



## **Market Commentary**

# **Is the Worst Behind Us? What Will Happen Next?**

February 2009

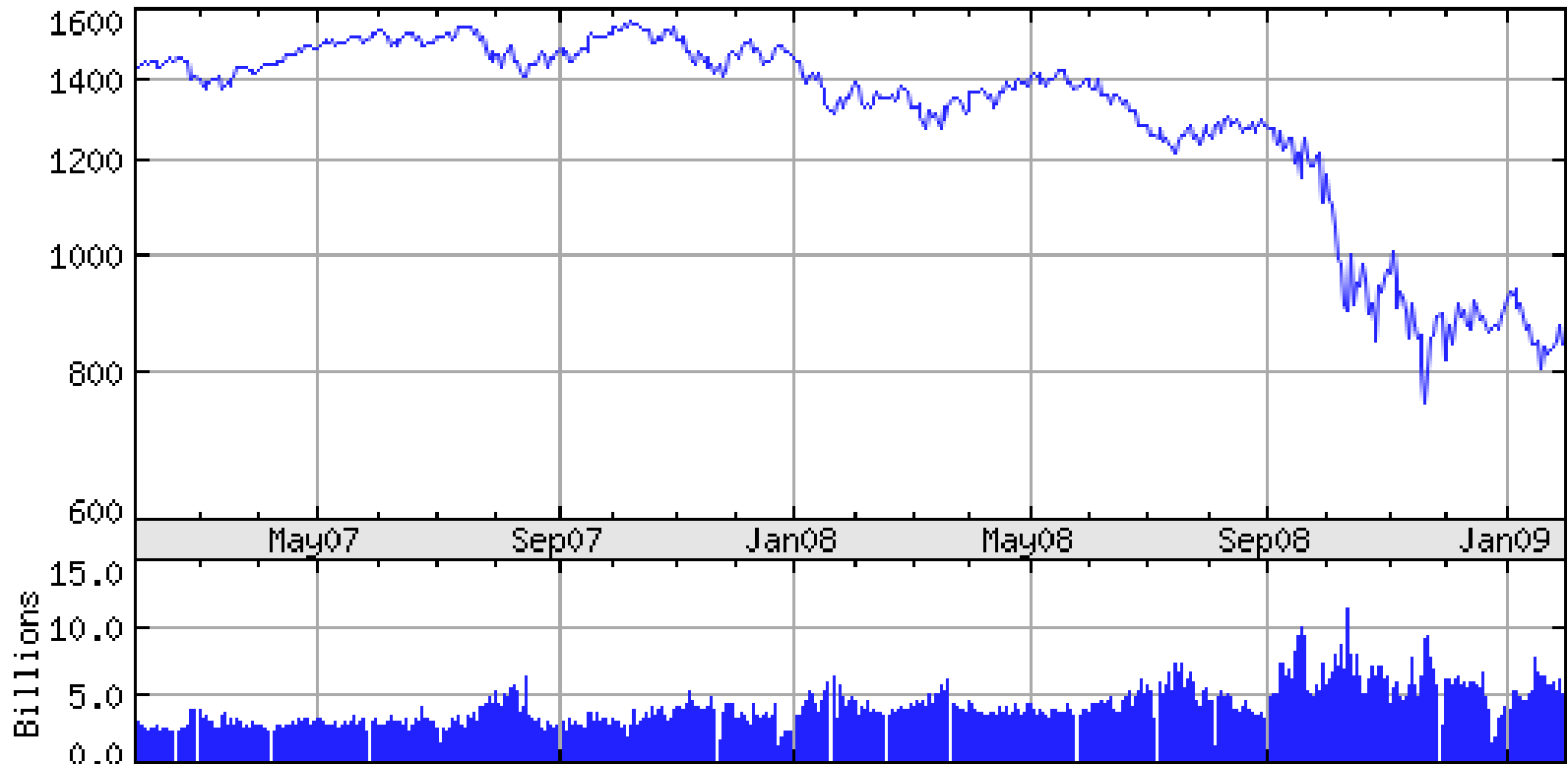
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# Summary

- The severity of the economic downturn will be determined by two factors: whether housing prices and debt reach a new equilibrium, and whether lending is restored throughout the financial system.
  - Credit markets remain highly risk averse. Government intervention has only unthawed the high end, and risk perception has increased elsewhere.
  - Housing prices have fallen 25%, but the associated debt (now \$14 trillion) has not. Government intervention can help but not correct the imbalance. Only the market can do that.
  - If you believe housing prices can reflate to support yesterday's debt levels, then the worst is behind us. If not, then debt must deflate, implying there is more pain to come.
- There is still a high probability of challenging news ahead: potential bank insolvencies, corporate defaults, and municipal deficits.
- Markets will likely remain volatile during this period, but keep in mind they rebound well before the end of the bad news.
- We may be entering our third bubble of the decade: first, the Internet, then housing... now US government debt?

# Is the worst behind us? What will happen next?

S&P 500 INDEX (STANDARD & POOR)  
as of 29-Jan-2009



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# **The depth and duration of the pain depends on two interrelated issues:**

Housing prices relative to debt and income

Willingness of credit markets to lend

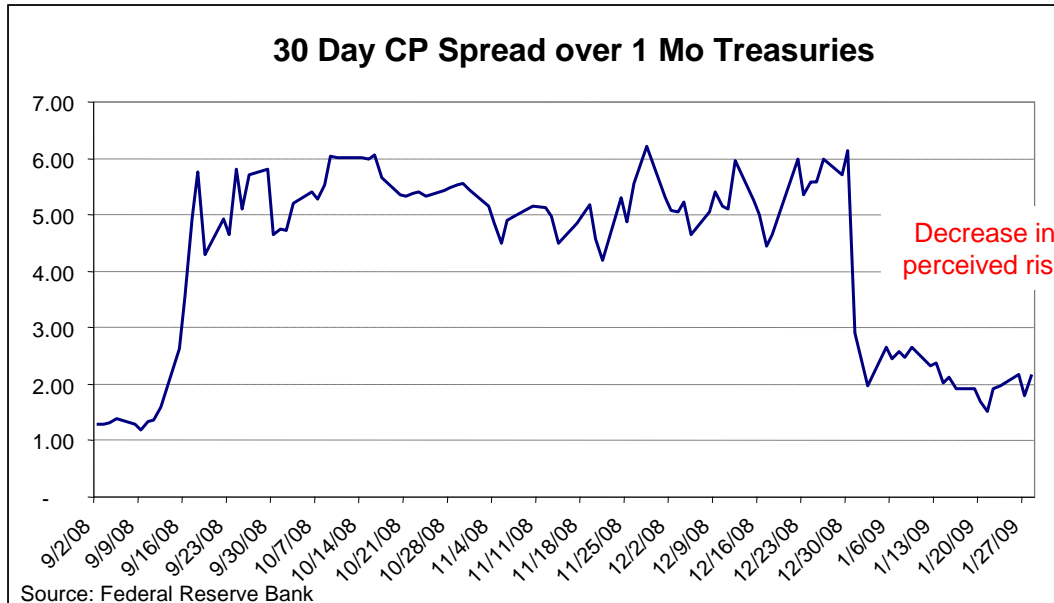
# Credit Markets: Since October, the Fed has announced a \$700 billion infusion (the "TARP")

Did it unfreeze the credit markets?

Has it stabilized bank balance sheets?

Has it spurred lending by banks?

# TARP has helped unthaw the higher end of the credit markets



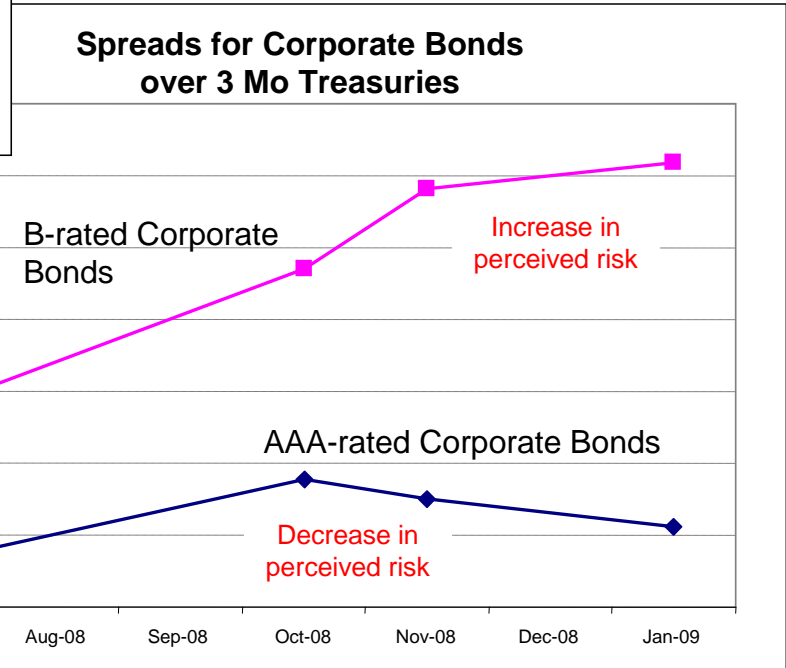
Spreads have improved in segments targeted by the Fed:

- Interbank money market
- High grade commercial paper
- Agency mortgage bonds

Spreads have also improved in high quality segments not directly supported by the Fed:

- Better quality commercial paper
- AAA-rated Corporate Bonds

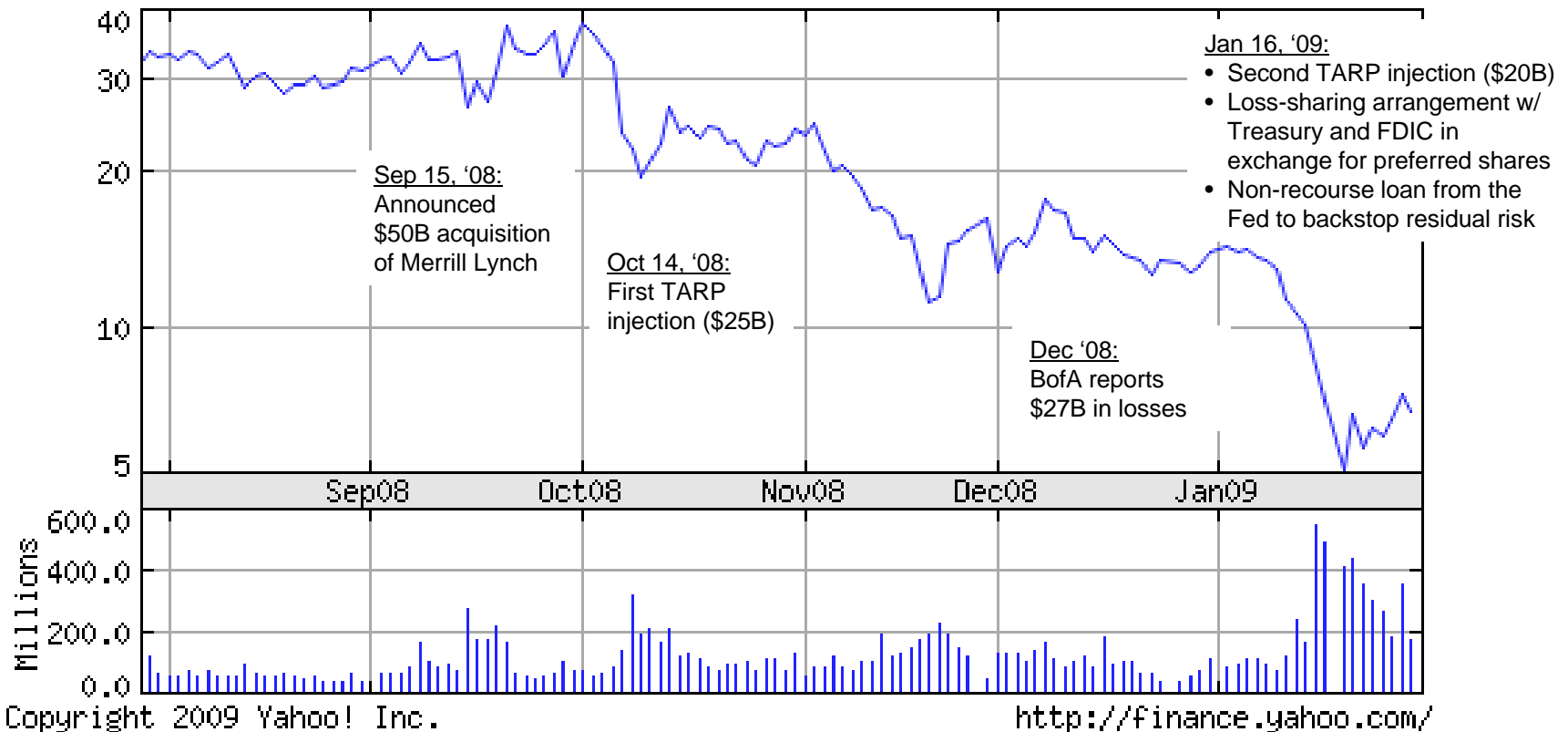
Outside the highest quality segments, spreads have deteriorated, indicating that perception of risk has increased



# The TARP has not yet convinced investors that it has done enough for banks and lending

BANK OF AMERICA CORP  
as of 29-Jan-2009

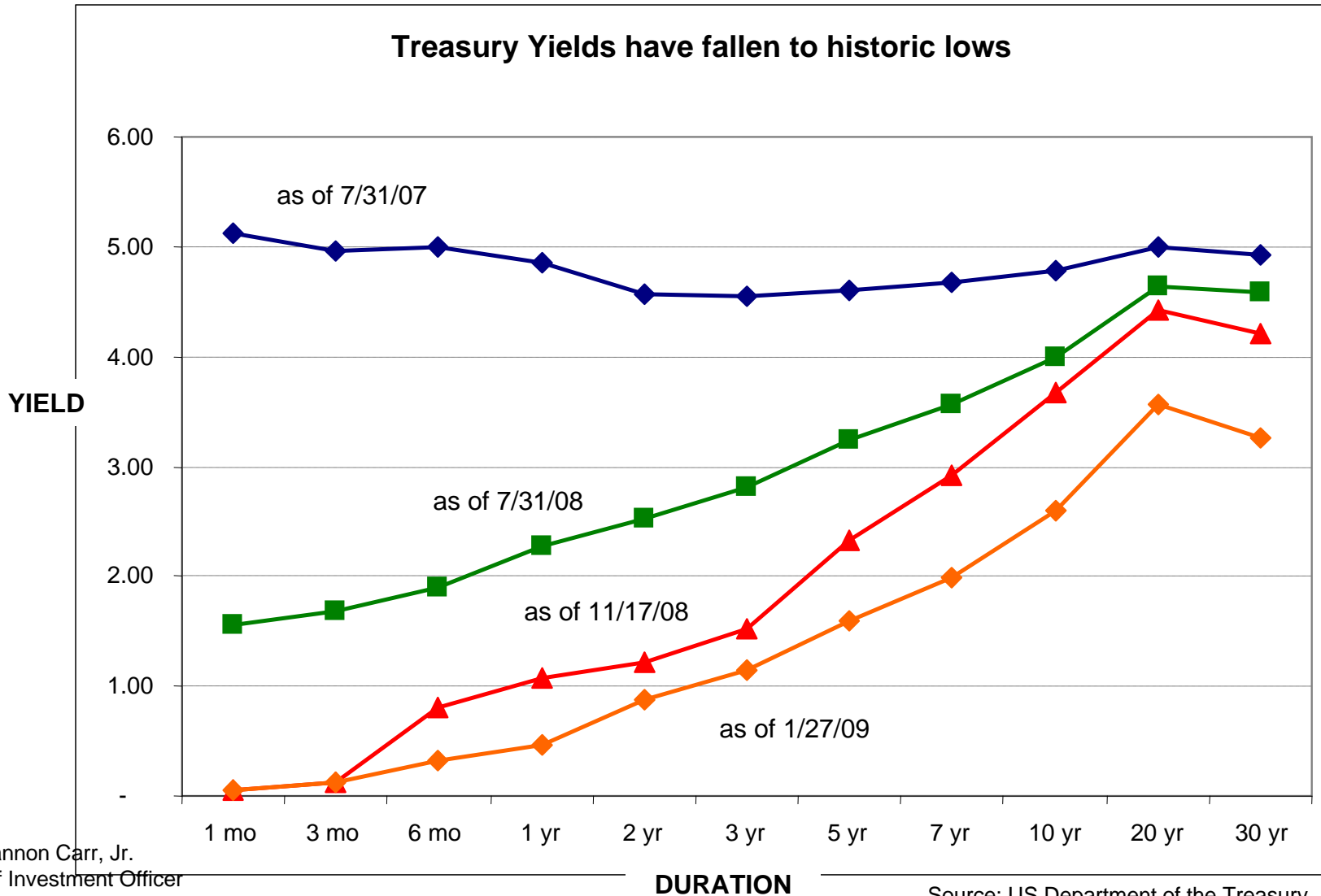
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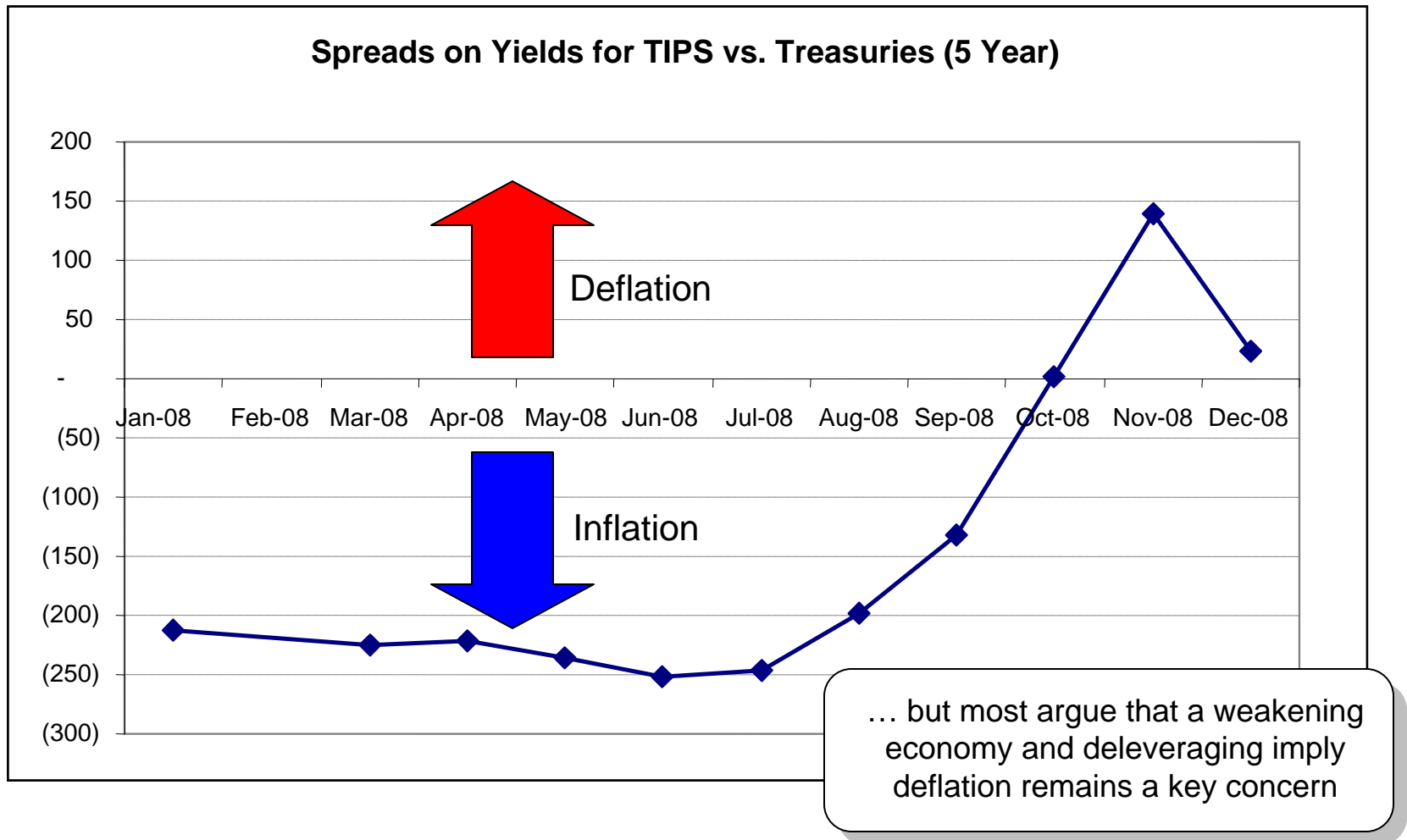
Note:

- To date, BofA, Citigroup and AIG have received the largest TARP funds. We use BofA stock chart as a proxy.
- Other large banks like JP Morgan and Wells Fargo have received TARP funds, but not as extensively. Their stocks are down roughly half as much.

# Credit markets are still very risk averse



# Credit markets may have relaxed deflationary fears a bit...





# What could happen over the next 18 months

## Challenge

- State/local government bankruptcies?
  - 38 states face \$370B shortfall
- Corporate defaults on debt?
  - \$750B due in 2009\*
- Several (major) banks insolvent?
  - \$1.5T book value vs. ??? in toxic loans
  - Unlikely to lend broadly without stability
- China and Japan may stop buying Treasuries
- Longer term: Higher taxes and Inflation

## Solution/Remedy

- Fed's ~CBFF for municipalities
- Banks willing to renegotiate/renew  
Loan guarantees by Fed
- "Nationalization"?
- TARP and stimulus of marginal help

\* Standard and Poors

# What's an investor to do?

- Focus long term and don't try to call a bottom or predict where lightening will strike
- Know your financial goals and near-term liquidity requirements
- Investment strategy:
  - Avoid Treasuries, as we consider them our “third bubble” (following tech stocks and housing...)
  - For stocks and corporate bonds, favor companies with healthy balance sheets and ample liquidity to weather an unpredictable period
  - Consider TIPS and REITs for (inevitable) inflation
  - Consider (select) municipal bonds for tax benefits