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The Impact of the Financial Rescue Bill

October 5, 2008

Congress Passes $700 Billion Emergency Economic Stabilization Act

The Emergency Economic Stabilization Act is not the magic wand that makes all the problems go away.

The U.S. financial system is under significant stress as a result of large investments in illiquid mortgage related assets and deteriorating capital levels. The U.S. Treasury has run from crisis to crisis seizing Fannie Mae and Freddie Mac, coordinating a loan for AIG, setting up an insurance fund for money market mutual funds, arranging the sale of Washington Mutual to JP Morgan and working with Congress on legislation directed at exorcising the illiquid assets from the financial system.

Last week Congress passed the financial rescue legislation known as The Emergency Economic Stabilization Act. Among other things, it gives the U.S. Treasury the authority to purchase as much as $700 billion in impaired illiquid mortgage related assets. This initiative is directed at treating the disease that is impacting our capital markets, not just the symptoms; and it is anticipated that the Treasury will move quickly to start the buying through an auction process. The legislation, the most significant fiscal policy initiative aimed at the financial markets since the 1930s, gives the Treasury Secretary sweeping power to address the purchase of these troubled assets including illiquid mortgage, student loan, credit card and auto related securities. In effect, the U.S. government is becoming the buyer of last resort for illiquid assets that no other financial institution wants to buy.

The Act includes several items:

The U.S. Treasury is authorized to purchase up $250 billion in illiquid mortgage, auto, student loan, and credit card securities immediately through a reverse auction process. The Treasury is authorized to retain private investment management firms to assist in the valuation of these illiquid securities and to purchase those securities through a newly created office called the Office of Financial Stability. The limit on bank deposits insured through the FDIC increases temporarily from $100,000 to $250,000 through December 31, 2009.

The Act establishes various methods for oversight and accountability. The Office of Financial Stability Board is charged with reviewing the exercise of authority under the Act. The Government Accountability Office, which is an arm of Congress, is expected to add resources in order to provide effective oversight. Additional oversight will be provided by the Congressional Oversight Panel. Another oversight body mentioned in the Act is the Office of the Special Inspector General for the Troubled Asset Relief Program.

What We Can Expect Now

The success of this legislation will be measured in the credit markets not the stock market.

Stock market volatility will likely persist. While the market is focused on the solvency of our financial system, fear has gripped investors worried about the safety of their retirement assets as well as their bank savings accounts. Good businesses are having trouble accessing credit, which, in turn, is having a negative impact on corporate earnings. As a broad generalization, financial assets tend to perform better in periods of easy credit; with severely restricted credit, we are expecting stocks to underperform until such time as credit becomes more accessible. Also, this is now a global financial crisis; as news of trouble in Europe and Asia moves through the markets, it will add to the volatility.

The credit markets will improve over time. At this moment in time, the credit markets have virtually stopped working. The free flow of credit, which is the lifeblood of our capital markets, is nonexistent. Many companies

have drawn on their bank revolvers and not rolled their commercial paper. Partially as a result, banks have simply stopped lending preferring instead to hoard cash for fear, in part, that more companies draw down their unused lines of credit. Banks are pulling (or not renewing) lines from some companies before they can draw on them, further restricting the flow of credit. When banks don't lend, economic growth stalls and consumers have a difficult time getting loans for cars and houses. Further, we've seen virtually no new issuance of corporate debt and secondary trading of bonds has ground to a halt. The process of getting the basic function of lending working again in this market will take some time.

The economy will slow dramatically. At this point, we do not believe that a more stable financial system will prevent a sharp economic slowdown. The economy is slowing dramatically and only time will reveal how much damage has been done to it through this credit crunch. The two pistons of the consumer sector, housing and autos, are contracting at a rapid pace. Auto sales in September dipped below one million units for the first time since the late 1990's. Job cuts in September reached 159,000, the largest one month decline in employment in five years. There is no way around it; the U.S. economy is contracting.

Consolidation in the banking sector will continue. Third quarter earnings for the banks will be released next month. There is no doubt that we will see further writedowns; the question is to what extent. This legislation should allow banks with impaired securities to sell them to the U.S. Treasury creating a market that didn't exist before; however, it is not clear at what price. This is critical since any price below the banks carrying value will require further writedowns which will be charged against an already thin capital level. Also, the Financial Accounting Standards Board has put FAS 157 d *Determining the Fair Value of a Financial Asset in a Market That is Not Active* out for comment until October 9th. This accounting proposal will allow securities where there is no liquid market to be priced at a value derived using discounted cash flows, potentially helping to preserve inherent value in illiquid assets through the mark-to-market accounting process. One lesson learned in this dysfunctional market is that the low cost of stable retail bank deposits is a preferred method of funding. Several banks, including US Bancorp and Citigroup will continue to pursue retail acquisitions and we believe that regional banks such as Nat City, Fifth Third, and Key Bank are potential take over (or Take Under) candidates.

The fiscal position of many state and local governments will deteriorate. The decline in the business sector combined with the deterioration in the employment picture is resulting in the deterioration in the fiscal position of many state and local governments. Last week the state of New York, rated AA by Standard & Poor's rating service, took steps to cut spending in the face of a $1.2 billion budget deficit. California has also taken steps to address its ballooning deficit. It is expected that many states, including Arizona and Massachusetts, will need to address their budget position. At some point, we would not be surprised to see pressure on taxes combined with cuts in government services.

This global financial crisis will define the agenda for the next President of the United States. The top stories in the media are dominated by the global financial crisis. It has shaped the campaign message of both candidates. The goal at this point is to get the capital markets up and functioning and restore confidence in our financial system. Once that is accomplished, the work to improve accountability and regulatory oversight will begin. Regulatory reform should be a significant initiative of the new administration. Under the current regulatory system, there is not one centralized regulatory body that has oversight over all financial institutions. We would not be surprised to see more regulatory authority rest under the Federal Reserve when this chapter is finally closed.

Gregory J. Hahn, CFA
President & CIO

Stephen P. Carr, CFA
Portfolio Manager

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