

alpha+ capital management

October 10, 2008

Dear clients,

There is a lot to say.

What's going on?

A credit contraction is underway accompanied by a banking upheaval and a palpable unease about what might happen next. It is widely believed that a recession is upon us as people are obviously scared and pulling back from discretionary spending. Drop in at a favorite restaurant and see if it looks like business as usual.

The role of government has become uncomfortably important for the time being as it works intelligently to remove impediments to the normal flow of credit. The financial rescue package widely known as the "Wall Street Bailout" would more appropriately be called the "Financial Hair Ball Removal Act" because it is intended to remove a large clog of securitized house mortgage loans knowingly created without good down payment or proof of affordability under the assumption that I will ask no questions and you will tell no lies.

These assets cannot be assigned a balance sheet value because buyers do not exist and so the government was forced into the position of banker of last resort, actively buying the securities at low prices. The losses will be suffered by whoever owned the securities: banks, insurance companies, pension funds, foreign governments and, very likely, highly leveraged hedge funds.

Once the Treasury removes the clog from the credit system, the creditworthy should be able to borrow but those not creditworthy would have to be turned away. Encouraging high risk mortgages to help the poor may have been well intentioned but has been the leading cause of the upset. And we will have learned from the story of Fannie and Freddy that the credit of the USA should not again be an entitlement of any political party or private interest.

The Treasury may well turn a profit on the rescue package as the actual mortgages move through the normal repayment processes, even after high foreclosure and liquidation costs. Many investors, major and minor and some mutual funds have suffered large losses in finance industry stocks. Check the last reported prices of Merrill Lynch, Bear Stearns and AIG. And most notoriously, the government sponsored enterprises Fan and Fred.

Little sympathy and even some enmity are in evidence for the managements of the most leveraged of the players even though they personally have suffered really heavy reductions in wealth, forget about

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cash flow, and now are being treated like pariahs. The Fan and Fred story is significant for political use and someone is bound to produce a video for the run up to the election. I can imagine one called *"How to cook the books and use the national credit for personal gain"*, with a shot of Franklin Raines in a chef's hat, saying *"I took home 90 mill!"*

One new aspect of the various adjustments underway is the trading pressure which must be arising from hedge funds of the type that borrow heavily at low short term interest rates then use the money to buy and hold assets which may experience unexpected price trends, risky in itself but not so much when you then turn around and buy loser insurance from AIG.

When uncertainty makes lenders unwilling to renew the short term loans, the hedge fund is forced to shrink. A lot of that must be going on now and there is no cure but to await their collapse and then sort out the rubble. Speculators are trying to withdraw and fund managers are dumping assets for what they will bring. The extent to which such behavior is parasitic will be a subject of future inquiry.

A special note is that stock market behavior of the last few days has taken on the appearance of a classic "capitulation", a climactic bottom on big volume caused by the last wave of investors who sold simply to ease the emotional stress of doing nothing while prices decline. Be forewarned though, because the current weakness might reflect hedge fund selling and perhaps the true last wave sellers would capitulate later. I make it about 50/50.

What should we expect?

We are about to experience an attempted reinvigoration of the banking system under conditions of slowing demand for commercial use of cash for inventory or expansion. For over twenty years the rise in real estate values has been monetized by refinancing for a range of spending along with rising reliance on credit card and auto loans. Recently, the tipping point created by the wave of excess credit broke along with the asset price in that particular bubble. This time around it was real estate, commodities, synthesized securities that defy private analysis, and loss insurance without surety.

What had become a normal part of the scene has now come to an abrupt stop. Added to that the generalized tendency to react to emotional headlines and TV journalistic embellishments one develops a tendency to pull in one's belt, as it were.

Nine months ago we said we noted an increase in risk because too many dynamics could go awry: politics, the economy, junk mortgages and the war. The way we see it now, the war and junk mortgages are being handled, politics remains uncertain and economy has turned worse. The slow period may last perhaps two years after which time an expansion should be underway.

Sparking the recovery would be rising levels of activity in drilling, pipeline, nuclear plant construction, health care, implements of war, electric power infrastructure, modified vehicles and some of the more more imaginative green energy sources at which money may be throwable.

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What should be done? We think conditions justify a modest step toward favoring equities. Let's say one fifth of the way between now and fully bullish.

They'll be talking about these days a long time from now.

Stiff upper lip,

John May