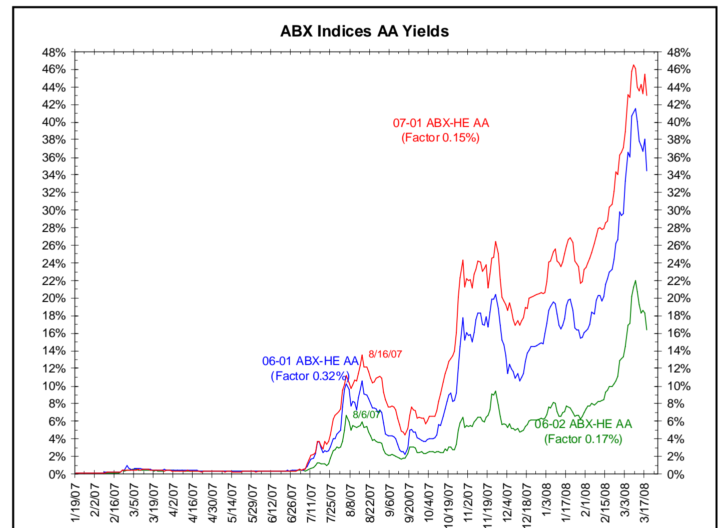
ABX and CMBX Indices

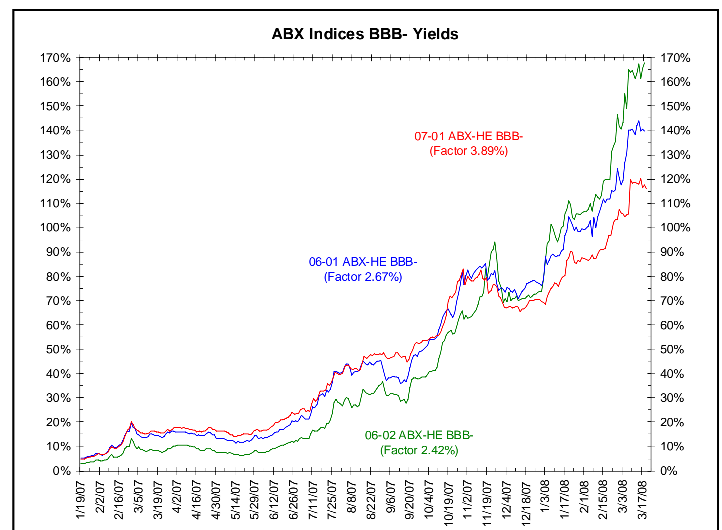
Keeping this in mind, let's go to Page 7 and the CMBX Indices on Page 8.

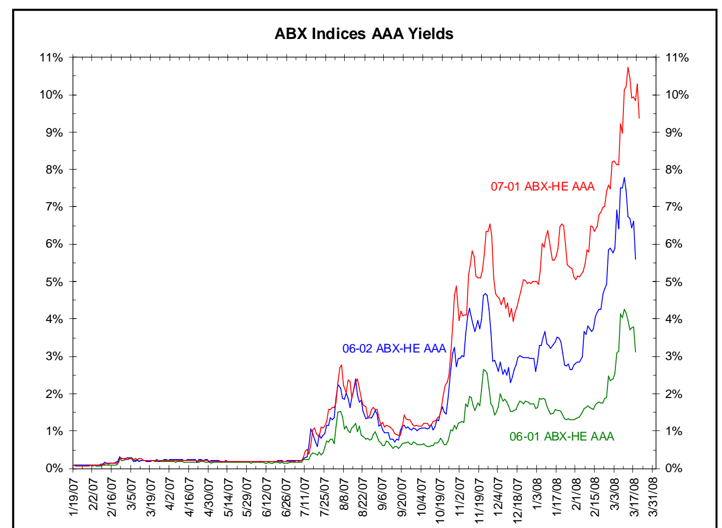
These markets are the focal point of the shrinking financial system. As they get worse, the losses pile up and the shrinkage continues.

The ABX Indexes, again, are credit default swap indexes measuring subprime loans. The tranches shown here are the AA tranche in upper left, the BBB- tranche in the lower left, and the AAA tranche on the right.

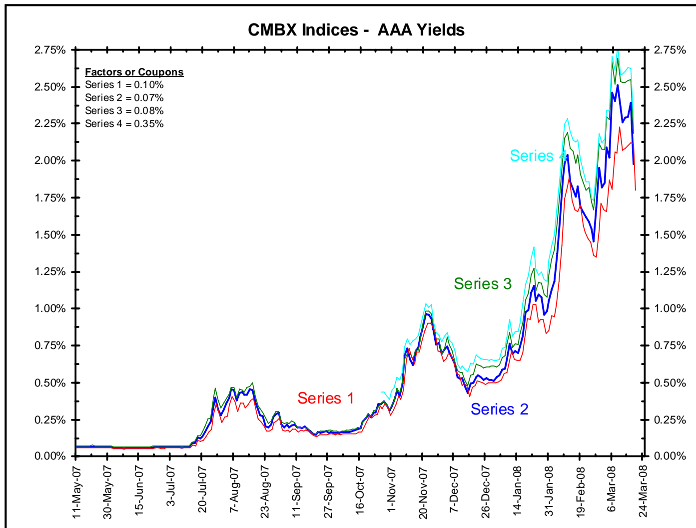
When were the worst levels for all of these indices? Answer, within the last 10 days. These markets did not hit their worst levels months ago, or three months ago. Currently they are showing few signs of stabilization.

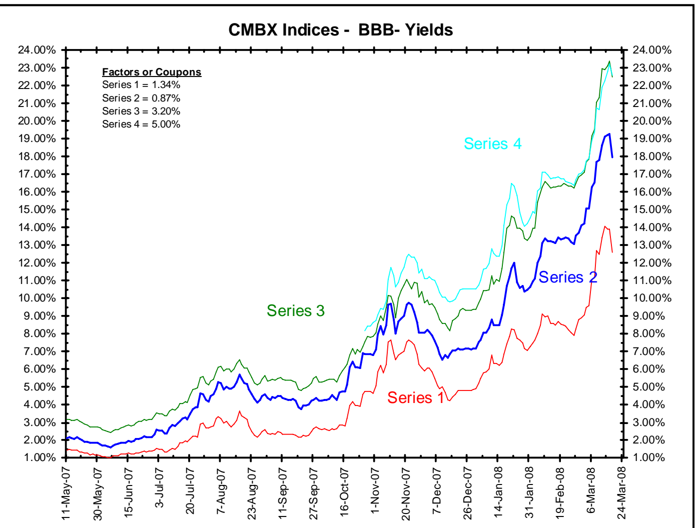


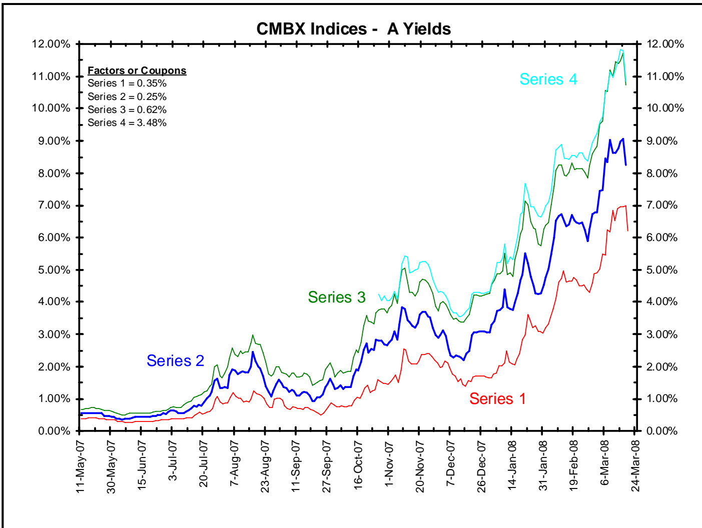




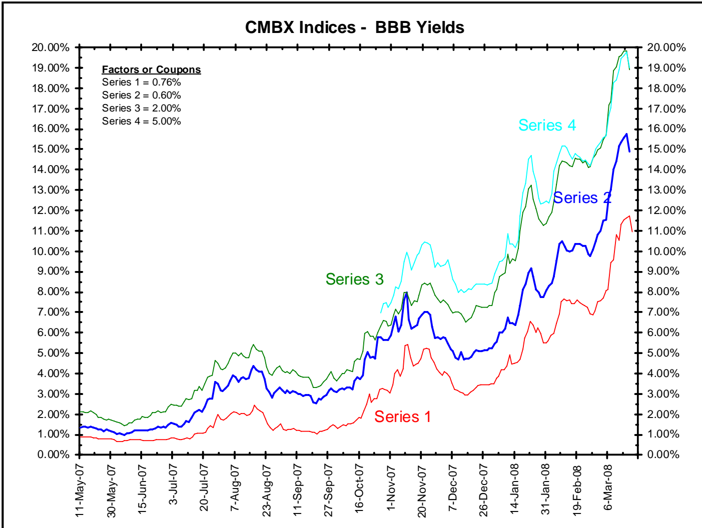
If you'll go to Page 8 and look at the CMBX indices, you'll see the same thing. These are credit default swap index on commercial mortgages. Here, I show, AAA Index in the upper left to the BBB- Indexes in the lower right.







The takeaway from all of these charts is where are the worst levels? The worst levels are in the last couple of days, or at least the few weeks. They are not several weeks or months ago.



Auditor Opinion, Not Management Opinion

The losses in the financial system will continue because of FASB 157-- one of the several hot point discussions during the credit crisis.

This is the mark-to-market rule. It was brought into place because the old rule of held-to-maturity, available-for-sale in trading accounts, frankly, did not work. They were being abused and the old system was inadequate. That is why FASB 157 was created.

The problem with 157, of course, is that Level 3 assets and the CMBX and ABX indices are important in valuing these assets. Level 3 assets are valued using "management judgment." By contrast, level 1 assets would be more like listed equities on a stock exchange. Level 2 assets use generally accepted models, like stock options using the Black-Schols Option Pricing Model. It's not controversial to price and option based on this model. Level 3 is where you just have the controversy.

The problem isn't management judgment; it is auditor judgment. Whether it's Price Waterhouse Coopers or Deloitte & Touche, or down the line, every auditor remembers 2001.

When Enron got into trouble, the first thing done was to liquidate Arthur Andersen. After they were given the death penalty, only then did we ask, "What was the problem?" We even heard rumblings of this earlier this week. How could Bear Stearns book value be $85 per share and the stock gets bought at $2? The conclusion was the auditors screwed up and should be investigated.

FASB 157 is not the problem. The problem is that it is not management judgment; it problem is it has become auditor judgment.

The auditors are putting the value on Level 3 assets, not management. And in this highly charged environment, no management wants a fight with its auditors.

That is why you have seen the problems at Credit Suisse a few weeks ago, when the auditor said, "You had the wrong marks on some CDS positions," and they had to take the write-downs. The big controversy at AIG was the same thing. The auditors said, "We don't like these numbers so you will change them." The recent controversy at Citibank with some hedge fund valuations is another example. They had to take them onto their balance sheet because the auditors didn't like the valuations of their portfolios.

I think that the answer is not to have FASB 157 rescinded. It's not that mark-to-market accounting is killing us. It's that we are not allowing management judgment to hold sway. It's auditor judgment, and the auditors are fighting for their professional lives because they are afraid of what happened to Arthur Andersen and what people are now saying about Bear Stearns. If they don't put the most conservative mark on Level 3 assets, and there is a problem, then everybody is going to scream, "The accountants screwed up like they did at Anderson, let's just liquidate the auditing firm for making that kind of mistake."

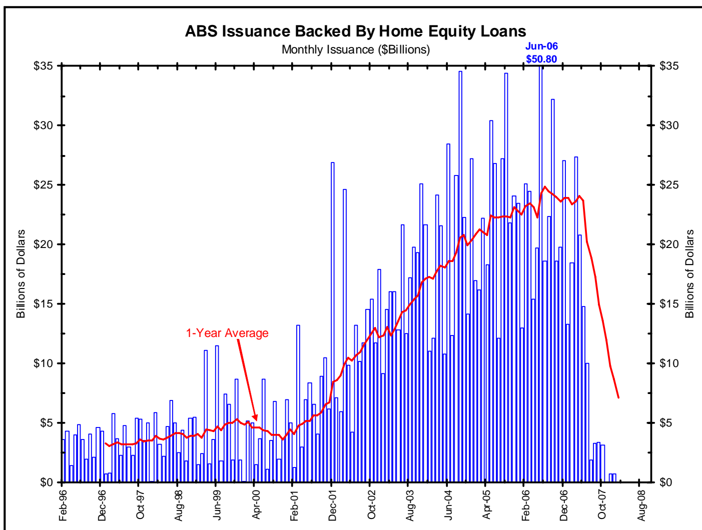
This is where I think that most of the problems with Level 3 assets are coming from. I think that the answer would be to get the auditors out of the business of valuing Level 3, and let management do it. They only need to sign off on "reasonableness", not "exactness." I don't know if that means exonerating them from future lawsuits or something else. But that, in essence, is the problem with Level 3 assets is the auditors.

The fact that the ABX and CMBX are at their worst levels in the last several days suggests we are going to see more write-downs, because the auditors are in charge. They are going to look at these kinds of benchmarks, and they are going to demand big write-downs coming in the first quarter. This means further shrinkage of the financial system; and further shrinkage of the financial system then means that we are going to have more rationing of credit and bigger problems.

Mortgage Issuance Disappears

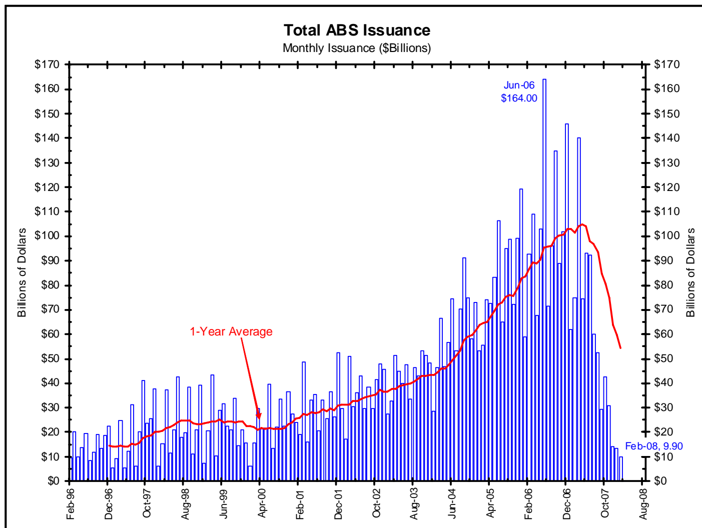
Let's move on to page 9 and talk about mortgages. Remember that in consumer finance almost every loan is packaged together as a security and sold, whether it is a home loan, a mortgage, a second loan, a boat loan, a car loan, or a credit card loan. It is all packaged together and sold.

The charts on page 10 show ABS – asset-backed security issuance – and CMO issuance from the GSE agencies. Let me start with the charts on the left, starting with ABS issuance for home equity loans.



We used to package together about 40 ABS deals a month with a value of around $25 billion per month. We used to sell those ABS deals in the marketplace quite regularly until the beginning of 2007. This has dramatically changed - down from 40 deals a month at about $25 billion a month to zero in November, less than $1 billion in December and January, and zero in February. In the last four months, we have done four deals with a total value of less than $2 billion. The same four-month period a year earlier same over 160 deals valued at more than $100 billion.

The lower left chart is total ABS issuance. Subprime lending heavily influences this number. June 2006 was the all-time peak at $164, largely subprime.



Total ABS issuance was about $100 billion per month by the beginning of 2007. $25 billion was home loans and the majority of the rest of was subprime loans. February set a new low at $9 billion. It's one of the lowest numbers that we have seen in a decade.

The point here is that what is happening in the consumer finance area is that there are no more home equity deals being done. There are no more subprime deals being done. If you can get a home equity loan, if you can get a subprime loan, then it is being "portfolioed" or "warehoused." The lender that is giving you the loan is unable to package it together sell it in the marketplace because this market no longer exists. The problem is that, after six or seven months of warehousing loans, lenders are quickly running out of balance sheet to continue to make loans.

Deleveraging Mortgages

In the past we could assume the terms of a loan were stable so we focused solely on the interest rate. To this day we focus obsessively on interest rates and never ask about the terms.

Today, however, we are seeing a change. Interest rates are only part of the equation. Now the terms are changing. As we discussed above, there are no highly leveraged loans available. And those that still have them are being forced to deleverage via margin calls.

Regarding mortgages, the story has been that mortgage rates are not coming down. However, what is not being discussed, and might be more important is the terms are tightening.

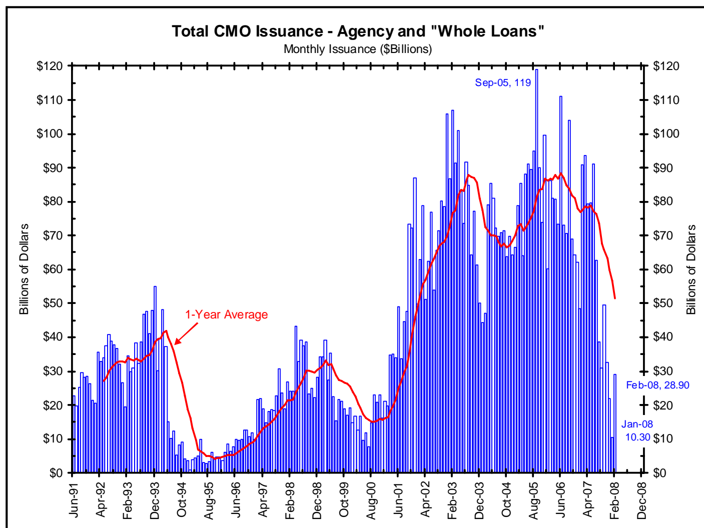
A year ago or 18 months ago, you could get a confirming mortgage with 10% or 5% or 0% down if you qualified for a first time home buyer program. Or if you wanted to go into a subprime mortgage, you could actually get a mortgage for more than 100% of the home's value.

A year ago, if you had a FICO credit score of less than 680 and above 620, you were still considered a prime credit, and you could still get a conforming mortgage. 15% to 20% of the country is between 620 and 680.

Effective earlier this month, Fannie and Freddie tightened their lending standards. If one had less than 20% for a down payment, don't ask for a mortgage if your FICO score is less than 680. This covers about one-third of the country. In June this bumps up to 730, covering about half the country. Getting a mortgage with less than a 20% down payment is difficult.

Nevertheless, the obsession with interest rates continues. The announcement that Fannie and Freddie's capital ratios have been lowered so they can leverage even more and buy mortgages is focused on interest rates, not terms.

But the chart here on the right shows total CMO issuance as a measure of their activity is down quite substantially, too.



There is a statistic that has been thrown out quite a bit about GSE agency issuance – Fannie and Freddie were about 40% to 50% of the mortgage market back in 2006. Now they are 80% or more. Problem is they are 80% of a shrinking market.

So obsessed are we with interest rates that we are hoping that Fannie and Freddie's buying will stabilize the mortgage market, and thus produce lower interest rates. We are not discussing the tightening terms. Yes, interest rates may come down because of Fannie and Freddie's buying, but the terms to get a mortgage are toughening.

Pushing On A String

Let's get into other fixes now that the Government is has been trying. By the "Government" I mean the broad term, including the Fed and the Treasury.

I will give you a general statement to say that I think that all of these are worthwhile attempts to fix the credit problem. I think that they can ease some of the pain at the margin, but they do not ultimately solve the problem of a shrinking financial system. That is solved by either having the home price decline stop or by having massive injections of capital into the financial system to offset the losses.

Page 10 – "Pushing on a String: How Much Has the Fed Helped?" Bearing in mind that terms are toughening, interest rates are not coming down. Combine the two and the credit crunch is really hurting the economy. Since interest rates are the easiest to measure, let's look at them.

How Much Has The Fed Helped?

Interest Rate	6/28/2007 FOMC Meeting	3/19/2008	Change
U.S. Government Rates			
Target Federal Funds Rate	**5.25%**	**2.25%**	**-3.00%**
3-Month Treasury Bill	4.76%	0.73%	-4.03%
2-Year Treasury Note	4.94%	1.60%	-3.34%
10-Year Treasury Note	5.10%	3.49%	-1.61%
Long-Term Corporate Rates			
Merrill Investment Grade Corporate Master	6.08%	5.90%	-0.18%
Merrill High Yield Master 2 Index	8.11%	11.06%	2.95%
Short-Term Corporate Rates			
Overnight Eurodollar Rates	5.40%	2.65%	-2.75%
3-Month Eurodollar Rates	5.36%	2.60%	-2.76%
30-Day Asset Backed Commercial Paper	5.33%	2.81%	-2.52%
30-Day Non-Financial Commercial Paper	5.26%	2.08%	-3.18%
30-Day Financial Commercial Paper	5.25%	2.40%	-2.85%
Mortgage Rates (National Average)			
1-Year Adjustable Rate Mortgages	5.50%	5.14%	-0.36%
30-Year Fixed Rate Conforming Mortgages	6.29%	5.66%	-0.63%
30-Year Fixed Rate Jumbo Mortgages	6.50%	7.03%	0.53%
Home Loans	7.69%	7.53%	-0.16%

The table measures the changes in interest rates since the last "quiet" fed meeting. We have identified that as June 28, 2007 when the Fed held at 5.25% and fretted about inflation.

If you look at corporate rates, the Merrill Lynch Investment Grade Master Index has barely moved over this period. High-yield rates are higher. And if you go down to the bottom of the table, showing that even though the Fed has cut 300 basis points, that there has been very little movement in mortgage rates, and don't forget the terms now are much more stringent now.

What Has The Government Done?

So let's go to Page 11 and continue. So what has the Government done?

August
Cut the discount rate premium to the funds rate
Allow the effective rate to diverge from the funds rate
Remove the stigma of borrowing from the window
Extend the term to 30 days
September
Fed cuts 50 basis points
FHA Secure to help homeowners
October
Treasury proposes bailing out SIVs
Fed cuts the funds rate 25 bps
November
"Teaser Freezer" Plan
December
Fed cuts 25 basis points
Fed Announces the TAF auction
January
Fed cuts 75 bps before open
Fed cuts 50 bps 8 days later
NY State insurance commissioner orchestrates "monoline talks"
February
Fed increases the size of the TAF auctions
Treasury arranges a 30-day freeze on foreclosures
Conforming loan limits increased
March
Fed changes the discount window rules, allows the dealers access and increases the term to 90 days for the banks
Fed increases the size of the TAF auctions
Fed orchestrates a bailout of Bear Stearns

I put together this list here – and I'm not going to read the whole thing to you – it has all of the major announcements going back to August.

I did this off of memory, so it's not a complete list, though I think that it has all of the major announcements that the Government has made since last August to try and solve the credit crisis.

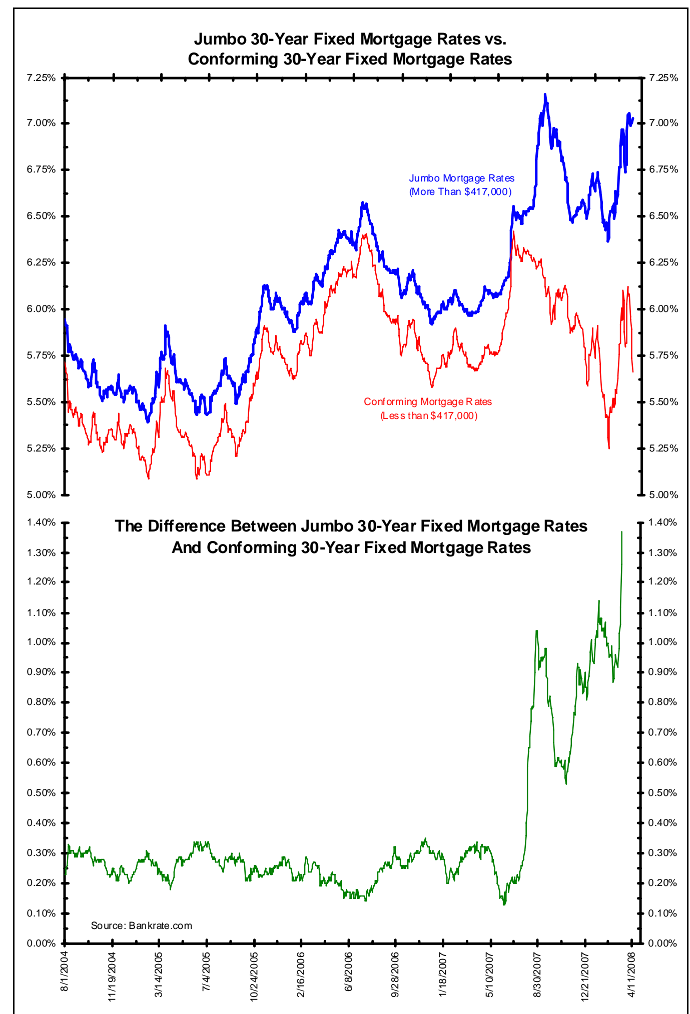
Most of these moves have been termed historic in one way or another. There are about 17 or 18 of these on the list. The last one on the list is, "The Fed Orchestrates a Bailout of Bear Stearns," which occurred, of course, on Sunday night/Monday morning.

We have had the Government being extraordinarily active in this market and trying to fix this problem. And what has been happening is that a lot of these have ***not*** been working.

Jumbo Versus Conforming Mortgages

Let's take one example that was really trumpeted about five or six weeks ago and is ***not*** working.

On the chart on Page 12, on the left, the blue line shows jumbo mortgage rates, the red line shows conforming mortgage rates, and the green line on the bottom shows the spread between the two.



When Fannie and Freddie were given the temporary authority to securitize and sell jumbo-rate mortgages up to about $730,000, they held press conferences, and everybody said, "Hallelujah! Problem solved!"

But here we are five or six weeks later, and the spread between jumbo and conforming mortgages has gotten worse. It is now to a level that we had not even imagined possible. Giving Fannie and Freddie the ability to securitize jumbos was supposed to narrow this spread, not shoot it out to new records.

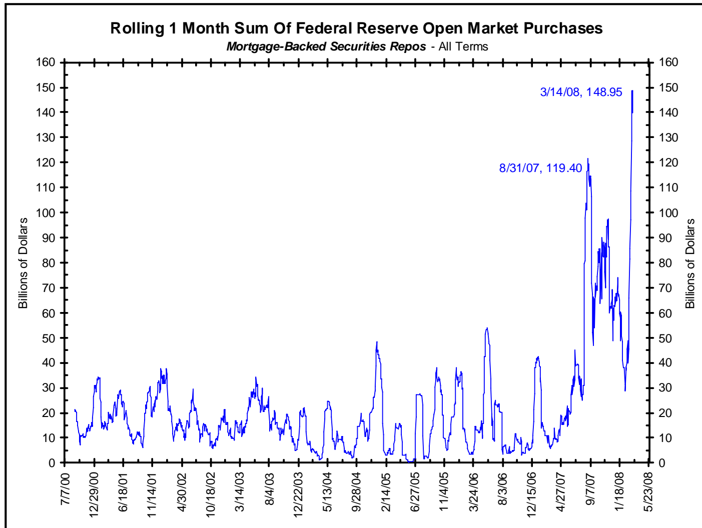
Why isn't it working? All of these fixes assume that credit quality is the problem. They assume investors are afraid of credit losses, which accounts for the markdown in prices.

Credit quality is not the problem. It is a liability issue that the lending is not there to do the transactions with the leverage that investors want or need. Increasing the credit quality of a jumbo by saying that Fannie is not going to guarantee them does not address this liability problem. In essence it becomes an attempt at artificially supporting prices. Investors see right through this and sell into it and, in the end, the situation is worse, not better.

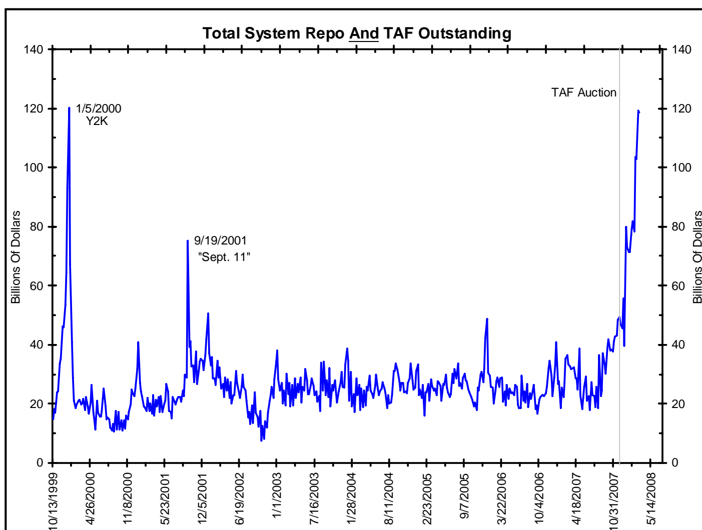
The Federal Reserve's Balance Sheet

Let's go to Page 13. The Federal Reserve has now jumped in, in a big way, with their balance sheet. Let me start by explaining the charts and start with the chart on the upper left.

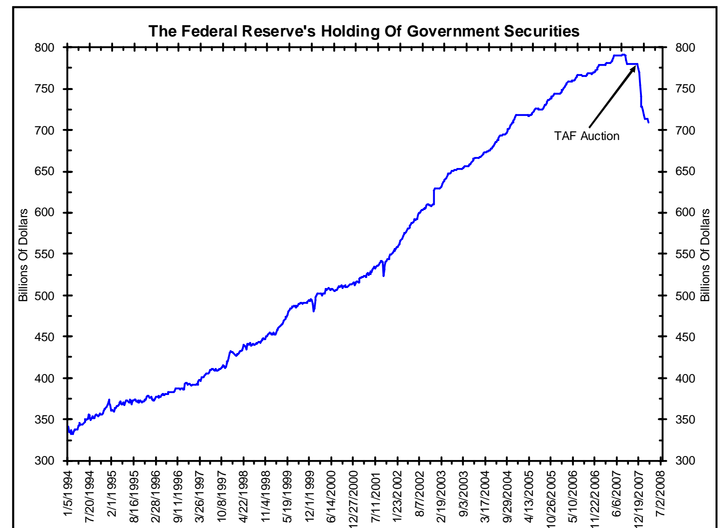
The Fed has jumped in again and has been taking mortgage-backed securities as collateral. They amount of repos back by MBS has jumped in the last month or so $148 billion.

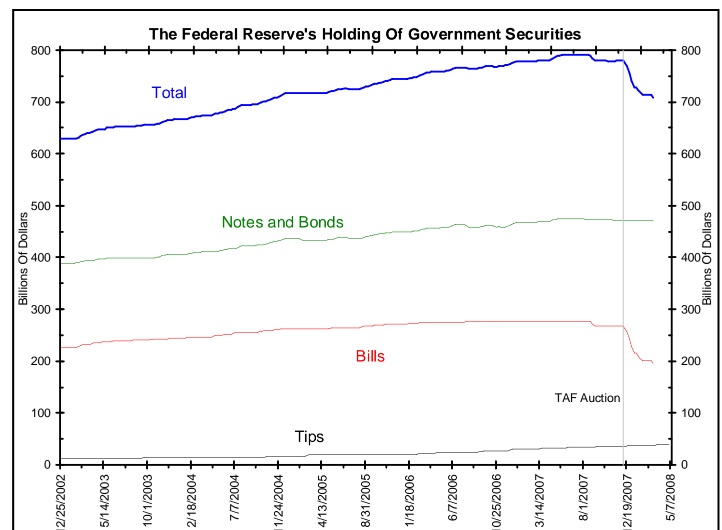


Next, if you look at the chart on the bottom left, which goes back to 1999, it shows the total amount of repos and the TAF outstanding in the market right now. The phrase "flooded the system with liquidity" comes to mind. We have not seen these kinds of liquidity injections since the Y2K crisis. The Fed has been pumping more liquidity into the financial system than they did during September 11.



If you look at the charts on the right, the top chart shows the total amount of Government securities holdings while the bottom chart shows the total again with a breakdown of notes, bills, and TIPs.





Again we have a lot of different type of investors on this call, so let me be simple to get the point across.

When the Fed buys and sells securities, when the Fed hands out collateralized loans, where does the Fed get the money and what does the Fed do with the money it gets from its sales? Answer, it debits or credits the reserve accounts of banks it regulates. It is assumed that banks will always manage to the maximum amount allowed by their reserve accounts. So, if the Fed sells securities and credits the accounts of banks with the proceeds from the sale, the banks will expand their balance sheets by that excess amount through handing out more loans. Again, this is a simple example.

By managing the levels in these reserve accounts, the Fed can keep the effective federal funds rate on its target rate, now 2.25%. So, if the Fed hands out loans, or conducts a TAF auction, it increases the amount in reserve accounts. All things being equal, this would reduce the need for a federal funds loan, a reserve account loan. This, in turn would drop the funds rate well below the target rate.

If the Fed is handing out collateralized loans, or securities lending, and it wants to keep the funds rate in line with the target rate, it needs to "sterilize" these actions by selling a like amount of Treasury securities. This is why these numbers are declining, and will continue to decline in the coming weeks.

The Fed has recently announced a securities lending program of $200 billion, a new 28-day system RP of $100 billion, $100 billion in TAF auctions, and $30 billion to bail out Bear Stearns. The dealers can go to the discount window as well. All told the Fed has committed well over $430 billion of its balance sheet, or over half of what it has.

Yesterday, they did a sale of $15 billion-worth of T-bills. That will be reported, and this chart will be able to get updated tonight with the release of the H4.1, report tonight. We should see another further drop in the Fed's holdings of Government securities tonight and over the next month or so.

Now, the takeaway from this is that the Fed has an $800-billion balance sheet. It's about half of the size of J.P. Morgan's. In a few months the Fed's balance sheet is going to be transformed from largely Treasuries to about 50% of all of these collateralized loans and securities lending programs.

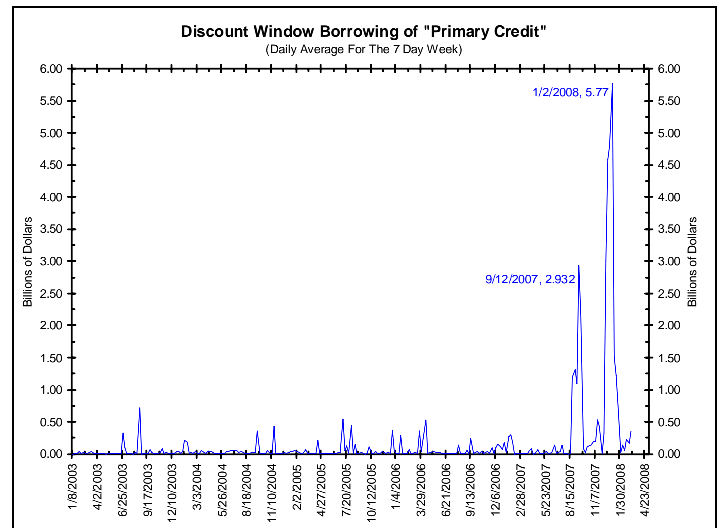
Regarding this, earlier this morning the Fed announced that all of the collateralized loans they are going to make will be very simple – you're going to get 95 cents on the dollar for every security that you put up, regardless of what kind that it is. Not everything qualifies, but as long as it investment-grade, they're just going to give you 95 cents on the dollar on every loan. So the Fed is going to take a tremendous credit risk with a lot of these securities. Credit risk? If one of these firms puts up a lot of securities, and they fail, then the Fed is going to be sitting on losses.

In theory, the Fed can expand their balance sheet into infinity -- that is what we called "quantitative easing." Japan did this, they expand their balance sheet, they piled cash into everybody's reserve account, and nobody ever needed to borrow for reserves again. Because they were all over-reserved due to the BoJ expanding its balance sheet, the overnight rate in Japan dropped to zero; and it stays there for a decade.

And if we go into quantitative easing, then the only thing that I would remind is that Japan did it for 10 years, and it did ***not*** work. It did not get the banks to lend. And in an environment where commodity prices – and I know that they are reversing now – but in an environment up until 48 hours ago, that commodity prices were rising because of a fear of inflation, the last thing that would help to assuage those fears would be some kind of a quantitative easing.

The Discount Window

The final fix I want to mention is the Fed's decision to allow the dealers at the discount-rate window. The chart on Page 14 shows discount window borrowings over the last several years.



The spike on the chart shows a big need to borrow at the window because of seasonal year-end pressures. That is why you see that spike into January 2nd, and then it went right back down to nearly zero.

But look at that spike on September 12, 2007. Recall that the Fed changed the terms in August for the banks. It changed the borrowing term from overnight to 30 days. The Fed also said that there was no stigma attached to borrowing at the window.

Then four banks – Bank of America, Wachovia, J.P. Morgan, Chase, and Citibank – all basically came out and said that they were all going to borrow $500-million or so apiece to show everybody that it was OK to borrow at the window. But they had to give a press release because they didn't want you to misunderstand what they were doing. They didn't need the money. They just wanted to show that it was OK to borrow at the window. This spike is that ceremonial borrowing, and then it went back to its seasonal number of $300- to $400 million per day. Why?

The problem, I think, with the window is that it is not so much the stigma as it is the transparency. Yesterday, I thought the *Wall Street Journal* unwittingly showed us the problem. They had a story about, "Will People Borrow at the Window?" There was sentence in there that said, "Yesterday, Lehman Brothers borrowed a small amount from the window."

This is the problem. Borrow from the window, and your name is in the paper the next day. So if any of the primary dealers – and, again, Morgan and

Goldman are trying to do the same thing that the banks did in August, saying, “We’re going to borrow from the window to show everybody that it’s OK.” The fact of the matter is that I don’t think that anybody is going to borrow from the window because, if you go to the window next week or in two weeks, then it is going to be in the paper the next morning that, “XYZ borrowed at the window,” and everybody is going to know what that means – XYZ is in trouble, and there will be a run on that brokerage firm.

How do you get people to use the window? You have to get rid of the aggregate weekly borrowing statistics for the window and, under penalty of death; the Fed cannot leak the name of anybody borrowing at the window. Don’t let anybody know if anybody is borrowing at the window, or, if they are, how much they are borrowing, and then maybe it will be used.

Don’t get me wrong. These moves are better than not doing them. But I think that they largely will not work. So, go ahead and try it. But at the end of the day, I think that we are not getting at the real issue. The real issue is that the financial system is shrinking. We have to stop that shrinkage. The answer, I think, short of home prices bottoming is that we need to see much more capital raising into the financial system.

In 1991, Prince Alwaleed, as we all famously know, bought into Citibank. He paid roughly half-book value. Citibank’s book value right now is roughly $21, $22 per share. That is where the stock is trading right now. It is trading at $21.50. Half-book value would be about $11, $11.50 per share. Maybe that is what we need to do, is to see Citibank – just to use one stylized example – start to dilute shareholders at $11 per share. Now, Vikram Pandit doesn’t want to hear anybody suggest that. He knows that could be career-ending for him to do that. John Thain knows that could be career ending for him to do that at Merrill. But until they raise serious amounts of capital, if there are $200 billion of losses about to go to $250 billion in the first quarter, then they need to raise $300 billion. If they have raised on $100 billion, then they’ve got to raise $200 billion more. Go raise, dollar for dollar, every loss and then some, and then the financial system will have the capital so that they won’t have to ration credit, and we would stop these crises from bouncing from one sector to the next sector every single week.

This move by the Federal Reserve, the moves by OFHEO, the moves to allow Fannie and Freddie to securitize jumbos to buy mortgages are nothing more thinking that the problem was that people thought that the credit quality of these instruments was poor – that is not the problem. It wasn’t a credit quality instrument. It is about leverage and about getting those loans.

So, ultimately, I think that the banking system needs to raise more capital to get this. Otherwise, this deleveraging process will continue as we move forward. This deleveraging process will hurt the highest credit quality instruments the most on a relative basis because they are the most levered. It will also hurt the lower credit quality instruments of high yield and stocks. But since they are relatively less leveraged, that is why they are not doing as badly.

Questions & Answers

With that, let me thank everybody for joining us. Seven, pound on you phone is the way that you can get into the queue to ask us questions. If you also want to ask us questions by email, then we do take questions relative to email, too. We also want to remind you that we use only first names in questions. We find that leaving people somewhat anonymous is a better way to encourage questions.

My first question is an emailed question from Chris. Chris is asking, “Do you think that the 2003 low in 10-year Treasuries at 3.10% is going to hold?”

I did think for a long time following the 2003 low that it was going to be the cyclical low for many, many years. But, no, I don’t think that the 2003 low is going to hold. The 3.10% is what the 10-year Treasury hit in June of 2003, now that we’re within shouting distance of it with the 10-year Treasury at around 3.37%.

I do think that, ultimately, though, if I am correct – and that is that the problem is that the banking system needs to be reliquefied – then all of these moves that the Fed has done, all of these moves that OFHEO has done, and all of these other moves may ease the pain for a little bit, are not ultimately going to fix the problem. A week, a month, three months from now, we will be back at the way that we felt on Monday or Tuesday about the credit markets. And when we are at that point on Monday or Tuesday to feeling the way that we felt about the credit markets, then we are going to start to say to ourselves, “Well, now that the Fed has pulled out all of the stops, what other trick do they have up their sleeves,” and that could produce a new low yield in Treasuries across the board. I might add that the 30-year did take out its 2003 low back in January. And it is very close to potentially taking out that low again soon.

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

Tim: I have two questions, always related. First of all, the OFHEO capital constraint reduction on Fannie and Freddie – I mean, those stocks rallied significantly on that news, which I didn’t think was such a great thing. I just want your opinion on that.

And, secondly, the Barney Frank $300 billion plan for mortgages – are we not really needing something that substantial? Isn't that the first one of these mortgage plans that might actually be significant?

Bianco: OK, on your questions, you kind of intimated an answer that is exactly along my lines.

First of all, for everybody who is not familiar with what happened yesterday, OFHEO – the Office of Federal Housing Enterprise Oversight – is the regulator of Fannie and Freddie. As you may recall, Fannie and Freddie have a long and glorious history of screwing up all of the time. Their latest screw-up was that their books were cooked. In 2003 or so, they admitted that all of their financial statements were a fiction. OFHEO then required two things of them while they got their act together – that they had to hold 30% more than their minimum capital requirements, and that there was a limit on the size of their portfolio for their own account, which was about $700 billion in the case of Fannie, and around $500 billion in the case of Freddie.

When they reported their 10K on a timely basis last month, OFHEO lifted the portfolio caps on them, so they can now expand their portfolios. But they have lost money, and they are bumping up against their 30%-above-minimum limits. Yesterday, OFHEO changed that rule so that they now need to hold 20% above their minimum. That would free up enough capital so that they could buy roughly $200 billion-worth of mortgages.

Yesterday, Daniel Mudd, the CEO of Fannie Mae was interviewed by Maria Bartiromo on CNBC -- on the Trading Floor at Fannie Mae, with people sitting in front of screens and holding phones to their ears, and I wouldn't be surprised if it was completely staged – saying, "We're buying right now." And when Maria asked, "What are you buying," Mudd replied, "I'm not going to tell you so that everybody can front-run me, to try and say, 'We're here, running to the rescue'." So that is what happened yesterday. That is why the mortgage market jumped.

The equity market -- I'm with you. It was a complete head-scratcher to me. They are taking a huge risk right now. And that risk could wind up backfiring in the wake of big losses and potentially very punishing dilutive capital raises in the future. Fannie and Freddie made it very clear that they are doing this at the behest of the government to help to stabilize the mortgage market, not because they think that they can make a buck off of this. So the shareholders are taking a huge risk. And yet the stocks went straight north and are continuing to go north on this news, which I think is nothing more than a gigantic short covering.

Lastly, Dick Syron, the CEO of Freddie, in their investor conference call last month, termed this the worst housing market in the last century, and we are only one-third of the way through it. Yesterday, he essentially said, "I can't wait to have Freddie start buying mortgages until his hands bleed." Well, if his housing forecast is correct, then he has just explained why Freddie is going to lose ridiculous sums of money. It doesn't matter to the bondholders. It doesn't matter to the mortgage market that they lose ridiculous sums of money. It screws the stockholders. So I don't understand the moves in these stocks. I don't understand if they realize that, in an era of deleveraging, these guys are leveraging themselves right into the teeth of a storm. They're doing it because the government asked them to do it, to make some attempt to stabilize the market, and it could be a very bad plan.

Now to The Barney Frank Plan – the second part of your question – for those of you not familiar, Barney Frank has proposed a plan that the government buys $300 billion-worth of troubled mortgages. They then forgive that part of the mortgage that is underwater. So if I have a mortgage on my house, and I am underwater by $20,000 – and I don't know how they're going to come up with that number – then the Government will buy my mortgage and say, "OK, Jim, we will just reduce the level of your mortgage by $20,000." So you go from negative equity to zero equity.

I agree with you that, if we get to that point – again, that's an artificial price support on the housing market – and those will ultimately work for a while, but not over the long-term, $300 billion is just the beginning. On January 20, 2009, when President Obama puts his hand on the Bible to take the Oath of Office, he is going to be sitting with a $700- or $800-billion deficit on its way to $1 trillion at that point if this plan passes.

I am in complete agreement with what you were suggesting, which is that $300 billion is the start. And when they do that, and the home price market has not stabilized, then they will do some more and do some more. Add on top of that the stimulus package that we have already blown up the deficit $168 billion with the next stimulus package that is going to come, the slowdown in the economy leads to the next tax receipts, and we could see an eye-popping deficit very, very quickly.

Did you have a follow-up on that?

Tim: No, but since you brought up the stimulus package, I guess that I have the opinion that it was a big waste of money that would have been better used on a mortgage bailout.

Bianco: Yes, the stimulus package, I thought, was somewhat of a waste of money, too. The problem

with the stimulus package is that they just basically will start in May in mailing checks to everybody. And my favorite anecdotal study about the stimulus package is that the retail analyst at Bear Stearns said that they have done some studies and think that most of that money will be spent on high-end consumer products at places like Wal-Mart. They actually put a buy-out on Wal-Mart because they think that people are going to go to Wal-Mart and purchase flat-screen TVs. One of the best comments that I heard about it was, “Maybe the Government should have just purchased $168 billion-worth of flat-screen TVs and mailed one to everybody, then it would have been a much more efficient way to go about the stimulus package than what we are doing right now.

Mailing checks back to people is not going to necessarily fix this problem, and then telling them to please go out and spend it. As much as I like the idea of cutting taxes, this kind of haphazard willy-nilly kind of tax cut – and it isn’t even going to people that pay taxes because if you make more than about $150,000 a year, then you’re not even getting a check back – it’s going to go to a lot of people that actually don’t pay taxes, so it is more of a social program, I don’t think is essentially going to do anything. But, yes, could that money have been better spent?

As I said, the banking system has lost $200 billion. And they have raised $100 billion, that, if you actually injected $150 billion of capital into the banking system, then that would have actually been a far, far more productive use of that $150 billion. Of course, that brings in a host of political problems, too – does the Government then start to run Citibank, get a seat on the Board? How does the Government try to explain that the fat cats on Wall Street are getting that money? But if you wanted to talk about efficiency, then that would have been a more efficient way to go about it.

Thanks for the question. Let me jump to the emailed questions because I’ve got a couple of emailed questions that have come in here. Joe writes, “What are your thoughts on inflation or deflation? Is deflation a la Japan likely, or will the Fed be able to reflate, and inflation become more of a problem?”

Taking the last part, the Fed cannot reflate. I think that the Fed is trying to reflate. I think that the Fed is pulling out all of the stops to reflate. That is what we have been talking about in the Conference Call, that all of these issues that the Fed has been attempting to do have been to try and stabilize the financial system. They cannot reflate. It’s up to the banking system to fix itself, and they don’t seem to be ready to start to raise punishing, really, dilutive equity, which I think is ultimately what is going to have to happen for them to fix this problem.

Deflation, inflation – I think that the inflation part of the problem is definitely a worldwide phenomenon, that commodity prices have gotten overheated. They are breaking right now. I do not believe that what we are seeing happen in commodity prices is the end of the game. This is more like what happened in 2005, when we had that massive break in commodity prices, when gold went from $700 to $500 very quickly. Crude oil went down 28 percent very quickly. Copper broke off of $4 very hard. And two years later, we made much higher highs. And in the biggest speculative bubble back in 2005, which was copper, we still made it back to $4 in copper again.

We might be seeing one of these things. We might have put in the highs for the first half of this year, or we might have put in the highs in 2008, in commodities. But I don’t think that we have put the highs of the cycle in. They will come back and ultimately make higher highs later on down the road.

So the Fed is fighting deflation. The Fed should be fighting deflation because of the shrinking financial system. The Fed is trying to reflate. I don’t think that it is going to work with their reflation. I think that it is ultimately up to the financial system to raise dilutive equity.

In commodity prices, if you want to use that as a measure of inflation, I think that the bull market will continue because it is happening outside of the United States, not inside of the United States.

The next question is, “How much further do home prices have to fall to return to a normal relationship with disposable income? And what is your estimate of how long it will take?” This question comes from David.

It’s a good question because there is a lot of measures of home prices that look at affordability indexes. The problem with the affordability indexes is that the biggest thing that drives the affordability indexes is the level of interest rates. If you get away from creative financing techniques – How do you make homes more affordable? Drive mortgage rates down to practically nothing, and then, all of the sudden, homes are more affordable. But if you measure home prices relative to incomes, then what that shows is that, from peak to trough, you need about a 30- or 40-percent decline per basis, Case-Shiller, to get back to affordable levels. We are now down to around 10 to 15 percent versus Case-Shiller. So, like Dick Syron said, that would suggest that we’re about one-third of the way through this process.

If the process continues at about its same level, that would suggest that it would be the second half of 2009 before you would finally start to hit a bottom. What I mean by continuing at the same levels, is if

home prices continue to decline at the levels that we have seen over the last six or nine months, and don't accelerate or flatten out, then it should be the second half of 2009.

But if we get a Barney Frank-type of bill or some other kind of price support mechanism, then, ultimately, the fix comes in when home prices get in line with personal income. And that would just make the process longer. It doesn't circumvent the process; it would just say that it would take more time for us to eventually get to that process, as well.

With that, there are no other questions. It is running up against 60 minutes now, at one hour, which is what I try to limit this Conference Call to. So I will wrap this up right now. If you've got any other questions, then you can call me. You can also email me afterward. I know that a lot of people like to do that and talk one on one. I will be available for anybody that wants to do that.

I want to thank everybody for joining us on this Conference Call. We will talk to you again next month. So have a happy Easter, and enjoy the long weekend!

Bye-bye.

END

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