Lebed Asset Management LLC

Investment Commentary—April 2009

The capital markets followed one of the worst years in history with another terrible quarter, as share prices plunged in January and February before recovering significant ground with a vigorous rally that began in early March and continues as of this writing. Your portfolio losses were roughly consistent with the overall market.

The mid-quarter update e-mailed at the end of February discussed six issues we've been tracking closely over the last several months. Picking up where that left off, the following looks at intervening developments in these critical areas.

Bank recapitalization

A great deal has happened in the last six weeks with respect to bank recapitalization. First, the Treasury provided details on its Public-Private Investment Program (PPIP) to purchase "legacy assets." We're reasonably hopeful that this plan will help to clean up the balance sheets of the large U.S. commercial banks. The plan allows the Treasury and FDIC to finance over eighty percent of the purchase price of distressed securities and/or loans. The ability to leverage the purchases with cheap financing will encourage participants to pay a much higher price for the assets than they otherwise would. The higher bids will, in turn, provide incentive for banks to sell the assets. Complicating matters, the Financial Accounting Standards Board (FASB) early this month relaxed mark-to-market rules on valuing illiquid assets. Some pundits have suggested that FASB's actions undercut PPIP, arguing that if banks can go back to "marking assets to model," they have no incentive to sell. That may be true in some cases, but we're inclined to think that most banks will still be eager to rid themselves of their so-called toxic assets.

On another front, there has been much discussion of banks' first quarter profitability, sparked in part by Citigroup's upbeat assessment of operating results for January and February. Simplifying the discussion just a bit, the magnitude of bank recapitalization will be determined by (a) the extent of future losses on distressed securities and loans, and (b) the extent of profits generated by performing loans and other operations. The larger that (b) is relative to (a), the less new capital, either from government or private sources, is required. The gist of the discussion about bank profitability is that (b) may comprise a larger percentage of (a) than previously thought. That would be very welcome news because there is not a tremendous amount of TARP money remaining, and in the wake of the furor over AIG bonuses, the appetite in Congress to approve more TARP money is non-existent. We'll know much more about bank profitability, and hence the prospects for successful recapitalization, when earnings for the big banks come out this week and next.

Meantime, the Fed-administered bank “stress tests” will be completed around month-end, after which banks will be notified of the results and given several months to attract private capital to make up for identified shortfalls. If insufficient private capital is raised, the government will inject further capital in the form of preferred securities. In that it will help force the issue of capital adequacy, we view the upcoming completion of the stress tests as welcome news.

All in all, the likelihood of successful recapitalization has in our opinion increased over the last couple of months. We still believe that significant additional government infusions will be required and suspect that bank share prices may have gotten too high in the recent run-up. But from the perspective of their impact on the overall financial system and the broad economy, the news on banks has been reasonably good.

Auto Companies

The administration’s auto task force appears to be taking a pretty tough stand with GM and Chrysler. In our mid-quarter update we indicated a preference for an orderly bankruptcy, and that is now appearing increasingly likely for GM, with Chrysler either completing its deal with Fiat or following suit.

Credit markets

As we wrote in February, credit markets have stabilized considerably since the fall, but securitization has been woefully absent. The Fed’s Term ABS Loan Facility (TALF) is intended to restart that market. Unfortunately, the program is off to a slow start with $8 billion lent in March to purchase asset-backed securities, but less than $2 billion this month. Investors appear wary of restrictions—those mandated now and those that could be imposed retroactively—on participants. Given the huge role of securitization in funding consumer credit, a successful TALF or an alternative will ultimately be important to a meaningful recovery. Tim Geithner will need to focus on TALF in the next couple of months and find ways to encourage greater participation.

Housing

We wrote positively six weeks ago about the administration’s mortgage initiative. One component of the initiative is to allow borrowers with Fannie Mae or Freddie Mac guaranteed mortgages to refinance even if their mortgage balance is as high as 105% of the value of the underlying home. The other key component of the plan, and the more important of the two, provides guidelines and incentives to lenders, borrowers and servicers for restructuring troubled mortgages. If successful, the plan could forestall a great number of foreclosures, thereby hastening a bottom in housing prices. The restructuring initiative is currently bogged down over the issue of second mortgages. Specifically, the question is how much of a loss the holders of second liens should absorb and how to force them to accept these losses. Like TALF, but perhaps with even more urgency, this is an issue the administration needs to address.

GDP

Increasingly, economic data suggest that U.S. GDP is beginning to contract more slowly. GDP in the first half of the year will surely be negative, but should be significantly improved from the -

6.3% experienced in Q4 of 2008. Personal consumption expenditures were up in January and February and down only slightly in March. For Q1 GDP, the good news on consumer spending will be offset somewhat by ongoing inventory reductions and big declines in business investment. But it does appear that we're past the point of maximum contraction (in the U.S. that is; Europe may be lagging a bit on this count). As they have for some time, many economists expect positive growth by the fourth quarter. In fact, when the Wall Street Journal surveyed economists recently, they collectively forecasted an end to the recession in September, one month *earlier* than anticipated in the prior survey. We've been dubious about a 2009 end to the recession—as opposed to early 2010—but it's not totally implausible. In any case, current prospects for GDP make comparisons to the Great Depression look increasingly inapt. That alone justifies a good deal of the recent stock market rally.

Earnings

There hasn't been much news on the earnings front since the mid-quarter update, but that will change very quickly as we head into the heart of earnings season. Whether the news is good or bad, it's probably safe to say that earnings season will create a great deal of volatility, as every report and conference call is scoured for what it may portend about the course of the economy.

Conclusion

Overall, things look a bit better than they did six weeks ago and not simply because of the run-up in the stock market. We appear to be through the worst of the recession, and while the light at the end of the tunnel is still dim, it seems at least to be approaching and not receding. Policy response, while surely imperfect, has been a bit clearer and steadier. Lagging indicators such as unemployment will worsen for quite some time. It's also unlikely that the road to recovery will proceed without significant setbacks along the way. But it's been quite some time since we've been able to say that things look a little better; that we can say it now is reason enough for some guarded optimism.

As to whether or not the latest run-up in the market is a bear market rally or the beginning of a bull market, we confess to being agnostic. On the one hand, if GDP is going to turn positive by this fall, then the surge in the market, which tends to anticipate the end of recessions by around six months, is well justified. Furthermore, valuations of high quality companies seemed extraordinarily inexpensive at the early March lows. On the other hand, a sustained bull market may require not simply that the end of the recession come into view, but that signs of a robust recovery emerge. As we described in our January essay, the current crisis resulted from the bursting of a debt bubble that was many years in the making. And, as we indicated in that essay, even after the recession ends the debt cleanup may weigh on the economy and lead at least for a time to a fairly tepid recovery.

April 14, 2009
Boston, MA