MARKET Commentary

Hell Hath No Fury Like the SEC Scorned

May 2010

The SEC's recent lawsuit against Goldman Sachs signifies its determination to reestablish itself as a relevant regulatory body—the thought of which makes us nervous. The increased litigation risk and regulatory scrutiny will increase volatility in the short-term and pave the way for passage of financial regulatory reform. We reiterate our viewpoint from April's commentary, **The People United Will Leave the Banks Divided**, that investors should evaluate their banking relationships and monitor credit risk in their portfolio very closely. We maintain an underweight view in the financial sector and see severe challenges to the industry going forward.

Not many things are more unnerving than a government agency looking to repair its bruised reputation and reestablish its authority upon a market that once took advantage of it. The lawsuit, regarding the way that synthetic CDOs were structured and marketed to clients, concerns us given the number of large financial institutions that were active participants in this market. Large players in this market include Bank of America through Merrill Lynch, Citigroup, Wells through Wachovia, and Deutsche Bank. What is yet to be seen is whether the Goldman lawsuit is an isolated incident where Goldman is targeted and made an example for the rest of the market to observe, or an indicator of additional civil and criminal lawsuits to follow. We do not claim to know the answer to this question, but caution that investors should be positioned defensively.

Figure 1: Top CDO Issuers by Total Funded Amount and Completed Deals

Lead Manager	Total Funded Amount	Deals
Bank of America/Merrill Lynch	133,267	197
SSB/Citi	90,914	184
Goldman Sachs	55,216	70
Wells Fargo/Wachovia Securities	54,344	83
Deutsche Bank	51,077	184
Union Bank of Switzerland	40,848	80
Barclays	37,274	31
Credit Suisse	36,803	69

Source: JP Morgan

Credit spreads on financial institutions have widened in the face of increased government scrutiny. On the Goldman news, credit default swaps (CDS) and senior unsecured paper widened significantly on select institutions throughout the industry. Goldman unsecured 2-year paper widened 60 basis points, while Morgan Stanley, Bank of America, and Citigroup widened 30-50 basis points. Goldman has now overtaken Bank of America in terms of credit risk as measured by 5 year CDS and is in lockstep with Citigroup and Morgan Stanley.

Goldman will likely be able to pay whatever punitive fine the SEC throws its

US Treasuries

As of 30-Apr

Benchmark	Yield
3 Month	0.16%
6 Month	0.24%
2 Yr	0.96%
5 Yr	2.42%
10 Yr	3.66%
30 Yr	4.52%

Merrill Lynch Indexes

31-Mar to 30-Apr

Index	Return
1-3 Yr Gov/Corp ≥ A	0.29%
1-3 Yr Municipals	0.31%
1-3 Yr Agencies	0.25%
0-3 Month UST	0.01%
S&P 500	1.58%

Source: JP Morgan

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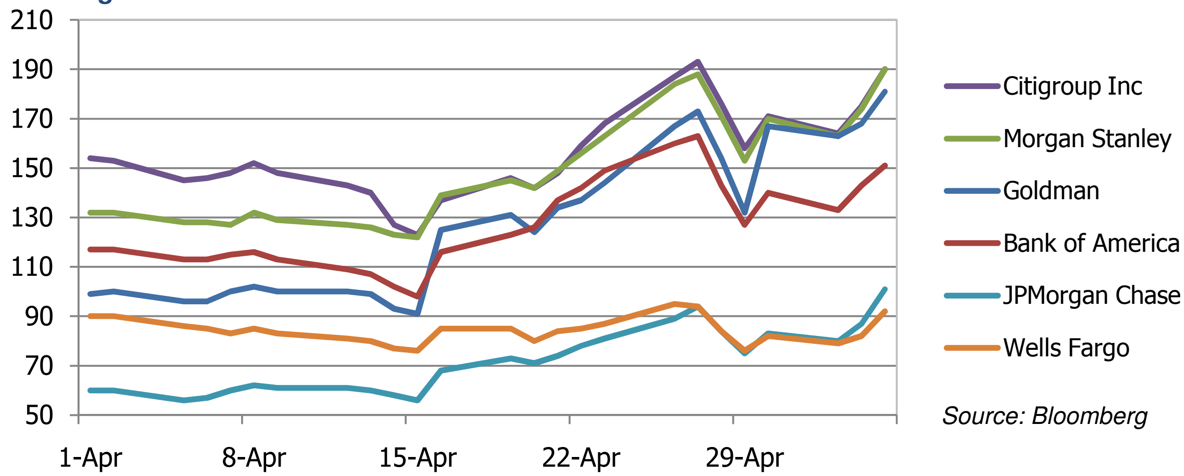
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan direction, but these civil and criminal suits being brought forth will increase market volatility, divert management resources for an extended period, and lead to a contraction in credit as institutions migrate towards risk aversion in the face of legal uncertainty.

Figure 2: **5-Year CDS of Select US Financial Institutions in Basis Points**



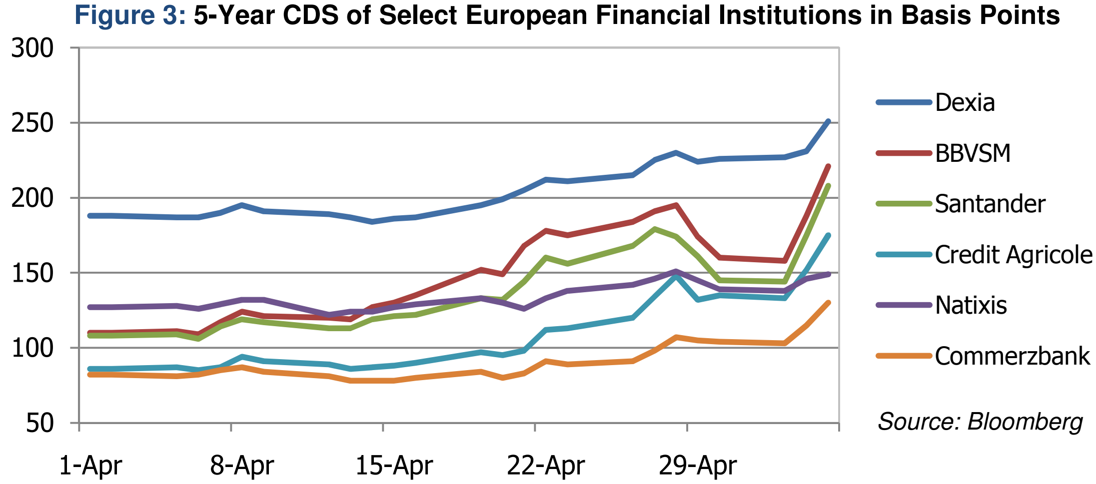
Source: Bloomberg

Even more significant is that this lawsuit will most likely be the final straw on the camel's back of resistance against increased financial regulation currently being debated in the Senate. If there was any question that financial reform would pass this year, the Goldman lawsuit puts that question to rest. This development is not positive in our view given the comments from S&P and Moody's about potential downgrades in the sector. Both rating agencies have reaffirmed their outlook as regulatory reform inches closer to passage. The rating agencies have held this view despite blowout Q1 earnings by the banks, signifying that economic conditions are indeed improving.

P.I.I.G.S Get Slaughtered

The current turmoil in the United States pales in comparison with what is currently happening in Europe as members of the European Union scurry to reach a resolution to the Greek debt crisis. We have long cautioned against the creditworthiness of select European banks, many of which owe their survival to unprecedented and continued support from the EU and member-state governments.

Figure 3: **5-Year CDS of Select European Financial Institutions in Basis Points**



Source: Bloomberg

The on-again-off-again Greek drama has brought to light a greater risk than a Greek default: a full-blown sovereign debt crisis. Portugal, Italy and Spain—widely viewed as the next countries at risk—will have to undertake strict measures to close budget deficits and debt burdens to avoid fate similar to Greece. Portugal, Italy, and Spain recorded budget deficits in 2009 of -6.5, -4.5, and -8.6 and debt-to-GDP ratio of 75.4, 113.0 and 50.8 percent respectively. The 2010 projected numbers look even more alarming. Portugal, Spain, and Greece were recently downgraded by S&P and all remain on negative outlook.

European bank stocks and spreads have suffered as a result of contagion fears. In recent days there has been a strong selling pressure on European bank floating rate notes. What was once an effort to avoid exposure to Greek debt has now turned to Portugal, Spain and Italian debt which is much more pervasive in investor's portfolios and widely held by European banks, whose debt make up a large concentration of USD money market funds.

The crisis in Europe is only in its infancy, and we do not see a viable solution unless a wide-sweeping rescue package is offered to ease the debt burden of weaker sovereigns. JP Morgan, Goldman Sachs and RBS have estimated that a cure-all package could cost as much as €600 billion ($794 billion). Financing the rescue program, if the problem becomes widespread, could prove rather difficult given the current political environment, particularly since members of the EU, with their own financial problems, may not have the will to bail out their neighboring countries.

Looking Forward

In the current environment credit risk, not interest rate risk remains our primary concern. While economic conditions have improved, the Fed will be reluctant to raise the target rate without sustainable job growth and signs of inflationary pressures. We have spent a significant amount of time in recent days reviewing troubled credits held by other money managers or in money funds held by clients and prospects. Investors with separately managed accounts and large allocations to money funds should consult with their investment managers to avoid potentially adverse credit events brought about by recent events.

For questions on developing events in the US and in Europe, please feel free to contact the desk.

Form ADV Part II

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