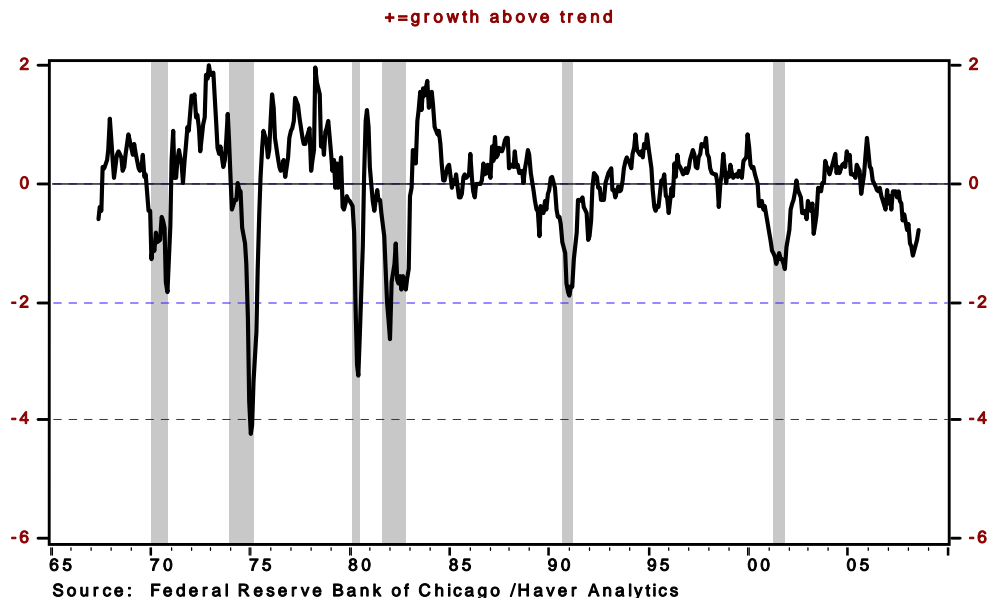


## The Post Bailout Blues

- Financial crises are confidence problems. The process of lending or investing requires a certain degree of trust that both parties will perform as promised. When that trust becomes impaired, there is less capital available for the economy to function. When confidence deteriorates significantly, governments usually step in; policy makers want to offer 'just enough' support to restore confidence but not too much as to create a 'moral hazard'. In other words, they want to help the markets but not reward bad behavior.
- The equity markets enjoyed a short-lived rally after the bailout of Freddie and Fannie. The much-anticipated Treasury department's action was initially seen as a relief. However, in the aftermath, it appears the government made a critical mistake by not protecting the dividends on preferred shares. Policy makers apparently believed that the primary risk of not paying on these instruments would be limited to a number of smaller banks held the preferred shares of Freddie and Fannie as capital. The bailout discussion specifically addressed this problem and offered extraordinary support for institutions that would suffer by the government's decision. However, it looks like policy makers underestimated the impact on other financial preferred shares.
- Over the past week, prices on other financial firms' preferred shares have suffered greatly. The spreads between REITs, a lower rated instrument, and quality financial firms' preferred shares has modestly inverted. Usually, REITs' yields exceed financial firm's preferred shares by 1% to 1.5%. By not protecting the preferred shareholding dividends of Freddie and Fannie, investors have become worried that other financial firms preferred shares may be questionable as well.
- In effect, it appears the law of unintended consequences is in place. The Treasury underestimated the impact of its decision not to protect the preferred shareholders of Freddie and Fannie and, in effect, has closed off that funding instrument for a significant portion of the financial sector. And sadly, this comes at a time when the firms need all the funding avenues available to them.
- So, the key question for equities is 'how bad does it get?' Unfortunately, it appears there is the potential for more downside. The Ned Davis Crowd Sentiment indicator has eased from near 50 in August to 43.9. The deterioration is bearish news, as the weakness in the index suggests declining sentiment but it isn't so pessimistic as to signal a bottom. A reading between 35 and 30 has historically signaled an overly pessimistic market, which is bullish because it suggests the bad news has been discounted. Technically, the S&P 500 has support at 1201, 1180 and 1165. So far, the 1201 level of support has held, but if broken, a test of the two lower support regions is likely. (The Ned Davis Crowd Sentiment indicator is designed to highlight short-to-intermediate-term swings in investor psychology)
- We remain underweight on equities and overweight on fixed income in our asset allocations. And, although we have short-term concerns about the equity markets, the restoration of confidence could bring a significant recovery. As we note below in the Chart of the Week; the overall economy still is acting as if this is a 'garden variety' recession but the equity markets are treating it as if it is similar to the 1973-74 and the 1981-82 recessions.

## Chart of the Week:

**FRB Chicago National Activity Index: 3 Mo. Moving Average**



*For illustrative purposes only. This does not reflect the performance of any specific investment.  
Past performance is no guarantee of future results*

This chart shows the Chicago Federal Reserve's National Activity Index. This index compares current economic growth to its long-term trend. The index is broad-based, calculated with 85 variables that measure economic activity. The data are smoothed with a three-month moving average.

Chicago Federal Reserve economists indicate that a reading of this measure under -0.75 suggests an economy in recession. According to this measure, the economy entered recession in December. There are two important conclusions to draw from this data. First, note that in the two deep recessions, the 1973-74 and the 1981-82 periods, this index fell well below -2. The current recession is more akin to the 1990-91 and the 2001 recessions, which were rather mild. Thus, the economy is probably in recession but conditions are not as bad as seen in two deep ones noted above. Second, it is worth noting that this index has already started to recover, suggesting that economic conditions are actually improving.

This is why we believe that the primary problem for the equity markets is the financial system, not the economy. And, once confidence returns to the financial system we should see a solid recovery in equities.

*Bill O'Grady*

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