Boenning Morning Comment

This report is prepared for us by Tower Bridge Advisors April 14, 2010

Stocks closed modestly higher yesterday awaiting the first big earnings reports. Suffice it to say they were good and that should be reflected in a strong stock market this morning. More on that topic later in my letter today.

On Monday I said I would discuss alternatives to perpetuating Fannie Mae and Freddie Mac. These two entities were designed as mechanisms to recirculate mortgage money. They would buy conforming mortgages from banks and similar institutions and either own them for their own accounts or sell them through securitized Ginnie Mae pools. For many years, they were the only game in town but gradually Wall Street discovered mortgage securitizations and created their own pools. They created plain vanilla pools similar to Ginnie Mae gradually moving down the ladder in the direction of sub-prime. Through further creative means they sliced and diced these pools into tranches creating all sorts of risk levels and confusion in the process. Without going into morbid details, many of these pools proved to be toxic and gave a bad name to all forms of non-government mortgage securitizations and mortgage-backed securities.

But there really is no reason that mortgage pools need to carry a scarlet letter on the outside. The structure is fine if the contents aren't poison. Mortgage pools built and designed to meet a conservative set of standards can be very attractive. That may take some convincing today but eventually investors will see the light. Here is where I want to stray into the world of original or semi-original thinking. To start let me switch gears and review what FDIC insurance is all about. Banks are charged a modest fee on all deposits. These fees are used to protect depositors of failed institutions. Banks are heavily regulated and, hopefully, as a result except in severe economic times, bank failures are few and far between and the insurance premiums collected are sufficient to cover losses. While recent bank failures have run down premium reserves, so far the FDIC has not had to use taxpayer money to bail out the banking industry.

It would seem to me that the same FDIC insurance principal can be applied to the mortgage business. Rather than own trillions of dollars of mortgages, the government can simply guarantee mortgages. The funds necessary to guarantee the mortgages would come from premiums charged to mortgage originators who choose to create pools of government guaranteed mortgages for resale. Banks that create these mortgages may even have to retain a certain contingent liability if they default and all principal and interest cannot be recaptured. If it is the pool that is being insured, not every loan has to be successful. Criteria to qualify for the guarantee could be similar to requirements today necessary to sell mortgages to Fannie Mae or Freddie Mac. Not all mortgages need qualify. Guaranteed mortgages could be packaged in a vanilla fashion or could be included in tranched pools but, at least in my model, no additional leverage would be allowed and all mortgages included must meet quality standards, not just some. As for existing holdings of Fannie Mae and Freddie Mac, they either could be held to maturity (or prepayment) or they could be packaged and sold in similar fashion. Because mortgage creators would pay the guarantee premium, the system would be at least semi-self policing. Too many failures would necessitate future premium increases. The system would require a strong regulatory and enforcement mechanism similar to the FDIC but the end result would be the government's exit from the mortgage business. The government would always have the right to subsidize or otherwise create below market products for low-income buyers but that would be in a separate program conceptually.

There are certainly other alternatives or improvements one could offer but the gist of my argument is that (1) there is no reason for the government to be in the business of owning or issuing mortgages, and (2) the transition could be surprisingly rapid. Wall Street would love the opportunity to earn origination, servicing and securitization fees. Strict underwriting standards would protect the public and buyers or mortgages as would an explicit government guarantee. And there would always be a higher risk/higher return market for jumbo and alternative mortgage loans.

Now I want to switch gears completely and make the following points:

1. We are in an absolute normal post-recession recovery. This one is somewhat different in that banks suffered the most this time around and will take longer to recover. That means lending, particularly to small businesses, may take longer than usual to recover but recover they will. What makes this recovery normal is that it was energized by monetary and fiscal stimulus. As it gains its own sustaining strength, the excess stimulus can and will be withdrawn.
2. Consumers are regaining confidence and all signs suggest they have been regaining confidence more rapidly in recent weeks. March retail chain store sales dramatized this. But it should be obvious to all. Think back a year. The bank stress tests were just being completed. Real estate prices were falling 2% per month or faster. The Dow was clawing its way back to 8000. Hundreds of thousands of jobs were being lost every month.
3. Tech spending is very strong. The Internet is becoming the backbone of every company, not an appendage. To accomplish that requires tremendous change. Smart phone, tablets, netbooks and other devices are revolutionizing not only the way we communicate but the very way we do business. These devices allow us to stay in touch 24/7 and give birth to a whole new way of communication labeled social networking. Meanwhile all media, from movies to magazines are going from analog to digital. This revolution may prove to be bigger than the first Internet wave and a growth adjunct to GDP for years to come.
4. Few respect this recovery because we have been burned too many times just within the past decade.
5. All this doesn't come without pain. Inflation pressures are building and they are building surprisingly rapidly. Apartment rental rates are beginning to rise. Interest rates are starting to climb. Commodity prices are increasing. Even lumber. Housing starts could triple within three years. The risk that the Federal Reserve is going to wait too long before tightening in a meaningful way is becoming more real.

To give you a sense of how much things have changed in a year, here are some headlines from the Wall Street Journal one year ago.

> "Stocks still cheap but not for long"
> "Retail sales fall damps hope that rebound is near"
> "Wal-Mart CEO sees lots of consumer stress"
> "Industrial Non-Production"

The last headline led a story discussing Intel's woeful first quarter earnings and outlook. Last night Intel (INTC-$23#*) reported record setting results that exceeded all expectations and raised guidance for the year. This morning CSX (CSX-$53) and JPMorgan Chase (JMP-$46#) also reported excellent numbers. Over the past two earnings seasons strong early results weren't necessarily warmly received. After an initial rally stocks like these gave back their gains and moved lower. Buy on the rumor, sell on the news. Going into earnings season, everyone was set up for a repeat performance.

Perhaps that is what will happen. We will know later today. All three are going to open high as is the overall market. But what if this time is different? Life in the stock market isn't exactly rule based. What if these three stocks hold on to their gains, perhaps because investors begin to believe that the recovery is broader and more enduring than they originally felt? What would happen then? On obvious answer (remember obvious answers aren't always the correct ones) is that investors will pile in realizing that waiting for a pullback isn't going to work this time around. As I always say, wait for the reaction and then react. But I think the risk right now is that disrespecting this market is not the way to go. The only place you want to watch carefully is inflation. Green shoots are sprouting. But with the 10-year bond back well below 4% (it is 3.80% this morning) and the CPI up only 0.1% and flat at the core level, inflation isn't a near term concern. Earnings are the story of the moment. They are excellent, they are moving higher and they are likely to keep surprising on the upside.

Futures point to a firm opening.

Today Julie Christie is 69.

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