

Quarterly Market Insight

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THE SOUND OF ONE HAND CLAPPING

In our role as raconteurs of the global macro landscape, we find ourselves well attuned to the record of the U.S. Federal Reserve and, over time, one of the most reliable formulas for making money in the financial markets has been the old Wall Street adage, "Don't fight the Fed." During the tenure of Alan Greenspan, prudent investors took this maxim very seriously, for when a crisis developed, he preemptively moved Fed Funds and injected liquidity into the banking system to stave off the long term consequences of asset deflation on the economic system. For two decades, he was so successful at executing this strategy that the behavior of the Fed in times of stress came to be characterized by "the Greenspan put."

We have a new Fed chairman now, and up until this past summer, other than taking Fed Funds to 5.25% in June 2006 to make the point that he was an inflation fighter, he has spent most of his time focused on increasing the transparency of the central bank. But it's "show time" now, with the crisis in the mortgage market having placed the Fed front-and-center in developing a response that balances the trade-off between moral hazard (i.e., bailing out irresponsible lenders) and its role as lender of last resort (i.e., reliquifying the financial system). As we mentioned in our last letter, the mortgage meltdown is the one of the biggest crises in our many years on the Street and we believe Ben Bernanke's response will define his legacy.

The financial writers have chronicled the events leading up to crisis, discussing at length many of the issues, including subprime and Alt-A mortgages, pricing models, market illiquidity, housing deflation and, of course, the write-offs. However, there remains limited clarity as to why the plumbing in the banking system is so clogged and why the Fed has been so slow to develop a game plan that the market can lend credence to.

The first responses to the crisis represented "Classic Fed" in both actions and statements. They cut the Fed Funds rate and also reduced the spread between Fed Funds and the discount rate to encourage institutions in need of liquidity to use the discount window. Almost as if on cue, the markets paid heed to the time-honored adage and elected not to engage in a fight against the Fed. Unfortunately, limited borrowing took place at the discount window because of the stigma attached to it and, as time wore on, it became apparent that this staid response was ineffective in the face of an illiquidity crisis proving both peculiar and persistent.

The real issue is that for the past 25 years the banks have been moving away from the practice of lending money to worthy borrowers and holding the loans on their balance sheets and toward a fee-based model of underwriting and securitization. This structured product model was developed by Salomon Brothers in the early 1980s as a way to move mortgage product and eventually morphed into the securitization of credit cards, auto loans, etc. To place the enormity of the problem into perspective, one need only know that the mortgage market alone is \$14 trillion in size. It is the largest bond market in the world – almost three times larger than the U.S. government bond market. The problem is that seemingly overnight this well-developed business model channeling originated mortgages into structured product was shut down, and financial institutions were forced to revert back to the days of old when mortgages needed to either be placed on bank balance sheets or sold to the government-sponsored entities (i.e., Fannie Mae and Freddie Mac). This is obviously not a novel approach to banking, but time is desperately needed to implement a structural shift to a new business model. Just in the past four months, to fund the unprecedented asset growth involved with bringing mortgages, structured investment vehicles (SIVs) and bridge loans onto their balance sheets, banks have issued an unprecedented \$400 billion in certificates of deposit (CDs)!

With the patient still in the operating room, in October the Fed begrudgingly reduced both the Fed Funds and discount rate, with accompanying "Fed speak" indicating that with the move, its policy should once again be regarded as balanced to the risks of inflation and economic contraction. This was followed by a number of well orchestrated speeches from the regional Fed governors that dwelt on inflation fears in combination with a degree of tolerance for weak economic performance. We were stunned, and at the time felt the Fed made a serious policy mistake. The markets appeared to agree and the little bit of good news that was making its way into the market was completely reversed. Unfortunately, the credit crisis and the accompanying blockage in the plumbing of the banking system was left unaddressed.

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APPLAUSE WAITS ON SUCCESS

In December, the Fed finally got it right, but they deserve a grade of "F" in communication skills. Bernanke dogmatically responded to the deterioration in the economy with a 25 basis point (bp) reduction in Fed Funds, but the market (and we) wanted them to address the real issue of stress in the banking system. A day later they would do so in announcing the establishment of a Term Auction Facility (TAF). While this is what we had been waiting for, the Fed had saved what could well prove the most important policy decision in Bernanke's career for the next day, rendering the coordinated international attack on the constrained inner workings of the financial system an afterthought and breaking the back of a tenuous market.

We believe the TAFs have, and will continue to, bring a significant measure of relief to the beleaguered market for interbank lending. The banks can now put up mortgages as collateral and the Fed will lend them money. The TAF loans are designed to strike at the heart of the problem by adding liquidity to the banking system with the goal of bringing the spread between Fed Funds and the London Interbank Offered Rate (LIBOR) back to normal. This is extraordinarily important because trillions of dollars of securities are priced off of LIBOR. Over the past six months, Treasury yields have fallen by an astounding 100bps to 200bps; unfortunately, the private sector, which desperately needs lower rates, has seen its borrowing costs rise. As intended, LIBOR has broken, and this will go a long way toward relieving some of the pressure in the private sector. Also, the Fed's aggressive and targeted move has the potential to serve as a much needed tonic for housing. Since the announcement of the program in December, 30-year mortgage rates have fallen 50bps, from 6.25% to under 5.75%, potentially bringing a sorely needed source of relief for homeowners and would-be buyers. In our view, the Fed is finally on the right track and, we believe, finally deserving of commendation. Perhaps they now need to take some kind of Hippocratic Oath which states, "first do no harm."

We have been surprised at how long it took the Fed to address the breakdown in financial intermediation. The unique nature of the crisis and the time lag in formulating the proper, laser-like response has allowed volatility to reign supreme since mid-year. We have experienced a number of second and third stage credit meltdowns and false recoveries in the second half, and we have also had to contend with currency movements of 10% or more in both directions over a few short months. The drama and angst has been led by the action (or inaction) of the Fed discussed above and has been overlaid by a U.S. recession capitulation theme that periodically weaves itself into and out of the market psyche. What is so disheartening is that the Fed, with 12,000 employees whose task is to oversee the workings of the banking system, by our estimates, single-handedly increased the odds of a recession from 20% in the summer to over 60% today because they took six months to address the crisis. Fortunately, the mammoth monetary operations, conducted in late December, by the major central banks have largely worked in reducing the short term cost of debt capital as measured by LIBOR and brought relief in the form of lower mortgage rates as well.

The divergence in economic performance between the U.S. and the rest of the world has been nothing short of breathtaking. At this point, the U.S. is well into the reliquification phase of the business cycle wherein the consumer appetite for savings trumps his appetite for goods. The maximum pain from this process is headlined everyday in the dour news from the housing market. It represents a reorientation of priorities that is part of the healing stage occurring in every economic cycle. The Fed's recent and expected future actions are also part of the framework for the renewal phase. These actions will intersect with a slowdown in global growth, but by mid-year we believe that the U.S. will have moved off the operating table and into the recovery room. With Europe and Japan slowing, the stage will be set for a narrowing of the growth differentials between the U.S. and the rest of the world which should be good news for the dollar.

PAUL LESUTIS, CFA PORTFOLIO MANAGER, FUNDAMENTAL LARGE CAP VALUE

The equity market weakened in the fourth quarter and the weakness cascaded into near panic selling both here and abroad in January. Value underperformed the market in the quarter and we underperformed the value benchmarks as our financial and retail stocks were hit hard.

Retail sales were very disappointing at year-end and it appears that economic growth has slowed to a stall. High oil prices, the severe slump in housing, a sharp decline in consumer confidence and significantly more restrictive lending policies at the banks were the primary factors causing the slowdown, while strong export growth was the bright spot in the economy.

The plunge in global equity markets appears to be anticipating a sharp drop in economic activity and corporate profits in 2008. This is based upon expectations of a housing-induced recession in the U.S. and fears of a significant economic slowdown in China, where regulators are raising interest rates and bank reserve requirements to reign in inflation.

Policy makers in the U.S. have responded aggressively to the numerous signs of weakening economic activity and increasing financial distress. On January 22nd, the Federal Reserve cut the Fed Funds rate to 3.5% and Congress and the Bush administration are working on tax cuts for most taxpayers.

Mortgage rates have fallen considerably over the past month and continue to decline. This is very good news as it should ease pressure on distressed borrowers and make housing more affordable for new borrowers. The combination of sharply lower housing prices and low mortgage rates offers the potential to stabilize the market much sooner than the dire commentary in the press would suggest.

Our judgement is that the combination of low interest rates, very stimulative monetary policy and tax cuts will prevent the present slowdown from deteriorating into a severe recession. Consequently, corporate profits should hold up fairly well in 2008. If this is true, stocks are much too cheap and should rally sharply as investors gain confidence in the economic outlook.

THE ECONOMY

The economy has come under severe pressure, as one hundred dollar oil, a sinking housing market and a sharp contraction in the availability of credit slowed it to a stall by the end of the fourth quarter. Holiday sales were very disappointing and December retail sales declined from a year ago. These declines were accompanied by a slump in business and consumer confidence as falling housing prices, the sub-prime lending scandals, a sharp decline in the stock market and financial difficulties at major lending institutions dominated the headlines. The totality of these developments has pushed the economy to the brink of recession and growth in global economies has begun to slow noticeably.

The reasons for the downturn should be no surprise. The sub-prime housing collapse has undermined the financial underpinnings of major banks and the financial guarantor insurers. Housing prices are in a meltdown in many parts of the country. New construction has ground to a halt and borrowers, builders, lenders and insurers find themselves in difficult, if not dire financial straits. This has caused banks to tighten lending standards and credit markets to close to nearly all but the most credit worthy borrowers.

Now that the slowdown is upon us, the question is how long might it last and how bad it may be. The bearish prognosticators warn that housing prices have much further to fall and that the decline will cause a prolonged recession with significant additional damage to lenders. This dismal forecast is reinforced by predictions that the recession will expose additional serious problems in other lending areas such as credit cards, commercial real estate, and automobile financing. So, the sub-prime mess is just the opening performance and not the entire show.

Another way to frame the bear case is to say that consumers are saddled with too much debt at the same time that high-energy prices and escalating food inflation are depleting their wallets, while their home values and mutual funds are plunging. To make matters worse, they can no longer tap their home equity like an ATM machine in order to purchase big-ticket items such as automobiles and home renovations or pay down credit card debt.

The bullish counter to these positions is that most citizens are not sub-prime borrowers. They are employed, have fixed-rate mortgages and substantial gains in their real estate equity, notwithstanding some declines over the past year. Also, U.S. corporations (outside of the financial sector) are still very profitable and corporate layoffs remain low, as do new unemployment claims. Most importantly, the Federal Reserve is aggressively cutting interest rates and, in election year politicking, the Bush administration, the Congress and the Presidential candidates are lining up to propose new tax cuts, largely in the form of rebates, i.e., the check will be in the mail.

It seems to us that the combination of very low interest rates, monetary and fiscal stimulus and a cheap dollar should provide considerable support for the economy even if this may not be the best policy for the longer term. We are inclined to believe that a more focused package including tax credits for home buyers, raising the conforming loan threshold for Fannie Mae and Freddie Mac mortgage purchases and arranging/facilitating new capital to backstop distressed mortgage and bond insurers, would stabilize the housing market and raise confidence that the economy and the financial system will solve their own problems.

Overall, we are sticking with the view that the economy will slow but not sink, and we suspect that the present combination of low and falling mortgage rates in the aftermath of significant declines in housing prices could create a bottom in housing sooner than most are expecting. On January 22nd, the Federal Reserve lowered the Federal Funds rate by 75 basis points to 3.5%, which is well below the 5.25% rate last summer, and mortgage interest rates have fallen significantly. Present rates of approximately 5.25% on 30-year fixed rate mortgages have rarely been lower over the past fifty years. And most importantly, the LIBOR bank-borrowing rate, which is the benchmark for setting rates on many adjustable rate mortgages, has declined more than 100 basis points over the past month.

We expect that economic growth will be miniscule in early 2008 and that it will teeter around the technical definition of recession. But with the Fed easing aggressively, tax cuts on the way and the corporate sector in good health, we do not anticipate a severe or prolonged economic decline. In this environment, we would expect corporate profits to flatten or decline slightly, which is much better than financial markets seem to be expecting.

THE FINANCIAL MARKETS

Led by financial and retail stocks, the equity market slumped badly late in the fourth quarter. But that was nothing compared to the panic selling that has emerged in January. As we write, the market is off to one of its worst yearly starts and the selling has spread to just about every stock market in the world, nearly all of which are down about 10% in the first three weeks of January. Overall, the U.S. market has declined more than 15% from its October 2007 high.

The selling obviously reflects fear of a recession that would have serious ramifications for the rest of the world. But the

severity of the selling suggests something more than a recession is frightening investors. Most likely, it also reflects concerns over the recent collapse of the stocks of the bond insurers. These companies initially limited their coverage to low risk municipal bonds and then, regrettably, expanded aggressively into the business of insuring corporate credits and sub-prime mortgage paper. Losses are mounting on the mortgage paper and these insurers are thinly capitalized relative to their insured exposure. If they can't provide the stated coverage, then they pose significant risk to the financial system, as many who thought they were hedged will not be so.

Another concern on the minds of investors is the lack of transparency in the huge credit default swap market, which offers no visibility with regard to positions and counterparties. (Credit default swaps are contracts in which one party guarantees the credit of another.) The volume of these financial guarantees has soared in recent years and, just like the numerous iterations of sub-prime mortgage paper, there is no transparency as to who owns the paper or guarantees it. But banks and insurance companies are heavily involved. There is plenty of leverage and the risks of default rise in a recession. Institutions which believe their exposures are hedged may be sorely disappointed if the economy deteriorates to the point at which too many guarantees are triggered.

On the surface, stocks look very cheap relative to earnings and alternatives in the fixed income markets. The S&P 500 is priced at just 14 times 2008 earnings estimates. The earnings yield (inverse of the price-to-earnings (P/E) ratio) is nearly twice the yield on the 10-year U.S. Treasury Note. And the 2% dividend yield on the S&P is more than half the bond yield. Compared to history, these are exceptionally favorable stock valuations unless you believe that corporate earnings are poised for a very substantial and prolonged decline, which we doubt will happen.

In our experience, which goes back some time, major market declines start from high valuations on equities, a leveraged corporate sector and interest rates that are high and rising. Typically, investor sentiment is also very positive. Government bond yields were near 10% in 1987 and 1990 and P/E multiples on the S&P 500 were in the high twenties in 1999 and 2000.

Today we have the opposite. The S&P is priced at a moderate 14 times projected earnings for 2008, the Federal Reserve is cutting interest rates and the yield on the 10-year Treasury is about 3.5%. And to top it off, the stock market is already down more than 15% and investor sentiment is very bearish. Historically, these are the conditions which have triggered major bull markets.

As to which areas are most attractive, it is hard to say, as most are depressed. So there doesn't seem to be a need to make big sector bets. Financials and retailers are the most depressed and probably have the best snap-back potential in the short run. The bad news is out and the short sellers have already had a field day. There is probably more risk in the global industrials which have held up better due to their exposure to rapidly growing emerging markets. These stocks rose with the China boom and they could come under pressure as China takes action to slow its growth and contain inflation. Still, these global industrials have very promising longer-term growth prospects. If the economic slowdown turns out to be mild, stocks should finish this year far above current levels.

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