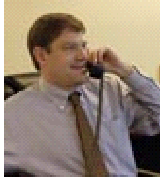
INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

JUNE 2008



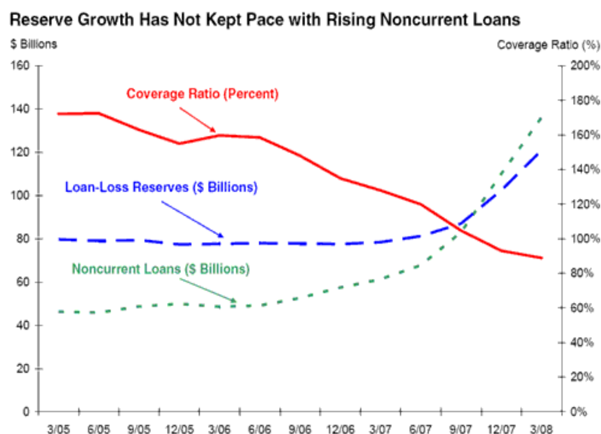
William A. Harris, CFA
Portfolio Manager

Settling in for the Credit Drama

This year's financial headlines could be pieced together to script quite a tale, but how much of the drama yet remains? Hank Paulson at the US Treasury would have us think the curtain has all but closed on the credit crisis, and we'll rise now from our seats and step into the bright of day.

At Allen Trust and Allen Capital Management, we're not so sure. While we agree that you can come out from *under* your seats (any of you who hunkered down during the scarier moments of this Winter's tale), we're not convinced the final act has played out. The theater lights haven't come on, too many plot lines need tying up, and there's still plenty of banging about to be heard from backstage.

To wit, consider this gem from the latest FDIC Quarterly Banking Profile:



Source: FDIC 1Q08 Banking Profile

We last visited this graph in December's letter, and since then, non-current loans have emphatically crossed above banks' loss reserves and gapped higher. In other words, through March, borrowers were going delinquent on their loans faster than banks could set aside capital to provide for potential losses. And the slope of neither line hints at any relent in their divergence.

Altogether, the notion that we are wrestling a uniquely *subprime mortgage* crisis continues to be invalidated with each new batch of data. Contrary to the journalistic short-hand by which this chaos is all about subprime homebuyers, delinquencies have been accelerating among the presumptively higher quality Alt-A and prime loan categories. Indeed, the Mortgage Bankers Association now reports that 42% of the foreclosures started in the first quarter were on prime loans. And just as the damage isn't being sequestered to subprime loans, it's not being sequestered to the housing market either. The FDIC profile shows bank charge-offs worsening broadly, up 131% year-over-year on commercial and industrial loans.

How are the securities markets interpreting this? Well, the bond market is awarding far tighter spreads to bonds outside the financial sector (i.e. valuing them more richly), and we can infer from the stock market's recovery (*ex* financials) that equity investors too remain blithe about the prospects for most companies. There remains, in short, what we believe to be an overconfidence in containment belied by what the last year has showed us, namely that the core problem – too much credit that shouldn't have been granted, too much debt that shouldn't have been shouldered – spreads its tendrils further and deeper than is convenient or pleasant to face up to.

Sorry, Hank, this is no brief matinee. It's *Nicholas Nickleby*, and though there may be multiple intermissions like this recent rally where we get to stretch our legs and grab a drink, we're going to be here a while longer.

William A. Harris, CFA

Next time: **The Dilution Solution: Rediscovering Equity's Essence as a *Residual* Claim**