

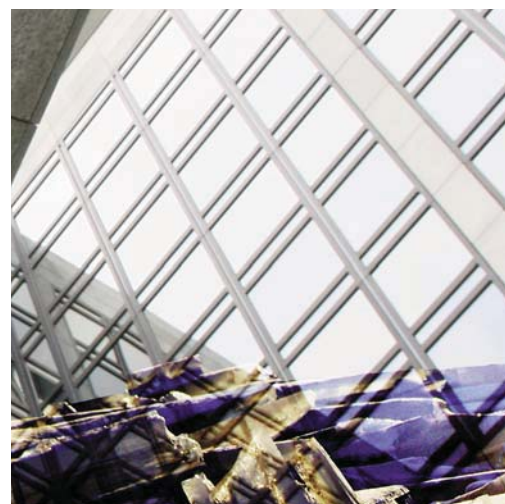
Capital Markets Update: Is This the Worst Ever Yet?



The current recession is one of the worst in the past 40 years but don't count out the U.S. economy. With a modicum of political leadership and stable economic policy we will get through this stronger than ever.

Capital Markets Update: Is This the Worst Ever Yet?

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Last fall, we examined how the 2008 recession compared to the six recessions of the last 40 years. At that time we noted that today's recession was the "least worst" of the seven episodes as of that time. Our updated analysis indicates that we are in the midst of the second-worst recessionary period of the last 40 years, and it is worsening quickly.

But do not bet against the U.S. economy. Entrepreneurs are still out there, and with a modicum of political leadership and stable economic policy we will get through this stronger than ever. However, it will take more time than we thought, due to the needless panic that was created by our political "leadership."

The dotcom bubble gave rise to a belief that fabulous riches can be achieved by age 30 (35 if you are dumb) through financial models, flip books and PowerPoint presentations. "Only chumps work past 35" became a prevalent culture. But great business enterprises, and the jobs and fortunes they create, are the result of decades of hard work and execution, not nifty models. Getting rich slowly is the American way, and most overnight successes prove to be fool's gold.

There is no substitute for rolling up your sleeves every day and working hard on the details. This is true even if you are a genius. We have done capitalism a great disservice by not saying that the "get rich quick" emperor has no clothes.

"Debt is wonderful on the upside, but remorseless on the downside. This **lesson** will hopefully be remembered for a new generation."

We Called It – Almost

Starting in December 2005, we wrote that failed political leadership, Fed policy errors, and private sector hubris would cause a recession in 2009. Did we foresee the magnitude of the Great Capital Strike or the current recession back then? Of course not. But we knew that humans being human meant that hubris would have its day. The last time it was tech, while in the 1980s it

"Worst Ever" U.S. Recessions Over the Past 40 Years

	Dec 1969- Nov 1970	Nov 1973- Mar 1975	Jan 1980- Mar 1980	July 1981- Nov 1982	July 1990- Mar 1991	Mar 2001- Nov 2001	Dec 2007- Jan 2009
Duration in Months	12	17	3	17	9	9	14
Change in GDP (%)	-0.4%	-3.5%	-0.7%	-2.7%	-1.4%	-0.2%	-1.6%
Change in Payroll Employment (%)	-1.2%	-1.6%	0.2%	-3.1%	-1.1%	-1.2%	-2.5%
Change in Real Household Net Worth (%)	1.7%	-10.1%	-1.8%	-1.4%	-3.5%	-3.4%	-4.3%
Change in Auto Sales (%)	-29.2%	-30.4%	-15.9%	-12.5%	-15.2%	-6.2%	-40.9%
Change in Industrial Output (%)	-7.1%	-15.0%	-0.8%	-8.5%	-4.4%	-4.0%	-12.8%
Change in Real Sales by Retail Stores (%)	-2.1%	-9.5%	-4.9%	-5.1%	-5.2%	-1.3%	-13.9%
Change in Construction Contracts for C&I Buildings (%)	-37.6%	-52.2%	-21.1%	-41.3%	-25.0%	-33.6%	-36.0%
Percent Real Return in S&P 500	-23.2%	-39.9%	-12.9%	-23.2%	-16.5%	-11.3%	-51.5%
Change in Real Median Home Price (%)	-15.8%	-4.0%	-3.1%	-8.7%	-6.2%	-1.1%	-14.6%
Change in Real After Tax Profit (%)	-13.3%	-30.4%	-12.7%	-6.8%	-12.3%	-8.3%	-4.4%
Lowest Consumer Confidence Level (Monthly)	72.4	57.6	62.1	65.7	65.1	88.6	25.0
Change in Housing Starts	-17.5%	-30.5%	-32.7%	-25.1%	-31.6%	2.1%	-55.5%
Highest Inflation Rate (Monthly)	6.4%	12.2%	14.6%	11.0%	6.4%	3.6%	5.5%
Highest Unemployment Rate (Monthly)	5.8%	8.3%	6.3%	10.7%	6.8%	4.8%	7.6%

"Worst Ever" U.S. Recessions Over the Past 40 Years

	Dec 1969- Nov 1970	Nov 1973- Mar 1975	Jan 1980- Mar 1980	July 1981- Nov 1982	July 1990- Mar 1991	Mar 2001- Nov 2001	Dec 2007- Jan 2009
	Rank Order (7 is Worst; 1 is Best)						
Duration in Months	4	6.5	1	6.5	2.5	2.5	5
Change in GDP (%)	2	7	3	6	4	1	5
Change in Payroll (%)	3.5	5	1	7	2	3.5	6
Change in Real Household Net Worth (%)	1	7	3	2	5	4	6
Change in Auto Sales (%)	5	6	4	2	3	1	7
Change in Industrial Output (%)	4	7	1	5	3	2	6
Change in Real Sales by Retail Stores (%)	2	6	3	4	5	1	7
Change in Construction Contracts for C&I Buildings (%)	5	7	1	6	2	3	4
Percent Real Return in S&P 500	4.5	6	2	4.5	3	1	7
Change in Median Home Price (%)	7	3	2	5	4	1	6
Change in Real After Tax Profit (%)	6	7	5	2	4	3	1
Lowest Consumer Confidence Level (Monthly)	2	6	5	3	4	1	7
Change in Housing Starts	2	4	6	3	5	1	7
Highest Inflation Rate (Monthly)	3.5	6	7	5	3.5	1	2
Highest Unemployment Rate (Quarterly)	2	6	3	7	4	1	5
Total Rank Score	53.5	89.5	47	68	54	27	81
Number of Worst	1	6	1	3	0	0	5
Number of Bests	1	0	4	0	0	9	1

was commercial real estate. This time it was Fed policy errors fueling hubris in housing and finance. And talk about hubris: Financial firms operating at 35:1 debt-to-equity ratios apparently believed they were incapable of 3% errors, which would wipe out all equity.

The serial disaster of the Troubled Asset Relief Program (TARP) turned a typical recession into a very serious recession. After failing to save Lehman but supporting AIG and forcing several shotgun mergers, former President Bush, Fed Chairman Bernanke, Treasury Secretary Paulson, both presidential candidates and the "leadership" on both sides of the aisle in Congress triggered widespread panic when they announced on September 24 that the world would end if they did not enact legislation saving us. Overnight they generated total panic on Main Street.

On the morning of September 29, they then announced that they had drafted the legislation that would save mankind, only to watch as their handiwork was handily defeated. Let's be brutally honest: No true political leader would ever call for a critical vote without knowing he or she had the votes. The magnitude of this political failure was grasped by investors, who wrung their hands with a 9.7% sell-off (September 26 versus September 29 S&P 500 close).

The farce did not end there, as four days later Congress easily passed the same basic TARP proposal, supplemented with loads of pork, including appropriations for a NASCAR race track and wooden arrowheads.

This political travesty, combined with the complete abandonment of economic policy for ad hoc decision making, caused a run on banks and money market funds, and a surge of hedge and mutual fund redemptions.

Instead of clear and consistent policies, the Bush Administration took on the transparency and consistency of Mugabe's Zimbabwe or Putin's Russia, with policy abandoned for ad hoc "deals." But when the rules of the economic game disappear, so too do the people willing to play that game. So it is not a surprise that when economic rules became idiosyncratic and unpredictable, people rushed to cash and government bonds. The "deal" approach of the past six months

* 2008, Construction Contracts, comparisons are through 2Q08.

2008 Median Home Price comparisons are through Oct 2008.

2008 GDP, Net Wealth, A/T Profit are through 3Q 2008

2008 S&P Percent Real Return calculated at lowest reading on 11/20/08

2008 Payroll Employment, Auto Sales, Industrial Output, and Real Retail Sales are through Nov 2008

Analysis: When comparing this January analysis to the one done through July, the 2008 "recession" score has increased by 42 points and is now is the "second worst" overall instead of the "best" out of all 7 historical periods examined. Similarly, 2008 now only ranks the "best" in 2 categories instead of 4, and is the "worst" based on the decline in the S&P 500 index, Housing Starts, Auto Sales, Real Sales By Retail Stores, and Consumer Confidence. The latest data show that today's economy lost ground compared to previous periods in GDP, auto sales, home prices, duration, retail sales, and the unemployment rate.

created a far deeper recession than necessary and will go down as one of the darkest eras of U.S. economic policy.

The disaster continued when, on October 14, Mr. Paulson (after appointing an inexperienced 35 year old to head TARP) announced that he would use \$250 billion of the \$700 billion to inject preferred equity in selected banks, after months of saying that this was not the right path. Then on November 12, Mr. Paulson announced that he would not purchase any troubled assets, but would inject funds into banks and other companies (like auto makers). This announcement was delivered with no apology and no apparent concern for the consequences of such a wildly changed "policy." Stocks fell another 5.2% and volatility grew as policy evaporated.

As governments around the world stepped in to prop up their banks, global stock markets plummeted, registering their opinion on the long-term impact of the global drift toward socialism and ad hoc "pragmatic decision making" rather than markets and consistent economic policy.

Be Wary of Saviors

In the past few months, we have discovered what it is like to live in a world where economic successes and failures hinge primarily on government dictate rather than on satisfying customers and competition.

Uncertainty is the deadly enemy of efficient decision making, and the government's daily attempts to "save us" ratcheted up the level of economic uncertainty. As uncertainty skyrocketed, the economy collapsed. Short-term Treasury bill yields took a nosedive, resulting in negative real returns and just as the economic fabric is thin in government-dictated economies like Russia, Zimbabwe and Venezuela, so too the collapse of the rule of economic law has crippled the U.S. economy. This abrogation of rules was underscored by the lame duck Treasury's decision to bail out the Hopeless Three automakers, within 24 hours after U.S. lawmakers defeated a bailout bill that was opposed by 65% of Americans. This decision made a mockery of the legislative process and was the nearest thing to a coup d'état we have witnessed in the U.S. during our lifetime.

The economy will rebound from a needlessly deep recession far more quickly than most anticipate. A major and widely overlooked cause of the worldwide recession was the precipitous run-up in oil prices to \$147 per barrel. As rapidly elevated oil prices worked through economies around the world the economic burden became unbearable, and global growth plummeted from 4.5% to less than 2.5%.

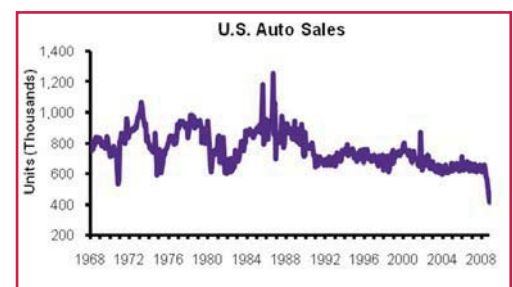
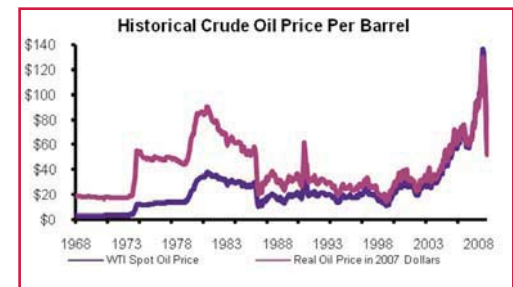
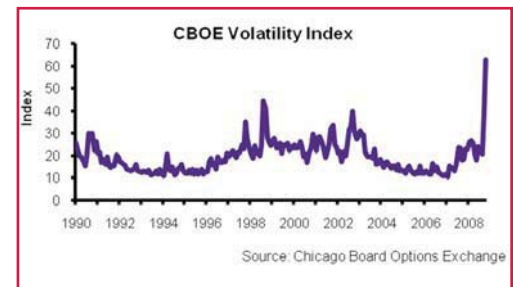
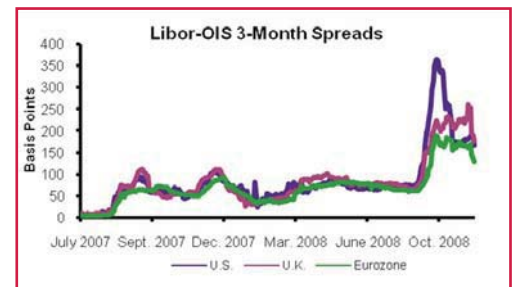
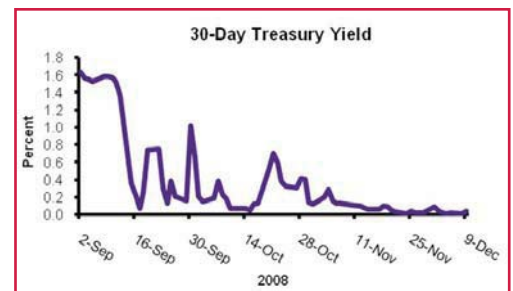
U.S. auto sales declined roughly 30% from their peak in the third quarter of 2005, while consumer real expenditures on gasoline and related products fell by 6% over the same period.

There are reasons why governments around the world sold off much of their nationalized interests over the past two decades, including:

- Scandals arising from political lending, hiring and contracting at nationalized firms
- Lack of financial and managerial innovation
- Lack of responsive customer service
- Growing subsidies to support inefficient financial entities
- Large losses suffered on loan portfolios
- Politicians retiring to well-paid cushy bank directorships

And remember that it was a state-owned German bank that was so asleep at the wheel that it wired €300 million to Lehman minutes before Lehman declared bankruptcy. Also, recall the political corruption that characterized state-owned banks in Mexico and Italy. And let us not forget the horrid underwriting record of state-owned Chinese, French and German banks.

Why was Bear saved from bankruptcy but not Lehman? Why did TARP initially focus on a buy-in of assets rather than guarantees or equity infusions? Why was the buy-in plan dropped in favor of cash injections just weeks later? Why was \$125 billion in preferred equity earmarked for eight





selected banks? Why were the Hopeless Three provided access to TARP after Congress said no to subsidies? No one knows or is willing to share the answers to these basic questions.

The absence of a clearly articulated economic policy may be understandable, but not forgivable. This is an era in which reporters were embedded with our troops in Iraq to assure that they “got the message out” expeditiously. The absence of a message in this case created widespread financial and economic panic, with cascading consequences.

Trust Matters

Every society requires a trust, without which they degenerate into petty survivalists. The primary function of government is to codify basic legislation that revolves around the beliefs that debts will be repaid, that entities seeking debt and equity truthfully reveal all relevant information and that governments will punish wrong-doers and not act capriciously. It is reflective of the serial failure of political leadership that from September 13 to November 21, not only did the stock market collapse and debt spreads substantially widen, but the commercial paper market all but ceased to function, and money market funds teetered. LIBOR spreads over the Fed Funds rate spiked 53% (from 248 basis points the day before the initial failed TARP vote to 380 basis points on October 10). REITs fell by 76%, while AAA CMBS spreads rose by 138 basis points, and the S&P 500 fell by 25.9%. Only the strongest and most transparent non-financial borrowers have been able to overcome this lack of trust. It reached the point where real yields on 30-day Treasuries reached -1.57%, underscoring the fact that many savvy investors were happier to experience guaranteed losses of nearly 2%, rather than stumbling into a huge loss. In addition, as of December 19, the 30-year Treasury yield was 2.6%.

What is needed is the immediate and total disclosure of all assets and liabilities (with no materiality, safe harbor or off-balance sheet exceptions) from any institution with access to any form of state or federal guarantee. It would allow investors to assess who holds the losses, restoring basic financial trust, and would quickly reveal which financial institutions are insolvent, allowing public and private liquidity infusions to be given only to the living, while an RTC-like agency set about the orderly liquidation of the dead.

We are in a mine field of losses, but these losses are finite. The mines the economy faces are the future losses associated with poorly underwritten investments made from 2004 through early 2007. The trouble is we do not know how big these losses are, when they will occur, which firms hold these assets or if these losses will wipe out their equity. Until the location of the losses is revealed, the economy and capital will largely stand around in a worried state, rather than moving forward.

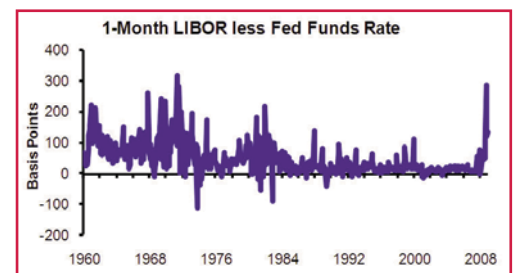
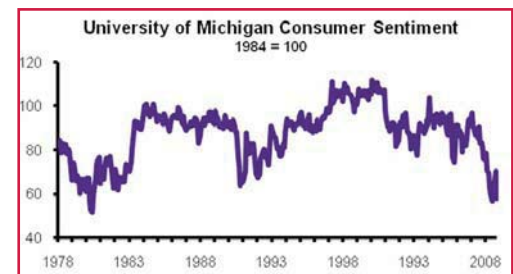
This is going to be a recession rivaling 1973-1975, and it is going to take time to work our way through it. Unfortunately, the politically created panic perfectly coincided with the Christmas retail season. People fell into a post-9/11 mentality, where even if they had money they did not spend because it seemed like the wrong thing to do.

Time for a Stimulus Package?

Regarding the much talked about stimulus plan, we are skeptical. What most people forget is the impact of substitution. For example, if the government were to buy school lunches for every single student in America, what will happen to spending on school lunches? It is true that the government will spend more, but as a result, the private sector will spend less. This huge offset will in turn result in very little or possibly no net “stimulus” at all.

Second, as we have seen in the past three years, a bill has not been passed without being padded with ample pork. With all of the well-intended (effective or not) stimulus spending will come earmarks for pet projects. This will not stimulate the economy; but rather, will simply burn money.

And so historically what undercuts most stimulus packages in this country and in others are the substitution effect and the pork effect. In the 1990s the Japanese spent unprecedented sums in



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stimulus packages that did absolutely nothing except increase their national debt. Most projects were pork and the rest were offset by a decline in consumer spending.

In the U.S., the most productive targets for a stimulus package are infrastructure projects – where the consumer substitution effect is minimized. However, the problems with infrastructure spending are twofold. First, infrastructure projects take time, and second, long timelines inevitably degenerate into pork projects. When you really want to have a meaningful impact on infrastructure – building much-needed bridges, repairing damaged tunnels, road widening, etc. – nothing is spent in the first year or two. The real money will not get spent until three or four years into true infrastructure programs when planning and analyses are complete. Therefore, what unfortunately happens is that the legitimate infrastructure projects get pushed aside and the pork projects with shorter time-frames compete for immediate funding.

The Way Forward

Contemporaneous descriptions of past recessions are always characterized negatively with no hope for the future. Yet even as boardrooms, analyst reports, the media and government officials make such statements, a sustained recovery is generally only months away. This time will be the same.

No modern recovery has had a “catalyst” to turn things around. In each case, sustained productivity growth, population growth and a return to fundamentals were the routes to resumed economic growth. And the growth was not driven by an industry or sector, but rather by a broad based recovery with isolated lagging sectors. This time will be the same. CMBS must return to its simple roots:

- LTVs of 50-60%
- Simple pass-through structures
- High debt coverage ratios
- Pools of assets with similar risk characteristics (all apartments, for example)
- Over-collateralization

This simplified structuring would restore transparency, and when fear is rampant transparency and simplicity maximize value.

The best news for real estate is that new construction financings were virtually non-existent in late 2007 and 2008. This will continue into 2009, meaning that weakening demand fundamentals will meet limited supply expansion, rather than the exploding supply that usually appears at the end of an economic cycle.

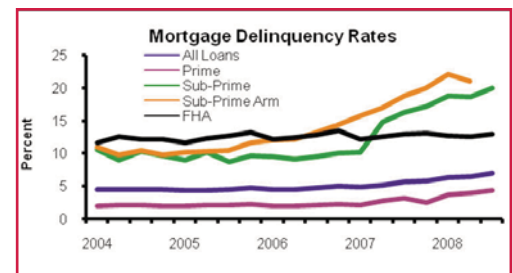
Housing prices are down 4% year-over-year for the nation, based on the OFHEO housing price index. By mid-2009, you will see the housing markets start to shift from an excess supply to the very early stages of an excess demand.

The roughly \$1 billion in global losses by financial institutions are primarily associated with loans that are fully current. This means the losses are primarily conjectural losses associated with current loans.

Are these staggering paper losses reflective of future cash flow losses, a greater liquidity premium, an increased risk premium or sheer irrational panic? Probably all of the above, but no one knows for sure, as the actual losses will not be known for many years. Only when every outstanding loan originated in 2004-2007 is either retired in three to 25 years or settled via a post-foreclosure sale will the actual losses be tallied. Until then, it is a pure guessing game.

If instead of disclosing the loss mines and getting the economy moving forward we point fingers,

“We must resist the urge to save everyone. Losers must lose if winners are to prosper... **death** is essential to life.”



MSA	Case-Shiller vs. OFHEO Home Price Changes Through 3Q08					
	Case-Shiller % Change			OFHEO % Change		
	YE 2005 to 3Q08	1- Year	3rd Qtr	YE 2005 to 3Q08	1- Year	3rd Qtr
Atlanta - GA	(5.8)	(9.5)	(1.5)	2.4	(1.8)	(2.3)
Boston	(10.3)	(5.7)	(0.8)	(8.9)	(4.1)	(2.7)
Charlotte - NC	7.9	(3.5)	(2.3)	15.9	1.6	(1.7)
Chicago	(9.4)	(10.1)	(1.5)	2.2	(3.8)	(2.7)
Cleveland - OH	(10.5)	(6.4)	0.2	(7.8)	(5.7)	(5.1)
Dallas - TX	(0.2)	(2.7)	(0.4)	8.7	2.6	0.0
Denver	(4.8)	(5.4)	(0.5)	(1.9)	(1.0)	(2.2)
Detroit - MI	(29.0)	(18.6)	(2.7)	(21.9)	(13.3)	(6.8)
Las Vegas	(36.1)	(31.3)	(7.5)	(26.4)	(26.8)	(12.6)
Los Angeles	(30.3)	(27.6)	(5.7)	(13.5)	(18.8)	(6.6)
Miami	(32.5)	(28.4)	(5.9)	(4.4)	(17.9)	(8.2)
Minneapolis - MN	(17.5)	(14.4)	(0.7)	(7.3)	(6.5)	(4.3)
New York	(10.0)	(7.3)	(1.8)	1.5	(4.5)	(3.2)
Phoenix - AZ	(36.7)	(31.9)	(8.7)	(11.9)	(16.6)	(7.5)
Portland - OR	3.5	(8.6)	(3.1)	13.9	(2.6)	(2.3)
San Diego	(34.0)	(26.3)	(6.4)	(23.3)	(17.6)	(6.1)
San Francisco	(32.3)	(29.5)	(8.9)	(6.8)	(8.0)	(2.6)
Seattle - WA	5.3	(9.8)	(3.1)	16.3	(3.0)	(2.2)
Tampa - FL	(24.5)	(18.5)	(2.2)	(10.5)	(15.1)	(4.6)
Washington	(23.2)	(17.2)	(3.9)	(9.5)	(12.5)	(4.7)
U.S.	(19.8)	(16.6)	(3.5)	1.5	(4.0)	(2.7)

Source: Case-Shiller, Office of Federal Housing Enterprise Oversight, Linneman Associates.



pass counter-productive legislation and raise taxes, our languishing economy will create unnecessarily large future losses. We all need to admit “I am guilty” because:

- I took some of that poorly underwritten debt.
- I invested in money market funds that bought anything rated AAA, irrespective of real asset quality.
- I financed (or built) a home or condo using excessively cheap debt.
- I put my money in insured depositories without caring if they were making sound loans with my deposits.
- In short, this mess is my fault.

Having accepted guilt, we can focus on identifying the location of the loss mines and providing capital transfusions (both public and private) to the living, thus getting the U.S. economy back on track without creating unnecessary damage.

Even if the present value of the losses is ultimately \$1.2 trillion, the full reimbursement of these losses via the proceeds of long-term federal debt will cost us less than \$1.4 trillion (including financing costs), versus aggregate U.S. GDP of roughly \$150-170 trillion, and federal spending of \$30-35 trillion over the next 10 years. That is, for a mere 0.7% of our income over the next 10 years, we can reimburse the maximum conceivable losses. It is only a few hours of work a year by each of us, and less than a couple percent of our net worth.

So take the “I am guilty” pledge and urge our political leaders to cover the losses as they occur out of our future income. This is easily be done by a 10-year federal guarantee of all remaining interest and principal payments due on every loan written from mid-2004 through mid-2007.

This loan guarantee program (subject to a good faith requirement effort to collect on loans and a fraud exception) will spread the government cash flow burden over time, as payments will occur only as the loans default. This policy can be implemented with minimal effort and will instantly raise the value of loans by converting most qualifying debt to government debt valuation, thus allowing this debt to be sold efficiently as government credit, creating cash proceeds for new loans.

Everyone agrees that the financial system was substantially over-leveraged and that we need to de-lever. But no one with debt wants to be impacted by this policy. De-lever “them,” not “me.” But all de-leveraging efforts must be concentrated on the debt that requires rebalancing, maturing loans or new loans, as the lender cannot generally reduce lending on long-term debt. Hence, the de-leveraging of the system is 100% focused on about 20% of all loans. As a result, many wildly over-levered situations get a free pass, while new loans are stonewalled by lenders.

But if lenders make new loans, they will not achieve their leverage targets. This “de-lever them, not me” sentiment is the schizophrenic element of the lender bailout efforts. On the one hand, infusions of government money are intended to increase the asset base to more effectively match current leverage. At the same time, banks are being told to expand their lending. But the first task is to right-size lender balance sheets. Lending will resume once this objective is achieved.

A Final Thought


We must resist the urge to save everyone. Losers must lose if winners are to prosper. If one or more of the Hopeless Three goes bankrupt, their competitors’ sales will rise as consumers shift their purchases. The increased sales realized by the competitors, who make their vehicles in the U.S., will improve their operating margins, allowing them to avoid financial distress and expand output and employment. As with wildebeest in the Masai Mara, death is essential to life.

Finally, people knew that leverage was not riskless. They relished its upside, and now must suffer its downside. The idea that a reasonably safe real estate cash stream bought at a 4-5% cap rate could generate a 20% return is absurd unless premised on carry trades and loads of ever available debt. But just as tenants do not always renew their leases, lenders do not always roll their loans. Debt is wonderful on the upside, but remorseless on the downside. This lesson will hopefully be remembered for a new generation.





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