

CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

After the Rally

Although stock markets continued their strong performance coming off the March bottom, the major indices showed some signs of cooling. In May, the DJIA rose 4.52%, the S&P 500 reached positive territory for the year after gaining 5.59% and the NASDAQ Composite another strong month with a gain of 3.32%. The indices are up double digits from their March closing lows with the DJIA rallying 29.83%, the S&P 500 up 35.86% and the NASDAQ Composite leading the pack by rising 39.86%. The rally was not unexpected. Previous waterfall market crashes saw similarly large rallies from their low. However, the duration of the current cyclical bull market has grown overextended as the major indices have reached technical resistance levels and will need to consolidate before moving higher. For the S&P 500, in particular, the 950 level has been difficult to summit and numerous thrusts have been repelled. The continued testing and failure of a technical level such as this typically points to a market retracement. The S&P 500 has retraced approximately 50% of its decline from October 2008 and is unlikely to move higher without some market catalyst or a clearer sense of when the U.S. will emerge from recession. There has been no shortage of events in recent weeks and every economic release has been dissected and used to paint a bullish or bearish picture, depending on which side of the trade you're on. Earnings season approaches and investors will be focusing on which companies are showing signs of life and which are likely to fade away. The financial sector will be closely watched to determine which banks can stand on their own and repay government TARP funds, but the larger question will be what the regulatory landscape will look like after President Obama's regulatory overhaul goes to Congress.

While financial firms have become the populist whipping boy of most Americans, the real punishment for these firms is only starting to be handed out. The need for regulatory overhaul of the financial sector has been long overdue as the risks these firms take have outgrown the legislation and the regulation that is currently in existence. The rules of the game are still being rewritten and investors are waiting to sort through the rhetoric to determine what it means for their portfolio. Banks will be front and center, as will companies that are part of the "shadow banking" sector, such as AIG. The ratings agencies will also catch the ire of politicians, but the easiest marks are still hedge funds and private equity funds. Firms that are further down the food chain like

credit cards companies must also adjust their models to a new world of more stringent consumer protection under President Obama's consumer protection agency. CEO's need to be aware as punishing corporate greed and capping excessive pay make for good television and help Congressman look like they are working for constituents.

There is no simple blueprint for a new regulatory environment and any rational government proposal should make clear that this will be a work in progress for several reasons. First off, as difficult as it has been to identify the nebulous risks in the U.S. and international financial markets, it will be more difficult to find an effective way to regulate them without choking global growth. Furthermore, regulatory authority will be toothless until the government withdraws from the private sector and shows that it is no longer in the bailout game. If large, "too big to fail" companies believe they will once again be bailed out by the taxpayer, they will continue to take regulation lightly and take risks that are not prudent for their shareholders or the financial system. While the desire to reform is sincere, it is unlikely that there will be lasting lessons as the U.S. has failed to learn from similar crises in the past, most recently the savings and loan debacle.

AIG's bailout has brought the shadow banking system to the forefront as Americans are outraged over the billions of dollars pumped into the company. The source of AIG's problems has been the massive exposure to unregulated credit default swaps that have made the company look more like an amateur bookie than a cutting edge financial power. The first step in regulating OTC derivatives, including CDS, will be to bring the trading of these instruments into the light of day. This means centralized clearing and exchange trading for standardized contracts, with more exotic versions still available in the OTC market, if needed at all. This is a no brainer and begs the question: why has this taken so long? A move in this direction will lower the cost (and profits) for CDS, help regulators better understand who the major players are, increase margin requirements and limit large speculative positions as well as lower the likelihood of fraud and market manipulation. Congress will also follow the OTC derivative trail to the door of hedge funds. However, despite highly publicized frauds in hedge funds, the majority of funds behave rationally, perform better than traditional asset classes and generally comply with regulations without threatening the system.

Additional regulation would be helpful, but hedge funds are not the utmost priority for regulators.

In addition to OTC derivative regulation, increased banking supervision should be the biggest focus for the administration in proposing regulatory changes. Capital reserve ratios clearly need to be higher and leverage has to decrease on bank balance sheets. Furthermore, the risk associated with assets needs to be priced appropriately and allow a cushion for what those assets would fetch in an illiquid market. Mortgage backed securities, both residential and commercial, were marked to model for years before the recent crisis exposed banks to the real prices of those assets. When the time came to raise capital, many of these positions traded at pennies on the dollar compared to the frothy valuations banks used to support their levered exposures. The major banks have raised significant amounts of capital in recent weeks but will it be enough if other parts of their portfolios, such as ABS (asset backed securities, backed by credit cards and auto loans) and commercial real estate, continue to hemorrhage? Assigning risk levels to different tiers of capital has been the foundation of the Basel banking accords, but those guidelines have been driven by the bankers themselves and underestimate the real risks on their balance sheets, especially during periods of deleveraging.

Any regulatory overhaul wouldn't be complete without a closer looking at the real estate market, specifically mortgages. The industry has begun to self-regulate, namely because there is less money to lend so lending standards have gone up, but don't hold your breath waiting for larger government intervention outside of a consumer protection agency. Government housing subsidies through the GSE's (Fannie and Freddie) is one of the biggest businesses around for politicians who receive campaign contributions from them. Dismantling the GSE's is not an option now, but a focus on prudent regulation of mortgages is needed. Prior to the sub-prime debacle, lenders and borrowers had a reasonable set of guidelines that provided security for both sides. The system has broken down for a number of reasons but primarily because the people making the loans are no longer taking on the credit risk of the borrower.

Mortgages are quickly sold and then enter the securitization process with the end investor taking all the risk on opaque pools of capital. A likely proposal of the administration would be for securitizers to bear a percentage of risk of the asset, prompting them in turn to be more selective in choosing which mortgages to package into a MBS. The trickle down effect will hopefully incent lenders to raise standards as there would be a smaller securitization market for them to sell their mortgages into. Liar loans and NINJA (no income no job and no assets) loans will hopefully disappear altogether as the premise for their existence is absurd in hindsight.

President Obama's proposals will have a difficult time passing through Congress, especially given the healthcare proposals he is pushing simultaneously. While the regulation of OTC derivatives will likely be passed, other measures regarding consumer protection and more stringent bank regulation are likely to be debated and watered down. Furthermore, the proposal to have the Fed oversee holding companies and large financial institutions will also get some pushback from Congress for fear of concentrating too much power in the Fed. Compromises will be made after fierce debate and closed door wheeling and dealing and the new regulatory environment is likely to have a dampening effect on the economy. Banks, insurance companies, and credit cards will all face new regulations that will change their business models and decrease earnings potential. With price to earnings ratios still high relative to prior recessions, there is a likelihood that financials will have to decline in price as earnings will grow at a more pedestrian pace in a more regulated market. More regulation, a higher savings rate and an uptrend on interest rates may curb lending further by year end and put a ceiling on the market rally. The S&P is likely to climb over the 950 level by year end, but don't expect markets to rally back to 2007 highs anytime soon. All of these factors point to slower growth in the US and could lead to international investors looking elsewhere with their portfolios.