

Summer 2009

The Picture Is Getting Clearer: What Lies Ahead

We are at a turning point in our view of the economy and of the asset markets, but it's a strange kind of turning point. It is not that things have stopped getting worse and are now getting better. Indeed, many things like unemployment and losses on virtually every type of credit continue to get worse. There will probably be more ups and downs in the coming months.

It is, instead, a turning point in the sense that we are beginning to feel confident in our assessment of how bad things are likely to get. This is a considerable development. In 2008, the price of almost every type of asset collapsed because of both forced and strategic risk reduction from major investors. Liquidity in investments perceived as being risky was available only at a steep discount to current valuations.

This cycle kept repeating, resulting in progressively deeper discounts. Indeed, investments perceived as safe – Treasuries – briefly offered negative yields as liquidity needed somewhere to hide. Institutional investors whose strategies depended on efficient markets were left holding assets that kept falling in price and came to doubt their ability to predict the price of any asset.

That was then. Now buyers are emerging for much of what had been illiquid, from troubled bonds to troubled real estate. This change is reflected in indicators of the markets' willingness to take on risk. Table 1 on the next page shows the so-called VIX, which is a measure of the volume of options being bet on large moves in the S&P 500. Table 2 shows the spread between bank overnight funding rates and Treasury rates. The degree of retreat from crisis fear is very clear.

Some commentators are calling for the resumption of a broad bull market. To us, this is far too aggressive. What we see are two phenomena: First, the beginning of *differentiation* between good and bad assets, something entirely lacking in the illiquidity-induced downward spiral. Second, signs that growth is resuming in parts of the emerging economies and, subsequently, here in the United States and other advanced economies.

You have already seen some focus on these issues in Contango's current strategy. For example, we have tilted our equity portfolios toward what we call "quality companies," with resilient balance sheets, and we have tilted them toward emerging markets.

We are now focusing on a broader array of questions.

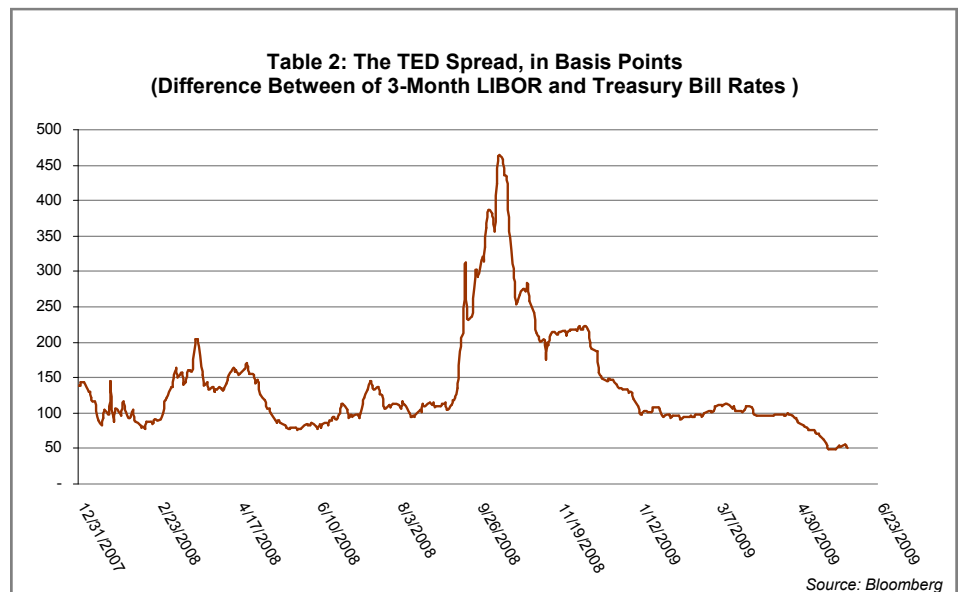
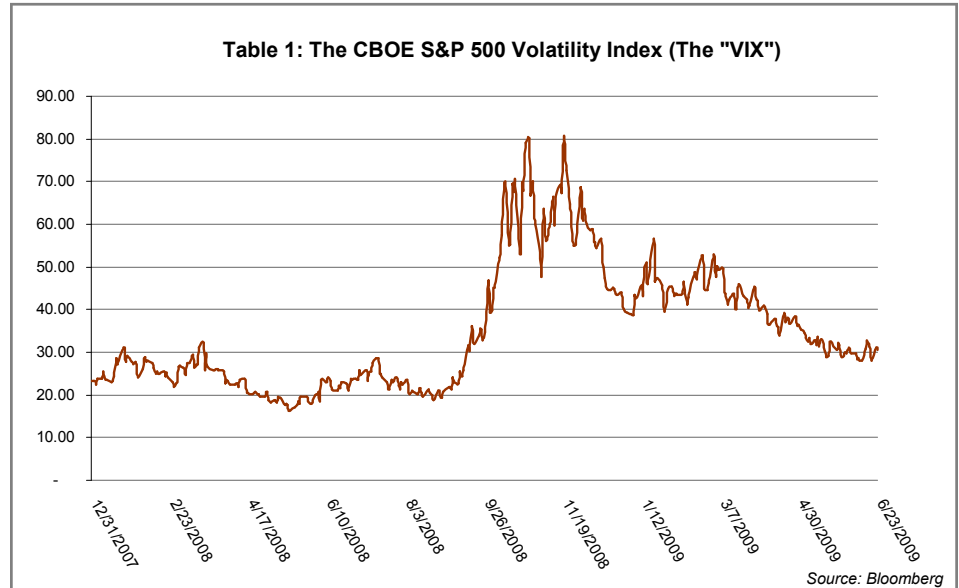
At the macroeconomic level

- Should we aim to pick up yield in our taxable fixed-income portfolios by a combination of extending duration and assuming somewhat lower grades of credit?
- Which categories of real assets are likely to benefit from renewed economic growth and are not already overpriced as a result of the recent rally?
- Will the Federal Reserve Board's combination of low interest rates and security purchases result in inflation and if so, when? If not, how will the US consumer and government release themselves from the burden of leverage? And, in either event, how should we invest?
- And, of course, how much more might equity prices rise after their recovery from the lows of a few months ago?

At the microeconomic level

- Can we find ways of distinguishing between the high-yield debt that will either default or be subject to coerced restructuring and the debt that is now underpriced given the real level of risk to the issuer?
- Is there accessible opportunity in the leveraged loan universe to buy the deeply discounted bank debt of companies that will pay off at par?
- Is it possible to sort through the available mortgage-backed securities and buy loan pools that are worth more than their current prices?
- Which REITs have now raised enough equity capital that they can thrive and buy out the less successful players?

Addressing these questions requires focus on macroeconomic issues and on issues specific to the various types of assets, and also a marked focus on regional differences. Aggregate demand growth, population growth and innovation are the key issues in determining overall economic gain.



Innovation is the easiest to address. Our economy is by far the most innovative and, despite the severe recession, resources have continued to flow into new companies and new ideas. Despite California's public finance woes, here in Berkeley, California we are surrounded by the biotechnology industry and myriad opportunities in alternative energy and clean energy. Private capital is being supplemented by a variety of federal and state initiatives.

When the capital markets turn, we will again see a parade of IPOs and trade purchases that will cause wealth to flow into the local communities and be recycled back into more innovation. Homes in Silicon Valley may well recover and grow in value faster than homes in most other places, for example. How soon could this turn in the economy come? We think before the middle of 2010. Innovation themes will slowly emerge as a long-term position in our portfolios as these technologies and services gather momentum and potential commercialization.

However, neither innovation nor economic problems are uniformly distributed across America. There will be pronounced regional differentiation in the speed of recovery, accentuated by changes in the growth of population. Further decline in the “rust belt” because of the ongoing collapse of the traditional automakers is one of the factors that will slow the conveyor that channeled snowbirds from the Midwest into the once fast-growing communities of Arizona and Nevada. If you can’t sell your house in Michigan and your investments have dramatically fallen in value, you won’t be a buyer in Phoenix. Economies that had been based on the many dimensions of development and construction will have to re-invent themselves, a process that will not be fast.

Aggregate demand remains the most troubling issue. During the credit bubble, every part of our society borrowed too much – households, companies and governments. Household savings rates fell from the 8% to 12% range of the 1980s to 0% by 2007. Why not spend every penny if your net worth in your house and your 401(k) are rising without any effort on your part? Indeed, why not further boost consumption by borrowing against some of that increase in house value? This is how consumption rose to more than 70% of GDP from around 60%, which is normal not only for our society but also for most of Europe and Japan. The share of consumption has to fall back to the 60% range to fund the retirement of the baby boomers and to try to pay off this debt.

How soon could this turn in the economy come?

We think before the middle of 2010.

What demand will replace it? Our government cannot run deficits equivalent to 10% of GDP for very long.

A structural decline in the share of consumption in GDP offers many investment opportunities, of course. We will need 15% fewer department stores and warehouses and retail clerks and less trucking capacity relative to GDP, so these resources will be repriced and redirected. Some of this redirection will likely be into renewal of our frayed infrastructure, much of which dates from the 1960s or earlier, and into those innovations we mentioned above.

For these reasons we are engaged in picking through the opportunities, looking for investments that will be reasonably safe and that are more likely to rise in value in this transitional phase of our economy and markets. We have already identified some of these opportunities and have or will be deploying to them. Other opportunities will become clear to us only over time, as we assess the ongoing developments in the economy.

About the author: George Feiger, Contango’s CEO, has a diverse background in the banking, financial services and wealth management industries. He is also executive vice president of the firm’s parent company, Zions Bancorporation. Mr. Feiger holds a PhD in economics from Harvard University and was an associate professor of finance at Stanford University’s Graduate School of Business.

Spotlight on Panics and Systemic Risk

If a couple needs to sell a house because of divorce, they will probably sell it at a decent price. If hordes of homeowners all put their houses on the market simultaneously, prices will sink. This is the difference between normal market conditions and a financial panic.

The financial markets are susceptible to contagion and toxicity, just as people are. When a large number of investors are exposed to something that suddenly goes awry, they all try to sell their assets at the same time. This massive selling scares away buyers, and creates a wave of selling and sharply falling prices. As the remaining investors see prices plummeting, many of them may decide to sell their holdings because they fear further price drops. This is called a panic.

To catch up on any of our client calls, go to www.contangoadvisors.com, and click on the link for the call you'd like to hear.

A classic panic is a run on a bank. We saw this in 2007 with Northern Rock, in England. Banks do not hold cash to cover 100% of their deposits. Instead, they lend it out. Their business is matching borrowers with savers. If something causes a bank's depositors to lose faith in the bank and to fear that they will not be able to get their money out, they hurry to withdraw their funds while they can. As other depositors see the doubts mounting, they too get in line to withdraw their funds. Because no bank will be able to satisfy the demands of all depositors simultaneously, panic can cause a bank to fail, even if its balance sheet was perfectly sound to start with.

A panic can also center on a particular asset. When Bear Stearns was on the edge of collapse, its stock went from \$62.30 to \$30 in four days. On what turned out to be its final day before the Fed's emergency intervention, it fell 47%. The Fed stepped in because it feared what would happen to the financial system as a whole if Bear Stearns failed.

The Fed had reason for concern. If a panic is limited to a particular asset or institution, the financial system as a whole will remain intact. However, if there is some common theme that joins the toxic asset or institution to others, if many depend on the failed entity for their value, or if there is one significant holder of a toxic asset who has obligations to many other market participants, then the panic can spread to the entire financial system. We call this systemic risk. When this happens, people and institutions start selling any assets that they can, prices fall across the

board, and liquidity dries up. This is when leverage kicks in and amplifies the damage. Because levered players have to repay their lenders quickly, they sell whatever assets they can into a declining market, thus further pushing down prices. We saw this in September 2008, with the collapse of Lehman Brothers, and again in October 2008 when the House of Representatives failed to pass the TARP legislation.

You could say that systemic risk exposes the dangers of volatility, illiquidity, and leverage all together. The more interconnected the global financial system becomes, and the more risk and capital become concentrated in a few large institutions, the more the system becomes susceptible to wholesale panic.

Even if individual investors limit their market risk, try to avoid assets that might become illiquid, and avoid leverage entirely, they may still be susceptible to panics and systemic risk. While we at Contango do our best to anticipate systemic collapses, we cannot foresee every one, nor can we completely shield our investors from the ravages of a panic. What we can do, however, is to emphasize the benefits of diversification and the benefits of being a long-term investor, which include the ability to bounce back over time after panics. Anyone who sees a meltdown around every corner will never take on any risk, and will never be in a position to benefit from asset growth. Those who fear to leave home become hermits.

About the author: Elisabeth Kashner is an analyst with Contango's Investment Strategy Group. She graduated from the University of San Francisco with an MS in financial analysis.

IMPORTANT NOTE: Investment products and services offered through Contango Capital Advisors, Inc., a registered investment adviser and a nonbank subsidiary of Zions Bancorporation, are not insured by the FDIC or any federal or state governmental agency, are not deposits or other obligations of, or guaranteed by, Zions Bancorporation or its affiliates and may be subject to investment risks, including the possible loss of principal value of amount invested.