CAPITAL MARKET COMMENTARY, SEPTEMBER 16, 2008

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Yesterday's manic Monday, following a weekend of frenzied activity and last-ditch negotiations, drew the final curtain on two storied Wall Street firms. A third firm has been left teetering on the brink, as it seeks to either sell assets or secure a capital infusion to allow it to withstand impending collateral calls and to continue operations. Several other well-known financial firms now find themselves under the microscope as well.

In the broadest sense, Monday's events were simply a continuation of the process of deleveraging and financial cleansing that began in August 2007 for major Wall Street firms, many of which continue to buckle under the weight of declining mortgage-related assets. For the firms in Monday's headlines, however, the systemic cleansing has certainly exacted a heavy toll.

What happened with Lehman and Merrill?

Lehman Brothers, a venerable Wall Street firm with a 158-year history, filed for Chapter 11 bankruptcy on Monday, succumbing to weeks of speculation that the firm was under financial distress. Lehman found itself with no other options after potential suitors—most notably, Barclays PLC and Bank of America—backed away from earnest purchase talks over the weekend.

The liquidity squeeze at Lehman was similar to that which brought down Bear Stearns in March, where an inability to access short-term funding, falling confidence among its business partners, and a declining stock price combined to sound its death knell. In stark contrast to its actions in orchestrating the March sale of Bear Stearns to JPMorgan, however, the Federal Reserve (the Fed) refused to pledge public funds to absorb any portion of potential losses that Lehman's potential acquirers might incur. While at times a deal appeared close, in the end any potential agreements evaporated in the absence of a governmental backstop, and Lehman found itself with no viable suitors. In this instance, the Fed and the Treasury drew a clear line in the sand—the government was no longer willing to put taxpayer funds at risk.

Merrill Lynch, seeing Lehman's ignominious fate as one potential outcome for itself, decided to control its own destiny by agreeing to sell itself to Bank of America on Sunday. Terms of the all-stock deal call for Bank of America to swap 0.8595 of its shares for each share of Merrill—which translates into $22.82, based on Monday's closing prices. Though Merrill did not appear to be in imminent danger, the potential for it to face a liquidity squeeze similar to Lehman and Bear proved too big a risk to take in the current environment.

The merger took the markets mostly by surprise, especially since Bank of America had been considered a key bidder for Lehman. It makes a great deal of sense for Bank of America, however. The firm has made clear its intention to pursue the mass-affluent marketplace—and in Merrill it acquires a premium franchise of 17,000 advisors who are considered strong players in that space, at what the firm has described as a low price. For Merrill, its shareholders receive a sizable premium over the then-market price, as well as the financial backing of its new parent company. The acquisition could pose integration challenges for Bank of America, however, as it is the second major purchase for the firm this year—following the January close of its buyout of troubled mortgage lender Countrywide.

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AIG's situation continues to unfold

With two major questions going into the weekend now resolved—Lehman and Merrill—the remaining (and biggest) unsolved mystery is now American International Group (AIG). The insurance firm entered the weekend seeking to sell prized assets to raise capital, or to gain access to a capital infusion or bridge loan of roughly $40 billion to stave off short-term liquidity concerns. It failed to succeed on either front and entered Monday under duress, which only worsened throughout the day—and night.

Investor concerns drove AIG's stock price lower throughout the day on Monday, to a loss of more than 55 percent. In addition, a severe deterioration in business conditions caused the $40-billion estimate of required capital to balloon to $75 billion—an amount that the Fed has asked investment banks Goldman Sachs and Morgan Stanley to participate in raising. The rapid deterioration in business conditions throughout the day caused major credit rating agencies S&P, Fitch, and Moody's to downgrade some classes of AIG debt as of 10:00 P.M. Monday evening. The downgrades are a significant negative development for the firm, as they can require AIG to post additional collateral of $14.5 billion with its credit-default-swap (CDS) trading partners, further worsening the firm's liquidity situation. On Tuesday, AIG shares opened down another 62 percent—down to $1.85—and its bonds were trading at roughly 30 cents on the dollar. It has subsequently rallied, as the potential for Fed involvement in maintaining its solvency appears to be back on the table.

AIG is the biggest provider of commercial insurance in the U.S., in addition to being one of the biggest writers of life assurance and a significant provider of fixed annuities. It is also a major counterparty in swaps and hedging transactions around the globe. In short, unlike the conclusion reached on Lehman, AIG may well be the poster child for an institution that is deemed too big and too interconnected (via the CDS market) to fail. Should it go down, the ramifications to the global financial system would be significant.

Reports indicate that AIG needs to raise cash by Wednesday in order to avoid a potential collapse. The firm is in desperate need of the gift of time—time to engage in an orderly unwinding of its various CDS exposures, in particular those related to mortgage-linked collateralized debt obligations (CDOs). As such, we believe the Fed and Treasury in the next two days will be creative and diligent in attempting to orchestrate a solution. The market's reaction, particularly on the fixed income front, implies that bankruptcy is not a low probability outcome, however. The situation is literally changing by the minute, and its outcome could have significant impacts on the market's short-term direction.

Fed seeks to increase market liquidity

Recognizing the seriousness of the current issues, the Fed also took steps to broaden its efforts to provide liquidity to the market. It loosened the rules for acceptable collateral for its Primary Dealer Credit Facility (PDCF) to include the types of collateral that can be pledged in the tri-party repo systems of the two major clearing banks. This is de facto an acceptance of equity securities as acceptable collateral—a significant concession. Previously, PDCF collateral had been limited to investment-grade debt securities only. Also, the Fed expanded the eligible collateral for the Term Securities Lending Facility (TSLF) to include all investment-grade debt securities. Previously, only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities could be pledged.

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Finally, the Fed increased the frequency and size of the TSLF auctions to be $150 billion each week, versus $125 billion every two weeks previously. These steps were designed to improve credit availability in the coming days and weeks, and to counteract negative implications of Lehman's Chapter 11 bankruptcy reorganization and the final resolution of AIG's situation.

On Tuesday, the Fed holds its regularly scheduled policy meeting, and the market is expecting an interest rate cut of at least 25 basis points. Commonwealth believes the Fed will stand pat, however, and instead continue to focus its efforts on more targeted liquidity injections.

The situation remains uncertain

Investors around the globe are eager to extricate themselves from the financial market stress that we have experienced since August 2007. Around each corner, however, there seems to lurk another accident scene. At this point, Washington Mutual and Wachovia are bearing the brunt of market pessimism. Questions have also been raised about the long-term viability of remaining standalone investment banks Morgan Stanley and Goldman Sachs, which remain highly leveraged and dependent on credit availability to fund operations. Commonwealth Research does not necessarily expect Lehman to be the final shoe to drop, though we hope that to be the case. Alas, hope is not a strategy, and so we will continue to monitor and update the situation as warranted.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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