



October 7, 2008

How Should Businesses Prepare for a Volatile Economy?

In summary, we recommend clients use the hoped-for short-term improvement in financial market conditions to prepare for potential substantial and continued market disruptions and economic contraction. Consider some of the following defensive actions: overcapitalize the balance sheet; push back credit maturities wherever possible; diversify revenues and costs across multiple currencies; carefully match revenues and costs in terms of exposure to inflation and currency fluctuation and engage in significant scenario analysis for sensitivity to these factors. Also, we suggest clients prepare for increases in business taxes, capital gains taxes and personal income taxes (at the highest brackets) beyond that being currently discussed.

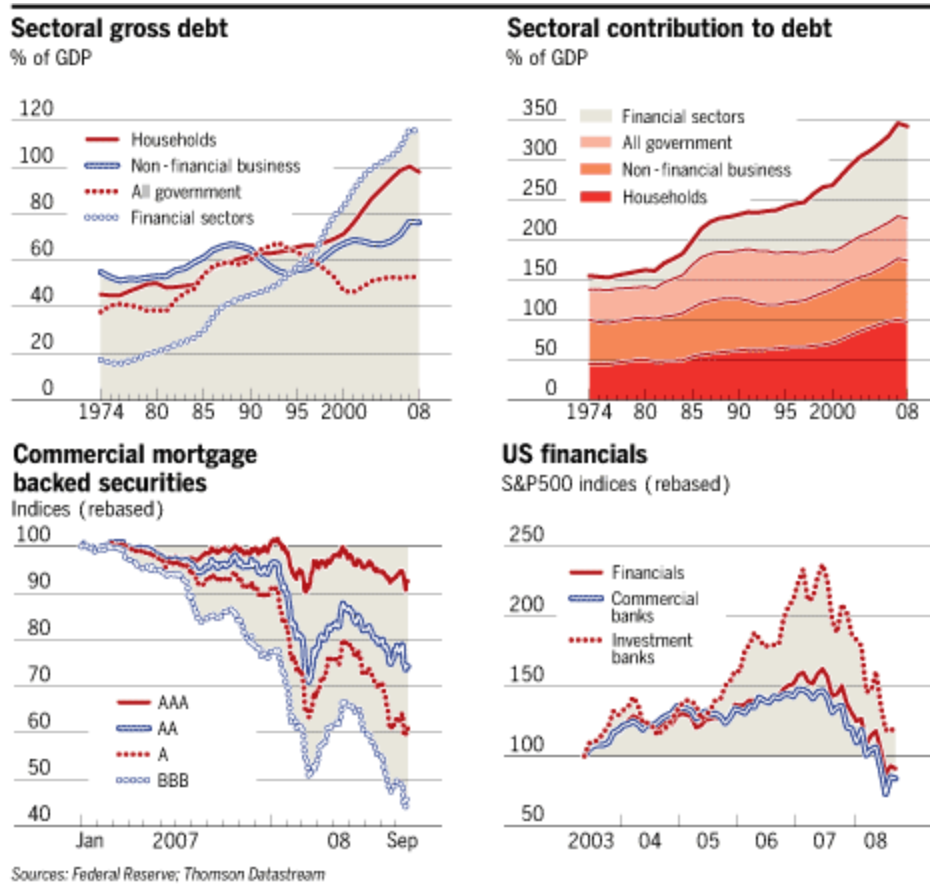
We feel the Emergency Economic Stabilization Act ("EESA") – the \$700BN Troubled Asset Relief Program ("TARP") and other measures -- poses significant medium- and long-term risks to the interests of our clients. We note that the benefits of TARP are highly uncertain, the proposed size will complicate the Federal Government's options for subsequent systematic remedies and fiscal stimulus, and that significant anti-business sentiment may emerge if Main Street benefits don't result.

We are concerned deflationary economic trends coupled with inflationary monetary and fiscal countermeasures will result in much wider ranges of outcomes for inflation, exchange rates and cost of capital. Economist Martin Feldstein recently noted 10MM homeowners currently own homes worth less than the mortgage, and 20MM will be in such a position in a year at current rates of home value decline. As multiple additional government actions may still be required, clients may find themselves whipsawed amongst deflation, inflation and the recessionary policies which would then be required to control inflation.

Still, the United States remains exceptionally efficient at re-allocating capital to higher return uses, especially those that involve innovation. The country has a deep and talented workforce, including in government where the speed with which the agencies and Congress have been reacting to extraordinary events is in itself astonishing. The authority under which the Federal Reserve and the Treasury have been acting was generally crafted about 70 years ago, which speaks to the depth of the system's roots. Many institutions will fail as a result of current economic conditions. The only certainty is that new entities will quickly fill any gap that is created per the country's unbroken multi-century track record of successful entrepreneurial innovation.

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A sustained period of deleveraging for the US economy is likely. U.S. entities, especially consumers and governments, simply have too much debt. The Financial Times recently noted that aggregate US debt rose from 163 percent of gross domestic product in 1980 to 346 percent in 2007. Household indebtedness jumped from 50 percent of GDP in 1980 to 100 percent in 2007; financial sector indebtedness jumped from just 21 percent of GDP in 1980 to 116 percent in 2007¹.



The economy is in the process of reducing leverage through write-downs, bankruptcies, and a contraction of credit availability, and consumer borrowing fell in August for the first time in more than 10 years. No government has the fiscal resources to alter the long-term course of the economy of which it is a part.

The chance that TARP's benefit to confidence, lending and economic activity is overwhelmed by secular deleveraging and recessionary trends is substantial. As such, we suggest clients take advantage of any immediate improvement in credit and capital conditions to increase capitalization and extend debt maturities. There is not much precedent that shows removing toxic assets from bank balance sheets will improve lending and credit conditions in the medium term. In fact, the other Federal Reserve

¹ <http://www.ft.com/cms/s/0/a09b317e-898d-11dd-8371-0000779fd18c.html>.

action to promote lending, injecting hundreds of billions of liquidity into the banking system hasn't improved lending conditions. Banks have been conserving cash to meet demand for deposits, loan portfolio quality deterioration and maturation of their own credit facilities (the Fed's discount window can help here). They may choose to similarly conserve the proceeds from the sale of toxic securities to the Treasury, or for example, engage in share repurchases to drive earnings.

The size of the EESA and TARP substantially complicate further systemic and stimulating action, and massive off-balance sheet risks are present.

Looking beyond this week's concerns, the actual and potential demands on Federal cash outflows are breathtaking. The FY2009 budget deficit estimates range from \$400BN to \$600BN without giving effect to the EESA. In addition to Fannie & Freddie exposure (\$5 trillion which the government chose to keep off its balance sheet), the FDIC insures \$4.3 trillion of bank deposits while having approximately \$50BN of capital remaining in its insurance fund (before giving effect to any Wachovia transaction). During the savings and loan meltdown (mainly during the 1980's), the FSLIC (the FDIC for thrifts) was unable to cover insured losses and itself needed Treasury assistance². The government has recently offered insurance to money market funds but, data on the total exposure is not available. A default here, a bank run there, another stimulus package, increased unemployment benefits and lower tax revenues -- pretty soon you're talking real money.

While there may be near-term satisfaction from some form of government action (that unquantifiable "confidence" benefit), prudence suggests the government keep substantial financial powder dry for uses where the effect of the spending is more clear and predictable. This could include directly helping individuals impacted by any economic fallout, and on systemic interventions when a better understanding of their efficacy emerges.

The massive toxic asset repurchase plan, especially if ineffective, will be great sustenance for profligate spending and anti-business sentiment.

First, the spending floodgates have been flung open. The cost of some of the "enhancements" (AMT tax reductions, pork) to the bill has been widely noted. Examples outside of the bill are the \$25BN low-interest loan to the auto manufacturers to "develop energy efficient vehicles", and requests by the states of California (\$7BN) and Massachusetts (\$700MM) for revenue anticipation loans from the Federal Government at favorable rates.

It will be difficult to defend against additional stimulus spending, especially if they have a more direct bearing on jobs and individuals than does TARP. The consequences of runaway deficit spending have been firmly established: higher cost of capital, increased taxes and/or inflation.

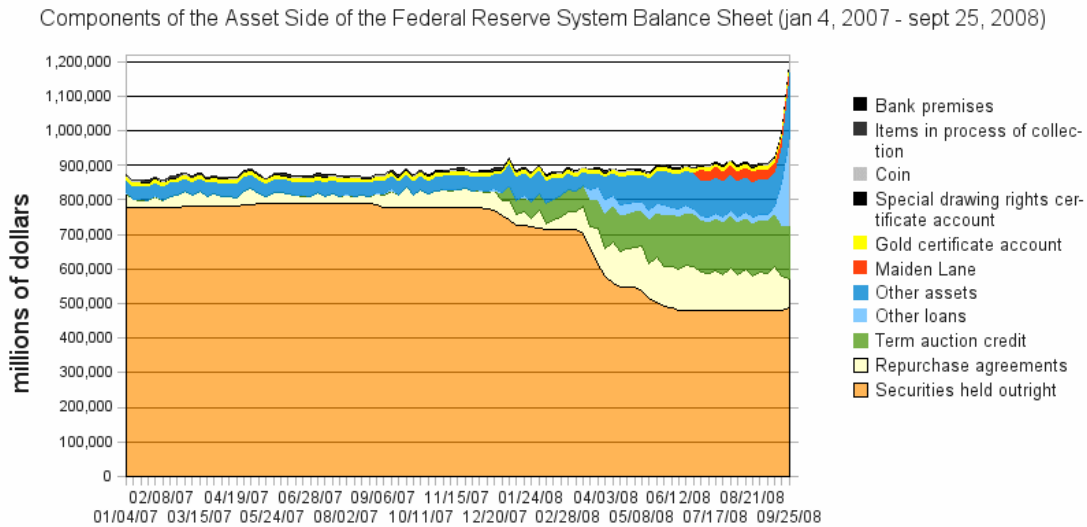
Second, if these measures are ineffective, or if the Treasury suffers substantial losses on the TARP plan, we would not be surprised if existing negative public sentiment were turned into action detrimental to business interests. It will be childish simple to demonize TARP as a give-away to Wall Street, Fat Cats, Big Business, ... Pick your

² Incidentally, from 1986 to 1995, the number of thrifts was cut in half due to closure and consolidation.

favorite derogatory phrase. We have difficulty imagining politicians standing in the way of (vengeful) regulation in the short term and significant business and executive oriented taxation in the medium term as a budget-mending action. Regarding regulation, note that speaking to reporters on the day the Senate approved the EESA regarding subsequent corrective regulatory actions, Majority Leader Harry Reid included the need to regulate the airline industry to re-introduce service to certain towns. On taxation, given that the proponents of trickledown economics seem to be losing the argument to those pointing to polarization of incomes, it is difficult to imagine that balancing the Federal budget would be done with anything other than raising taxes on business and high-income individuals.

If you think we are exaggerating the likelihood and severity of a public backlash, consider that for \$50BN, two million people could each receive \$25,000 of unemployment and retraining benefits. Sophisticated retrospective arguments about the rationale for “Wall Street” rescues carry little water when, presuming \$250BN of total intervention cost, 10 million people could have been provided assistance for the same cost.

The effect of Federal Reserve intervention is inflationary. This is a long, technical debate but basically the central bank can always bail out any entity and fund itself at will through the issuance of money³. These activities are considered inflationary in a “fiat” currency, i.e. one not backed by gold or other hard asset deposits. The graph below illustrates the sharp effect Federal Reserve intervention has had on the bank’s balance sheet. You get the picture^{4,5}:



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³ http://www.cepr.org/pubs/PolicyInsights/CEPR_Policy_Insight_024.asp

⁴ <http://www.federalreserve.gov/releases/h41/>

⁵ http://upload.wikimedia.org/wikipedia/en/e/eb/Components_of_Asset_Side_of_the_Federal_Reserve_System_Balance_Sheet.gif

Below we discuss additional thoughts on the merits of a bailout. These are opinion, whereas above we've tried to focus on purely analytical considerations to clients. We hope that by disclosing our opinions, the reader can expose and control for whatever biases we may have allowed, despite our best efforts, to creep into our analysis.

TARP "optics" look terrible to the average voter. "We made massive amounts of money making what turned out to be capital-destroying, destabilizing decisions, and now Main Street better save us for its own sake." No concrete evidence or historical fact has been given to connect TARP to Main Street benefits. We encourage you to listen to the detailed Congressional testimony by Paulson/Bernanke and review various trade journal articles. Everyone speaks generally in terms of "confidence" and dire consequences of inaction, but without some examples or evidence, the logic for TARP to the taxpayer is circular: Congress is taking a huge, almost all-or-nothing pot-shot at a plan to help Main Street avoid potential pain by sticking it with financial exposure today, with the only certain beneficiaries being those who contributed to and benefitted from the causal factors of the crisis.

There are numerous healthy, successful, untainted banks, many at the local level and some national (e.g. Wells Fargo). There's been no discussion of direct government investment in these institutions in return for their commitment to increase lending. At least, such action could be viewed as rewarding the successful versus those perceived at fault. Also, much of the heartland works for small, independent businesses and farms. Many people across the country are entrepreneurs. To them, our financial institutions are intuitively replaceable through the traditions of American entrepreneurship. We disagree with the argument that suggests loans for automobiles, education and other goods and services will disappear without intervention. We believe anything for which people will pay will quickly be provided for in a capitalist economy.

The private markets are capable of recapitalizing many if not all deserving institutions: JP Morgan, Goldman Sachs and Morgan Stanley recently raised \$30BN of private capital in a few days. Today, GE raised \$15BN including \$3BN from Warren Buffet. Private capital is perfectly capable of purchasing "toxic" assets by using the same reverse auctions the Treasury has proposed in order to deploy public funds.