U.S. Credit Strategy

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The Liquidity Turn

TIME TO BUY BROKERS AND MONEY-CENTER BANKS

CREDIT STRATEGY
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The Fed has finally intervened with overwhelming force. On Sunday, the Fed announced a Primary Dealer Credit Facility (PDCF), through which it will make secured loans directly to primary dealers. Of critical importance, the Fed has said that it will accept a wide variety of investment-grade collateral, including corporates, municipals, RMBS, CMBS and ABS. The price for these loans will be the discount rate, which the Fed cut 25bp on Sunday in another accommodative move to 3.25%.

In another Fed orchestrated move, also on Sunday, JPMorgan Chase announced that it will acquire Bear Stearns in a stock-for-stock deal equating to approximately $2/share. Systemic risk increased dramatically going into the weekend, as we saw the beginnings of a new-style bank run, driven not by depositors but by counterparties fleeing their exposures to Bear Stearns. The deal announcement should limit this systemic risk concern, though we acknowledge that some deal risk remains.

In recent weeks, financials, particularly banks and brokers, have traded off dramatically as systemic deleveraging accelerated. Liquidity conditions had become dire. As a result, we have seen both banks and brokers trade to spread levels not seen in decades. Furthermore, macroeconomic and fundamental news has provided little support; the U.S. economy appears headed for recession. In synthetic credit, concerns over structured credit unwinds and correlation desk hedging have provided constant pressure, while in the cash market, heavy supply and a significant supply overhang (both across investment grade and speculative grade markets) have been a challenge.

However, the recent run on Bear Stearns has at last driven policymakers to more aggressive confidence boosting action. We believe the regulatory authorities now understand that the time for half-measures is at an end. With today's moves, the Fed has signaled a major campaign – and we believe the Fed will win the liquidity battle. In this context we believe the time has come to change our view on financials. We are maintaining our more negative views away from financials, as we expect the economy to continue to weaken and credit quality along with it.

To summarize, there are three key drivers to our financials call:

1) Spreads are at attractive fundamental levels;

2) The regulatory response will be as aggressive as necessary to restore confidence in the financial system; and

3) The liquidity crisis will end, but solvency (i.e., asset quality), remains a concern. Thus, we recommend investors keep longs in diversified money-center banks and brokers. **We remain more concerned with respect to independent finance companies and regional banks.**

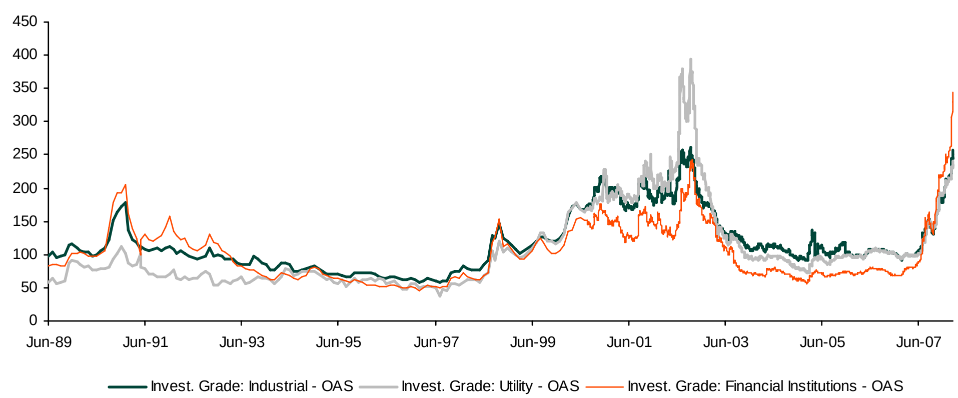
We acknowledge that technicals will likely drive the spread peaks and there will almost certainly be further negative headlines in the sector. That said, in our 2008 outlook, we stated that we believed 2008 would provide the best buying opportunity in financials in the past decade. For the reasons mentioned above, we believe that that opportunity has now presented itself. We lay out further discussion of the key points below.

1. WHY WE BELIEVE INVESTORS SHOULD BUY NOW

A) Spreads are at attractive fundamental levels

Given the recent widening, we have seen financials spreads in particular reach levels not seen in the last 20 years. As shown in the chart below, financials spreads have materially breached the wides seen during either the 1990/91 cycle or the 2001/02 cycle. While we acknowledge that this does in part reflect the liquidity and funding risk driven nature of the current downturn, we do note that the current levels appear to represent the best fundamental entry level for the sector in years. On a relative value basis, financials are materially cheaper compared to industrials, in particular, than has been seen at any point in the last 20 years.

Figure 1. Historical Investment Grade Spreads



Source: Lehman Brothers

B) The regulatory response will be as aggressive as necessary to restore confidence in the financial system

While the Fed had been using a measured approach to stabilizing the financial markets, both through traditional monetary policy and through the innovative approaches mentioned above, in light of today's PDCF announcement we believe that the period of a more conservative policy is at an end. The regulatory authorities are now effectively providing a liquidity backstop for a wide variety of investment-grade assets – an effective wall of liquidity. In addition, we believe the authorities could use additional tools as needed to achieve their goal. The key point, as we see it, is that we believe the regulators will not cease intervention until liquidity conditions have been clearly stabilized.

The Bear Stearns news on Friday was jarring for a market already fighting deteriorating liquidity. However, in addition to the points mentioned above, the decisive response from the Fed and other regulatory authorities is telling in another critical way. The Fed seems unwilling to risk further damage to the financial system, which in this environment appears to mean not allowing a major bank or broker dealer to fail. The Bear Stearns bailout seems to have set the boundaries of "too big to fail" thinking. We believe this further bolsters the case for investing in the major banks and brokers.

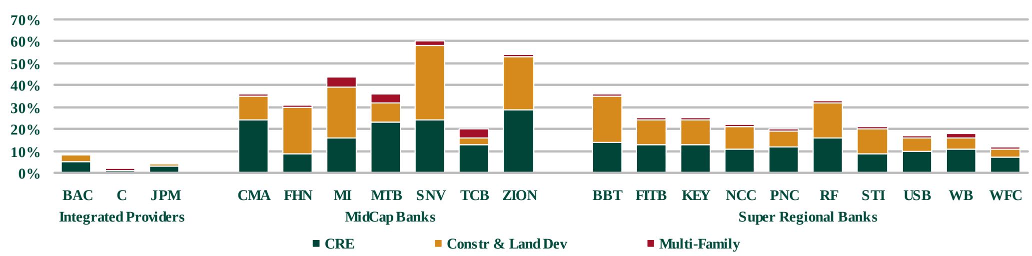
2. BUY BROKERS AND MONEY-CENTER BANKS; MORE CAUTIOUS ON INDEPENDENT FINANCIALS AND REGIONAL BANKS

A) Keep longs in diversified money-center banks and brokers. We remain more concerned with respect to independent finance companies and regional banks.

Given our belief that the regulators will win the liquidity battle, we thus expect funding-sensitive financial issuers to ultimately receive renewed access to capital. This should be a boon to many issuers in the sector. However, we also believe that fundamental asset-value problems are not over – the cycle turn has only begun; the macroeconomic outlook remains weak. As our Economics team suggests, we expect lackluster growth through both 2008 and 2009. As a result, issuers with heavier exposure to problem assets could continue to face significant challenges as the credit cycle plays out. Thus, we believe credit selection continues to be critical.

From a risk/reward perspective we believe investors should be more aggressive regarding the major well-diversified money-center banks and brokers. We believe these names will have the necessary asset diversity to weather the credit cycle. We would be more cautious with respect to the independent financials and the regional banks, as we believe their less-diversified asset bases could prove more problematic as the credit cycle continues. While we acknowledge that these names should benefit somewhat from the improved liquidity situation, we believe the risk/reward in those names is less attractive.

Figure 2. Percentage of Bank Loans Funding Commercial Real Estate Assets



Source: Lehman Brothers, SNL Financial

As to how investors should look to express our view in the major banks and brokers, we believe investors should look to add risk in these names by whatever means available to them (given the recently weak liquidity conditions). That said, we believe low dollar price, long-dated subordinated paper and hybrids offer the most attractive opportunities. We note that the new Citi 8.3% 2037 hybrid was recently trading around 425bp Treasury spread (400bp Z-spread), well wide of the ~235bp range for senior 5-year CDS. This reflects the subordination and curve premiums currently prevalent in the market. Figure 3 provides a selection of what are, in our opinion, attractive bonds in these names.

Figure 3. Selected Attractive Bank/Broker Subordinated Bonds

Ticker	Identifier	Issuer Name	Coupon	Maturity Date	OAS	Amount Outstanding	Price	Moody Rating	S&P Rating	Fitch Rating	Subord Type
BAC	06050TJZ	BANK OF AMERICA NA	6	10/15/2036	230	1,250,000	93	AA1	AA	AA-	LT2
BSC	073902PR	BEAR STEARNS COS INC/THE	6.4	10/2/2017	659	2,500,000	77	A2	A	A+	SRNOTES
BSC	07385TAJ	BEAR STEARNS COS INC/THE	5.7	11/15/2014	773	1,700,000	77	A2	A	A+	NOTES
C	172967CQ	CITIGROUP INC	5	9/15/2014	384	4,082,785	92	A1	A+	AA-	LT2
GS	38141GEU	GOLDMAN SACHS GROUP INC/THE	5.625	1/15/2017	344	2,250,000	92	A1	A+	A+	SUBDEB
GS	38141GFD	GOLDMAN SACHS GROUP LP	6.75	10/1/2037	384	5,545,000	85	A1	A+	A+	LT2
JPM	46625HGN	JPMORGAN CHASE & CO	6.125	6/27/2017	253	750,000	101	AA3	A+	A+	LT2
JPM	48121CYK	JPMORGAN CHASE BANK NA	6	10/1/2017	233	3,000,000	101	AA1	NR	A+	LT2
LEH	524908R3	LEHMAN BROTHERS HOLDINGS INC	6.5	7/19/2017	543	2,000,000	85	A2	NR	A+	SUBDEB
LEH	5249087M	LEHMAN BROTHERS HOLDINGS INC	6.75	12/28/2017	534	1,500,000	86	A2	A	A+	SUBDEB
LEH	524908R4	LEHMAN BROTHERS HOLDINGS INC	6.875	7/17/2037	511	1,500,000	75	A2	A	A+	SUBDEB
MER	5901884M	MERRILL LYNCH & CO INC	6.05	5/16/2016	396	2,000,000	93	A2	A	A	SUBORD
MER	59022CAJ	MERRILL LYNCH & CO INC	6.11	1/29/2037	418	2,000,000	75	A2	A	A	SUBDEB
MS	61748AAE	MORGAN STANLEY	4.75	4/1/2014	414	4,000,000	90	A1	A+	A+	SUBDEB

Source: Lehman Brothers

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