



About Bob Andres

Bob is the Chief Investment Strategist for PMC and is responsible for the communication of our economic viewpoints and investment strategies to the marketplace we serve. Bob serves as a source of insight and perspective to advisors and their clients. He regularly engages with advisors in support of their client meetings, presentations and conference calls.

His business pedigree includes:

- President of Merrill Lynch Mortgage Capital Corporation.
- Vice President and Manager of Merrill's secondary corporate bond trading division.
- President and Co-Founder of Martindale Andres & Company, a firm that managed in excess of \$2 billion in assets.

Bob has been featured in Barron's, Institutional Investor and a broad array of financial publications throughout his career.

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Paulson's BARF

By: Bob Andres, Chief Investment Strategist

Paulson's TARP program, which has endured many versions since its inception, has now morphed into Paulson's "BARF" program right before our eyes. The "Troubled Asset Relief Program" should now be appropriately titled the "Bank Assistance Relief Fund." This name is fitting for multiple reasons, not all of which are economic.

Secretary Paulson, who throughout the summer and fall suggested, "We will not solve the current crisis until we solve the housing and mortgage-backed securities market problems," has now proposed that troubled asset purchases are "not the most effective way to use TARP funds." He recommends that the remaining funds would be used for capital injections, stabilizing markets for securitizing credit, and reducing the risk of foreclosures. This is an ill-conceived reactionary strategy that represents a return to a policy of what we refer to as "Whack-A-Mole." It does not represent a studied rational approach aimed at moving the ball forward, nor does it build investor confidence.

The market for non-agency mortgage-backed securities declined by approximately 10 points last week as a result of Secretary Paulson's actions. The Secretary's decision unfortunately coincides with Standard & Poor's decision to re-rate (downgrade) mortgage-backed securities. Mortgage paper issued between 2005 and 2007 has an average valuation of around 60 cents on the dollar even though these assets do not have more than a 5% to 10% delinquency rate. It is ironic that the recent actions of both S&P

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and the Treasury Secretary are causing additional paper losses for the very institutions (banks and pension funds) that Treasury Secretary Paulson is attempting to support with the “BARF program.” Sheila Bair, Chairman of the FDIC, now appears to be the only administration official who clearly understands that if you don’t resolve conditions in the housing market, the crisis will continue, and in all likelihood, get worse.

What has always been a puzzle to us is why policy makers, suggesting they want to save the taxpayers money, do not simply buyout the delinquent loans. It is the cheapest and most efficient way of returning value and liquidity to the mortgage-backed securities market. There was approximately \$2.5 trillion non-agency mortgage paper issued between 2005 and 2007. Let us do the math: If 10% of the \$2.5 trillion went into default we are dealing with a gross number of \$250 billion in damaged products. Now let’s assume that the “average loss severity” maxes out at 50%. When a foreclosed home sells for less than what the borrower owed to the mortgage lender, the lender suffers a loss. The amount of that loss is known as the “loss severity,” which includes the costs to foreclose and liquidate a home in securing a defaulted mortgage, as well as any decline in property value. The total cost to purge the market of troubled loans would be approximately \$125 billion. This approach would save the taxpayers an enormous amount of money while returning the mortgage-backed securities market to a more normalized state in a nanosecond. A good question to ask, “Why has this approach not been employed?” We suspect the reason that this method has not been utilized (assuming it has been discussed) is the concern for creating a “moral hazard.” In other words, they may be wary of setting a precedent from which it would be difficult to extricate in future years. This appears to be the case, despite empirical evidence indicating that as many as 93% of families who are underwater eventually pay their loans. Most people recognize that housing prices will eventually recover and that one ultimately has to live somewhere. The concept of a house as an investment will come to be viewed as a historical aberration.

The intent of the new BARF program is to stabilize the financial system through equity capital injections and to revive the market for ABS (asset-backed securities) in an attempt to stimulate non-mortgage consumer lending. We assert that direct capital injections have done nothing to reduce bank losses and clearly have done nothing to reinvigorate the housing market. We would also suggest that reviving the market for MBS (mortgage-backed securities) would currently provide a broader array of benefits than any revival of the ABS market. Confidence in equities is not enhanced by the

Treasury's program, which is dilutive to current shareholders. The fact that the initial TARP program has been jettisoned raises questions of how much thought went into the original rationale, how politics has affected the current decision since then, and the suitability of the new BARF program. Let's hope that Paulson's Bank Assistance Relief Program does not morph into Paulson's Credit Relief Assistance Program (no acronyms necessary.)

Inflation/Deflation Assessment

Inflation - Earlier this past summer, we expressed our disagreement with Philadelphia Fed President Plosser's hawkish views on inflation. We suggested that there was a set of merging factors in play that will actually dampen inflation and inflationary expectations over the near-term. We pointed to ten key factors supporting our position, three of which are repeated below for emphasis:

- The real estate decline clearly represents a strong deflationary force.
- Prolonged below-trend GDP growth should eventually be helpful in offsetting commodity inflation.
- Rising unemployment and declining jobs (non-farm payrolls) reduce worker wage leverage, thus mitigating a major component of a potential wage-induced inflationary spiral. Rising productivity also works against a wage spiral. It compensates employers for higher wage costs while allowing employees to receive increases in real wages without affecting the company's margins.

The Consumer Price Index is scheduled to be released on Wednesday. We expect to see a precipitous month over month decline as deflationary forces continue to exert their influence. These deflationary forces should cause headline inflation to approach zero with a strong likelihood that we will see a crossover to a negative CPI in the near-term. Break-even inflation analysis supports this contention. This analysis, defined by the difference between U.S. Treasuries and Treasury Inflation-Protected Securities (TIPS), is commonly employed by market participants to measure expected inflation. The current break-even rate extending from short to intermediate securities is actually negative, implying that markets are pricing in an extended deflationary period.

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be happy to add you to our
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Economic Calendar

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	Survey	Prior
Tuesday 11/18		
PPI (MoM)	-1.9%	-0.4%
Total Net TIC Flows	N/A	-\$0.4B
NAHB Housing Market Index	14	14
ABC Consumer Confidence	-49	-50
Wednesday 11/19		
MBA Mortgage Applications	N/A	11.9%
CPI (MoM)	-0.8%	0.0%
Core CPI (MoM)	0.1%	0.1%
Housing Starts	780k	817k
FOMC Minutes (Oct. 28-29 Meeting)		
Thursday 11/20		
Initial Jobless Claims	503k	516k
Leading Indicators	-0.6%	0.3%
Trade Balance	-\$57.0B	-\$59.1B
Philadelphia Fed	-35.0	-37.5

source: *Bloomberg*

* As of 9/30/08