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Economy Hits Brick Wall; 1980 Parallel

We're in a sharp recession, the real deal, as sudden as the second quarter of 1980 when GDP fell 7.8% (followed by a 0.7% decline in the third quarter of 1980.)

- As the current recession deepens, the equity market testing process has expanded to non-financials, looking for companies which are too leveraged to survive. Retailers are the latest question mark, though the testing of banks and insurance companies is still intense.

- Washington has taken numerous powerful steps to stabilize the financial system. Among others steps, Washington is defending bank assets, bank liabilities, money market funds, and commercial paper facilities and will soon inject capital into banks.

- Perhaps most important, Washington now seems willing to help troubled financial institutions achieve a higher stock price (Morgan Stanley) rather than forcing equity collapses as required in previous 2008 financial rescue efforts.

We think more actions would help shorten the recession, but that this week's actions are probably broad enough to stop the financial collapse. The new tools will take a few days to become operative, so it's too early to call them ineffective. Other helpful steps would be:

- Treasury could lower conforming mortgage rates through its control of Fannie Mae and Freddie Mac.

- Washington should long ago have suspended and reviewed the mark-to-market auditing requirements. They may be preferable in theory, but the new tests and severe liability risks stemming from Sarbanes Oxley are harmful during the crisis.

- Washington could interrupt the harmful interplay between the unregulated CDS market, bond rating agencies, debt covenants, and anti-stock bias in the rules for company information disclosures. The interplay goes way beyond creative destruction. Washington could discourage regulators and bond raters from using CDS prices without full disclosure of CDS volumes and holders. It could invite companies and their counterparties to provide more information more quickly than current rules.

- LIBOR is broken as a benchmark due to the Lehman bankruptcy (which caused defaults on some interbank loans). LIBOR could be replaced until it functions better, or immediately forced lower (the British government now owns several of the banks contributing rates, others are too weak to be included in the LIBOR survey.) Many LIBOR-related contracts contain an out-clause allowing other benchmarks, opening a path away from LIBOR if it can't be fixed fast.

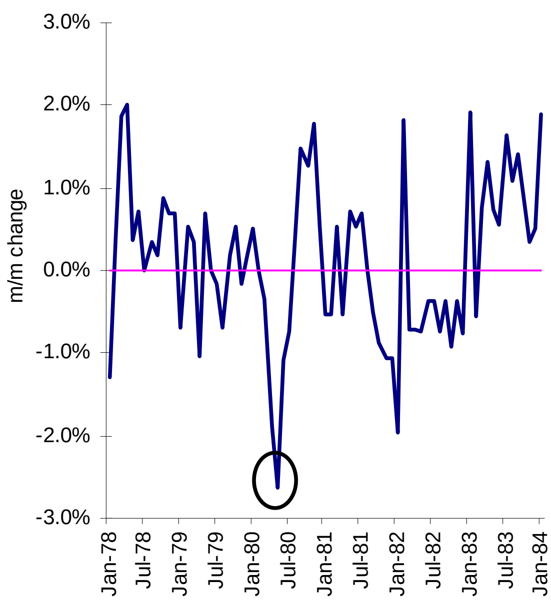
Economy Hits a Brick Wall

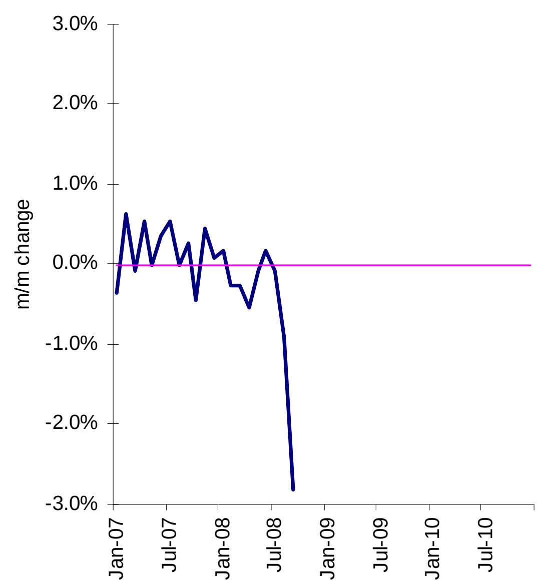
We expect a sharp recession brought on by the high mortgage rates, the dollar collapse in the first half of 2008, the commodity spike into July, and the equity collapse at Lehman, AIG, Fannie/Freddie and more broadly. These problems have expanded into jobless claims, consumer credit, and retail sales. We expect sharp new weakness in non-financial corporate earnings as the recession deepens.

- While the current situation is unique, it is interesting to compare it to historical parallels to try to assess the range of possibilities. The summer-1980 recession offers a comparison to a sharp, deep decline in economic activity.

- Industrial production fell 2.8% in September 2008, worse than the 2.6% decline in May 1980 toward the end of that recession (which extended from January 1980-July 1980).

Industrial Production mo/mo chg comparing 1978 to 1983 and 2007 forward (last obs. September 2008)





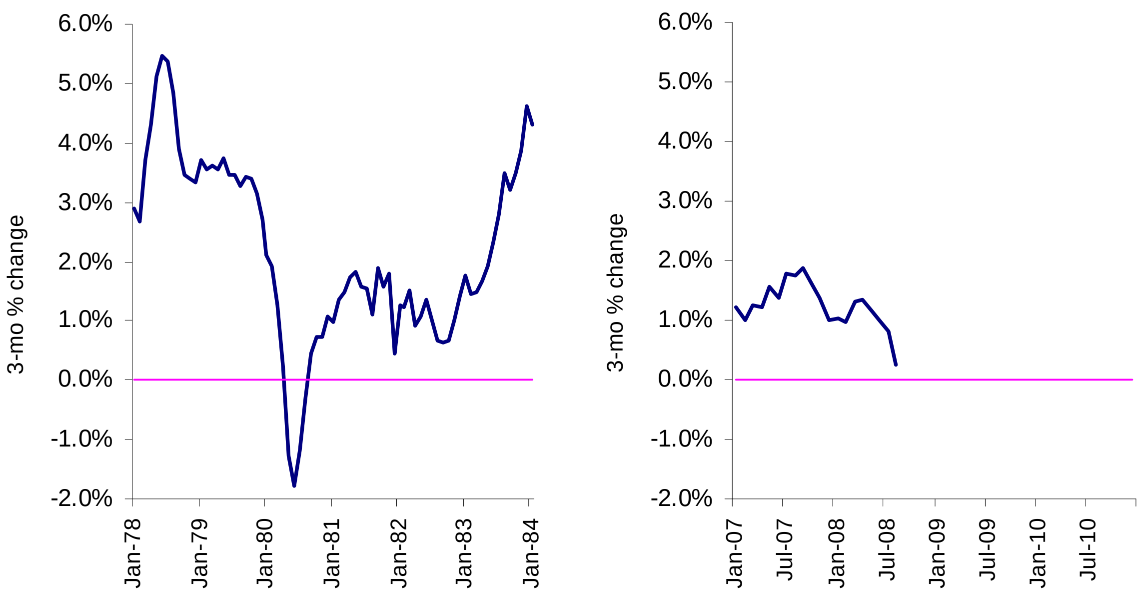
Source: Haver; Encima Global

Sudden Credit Cessation (March 1980 and September 2008)

- The Lehman bankruptcy and AIG collapse have created an abrupt cessation of credit. Banks are choosing not to lend, waiting to see which customers will be bankrupt.

- Creating a similar credit event, the Fed pushed the Fed funds rate to 20% on March 3, 1980, stopping banks from lending almost overnight. In that instance, consumer credit fell 1.8% from March through June, 1980.

Consumer Credit 3-mo chg comparing 1978 to 1983 and 2007 forward (last obs. August 2008)



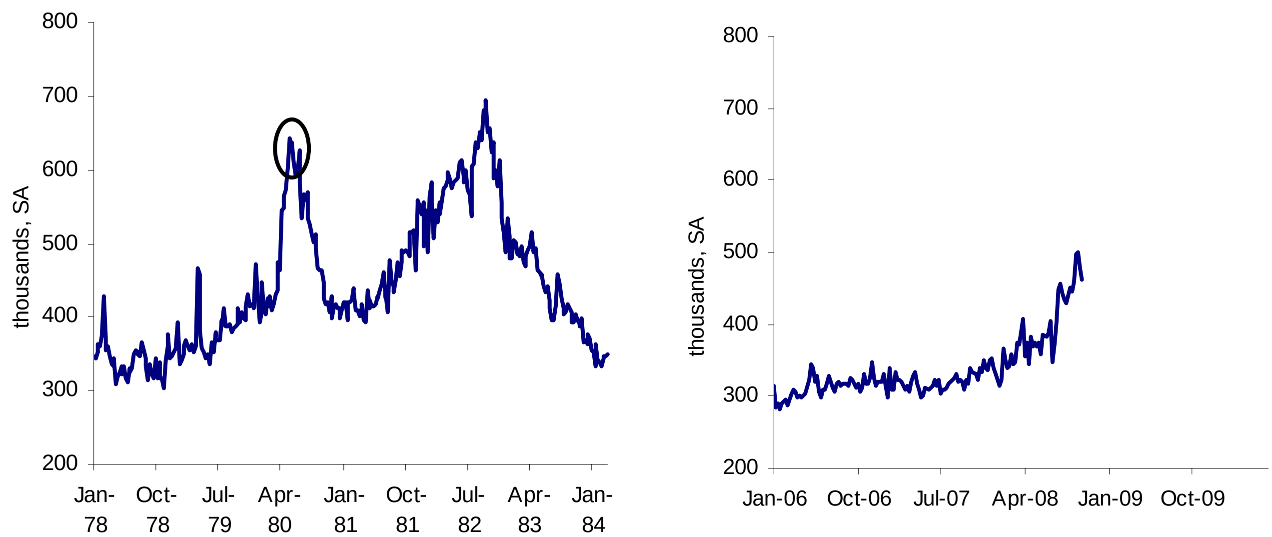
Source: Haver; Encima Global

Labor Situation Worsens

The 2008 labor situation has deteriorated rapidly, though not yet as precipitously as in the spring of 1980.

- In 1980, jobless claims rose from 409,000 on February 29, 1980 to 642,000 by May 16, 1980, pushing unemployment to 7.8% in July 1980, up from 5.6% in May 1979.
- In 2008, the four-week average of claims has risen from the 380,000 level mid-year to 483,000 in the October 16 data release. We expect jobless claims to move substantially higher, pushing unemployment from September's 6.1% to 6.5% in coming months, perhaps higher due to the likely deep slump in retail employment.

Initial unemployment claims comparing 1978 to 1984 and 2006 forward (last obs. October 11, 2008)



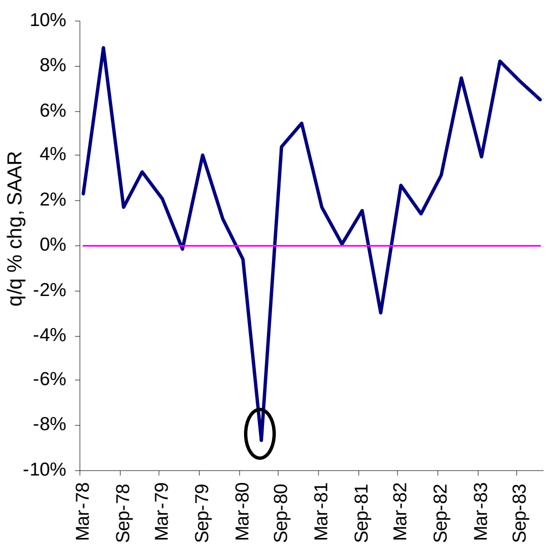
Source: Haver; Encima Global

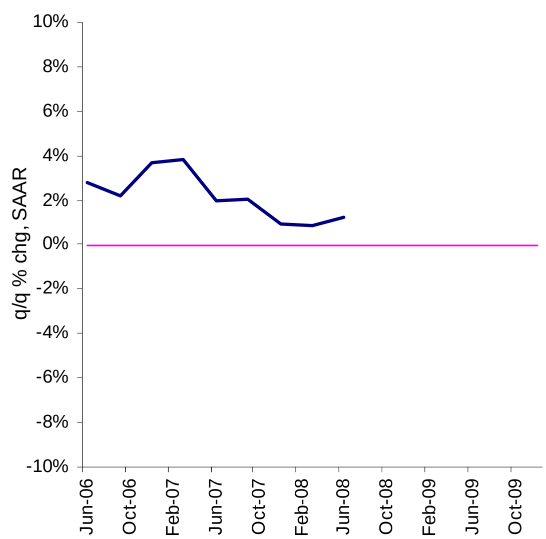
Consumption Responds to Labor and Credit

- After jobless claims spiked and credit stopped in March 1980, real consumption fell 8.6% in the second quarter of 1980. Our September 26 GDP forecast has a 0.6% decline in real PCE in the fourth quarter, but we now think it will be much deeper given the October market panic and the continuing increase in jobless claims.

- Auto sales fell from a 14.1 million annual rate in January 1980 to a 9.3 million annual rate in May 1980. In the current episode, auto sales have fallen from a 16.3 million annual rate in December 2007 to a 12.5 million rate in September 2008.

Real PCE Q/Q chg comparing 1978 to 1983 with 2006 forward (last obs. Q2 2008)





Source: Haver; Encima Global

Stocks Hit Harder in 2008 than in 1980

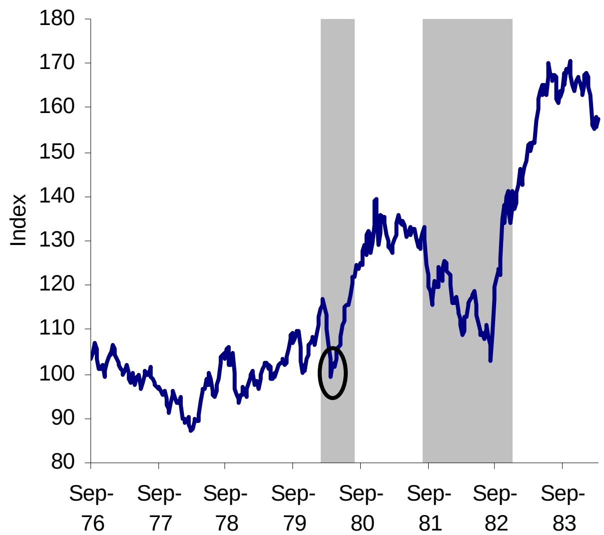
- The S&P hit an interim low of 99 on March 26, 1980, down from 108 in September 1976, and down massively in inflation-adjusted terms. (The CPI peaked at 14.7% year-over-year in March 1980, eroding equity values.)

- From 99 in March 1980, the S&P then rose to 140 by November 1980 as investors looked past the recession and selling panic.

- As the 1980 recession unfolded, Fed Chairman Paul Volcker cut interest rates to 11.5% in April (from 20% in March.) Inflation stayed high, so rates rose back to 20% in December 1980 and May 1981, contributing to an even deeper recession than the first half of 1980. **In both recessions, equities bottomed in the middle of the recession and enjoyed sharp gains.**

- Equities have been hit harder in this recession than in 1980, though from a higher level in terms of the PE multiple. **We expect a sharp recession but a relatively quick recovery in the first half of 2009, allowing strong equity gains once the recovery comes into sight.**

S&P 500 comparing 1976 to 1983 and 2006 forward (last obs. October 16, 2008)



Source: Haver; Encima Global

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