WESTWOOD CAPITAL, LLC

ANALYSIS

March 23, 2009

Daniel Alpert Managing Director • dalpert@westwoodcapital.com • +1-212-953-6448

Me Too!
Look Ma, I can Earn a Positive Interest Spread with Fed Funds Near Zero and Bernanke Stomping on the Yield Curve! It's gonna be OK, Really!

Highlights

- The near daily announcements over the past two weeks, by money-center banks and finance companies, that they are making money this year on an operating income basis, have become borderline irresponsible relative to continued deterioration in value of the assets on their balance sheets and the continuing impact of a worsening recession.

- This week the Treasury, the FDIC and the Federal Reserve Bank are cooperating in the release of the details of the Public Private Investment Fund plan to remove the still-enlarging pool of troubled, and no doubt insufficiently marked, assets from bank balance sheets in an attempt to reinvigorate our lending institutions. But so much will depend on the cooperation of the banking, government and private investment sectors in ensuring that the assets weighing down financial institutions are ultimately priced to sell.

- Many of the future losses to financial institutions are already "baked in" from the already precipitous decline in financial asset values, regardless of recognition, with the rest soon to materialize given continuing valuation trends. We see another $1.5 to $2.0 trillion of as yet unrecognized loses from U.S. assets still to hit global financial sector balance sheets and challenge its institutions.

- We expect that there are considerably rougher roads ahead and it is way too early to call a bottom to any major players in the financial sector and – inasmuch as the rally over the past two weeks predominantly emanated from what we see as misplaced confidence in that sector – for the market as a whole.

- The institutional spin over the past two weeks has said basically nothing other than the fact that our banks can generate a positive interest rate margin over near zero cost of leverage and that enough of their loan assets are still current on interest payments to generate overall positive cash flow before additional reserves, write-downs and other unknowns below the line. These statements do not mean that the institutions making the statements are sufficiently capitalized relative to the true value of their assets – now, or under the additional stresses posed by the future losses from a deteriorating economy.

- We believe a bottom can only be called when the government demonstrates that it has an understanding of, and control over, the real health of our regulated financial institutions, when the government has viable plan (hopefully starting to be unveiled this week) to recapitalize them in a way that is politically palatable, and when companies stop offering vague guidance about the future and put on the table earnings targets for the ensuing 12 months that they can really and verifiably meet.

Overview

We believe this needs to be said: The near daily announcements over the past two weeks, by money center banks and finance companies, that they are making money this year on an operating income basis have become way overdone. The fact that such comments have served to spur a rally in bank and other shares makes such statements borderline irresponsible relative to continued deterioration in value of the assets on financial sector balance sheets and the continuing impact of a worsening recession. Add to the mix this week's announcement that the Federal Reserve will be buying, by the bucket load, long dated bonds issued by the government in basically any form, and we saw those with a failure to appreciate asset value fundamentals clicking the BUY button on their screens with abandon.

The condition of many classes of assets on the balance sheets of our financial institutions, as discussed below, is almost certainly more dismal than advertised. This week the Treasury, the FDIC and the Federal Reserve Bank are cooperating in the release of the details of the Public Private Investment Fund plan to remove the still-enlarging pool of troubled, and no doubt under-marked, assets from bank balance sheets in an attempt to reinvigorate our lending institutions.

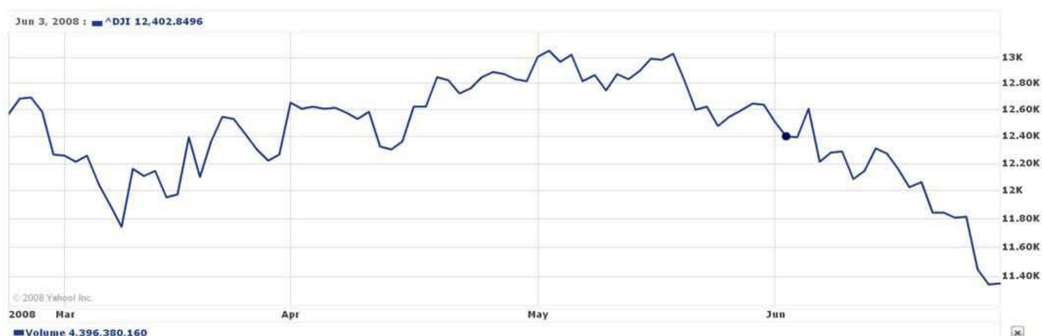
The plan will likely meet with either huzzahs or antipathy from the financial markets – but we would asset that caution is warranted, in that that the devil is very much in the details of the plan's execution. So much will depend on the cooperation of the banking, government and private investment sectors in ensuring that the assets weighing down financial institutions are ultimately priced to sell and that the subsidies offered to investors serve as substitutes for normal market financing (not currently available) rather than a way of bringing the purchase prices of toxic assets up to the levels at which the financial institutions have them marked on their books.

This analysis discusses the events of the past two weeks, in light of somewhat extreme market reaction that ensued relative to the reality of the underlying fundamentals.

Here we go again

Just as the game had not yet become clear at this time last year, a pre-Q1 earnings rally is yet again holding sway, based more on market optimism (especially about the financials) than on the ability to understand and evaluate underlying fundamentals. We are all pretty much familiar with the trajectory of last year's rally, diagramed below, but for some reason feel that all the events between then and now have resulted in a market bottom (again) this time around.

The 2008 Spring Bear Market Rally



We see the situation differently. The markets, like last year, remain enveloped in many unknowns. Banks have not yet written troubled assets down to market-clearing levels and they face what Wells Fargo CEO, Richard Kovacevich, last week termed "asinine" stress tests of banks' assets and overall capitalization. Furthermore, the value of many financial assets and derivatives thereof (especially illiquid assets on the books of regulated institutions, the value of which is being guessed at by management and regulators alike), reflect neither the full impact of underlying asset re-pricing nor the magnitude of the recession in terms of the employment and consumption levels that fell off a cliff only in the current quarter. Are these asinine factors to consider? We think not.

Home prices continue to fall and defaults and foreclosures on the +/-$11 trillion of outstanding home mortgages continue to rise. We continue to see total losses on home mortgages and their derivatives of just under $2 trillion by the end of this crisis, of which about $1.1 to $1.2 trillion have already been recognized. That is pretty much a consensus number among many market watchers, but the current rally in financials seems to discount the magnitude of the remaining losses.

What are the Likely Next Shoes to Drop?

Commercial real estate is just beginning to generate a melt-down of epic proportions. There were $3.3 trillion of commercial mortgages outstanding at the peak of the bubble, of which $830 billion were multifamily mortgages (rental apartment buildings) which we regard as relatively stable. The remaining $2.5 trillion, however, are secured by office buildings, retail centers and malls, hotels and hospitality properties and industrial buildings. Hotels have already hit the wall – we are seeing the disaster that is Las Vegas beginning to be played out all around the country. Retail centers are beginning to lose "in-line" tenants (local retailers, as opposed to national anchor tenants) or are waiving rents in order to keep such tenants from departing and turning shopping centers and malls into ghost towns. Office buildings, generally more resilient, have already seen a dramatic drop off in asking rents and a huge pick up in vacancy that is almost certain to increase. All of these factors take time to translate into mortgage defaults, but that translation is well under way as of this quarter. We expect $300 to $500 billion in lender losses from commercial real estate.

Credit card and installment sales contract delinquencies and defaults, on the nearly $2.6 trillion of outstanding consumer debt, are skyrocketing. The Fitch Credit Card Index data released this month for January showed 60 day delinquencies at historic highs. The 180 day charge off rate was at 7.4% in January and is expected by Fitch to hit 9% by year end. Auto loan and student loan default rates, while lower than credit cards, are also at historic levels. We estimate that losses in the $150 to $200 billion range are likely in this category.

Corporate debt defaults threaten at an equally alarming rate. Standard & Poor's estimates a worst-case scenario resulting in the three-year U.S. cumulative default rate between 2008 and 2010 among speculative-grade non-financials will rise to 23.2%, the worst on record since 1981. If realized, this estimate suggests that 353 speculative-grade rated non-financial firms could default between 2008 and 2010, with potentially more than 200 of these defaults materializing in the second half of 2009 and in 2010. This of course ignores investment grade corporate credits – some of which will surly turn out not to be so credit worthy (but then, what good is a credit rating these days?). With over $9 trillion of conventional and high yield corporate debt outstanding (excluding mortgage and asset backed debt) in the U.S., one can easily expect several hundred

billions in losses, many of which will come in the highly leveraged, so-called "covenant-lite" loans that enabled the wave of private equity deals that were so prevalent at the top of the bubble.

Much of the forgoing losses are "baked in" from the already precipitous decline in financial asset values (the value of real estate, consumer loans and equities), regardless of recognition, with the rest soon to materialize given continuing valuation trends. We therefore see another $1.5 to 2.0 trillion of as yet unrecognized loses still to hit the financial sector and challenge its institutions.

Calling a Bottom to an Economy on its "Bottom"

Even a thoughtful prognosis of the direction in which assets and business operations are heading does not fully reflect the potential impact of a continuing spiraling-down of employment and corporate earnings (which feed on each other). The propensity for the economy to overshoot what should be regarded as reasonable retrenchment of earnings potential and valuation, in a radically de-leveraged environment, is very significant given the insidious impact of a high level of unemployment and under-employment.

We are also very concerned about the impact of the massive decline in the values of 401(k) portfolios and large pension funds. The erosion of value will place pressure on individuals to spend less (reduced consumption) and work longer (larger labor force/higher unemployment) in order to afford retirement. In the case of defined benefit pension plans, unfunded liabilities have risen to catastrophic levels and the shortfalls will eventually have to be made up for by an outside source (a massive recovery in share values or emergency government infusions) or, in the long term, pension funds won't be able to meet their obligations to beneficiaries.

In sum, we expect that there are considerably rougher roads ahead and it is way too early to call a bottom to the share prices of any major players in the financial sector and – inasmuch as the rally over the past two weeks predominantly emanated from what we see as misplaced confidence in that sector – for the market as a whole. So as not to beat around the bush – in the current political climate there is little reason to believe that existing shareholders of even those institutions that have been deemed "too big to fail" will see any residual value if any of their particular institution requires materially more federal aid.

What is particularly alarming to us is that our capital markets feedback continues to inform us as to the principal underlying reason that the credit trading markets remain frozen with respect to so-called "legacy" assets: There appears to be a distinct unwillingness on the part of holders of illiquid and hard to value debt securities and "whole loans" to mark them to levels at which they will clear the market in a sale. This is especially true for whole loans (actual mortgages and any other loans that have not been transmogrified into securities) which banks/finance companies are not required to mark at all. Consequently, we are not only worried about future degradation of asset values and the economy, but are advised that even with respect to the carrying values of assets that have suffered significant reduction in the value of underlying collateral, existing marks on the books of financial assets are likely inadequate.

It Must be True if EVERYONE is Saying It

"Freddie Mac remains a well capitalized company."

David Duval

Freddie Mac spokesperson

April 14, 2008

"Rumors of my death have been greatly exaggerated."
Mark Twain

According to my parents, as a young child my younger brother – sick and tired of being the unnoticed and under-praised little sibling – developed a habit (no doubt universal among younger brothers, poor guys) of drawing attention to himself by announcing that he was also capable of my advanced feats by yelling "me too" and demonstrating (generally without success and hopefully without hurting himself) that he could perform in a praiseworthy manner as well. Needless to say, he also discovered the use of "me too" to elicit equal material rewards when I was a recipient thereof. The family soon dubbed my little brother "Mr. MeToo" and I doubt he was alone among little brothers in carrying that moniker or something similar[1].

The specter of large commercial banks announcing, one after the other, that they are making money and currently don't need any injections of capital is getting (like my kid brother at age three) a little embarrassing. It seems as though none of them wish to be left out of the "confidence" rally that began two weeks back with the very public leaking of an internal memo from Citibank's CEO, Vikram Pandit, to his employees. This was followed by interviews, statements and speeches from other large bank CEO's (Mr. MeToo's) declaring "me too, my bank/finance company is making money too!"

But what are they really saying?

They are saying, of course, that before the application of any additional write downs or increases in reserves at the end of the current quarter (and following quarters), their institutions have positive operating income. Surprising? Shocking? Not really.

Large banks and finance companies have been shedding staff and expenses (including not a few executive perks) for a year now. More importantly, their short term borrowing costs have fallen to near-zero levels and deposit interest rates have plummeted. Does that mean they are certifiably healthy and capable of withstanding another onslaught to their asset base? Nope. Does it mean that they will come out of the Treasury's stress tests smelling like a rose? Nope. Does in mean that they have marked their existing toxic assets to levels necessary to clear the market with potential buyers (even helped along by the Treasury's Public Private Investment Fund subsidy initiative)? Nope again.

These statements mean basically nothing other than the fact that our banks can generate a positive interest rate margin over near zero cost of leverage.

- With the ability to borrow at +/-0% from the Federal Reserve against almost any non-toxic asset they wish to pledge, banks have reduced their daily cost of funds tremendously.

- With the Federal Reserve now stepping in to hammer down the long end of the yield curve (in the hope of re-inflating the economy and lowering borrowing costs) by buying Treasury bonds and being essentially THE only bid for GSE guaranteed mortgage paper, banks will be able to increase interest margins on all sorts of loans.

- With many of their fellow banks (especially highly leveraged investment banks) consigned to the dustbin of history, the remaining banks have grown into even larger institutions with fewer competitors (J.P.

[1] Sorry bro, your past has yielded a convenient metaphor - nothing personal, love ya.

Morgan eating Bear and WaMu; Wells Fargo swallowing Wachovia; Bank of America digesting Merrill, and the list will lengthen).

With lower costs, wider interest margins, and less competition, the Me Too statements from our financial institutions amount to nothing more than an assertion that enough of their loan assets are still current on interest payments to generate overall positive cash flow before reserves, write-downs and other unknowns below the line. What these statements do not mean is that the institutions holding piles of distressed assets are carrying them at values reflective of their ultimate collectability in accordance with their terms, to say nothing of current market values. They do not mean that the institutions making the statements are sufficiently capitalized relative to the true value of their assets – now, or under the additional stresses posed by the future losses anticipated above.

The really sad part is that they can probably scream ME TOO! for another few weeks, perhaps even straddling the quarter end and showing real earnings, until increasing payment defaults (and the stress tests) ultimately force institutions to take the next round of hits to assets.

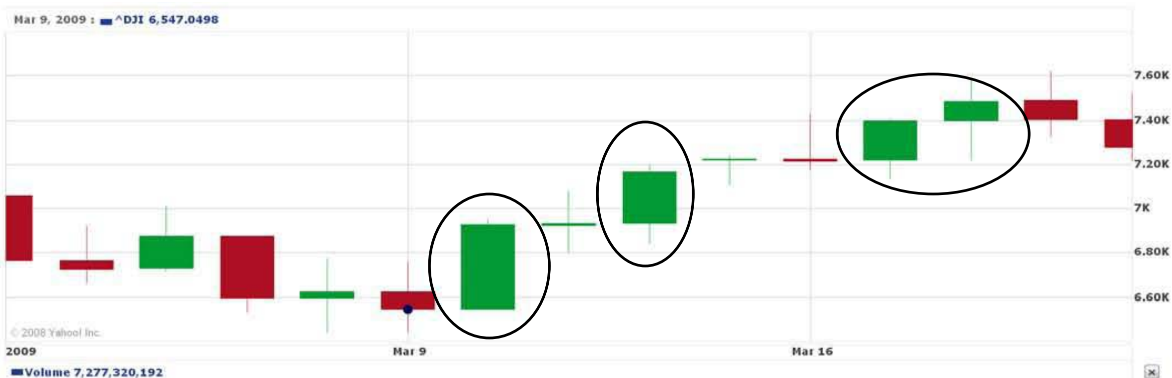
Itchy Trigger Fingers – Making Much of So Little

The financial markets have been so beaten down that it is, we suppose, not surprising that the least bit of potentially good news or well spun PR would generate "panic buying" – the result of fear among investors that they will miss the market bottom and potential profits.

The Citibank Spin Memo

The market hit its closing low for the year (so far) on the 9th of this month with the DJIA plummeting to 6,547 (a level not previously seen since 1996). It was not unrealistic for investors to be seeking a bottom and, the following trading day, the market had its impetus for a rally in the form of the spin memo, discussed above, released by Citi's Pandit, the day that institution's shares reached an intraday all-time low of 97¢ (yes, that's cents). Based on this first of the several "we're makin' money" missives to come, the market rallied strongly on the 10th (to DJIA 6,926 – the first oval on the diagram below) – more on relief than sound fundamentals, given our analysis herein.

The Beginnings of a Spring 2009 Rally?



WESTWOOD CAPITAL, LLC

Retail Sales Data

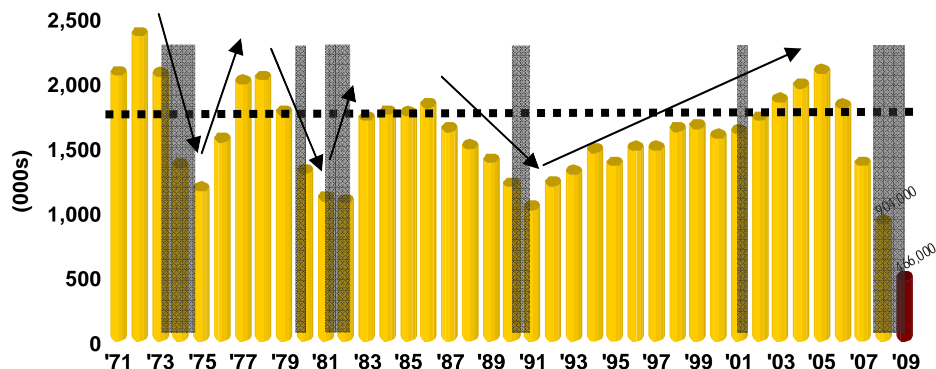
In the area of general economic fundamentals, the "good news" was kicked off this month on the 12th (two trading days after the low for the decade, and the second oval in the diagram on the preceding page) when retail sales for February were preliminarily announced to have fallen by a less than expected 0.1%, and rose 0.7% after eliminating auto sales, from the month before. A few issues here. First, the 90% confidence interval for these numbers is a full half percentage point. Second, retail sales numbers are often substantially revised by the Department of Commerce in subsequent reports. Third, the numbers reflect seasonal adjustments (which for a slow month like February, would be upward adjustments, one imagines, reflective of consumer behavior in typical years – and this is certainly not a typical year). And fourth, sales were down a whopping 8.6% from the February before (about 5% excluding autos) AND the numbers aren't adjusted for inflation, which was actually a positive 0.2% from last February, so the decline is that much worse.

Objectively not a reason for dancing in the streets, especially relative to what threatens the economy down the road, but the DJIA rallied 240 points on the 12th.

Housing Starts

Then we had the release by the Census Bureau, on March 17th (the third oval in the diagram on the previous page), of housing starts and related data for February 2009. This highly volatile number reflects the number of homes which construction began, on a seasonally adjusted basis, during the preceding month. The starts number was – at face value – up slightly from January's starts, rising at a seasonally adjusted annualized pace to 583,000 units from 477,000. But that's just the headline number – take that anywhere below the surface and you have a very different story:

- Starts are down over 47% from the same period last year. Moreover, the annualized pace of new starts has averaged over 1.5 million units for the 30 years preceding the current housing cycle. That means the current levels of production are down more than 60% from a pace that has been a primary driver of the U.S. economy since the 70's.

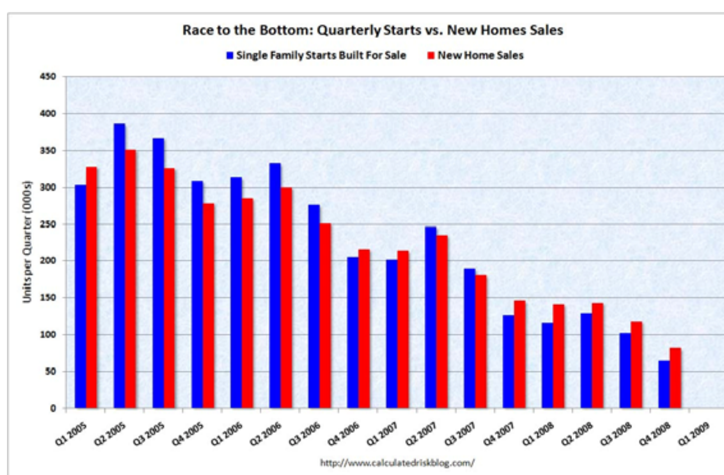


- The headline housing starts number is both seasonally adjusted and annualized. In fact, the total number of February starts counted by Census was only 40,400 nationwide (a pretty small number of new homes in a country with household growth of over 100,000 a month). That would (multiplied by 12) result in an unadjusted annualized pace of 484,000, with the adjusted pace being over 20% higher. The seasonal

adjustments (as in the case of retail sales, discussed above) reflect trends established over past years – and this year is not at all expected to be like past years.

- Finally, the housing starts number contains both rental and for-sale housing. About 35% of housing in America is rental housing and most of that is in multi-family structures. Much of the multi-family (five units and over) construction is for rent (with the balance being condominiums, although there are few condo starts in the current market as one might imagine). Here's the rub – of the 40,400 homes that actually started construction in February, only 24,600 were single family (most, but not all, being built for owner occupancy). That's down to 61% of all starts, from 66% in February 2008 and 77% from the year 2007. Throw in the fact the single family starts include homes commissioned for construction by owners and, essentially, the homebuilding industry – the business of production building of home for sale – has ground to a historic halt, along with the jobs and materials sales generated by it.

Housing starts data, although misunderstood this past week by many, has good and bad elements associated with it (although the margins of change reflected in the February data do not diverge from already established trends). A decline in home starts is – while not an economic positive – part of the bitter medicine that needs to be endured in order to reduce the enormous overhang in both new and existing home inventories. As the adjacent diagram illustrates, housing starts of homes built for sale (as opposed to rentals) have fallen below the level of new home sales (which our industry contacts tell us have picked up over the past six or so weeks, with continued price discounting and improvements in mortgage interest rates), meaning that inventory is being worked off. The flip side is, of course, the necessary decline in single family, owner-occupied, housing development is a huge drag on the real estate investment component of GDP – and that is unlikely to recover until the overhang in existing and new home inventories is substantially absorbed. We believe that point is 12 to 18 months away.



The Fed's Houdini Act

The market rally of the past two weeks reached its apogee with the announcement by the Federal Reserve on the 18th (on the occasion of its usual statement at the conclusion of a meeting of the Federal Open Markets Committee) that it was, for the first since the 1960's, entering the market to purchase long-term government bonds and stepping up its existing program of purchasing government-guaranteed mortgage securities. The Fed finally found itself chained by having eliminated its principal tool for influencing the economy – the control over short term interest rates – having previously reduced the Fed Funds rate to essentially zero. Consequently, to escape its self-wrapped chains, the Fed has resorted to quantitative easing – growing the balance sheet of the central bank by printing money and pouring more cash into the markets in an attempt to spur economic activity by buying, essentially, the government's own securities.

The impact of quantitative easing, in textbook analysis, is generally straightforward. It obviously forces the long end of the yield curve downward ("flattening" it) as government bonds rally in response to the central

bank's intervention. It is generally inflationary and tends to devalue the currency of the country engaging in it. After all, the central bank is flooding the markets with cash in an attempt to avert deflation, among other things. The market reacted to the move with an initial surge in equities, a huge pop in commodities and the tanking of the U.S. dollar.

But, again, this is not a simple issue. The flattening of the yield curve is desirable in many circles – interest rates at the long end had crept up because of expectations of generalized future inflation caused by the mammoth government bailout spending – in order to bring down long term borrowing costs (such as those for mortgages) throughout the economy. But quantitative easing is a blunt instrument for doing that. Bond rates came down immediately, but mortgage rates only came down by half as much as lenders used the other half of the savings in cost of funds to improve their own margins (spreads).

The rally in commodities and the devaluation of the currency is a direct reaction to anticipation of additional inflation around the bend. But it may turn out to be a very long bend, in that the printing of more money and the incurrence of additional government debt in this crisis is essentially plugging up the huge holes in the economy caused by the losses discussed above. In effect, much of what is occurring is the transfer of private sector and GSE indebtedness onto the books of the government. These moves are therefore not, by themselves, inflationary, as no net new capital is being created to fuel inflation. Also, it has been shown that not all quantitative easing results in inflation – Japan's history in the early part of this decade is case in point. Of course, inflation may ultimately occur as the global recession eventually subsides, the capital shortages are plugged, and economies begin to grow. But in the meantime, with the U.S. currency and economy a haven and the "winner amongst losers," it is likely that the market reaction to the Fed's announcement was very premature.

The desire to lower interest costs, in this most severe of all contractions since the Great Depression, is understandable. But this crisis was caused by an asset inflation bubble, in turn fueled by irresponsible credit creation. As the analysis above demonstrates, our economy remains besieged by over-leveraged assets and distressed borrowers. It's the outstanding debt principal, not just the interest costs thereon, that is the feature of this crisis. There is a dearth of creditworthy borrowers and equity against which to lend. Until that problem is resolved – the recession will not subside.

Conclusion

There will obviously come a point where the equity market reaches a decisive bottom. We believe it will come when two things happen:

(i) when the government demonstrates that it has an understanding of, and control over, the real health of our regulated financial institutions, and a plan (hopefully starting this week) to recapitalize them in a way that is politically palatable (whether that involves partial nationalization or some other series of solutions); and

(ii) when companies stop offering vague guidance about the future and put on the table earnings targets for the ensuing 12 months that they can really and verifiably meet.

At that point, with conviction that the economy/government can absorb whatever additional losses are to come and the financial sector can once again resume the business of capital formation, we believe that

investors will place on those hard earnings forecasts an old-fashioned 10x multiple (essentially buying companies not for growth, but for what they produce today) and a bottom will be struck. Then, we can – with sober expectations – begin to share in the slow and steady rebuilding of our nation and its economy.

This analysis ("Analysis") is for discussion purposes only and intended only for Westwood Capital LLC ("Westwood") clients. This Analysis is based in part on current public information that Westwood considers reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. Westwood's business does not include the analysis of any specific public company or the production of research reports of the same. Westwood may produce other opinions, published at irregular intervals. Westwood's employees may provide oral or written market commentary to Westwood clients that reflect opinions that are contrary to the opinions expressed in this Analysis. This Analysis is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction. It does not constitute any recommendation or advice to any person, client or otherwise to act or invest in any manner.

This Analysis is disseminated primarily electronically and, in some cases, in printed form. Electronic research is simultaneously available to all clients. Disclosure information is also available at http://www.westwoodcapital.com/.

If this Analysis is being distributed by an entity other than Westwood or its affiliates, that entity is solely responsible for distribution. This report does not constitute investment advice by Westwood, and neither Westwood nor its affiliates, and their respective officers, directors and employees, accept any liability whatsoever for any direct or consequential loss arising from use of this Analysis or its content.

Daniel Alpert is a Managing Director and Founding Partner of the New York investment bank Westwood Capital, LLC, and its affiliates. He is a frequent commentator on the housing and credit crises on the CNBC, FoxBusiness and Bloomberg networks, as well as in leading newspapers, periodicals, and websites.