March 11, 2010

MONTHLY SUMMARY FOR FEBRUARY[1]
ARE DERIVATIVES INHERENTLY UNSTABLE?

A few months before his death, Paul Samuelson reputedly said that if he had known how derivatives would be used, he never would have written his seminal paper on stock options. (He never identified the host of financial derivatives that since have developed and he clearly believed that options trading would lead to faster price discovery and increased stability despite the obviously higher leverage that such investing permitted.) Most of modern finance followed from that options paper.

Now, the Prime Minister of Greece is claiming that his high borrowing costs are the result of trading in credit default swaps. (Others claim that deficits of 12.7% of GDP might have something to do with those interest charges.) At any rate, a reappraisal of financial derivatives and what they are doing to the stability of the financial system is now underway.

The first question is whether an economic benefit is derived from the existence of a derivative, or does it merely allow greater leveraging of capital (an inherently unstable activity). When Samuelson discussed options he recognized that the cost of price discovery might be high if large blocks of stocks needed to be traded before new information can be fully incorporated in stock prices. By actively trading options, price discovery could be transmitted from the options markets to the stock markets without the high transaction costs that otherwise would develop. (While this is not the equivalent of Sir John Hicks' auctioneer, who called out prices but made no settlements until a market clearing price was reached, it is the next best thing, and it is real while Hicks' auctioneer was abstract.) Options also could be used as low cost compensation for achieving long term objectives (although their low cost clearly contributed to the high effective compensation that senior management receives). We can argue whether options are a bane or a boon, but they clearly have defined economic objectives. Despite Samuelson's comments, I believe we are better off for them if we disregard their apparent abuse in some compensation decisions.

Derivatives soon led to pools of obligations that could be sliced according to the expected receipt of payments. Thus, thirty year mortgages could be combined, allowing pooling of risk and underlying derivatives that could be organized by payments. If you need your principle back in a year, you buy the first year's stream of payments from the pool. If your liabilities average thirteen years, you can buy the payments at thirteen years to match the term of your liabilities. If not for these derivatives, financial officers would need to continuously be buying and selling bonds of different maturities to match the asset terms to the terms of the liabilities. These instruments, mostly CMOs, provided a pooled risk and a more efficient method of balancing terms on the balance sheet. Again, the economic benefits of these derivatives are clear. (The price paid for the final payments suffered from large market interest rate risk. Some investors made interest rate bets with those tranches and sometimes were singed when rates moved in the opposite direction from their expectations.)

At some point, however, the architects of derivatives became more enamored of building products than providing benefits. The collateralized debt obligations supposedly were derived from risk classes. Again, standard debt obligations would be pooled. However, instead of using time as the means of deriving alternative assets, they used risk. While most people would want Aaa credits with increased returns, who would want the high risk residue of the obligations? In other words, while creating some Aaa credits from a standard pool might provide benefits, the residue might be unmarketable. For a while, this problem seemed to

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[1] *The Monthly Summary is prepared by Dr. Donald Ratajczak, PhD., Morgan Keegan's Consulting Economist. Additionally, this report is a transcript of comments made by Dr. Ratajczak and should be read in that context. Additional Information Is Available Upon Request.*

be resolved by the high yield funds, who were seeking more high yield instruments than were normally provided in the bond market. Unfortunately, the building of risk based tranches from a standard pool of loans was hard to understand. These instruments appeared to lower risk by creating derivatives. That the inherent risks continued to reside in the initial loans was not understood. I actually heard a sound explanation for why the collateralized debt obligations were created at the recent American Economic Association meetings. The paper's author argued that demand for Aaa credits had grown while supply had diminished, so new supply needed to be created. That the CDO did not effectively do so was not understood in the rush to obtain more Aaa securities. In short, the tranches of the CDOs were graded with less risk than existed in the underlying assets because the markets demanded an increased supply of Aaa rated paper. Investors wanted to believe that even subprime mortgages would not default in the first year of their mortgage payments (though when housing prices began to fall, defaults sometimes happened before the first monthly payment). The credit ratings did not consider the sensitivity of payments to falling real estate prices.

Whether some form of collateralized debt obligation can be resurrected that truly sorts out the payment risks of a pool of loans and can be fully marketed remains to be seen. If there truly is a shortage of Aaa paper and if we can correctly assign such ratings to a portion of a loan pool (but also sell the hind end of the pool), some instrument may develop. At this point, however, no one wants CDOs at almost any price (some information, such as the capacity to pay of the borrower or the number of liens on the collateral, is incomplete. This continues to hamper the ability to assign correct risk ratings to the tranches developed from the asset pools). I remain ambivalent about the economic benefits of CDOs, as the credit rating of tranches remains a serious shortcoming.

Some of the Structured Investment Vehicles made little sense as well. In equilibrium, it is true that short term borrowing rates are lower than long term rates. This is because the market interest rate risk is small over a short period of time, but rises as time lengthens. The statisticians demonstrated that financing long with short term instruments could lower costs if the normal term structure of interest rates persisted. (They should have known that the term structure is part of the leading indicators, meaning that it changes over the cycle.) They failed to consider what happened when equilibrium was disturbed (e.g. when LIBOR jumps dramatically because European banks no longer trust each other's obligations). The auctions in the tax exempt market also were attempts to finance long term obligations with short term rates. (The S & L's failed at borrowing short to lend long a couple of decades ago, but the statisticians were convinced that those problems would not recur.) While some such structures with back-up longer term financing can lower borrowing costs, using models based upon equilibrium conditions can explode when those assumptions no longer are valid.

The problem with these special financing vehicles is that they only make sense if the market is out of equilibrium, but they are evaluated by models that assume equilibrium conditions. Somehow I have trouble seeing the economic value of such financing tools (though I understand the builder of the tools might profit from their creation).

Now we come to the credit default swaps. They are called insurance, but they are not insurance. An insurance product has a capital pool supporting the liability created by the writer of the insurance. The adequacy of the pool to meet obligations is evaluated by regulators and is based upon actuarial analysis supported by historical performances. (Though all insurance events are unique, there are enough similarities to pool these risks and lower risk exposure over time.) By contrast, there is little capital supporting credit default swaps. When an event occurs, the writer must sell assets to meet their obligations. If the exposure is too large, the assets sold could undermine other financial conditions, leading to a cascading of defaults. In regular insurance, the capital requirements limit the amount of exposure written. Without the same restraints, credit default swaps have grown to multiples of the economic loss created by the default. Thus, the margin calls (for that is what the asset sales are) could be very large for even relatively moderate events.

This does not necessarily mean that credit default swaps are inherently unstable. Some instrument that offsets financial risk has merit, if contained. However, many of these credit default swaps are bought and sold without regard to the capital strength of the initial writer (if this were not so, we would have graded swaps based upon the financial strength of the writers). Another problem is the ability to "gang up" on the financial instruments of companies. The prices of credit default swaps surged a week before the collapse of Bear Stearns and a week before the Lehman fiasco. Did they cross a threshold of no return, leading to the price surge, or was the price surge the reason why they could not hold their accounts, thus causing their capital to collapse? I have not yet heard a satisfactory answer to that query. At any rate, the lack of transparency increases the likelihood of "bear raids" against companies or even against countries.

Those buying credit default swaps must understand that one major counter-party (AIG) could only meet its obligations with the intervention of the government. And the officials who agreed to that support believe they made a big mistake. The margin like settlement

process and the risk of counter party failure makes the current credit default swap market a source of financial instability that amplifies and transmits financial problems throughout the world. Hasn't anyone wondered how a mortgage problem in the U.S. created a recession for more than forty countries throughout the world? Without these derivatives, would that have happened?

Enough on my musing about derivatives. Some provide significant value, but others are motivated by returns to the inventors and not the economic value of the instrument. I certainly believe all new types of derivatives should be reviewed by the SEC before they are traded and that the characteristics are periodically reviewed to insure that mislabeling has not developed (as it clearly did for the CDOs). I also believe all trades need to be recorded so that market distortions are not created by users of the instruments, or at least, they can be caught after the fact if such manipulation develops.

Just a word about the economy. The inventory phase of the recovery is well advanced. Economic growth will be slowed this quarter by snow storms, but much of that distortion will be recaptured in the spring. By the end of spring, the inventory thrust will be spent.

Unfortunately, a few other temporary thrusts also will expire in the spring or early summer. The census will require more than 700,000 net additions to the workforce through the spring followed by their departure in the summer and fall. In addition, the homebuyers' tax credit requires contracts to be written by the end of April and closings must be completed by the end of June. While the price impact is only about 4% (down dramatically from the more than 22% price impact of the clunker incentive), sales clearly will be shifted into the spring from the summer. Thus, weakness is likely in the summer though I believe enough consumer, export and capital spending momentum will exist to offset the sluggish housing, government, and commercial real estate sectors. A return to more normal recovery growth is likely in the fall. (Current law leads to a dramatic tax drag in the winter, but I believe some relief will be passed by the lame duck Congress, though not full relief. Thus, slower growth is likely early next year before capital spending, replacement demand for durables by consumers, and exports lead to recovery growth resuming in 2011.)

While I hear people saying the Fed will wait for unemployment to decline before changing the policy rate, they really are looking at employment growth. They know the census hiring is temporary and will wait for several months of 100,000 or more private sector job growth before raising rates. I expect a little of that growth to develop in the fourth quarter, but rates probably will not move above the near zero level until that strategy meeting at the end of January. Then I expect rates to rise quickly until they reach 3% early in 2012.

To a large extent, the long rates are assuming some increase in policy rates, but they don't fully reflect the policy shifts because investors don't know when or how much those rates will change. Needless to say, not all the policy rate change currently is priced into long term interest rates.

Finally, I was asked what economic issue keeps me up at night. Obviously, a financial collapse somewhere in the world is a worry. The credit default swaps could transmit defaults around the world, as they did after the CDOs became unmarketable. This time, however, I do not expect governments to bail out the counter-party risk. If I am right, and most people in Europe think I am, such a counter-party collapse could create another wave of financial uncertainty. I don't know if we have enough capital in the financial sector to contain it. Of course, the Europeans see this prospect so clearly that they believe such an outcome will be avoided. However, they have not yet told me how.

CREDIT MARKETS

At this time, the government deficits are about $50 billion higher than the same months last fiscal year. However, the revenues are beginning to grow in the corporate sector and the drop in personal income taxes is declining. While some additional spending is likely, I believe the deficit will be no higher than the $1.42 trillion of the previous fiscal year. I also believe the deficit will then fall below a trillion in the following fiscal year. However, I expect the declines in deficits not to go much below 4% of GDP even at the next cyclical peak. In other words, the high employment deficit, which is actually a slight surplus and a deficit of $200 billion under Bush is now tracking down about $600 billion under Obama. Part of the growth is because the unfunded liabilities in existing programs begin to exert themselves. Part is because of new programs with new unfunded liabilities.

At any rate, the deficits are peaking and the borrowing needs of the government will begin declining in the summer and fall. State and local governments will continue to struggle, but should not add to their exhaustion of rainy day funds (which already are gone). This means that net borrowing by those entities will diminish. As a result, the pressures from the government sector will decrease after this spring.

Unfortunately, the corporate sector had been a major contributor to the credit markets as it raised about $600 billion in cash in the past fifteen months. With inventories swinging from liquidation to accumulation and with slightly slower growth in internally generated cash, the corporate sector will continue to supply cash

to the credit markets, but at less than half of the rate of the past year. In 2011, some capital spending should commence even as profit growth continues to moderate from the 20% this year to 12% next year (using the economist definition of profits to exclude changes in asset values).

The household sector increased savings by almost a half trillion last year and then began dropping their rate of savings. I expect that decline to be temporary, but the growth in household contributions to the credit markets will generally slow. Some significant decline in contributions may occur in the spring, as housing purchases are shifted from the summer. The summer months then will allow contributions from the household sector to increase.

If the government, corporate and household sectors are combined we get lower borrowing from the government, lower contributions from the corporate sector and slightly higher contributions from the household sector. The net effect would be a slight easing of credit market conditions;.

Then there are the international flows. So far, the reluctance by China to increase their holdings of U.S. assets has been offset by more enthusiasm from Japan. I believe the Chinese will continue to seek diversification, but the Japanese will not be as aggressive at replacing China's shortfall. Overall, I expect higher interest rates will be needed to attract international capital. While we will not need as much of it to finance our shrinking but still very large deficits, I expect rates to rise.

As I mentioned above, the Fed's policy rates will remain unchanged into next year, but then will rise sharply. With a modest upward trend in interest rates, most of the policy change will have limited impact upon the long end of the yield curve. Nevertheless, some upward pressures are likely later in 2010 with slightly more pressure when policy rates change in 2011. This means the yield curve will become steeper this year and then flatten with the change in policy rates next year. I still have a 200 basis point gap between the 2 and 10 year treasury near the end of 2011. That remains unusually high for a normal yield curve though the gap will have narrowed significantly.

Most of the corporate spreads appear to be near normal with each other, though they are not normal with respect to the treasuries (some quality premium still exists for the government bonds). The exception probably is in the high yields where the absence of CDOs led to a modest shortage of high yielding instruments (though the CDOs ceased to provide much yield). As a result, those high yield rates seem to be slightly low. As a rule, I expect most bonds to nearly earn their coupon this year, but to not have enough yield to offset the capital erosion as rates rise next year. The objective I would follow is to get some yield now, but be able to buy bonds in about 2 years. That is when yields will be much more enticing.

EQUITY MARKETS

The first week of March appears to be similar to that first week of the year, when prices rose sharply only to fall into a 7% correction for the remainder of the month. At that time, the catalysts for market correction were initially signs of tightening by the Chinese followed by the liquidity and debt issues of Greece. While default was feared, most countries continue to place their bonds, though at a higher interest rate than on the bonds they are replacing. The liquidity problems in Greece appear to be overblown, but the continuing debt issue remains not only for Greece but for Spain, Italy (which fell back into recession), Ireland, and Portugal as well. Increasingly, however, this is perceived as a European problem with a possible IMF like European solution. Thus, other emerging market issues rallied. To some extent, I believe that rally will persist into the spring.

So far this year, telecommunications services has been a major loser while utilities, information technology and materials also are down for the year. Energy prices had a strong rally early in March as oil prices moved toward the upper end of their $70-$85 trading range, but only barely registered gains for the year.

While no sector is a runaway winner, strong gains so far this year have occurred in industrials, consumer discretion, and financials. Strong Asian economies allowed materials to lead the gains in the latest week, though consumer discretion, financials and energy were close behind.

It appears that the PE ratio for the S&P ended last year under 15, as earnings grew even faster than stock prices. Historically, this is not a high price for stocks. Moreover, the analysts are assuming that profits will grow under 15% next year. I mentioned that my profit estimates were 12%, but that is consistent with about 18% for the analysts, as they include profits created by asset sales. At 14% of the S&P, financials appear to be undervalued while industrials, also 14%, are high.

While I believe industrials will perform better than normal, so will the S&P. Thus, I do not expect them to outperform the market. I do expect outperformance from the financial sector and also from information technology, which no longer appears to be overpriced. Until some uncertainties are removed, healthcare appears fairly priced while energy also is fairly priced if oil prices remain in the trading range.

I have begun to benefit from investing in homebuilders and have also shifted to maritime and LTL trucking. If

this is a true recovery, those transportation segments should outperform the market.

So far, the small cap stocks have been the strong segment in the market. I expect that to continue through much of this year before dividend paying international stocks become relatively more attractive later in the expansion.

MORGAN KEEGAN UNIVERSE

With less than a quarter of the year down, the MK universe is outperforming the S&P by more than 4 percentage points. I still believe some rotation away from the small cap into larger cap stocks is likely later in the year, I would not be surprised to see a 10 percent gap open before that shifts narrows the gap by the fall.

While no major S&P sector reached double digit gains so far this year, several MK segments have done that well. The stronger gains were for communications components, which are recovering from a difficult profit year. They still had momentum early in March. Other sectors increasing at least 20% so far this year are regional banks and air freight. Restaurants advanced just under 20% while double digit gains were achieved by system area networks, communications equipment, and truckload carriers. The truckload carriers lost some momentum early in March, but the other sectors continued to achieve strong gains in that first March week.

Not all sectors have prospered. Aside from medical devices, the healthcare sector declined so far this year, though they improved modestly early in March. The LTL trucking also declined for the year as an anticipated bankruptcy that was supposed to remove capacity did not materialize. The group is slowly adjusting to that surprise, but remains expensive relative to expected earnings. Marginal declines also occurred for transactions processing and railroads.

If uncertainty can be removed from the healthcare industry, the healthcare services are selling near the lowest values to earnings in decades. Medical devices also may surge though healthcare information is not cheap even after the price declines.

The real bargain in consumer services is in our special situations, but the restaurants also may surprise to the upside following the first quarter (snow days hurt earnings in the quarter).

I still believe the regional banks will earn more than our analysts say, but that will be needed to sustain the price gains they have generated so far this year.

Without a breakout from the trading range, the oil patch appears to be adequately priced. That also is true of the REITs, which should be market performers, but no more. The security and safety segment also appears to be a market performer this year, though some upside earnings surprises could generate a little enthusiasm.

I am also at odds with our analysts on the earnings of building products. Appliance sales are surprisingly strong (probably remodeling because those with mortgages under water are resigned to stay in the same place for an extended period of time).

Our technology is not as inexpensive as earlier in the year, though I would certainly consider rebounds in semiconductors, communications technology, and enterprise storage. I also believe earnings will improve in transactions processing, though investors want to see them before going there.

Finally, transportation must be a player if this recovery is sustained. Despite large unutilized capacity, I believe maritime rates in Asia are rising and that will improve profits. I am less certain about air freight, as the current shortage of supply in a few areas should be relieved by rising production later this spring.

Our analysts believe profits will grow only slightly more than 10% in the MK universe. I expect a bit more growth than that. As you know, upside earnings surprises usually aid stock prices, so I am looking for significant gains in the MK universe in the next few months.

Current forecasts for several key economic variables are shown below (they reflect the chain weighted measures of GDP):

	2009	2010				2011				Ann.	Ann.	Ann.	Ann.
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010	2011
Real GDP	5.9	2.7	4.3	1.7	3.2	3.1	4.3	4.7	4.4	0.4	-2.4	2.7	3.6
GDP Deflator	0.4	1.3	1.6	1.8	2.1	2.3	2.5	2.4	2.6	2.1	1.2	1.5	2.3
Nominal GDP	6.3	4.2	6.0	3.6	5.4	5.5	6.9	7.2	7.2	2.6	-1.3	4.3	6.0
CPI-U (annual rate)	2.6	2.3	2.8	2.8	2.7	3.0	2.9	3.1	3.3	3.8	-0.4	2.7	3.1
91-Day Bills	0.0	0.1	0.2	0.1	0.3	0.9	1.3	1.8	2.2	1.5	0.2	0.2	1.6
Prime Rate	3.3	3.3	3.3	3.3	3.3	3.9	4.7	5.3	5.7	5.1	3.3	3.3	4.9
Federal Funds	0.1	0.1	0.2	0.2	0.2	0.9	1.6	2.3	2.7	1.9	0.2	0.2	1.9
2-Yr Note	0.9	0.9	0.9	0.9	1.3	1.7	2.2	2.5	2.9	1.9	1.0	1.0	2.3
5-Yr Note	2.3	2.4	2.4	2.4	2.6	2.9	3.2	3.4	3.8	2.8	2.2	2.5	3.3
10-Yr Note	3.4	3.7	3.8	3.9	4.0	4.4	4.6	4.7	5.0	3.7	3.3	3.9	4.7
LT-Average	4.4	4.6	4.7	4.9	5.0	5.3	5.5	5.7	5.8	4.3	4.1	4.8	5.6
Aaa	5.2	5.3	5.5	5.6	5.8	6.1	6.3	6.4	6.6	5.6	5.3	5.6	6.4
Baa	6.4	6.3	6.5	6.6	6.8	7.0	7.3	7.4	7.6	7.5	7.3	6.6	7.3
Corporate Profits ($bil)	1260	1302	1352	1371	1409	1448	1503	1555	1602	1171	1111	1359	1527
Operating Profits Adjusted ($bil)	1109	1148	1193	1210	1248	1281	1332	1384	1430	1068	996	1200	1357
S&P 500	1089	1129	1192	1243	1301	1352	1402	1415	1468	1220	948	1216	1409
S&P 500 Equil.*	1333	1402	1411	1410	1412	1408	1403	1439	1447	1220	1112	1409	1424
Value Gap (%)	-18	-19	-16	-12	-8	-4	0	-2	+2	0	-15	-14	-1
Dow Jones	10172	10414	10992	11416	12091	12564	13097	13211	13642	11253	8876	11228	13129
NASDAQ	2162	2227	2442	2538	2662	2757	2897	2915	3005	2162	1845	2467	2916
Trade Weighted Dollar	100.9	103.7	103.5	103.1	103.8	104.3	105.0	105.5	106.1	100.7	105.6	103.5	105.2

**This is an equilibrium value based upon discounted cash flows related to current earnings and discounted by Baa rates and adjusted for additional share supply for existing companies. I have recalibrated the estimates based upon trend peaks in stock market values.* *Updated March 11, 2010*