

Monthly Chartbook

July 2008

Let's talk about the Sub-Prime Crisis

(things may not be as bad as they seem)

Sub-Prime is just a normal credit cycle

When the financiers have the ability to define the crisis du jour, it is done in terms that are not as “unfavorable” towards their industry.

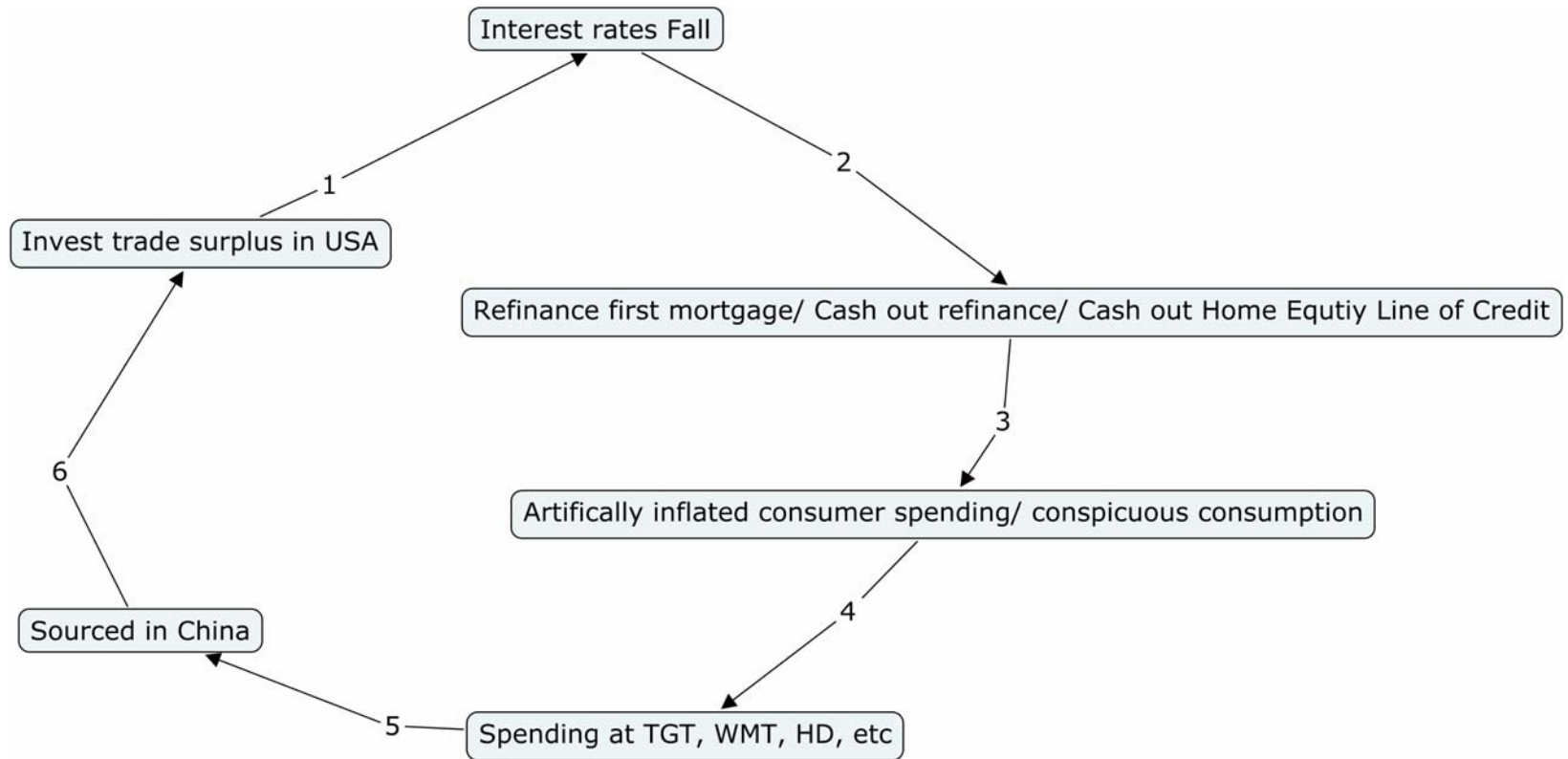
They can hardly call it “*The End of the Drunk Clown Parade Enabled by Cheap Money*”, but that’s what it is.

What the Financial Press is calling the “Sub-Prime Crisis” is simply people with marginal credit not repaying mortgages as expected.

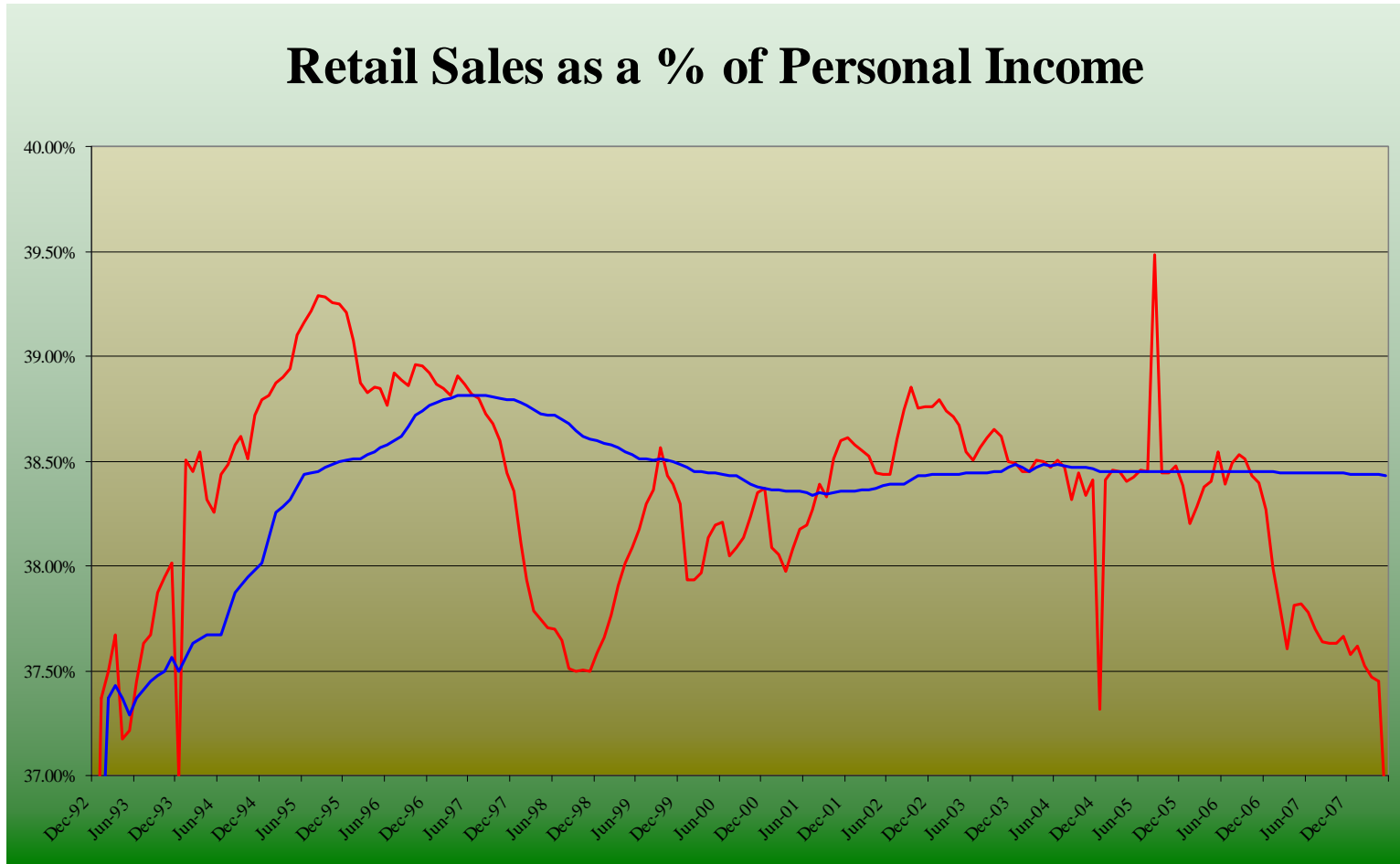
This is a result of lax lending standards towards the end of the crisis. Also, note that this is the first credit cycle under the reign of the FICO (credit) score where algorithms make the decisions instead of people.

Remember, though, credit cycles are a normal part of market capitalism.

Will the Cycle be Un-broken?



Retail Sales as a % of Personal Income



Perhaps the consumer spending of the past few years is indeed slowing. This is part of what is required as consumers re-calibrate their personal balance sheets.

Considerably looser underwriting standards, combined with an asset bubble in real estate speculation has led to this particular credit cycle.

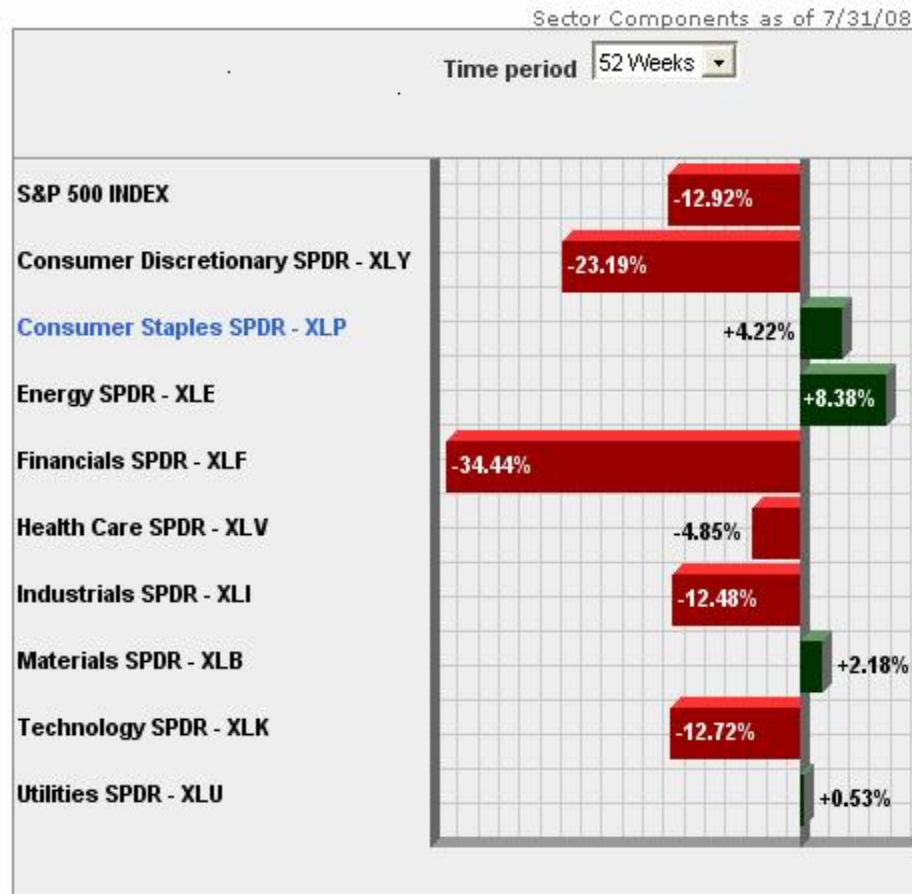
Consider some examples...

- no income verification loans
- 0% down
- negative amortization mortgages (based upon the assumption that real estate never declines in value)

People were buying houses they could not afford or cashing out the equity in their home to fund lifestyle expenses.

Bankers, Wall Street and the Federal Reserve enabled them each step of the way.

So, who pays the price?



Financial sector and consumer sector are down the most by far over the last 12 months.

Banking, as we know it...

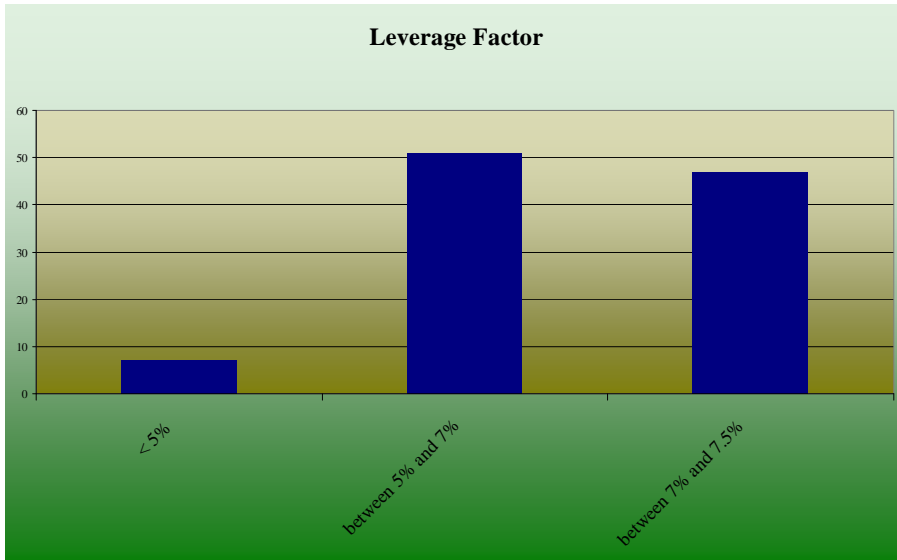
Historically, banks borrowed money from savers and lent it out using 10:1 leverage.

They would set aside 1% of capital for loan loss reserves and earn 1% return on assets.

This 1% return on assets would become a 10% return on equity (due to the leverage factor).

Half of the return would be used for bank operating expenses and half would be returned to shareholders.

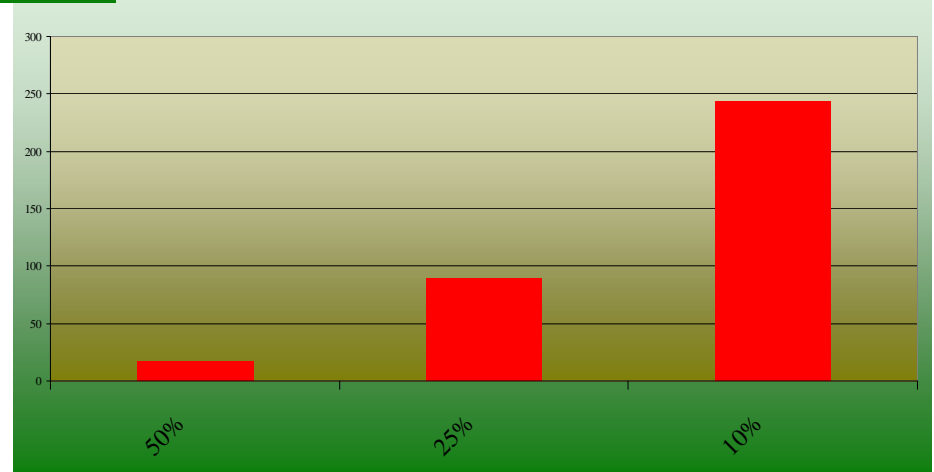
Banking, as it has become...



At the same time, loans are beginning to default.

While the median leverage factor for the sector remains near 10%, there are some institutions who have become more aggressive.

Non-performing Loans as % of Tangible Capital



The Moral Hazard, and the Current Conundrum

Why did the Regulators have to “save” Bear Stearns, Fannie and Freddie?

- **The system risk was too great for them to fail.**
 - Bear Stearns had 3¢ in assets for each \$1 in debt. But, they served as prime broker to much of the hedge fund industry, which itself operates on leverage.
 - Imagine the impact to financial markets of all of those trades being un-wound over a short period of time.
 - Fannie Mae and Freddie Mac provide access to mortgage loans for a sizeable number of American households.
 - Consider that liquidity being taken away while we’re in the midst of an inventory correction in housing.

The Moral Hazard, and the Current Conundrum

If they are “too big to fail”, then the message being sent is that in financial services gains are privatized but losses are socialized.

This is the **Moral Hazard** the regulators will be re-introducing to the markets in coming months.

Look out for “bodies” thrown on the street for all to view as a warning sign.

Who is likely safe?

This is **NOT(!)** a security recommendation.

SECURITIES EXCHANGE ACT OF 1934 RELEASE NO. 58166 /
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BNP Paribas Securities Corp. BNPQF or BNPQY
Bank of America Corporation BAC
Barclays PLC BCS
Citigroup Inc. C
Credit Suisse Group CS
Daiwa Securities Group Inc. DSECY
Deutsche Bank Group AG DB
Allianz SE AZ
Goldman, Sachs Group Inc GS
Royal Bank ADS RBS
HSBC Holdings PLC ADS HBC and HIS
J. P. Morgan Chase & Co. JPM
Lehman Brothers Holdings Inc. LEH
Merrill Lynch & Co., Inc. MER
Mizuho Financial Group, Inc. MFG
Morgan Stanley MS
UBS AG UBS
Freddie Mac FRE
Fannie Mae FNM

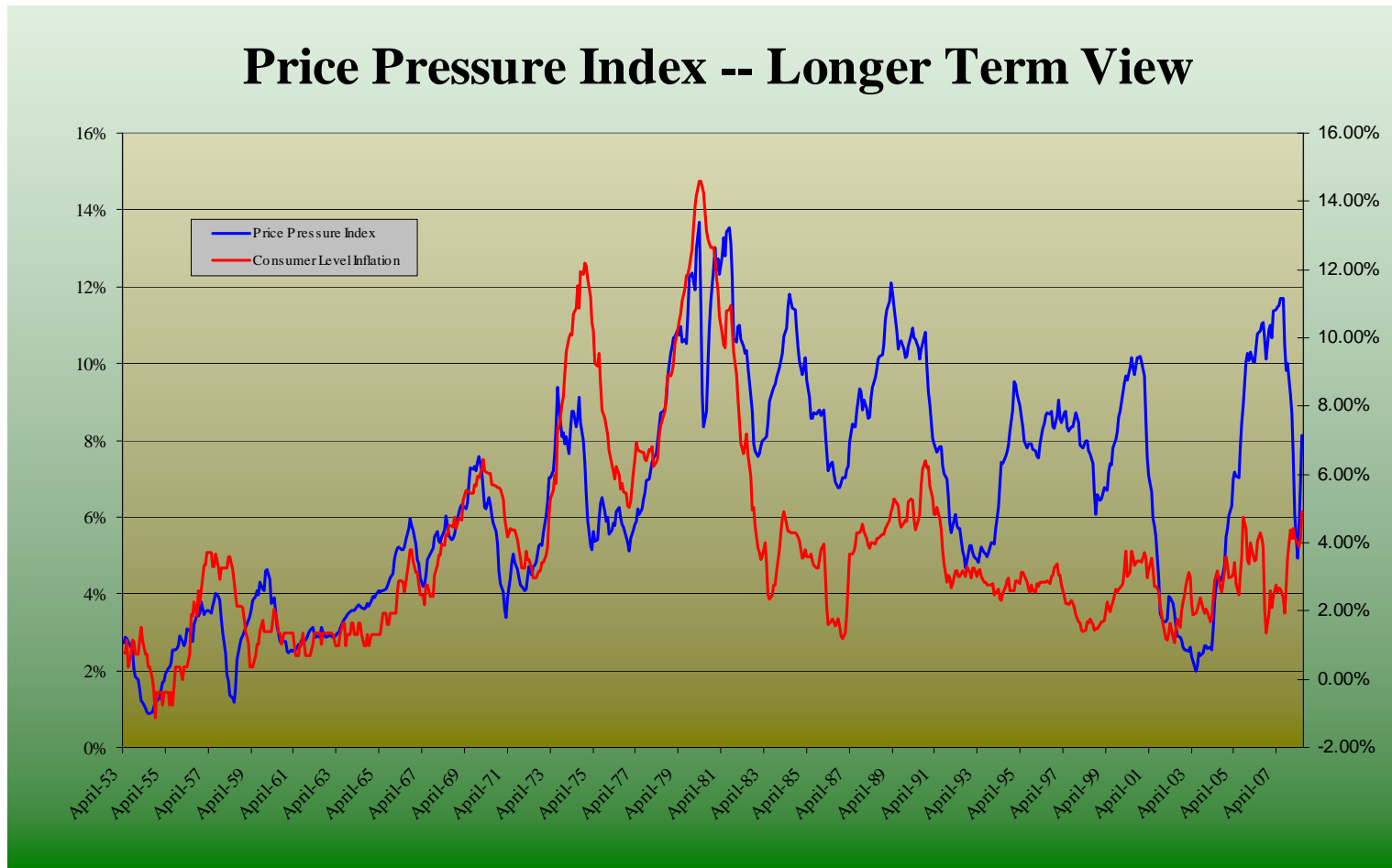
Big Picture

The Federal Reserve and the Department of Treasury did not understand the crisis for quite some time, but now have a thorough grasp of the situation.

There will be bank failures and arranged marriages in the coming months as the bad debt moves through bank balance sheets and adversely affects those who are mis-capitalized and/or issued loans more aggressively than their peers.

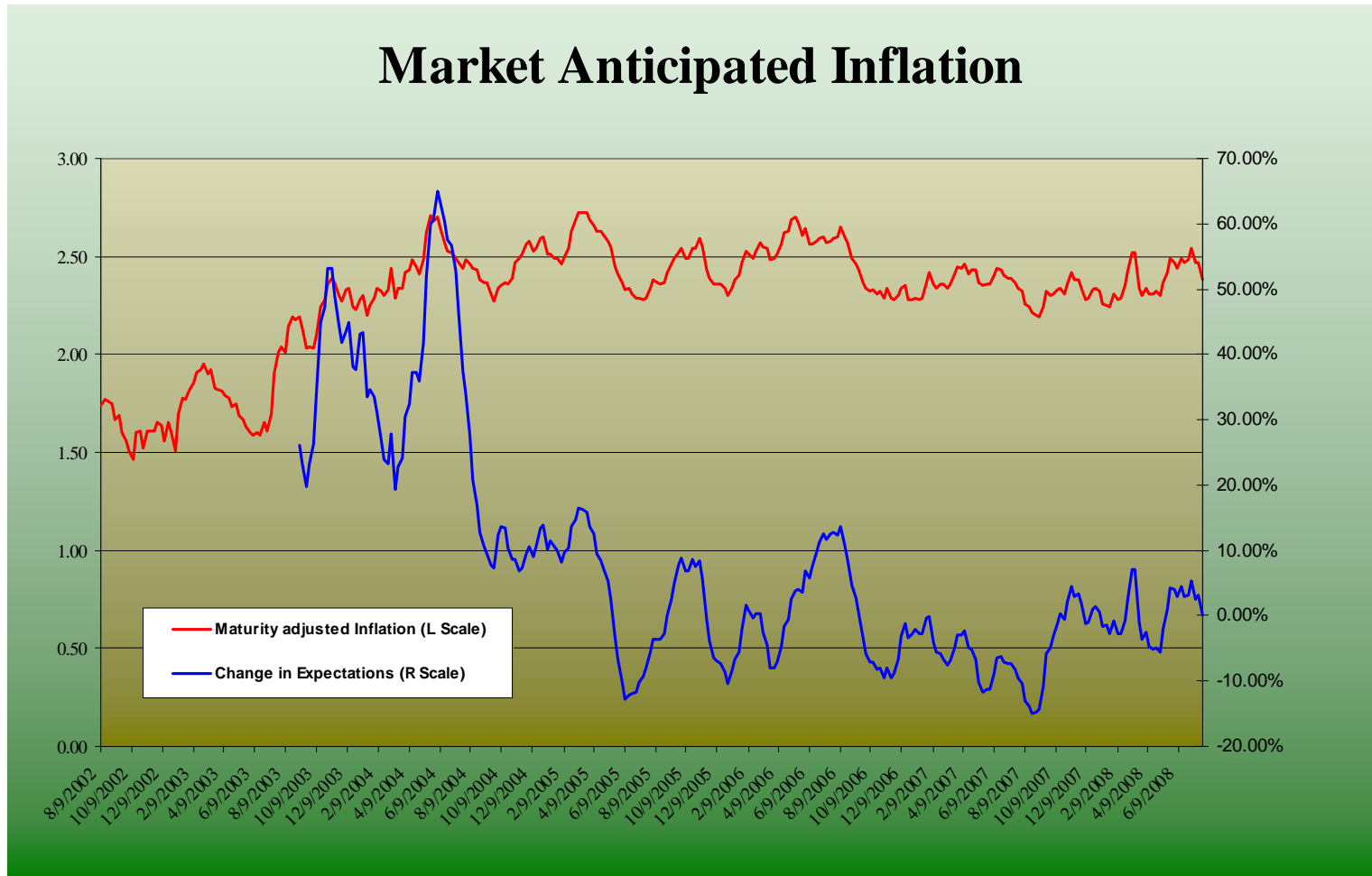
Now that they have a strategic plan for dealing with the crisis, the *next worry* is inflation (which is also a result of the “cheap money” policies of recent years).

Inflation expectations



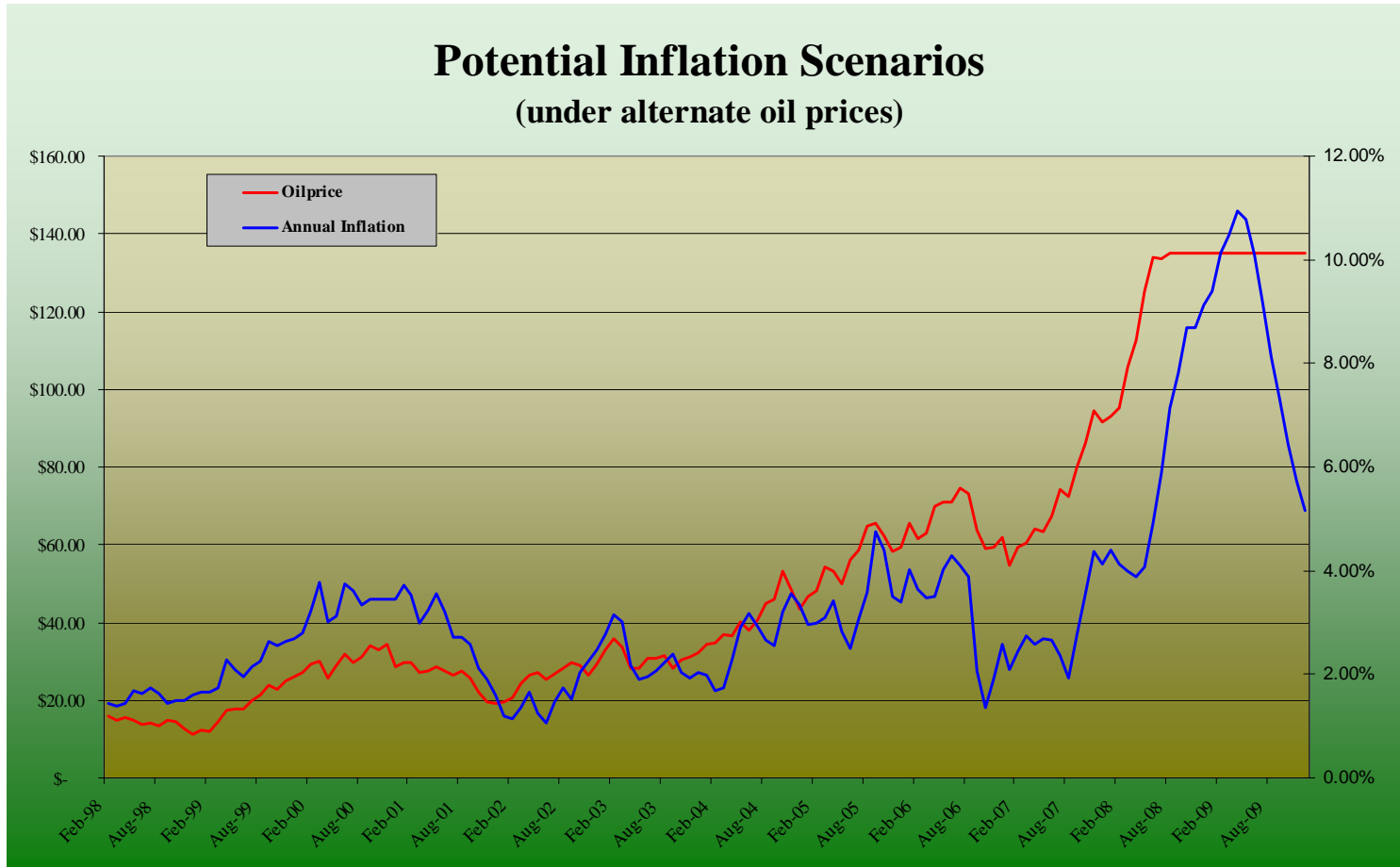
The decline in the Price Pressure index is mostly related to falling short term interest rates. Most price pressures remain.

Inflation expectations



Long-term inflation expectations remain unchanged. Our biggest concern is that they become “un-hinged”, which would put considerable pressure on interest rates and the dollar.

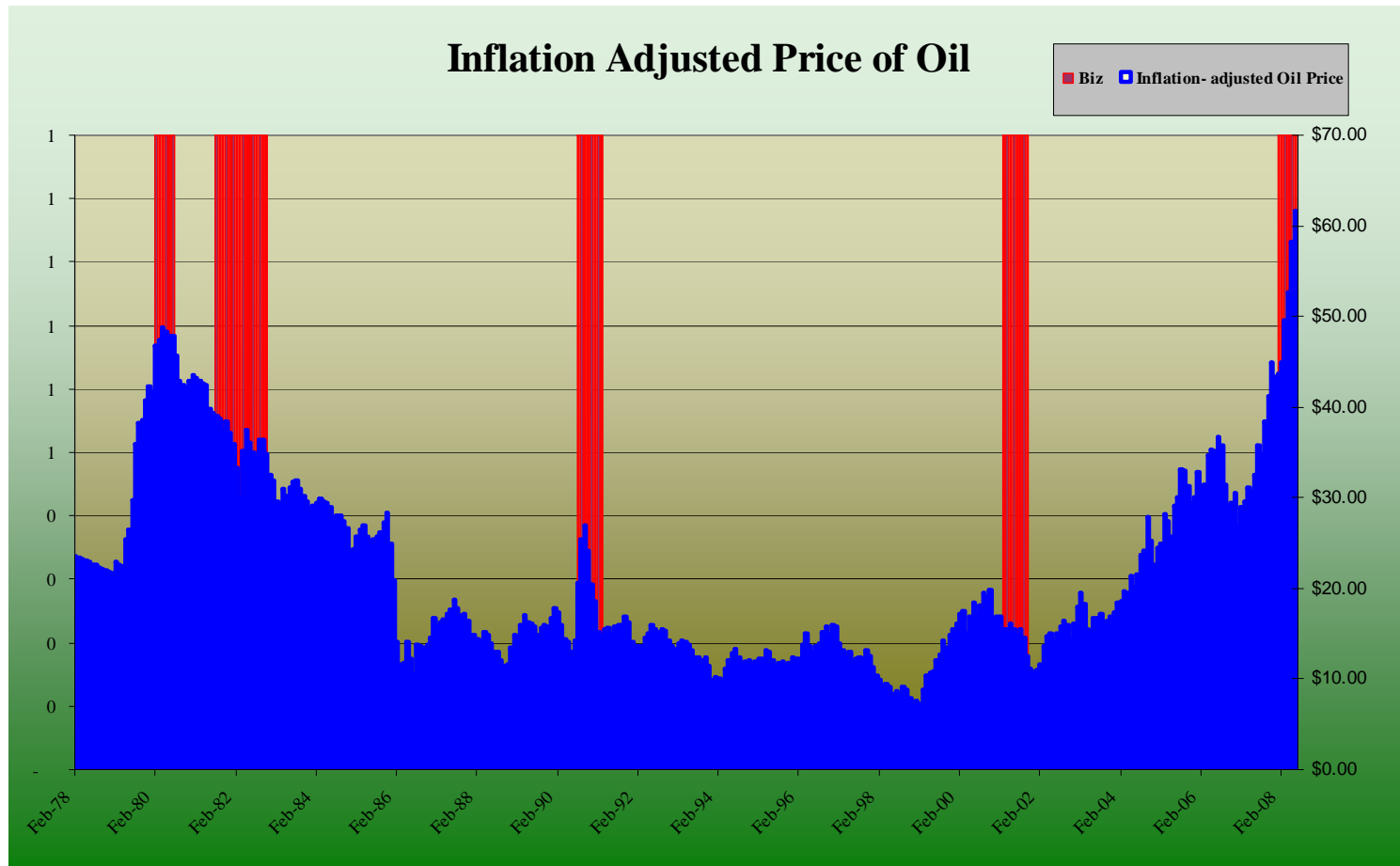
Inflation expectations



What might inflation do under different oil price scenarios? In this case, oil is forecast to remain near \$135 / barrel for the near-term.

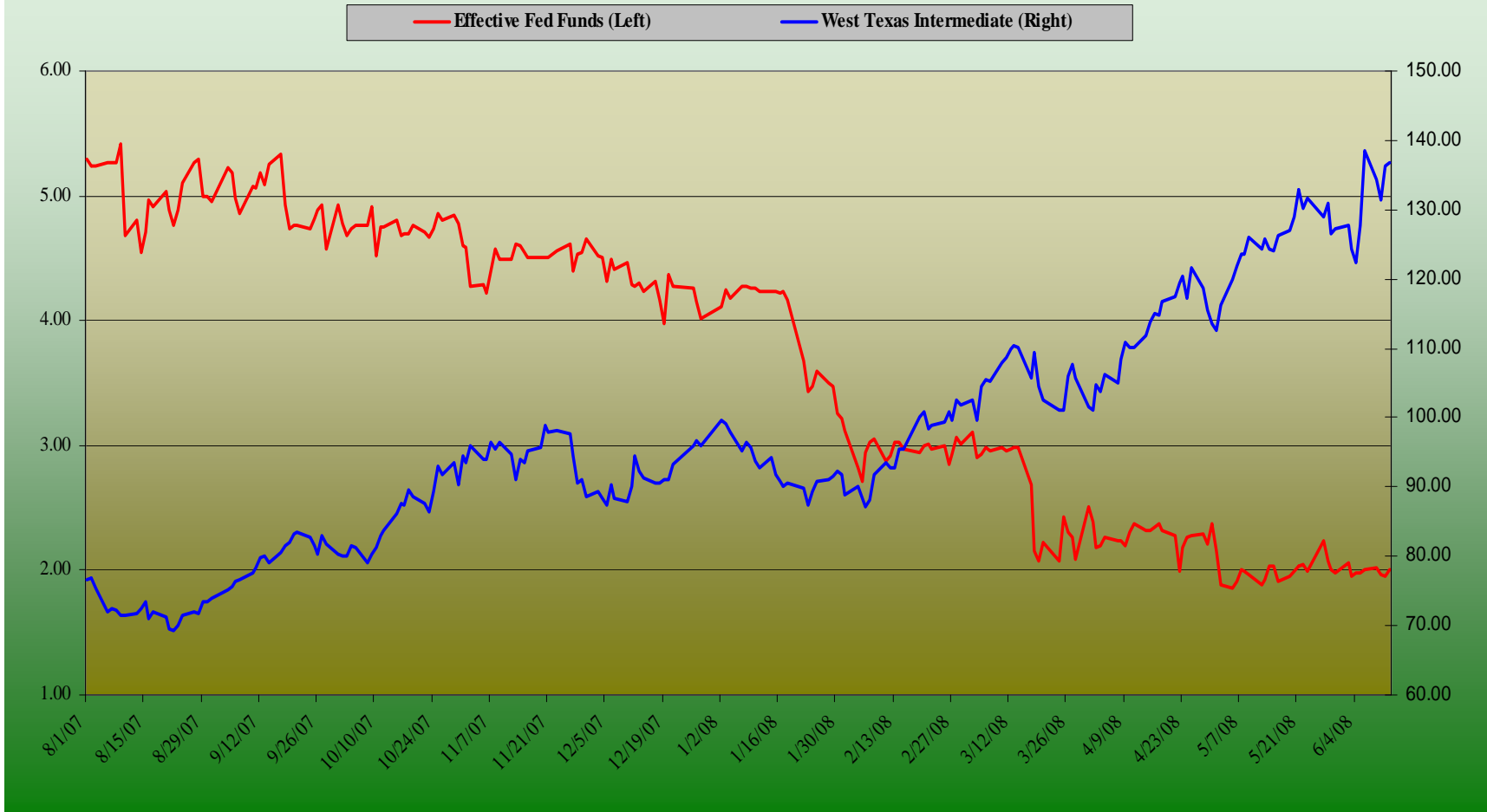
Inflation pressures remain one of our largest concerns, even though they will likely abate once the annualized pressure from oil subsides.

Inflation expectations



Oil is already at cyclical highs on an inflation-adjusted basis. Part of this increase in price is investors seeking a “store of value” which the dollar has not been providing.

Fed Funds vs. Oil



Federal Reserve Watch

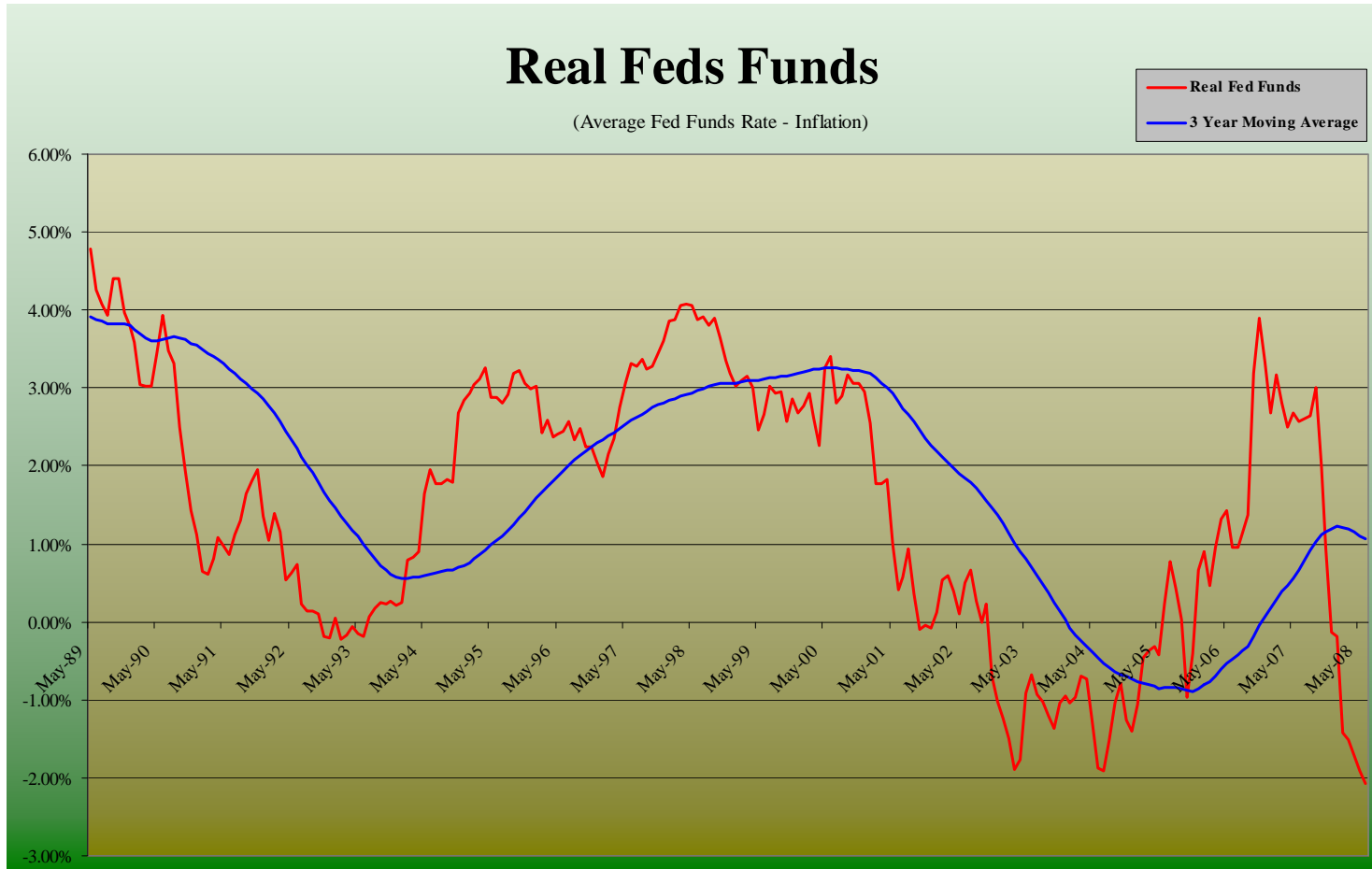
This is where we *hope* our thoughts about the Fed understanding are correct.

Part of the strength in oil is due to the weakness in the dollar, with no sign of support from the Federal Reserve as we seem to “print (money) our way out of and in to problems”.

The Fed needs to take back 1% of the Fed Funds rate cuts, especially since 75 basis points was offered in January as a blind reaction to rogue European trading.

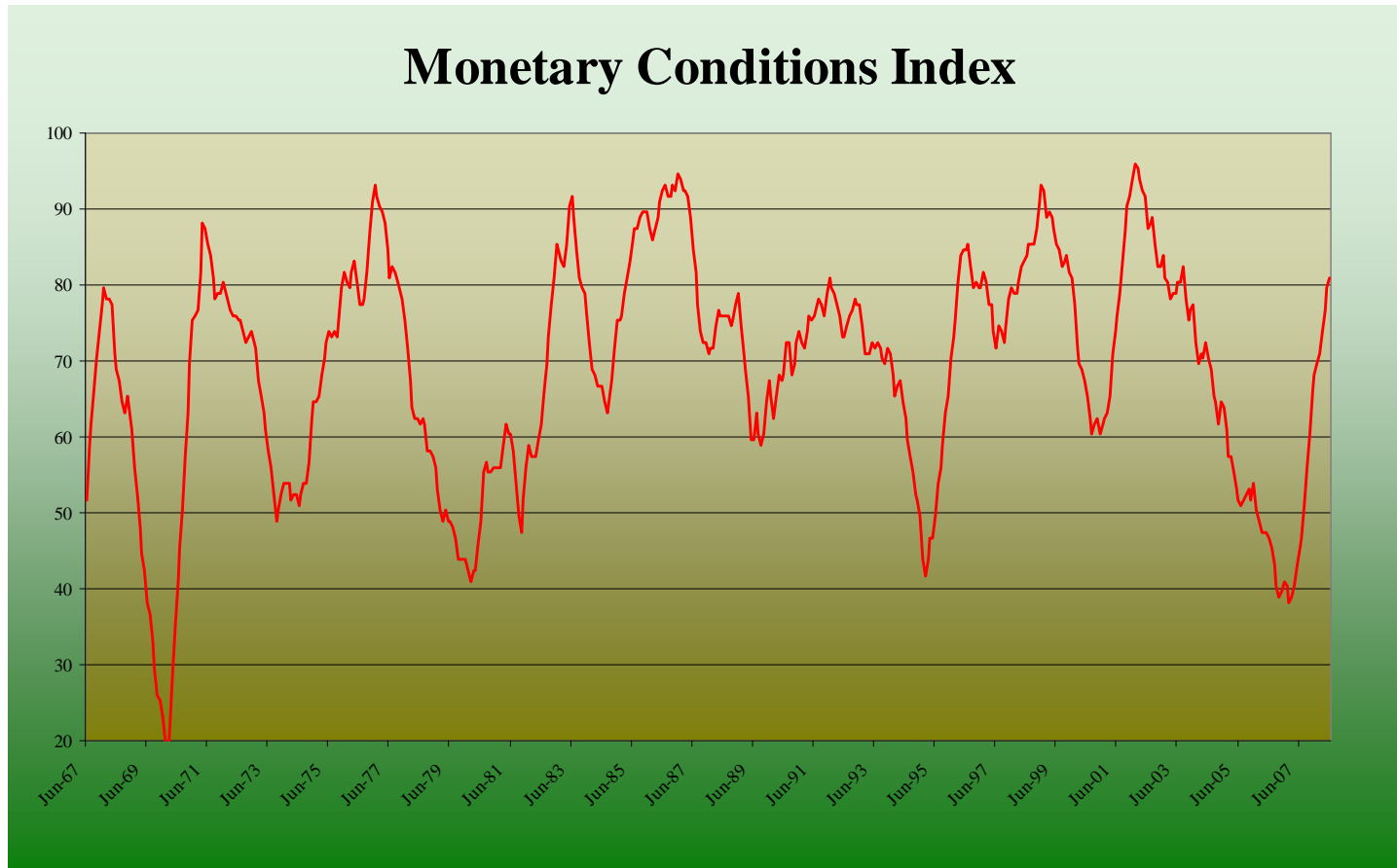
Pay attention to any speeches by the two dissenting voters, Plosser and Fisher. The only hope for the US\$ is hawkish dissent.

Federal Reserve Watch



This is a big problem, but it can be fixed if inflation moderates and interest rates rise. Americans have actually been behaving in a prudent manner when real rates are less than zero %. The problem is when this spending becomes habit and is aggregated across the entire economy.

Federal Reserve Watch



Monetary conditions must become tighter for the Fed to fight inflation and restore credibility to the dollar.

Potential Outlook

Challenges that remain...

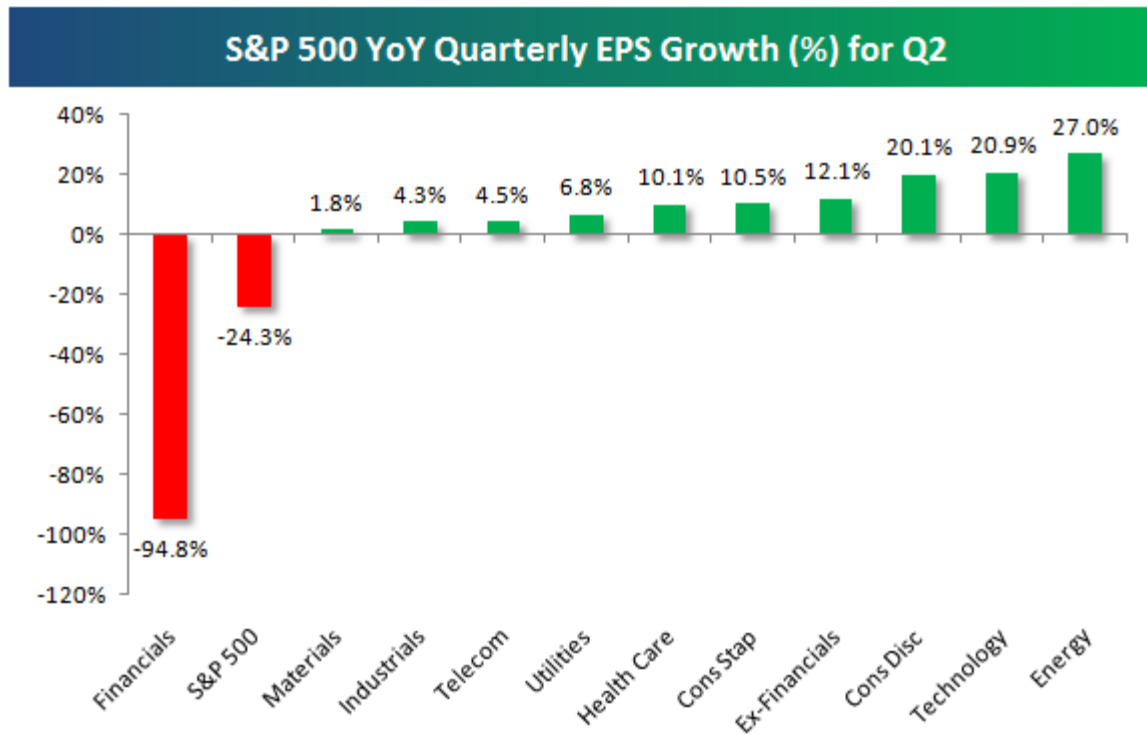
Housing impacts ordinary Americans perception of their wealth and, as such, is an important component of any macro-economic analysis. This may play a role in the timing of interest rate increases.

There is also some fear that weaker employment numbers may delay the needed rate increases. But, the Fed has got to replenish its arsenal.

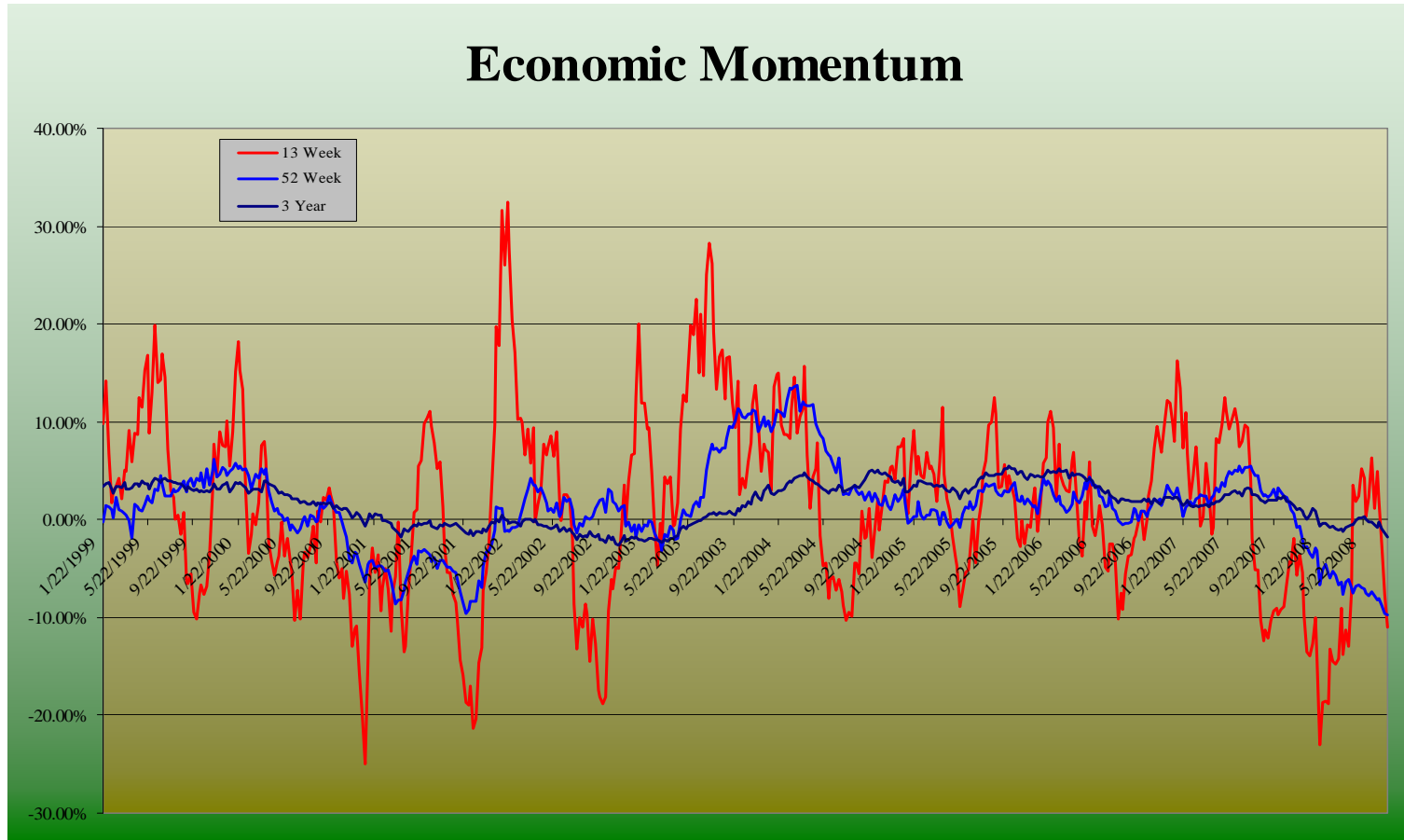
Also, the market may raise interest rates for us as foreign entities diversify away from the US \$ as their primary currency.

Potential Outlook

We are living in a bi-modal economy – where it's good, it's good; where it's weak, it's awful.



Outlook



The worst of the crisis *may* be over, but there will likely be residual shocks that continue to impact headlines for some time.

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