



OAKWORTH
CAPITAL BANK

COMMON CENTS

BY JOHN NORRIS

On Wednesday night, I pretty much read Michael Lewis' "The Big Short." I devoured the first 140, or so, pages and the ending chapter, but skimmed over a couple of the chapters towards the end. It was a good read. For those not familiar with the book, it details the events leading up to the popping of the subprime bubble by focusing on several different money managers who saw it coming, but couldn't believe it was happening. This weekend, I will probably reread the chapters I gave the short shrift.

I suppose a lot of people's kneejerk reaction to the book would/will be to absolutely lambast Goldman Sachs and the other investment banks for their role in causing the greatest financial disaster since the Great Depression. After all, the greed and dishonesty was palpable. Is money really so important you would knowingly foist garbage on the unsuspecting? Knowing they would certainly lose whatever it was they were essentially betting? Is your obvious intellect best serving society by conjuring various ways of making chicken salad out of chicken effluent? Didn't your mama raise you right?

However, that wasn't my take. I didn't get mad at the investment banks for being, arguably, unethically clever. Frankly, I expect that out of them. Their job is to create and sell investment vehicles which make money for, well, the firm and its shareholders. If there is an ultimate benefit to society, that is a bonus. Essentially, while I might not always approve of their tactics, they are what they are. You can't change a tiger's stripes and all of that. Still, for some reason, the public expects more out of them than what they can possibly deliver. You don't expect the ice cream man to serve up healthy, organic snacks light on the dairy and heavy on the soy do you? I doubt it.

Nope; I save(d) my enmity for the ratings organizations. Without their, what you can only call, acquiescence, I believe we wouldn't have had a subprime bubble. Without their apparent lack of due diligence, I don't believe the world would have coming crashing down around us. Those are strong statements.

If Lewis is correct, and there is no reason to believe he isn't the way things ultimately transpired, AIG was the backstop for much of the subprime mess, either directly or indirectly. In the book, it was apparent AIG bet on the various subprime investment devices largely because of the AAA or investment grade rating so many of them had from a Nationally Recognized Statistically Ratings Organization (NRSRO). Why not bet on a AAA piece of paper? "Sure, I will insure it for pennies, because AAA securities almost never go belly up."

Implicit was AIG didn't bother analyzing their credit/credit structures correctly because it assumed an NRSRO already had. Of course, you can find fault with money managers and insurers don't do their homework; however, the markets believed the NRSROs were doing their job. Investors trusted they had analyzed and scoured the particulars of a deal and blessed it to some degree and some small fashion.

Suffice it to say, and I believe this to be true, without the AAA and other investment grade ratings these securities had, investors wouldn't have purchased them. There would have been no market for them, and investment banks like Goldman Sachs wouldn't have wasted their time with them. Essentially, there wouldn't have been the vast secondary and even tertiary markets for subprime backed mortgage securities and the accompanying CDOs (collateralized debt obligations) but for what can only be called illusory ratings based on faulty analysis.

I think it safe to say it is now quite clear the NRSROs didn't know what they were doing when assessing these securities and this market; however, the damage has been done. We have entered a post-bubble economy and credit is tight. Due to the enormous amount of capital we completely frittered away, it will take us literally years to get back to a semblance of strong financial health. That doesn't mean we are going to Hades in a hand basket; it doesn't. It simply means we, in the US, won't grow as rapidly as would have ordinarily.

For better or for worse, investors pay great attention to ratings. They assume them to be unbiased and at least some-

Inside this issue:

Something To Think About	1-2
The Week in Review	2-3
Bringing It Home	3
Tables & Charts	4-5
Disclaimer	5

Progress comes to those who train and train; reliance on secret techniques will get you nowhere.

Morihei Ueshiba

Something To Think About cont.

what accurate. When a respected ratings firm gives an investment its highest rating, folks assume it to be reasonably safe. I don't know how many times in my career a broker has called to sell me a particular bond: "We have 2MM of a 5-year XYZ County G.O...AAA rated, to you at X%." The rating, if it is a good one, is almost always in the first or second sentence of the "offer."

If not bonds, how about mutual funds? Investors pay close attention to the Morningstar Rating, don't they? How many stars does a particular fund have? Shoot, I don't know how many times I have heard something along the lines of: "I won't buy any fund unless it is 4 or 5 stars from Morningstar." In truth, it is hard, if not impossible, to 'sell' a 2 star fund to anyone; even if the 2 star fund is a more appropriate investment option. Never mind not all funds fit neatly into a Morningstar category, and are thus compared to funds which may or may not have the same specific investment criteria. As such, there are a lot of times when Morningstar compares Granny Smith apples to Red Delicious ones, and proclaims the Red Delicious superior....even if the Granny Smiths are of the highest quality, and would make a better pie.

It might sound like I am making a case investors are to blame for putting too much credence in ratings, and that holds water. However, if your business model is to avail yourself on the public as THE expert in a particular field, as with the NRSROs, you had better be somewhat close to being so or face some consequences. If whole markets behave in a particular manner they wouldn't have ordinarily BUT FOR your recommendations/ratings, do your homework. You don't always have to be right, and you likely won't be. However, if your recommendations are the basis for an entire market which has the potential to subterfuge the financial sector, you had better get it mostly right.

When all of this stuff was at its zenith, subprime mortgages and CDOs and the like, I confess I didn't understand them at all. I couldn't get my arms around how you could combine a bunch of cruddy, obscure loans and turn them into something clean and transparent. It didn't make sense. You can't make a key lime pie out of a bushel of Brussels' sprouts, can you? Hey, my inability to grasp this cost me huge chunks of relative outperformance, as this market(s), for garbage, soared to great heights and old-fashioned fixed income securities sort of languished. The blocking and tackling didn't work anymore. We had entered a new world, a new paradigm if you will, and I felt incredibly old-fashioned. Behind all this were the ratings. Why wouldn't I buy AAA securities? Hey, this complicated piece of paper has a AAA rating, why won't you buy it like so & so? The world was passing me by.

Now, it is probably safe to say the folks from the various investment banks completely buffaloed the analysts at the NRSROs. I don't know this to be fact, but I understand how the system works. The folks in the expensive suits and the complicated ideas pushed these structured/complicated products on these guys and treated them to lush meals and drinks. In turn, the lambs bought what the wolves were selling, and drank the Kool-Aid....partly to avoid having to admit their naiveté and relative inexperience in such things. You can liken it to a rock star giving backstage passes to a group of teenage girls. Nothing good can come of that.

However, had the NRSROs simply said: "This doesn't make sense, and your assumptions are too narrow. You can't make chicken salad out of chicken effluent (again with that), and yet you say you can. We can't, in good conscious, place a rating on this stuff. We just don't understand it." But, and this is a big but, that would have meant turning down a fee, right? And no one likes turning down fees.

So, as a result, a bunch of mismarked or rated securities found their way into the investment markets that wouldn't have otherwise, and firms like AIG and other easy marks bought them....providing fuel for even greater creation of the things. It was a perfect storm, and while the investment banks were the masterminds, they couldn't have done it without the help and unintentional support of the NRSROs, and yet the hue & cry over that is almost non-existent. Why is that I wonder?

The Week In Review

This week would suggest we are in a non-trending market. By that, I mean we are neither going up or down in a real hurry. When left to its own devices, the markets will eventually head higher, but there are times when they move sideways. This was essentially one of those weeks.

Last Thursday, the S&P 500 closed at 1096.48. As I type this morning, right now, the index stands at 1093.78. That is a decline of 0.25%. Clearly, you can't have that each week over 52 weeks and expect folks to be real happy, but it isn't cause for great alarm either. That doesn't mean we didn't have some fun getting back to square 1 this week; brother, did we.

Stocks completely fell apart on the 16th due to disappointing results from Bank of America and General Electric coupled with a decent decline in the University of Michigan's sentiment gauge. You would have thought all hell was breaking loose. It wasn't, as we flipped and flopped about the next three days before rallying sharply yesterday on good earnings results. I suppose you can say this is just how it is during a non-trending market and the summer doldrums.

Even so, I have found more people interested in talking about the economy as opposed to the markets recently. Perhaps that is because of what I outwardly do for a living, however, it seems most people are increasingly realizing the economy and markets are inexorably intertwined. Given the mixed economic data and market action since the end of May, people want to hear the light is at the end of the tunnel.

I wish I could say it was, at least a bright light. When a client pressed me this week after I had given a lukewarm answer to their question, I responded with something along these lines.

Imagine I have made it a habit of going to Jim Davenport's Pizza Palace once a week for years, and I get the same thing each time I go in there. Last year, because of the tougher economic conditions, I went once every other week for a few months. Now, I feel better about things than I did, so I am back to going to the restaurant once a week...getting the usual. Is that really growth? Because that is where we are.

They responded with: "No, you would have to go in more than once a week or increase what you order to have it be real growth." In my opinion, this is an accurate statement and made perfect sense. Getting me back to where I was isn't absolute growth, it is relative. I will have to consume more at Jim Davenport's Pizza Palace for it to be real growth. Hey, that doesn't mean Heather can't make a living over there or even increase her profit. She can employ fewer people or cut back on the toppings or have the wait staff be slow on getting soda refills. Or, she could increase her prices, which would increase her revenue, but not necessarily grow her business in inflation-adjusted terms. I wouldn't be consuming any more product; I would just be paying more for it. That isn't real economic growth, unless she uses her new profits to expand her business. This is key.

As I have explored here, loans & leases on the books of commercial banks in the United States have been going down. As such, there is less credit and liquidity in the US economy. If so, the money supply should be relatively stagnant, which puts a lid on economic activity. One of my current favorite gauges is Commercial & Industrial loans. What are they doing? Well, since the beginning of the year, they have fallen. Since the end of May, they are stagnant. This suggests, to me, businesses aren't borrowing money to expand, and any money they do borrow is primarily for operating purposes. That doesn't necessarily foster rapid economic development.

As such, we have likely entered a period where absolute economic growth is going to be tepid, and largely driven by population growth. Relative growth might be better than expected due to some of the accounting the Bureau of Economic Analysis uses. As a result, there shouldn't be anything prohibiting companies from generating a reasonable profit in this environment assuming all heck doesn't break loose again. This, then, means stocks might offer some reasonable value relative to fixed income, and we will be making some changes to our investment strategies reflecting this. Things aren't great, but stable works sometimes.

Bringing It Home

Recently, Annie has been performing in a local theater company's production of "The Sound of Music." Let's face it: Birmingham is not New York. It doesn't have an overtly rich theater culture; although you would be surprised how vibrant it is once you are involved in it. Still, to the average person on the street, Birmingham theater is sort of underground, if that makes sense. Yeah, folks know it is out there, but they don't see it all that often, until the traveling Broadway shows come to town.

With this as a backdrop, you probably wouldn't be surprised a lot of people have the impression local productions are going to be very much like what you would expect at a high school, particularly if and when children are involved. It isn't going to be bad, it just ain't going to be real professional. The only folks in attendance will or would be relatives and friends and all of that.

At one point, I was sort of in that camp. As Annie has become more active in this scene, I have come to appreciate the true talent we have in our community, and our ability to support it in some fashion. So, with this particular production, I wasn't too surprised they gave us a W-9 form, even though Annie won't get a paycheck. I also wasn't shocked by the daily practices and the late hours. After all, this is a professional production, and there are people who make their living doing this stuff and working for the theater company. That is how they put food on the table. As a result, this ain't no high school equivalent production, where the prettiest girl in school gets the lead role, and everyone laughs when one of the football players comes on stage. This is the real deal.

Non-theatrically involved folks have been shocked when I have told them about the amount of work Annie has put into this play. When I tell them you have to be good if you are going to charge \$30/ticket, they almost always respond: "\$30! For The Sound of Music? Are you kidding me?" Perhaps it is this sentiment, the disbelief a locally produced production would be professional quality, coupled with the lack-luster economy which led to sort of so-so ticket sales leading up to opening night. Oh, don't get me wrong, sales were fine, but you could easily go online and find decent seats for most productions.

Then the review came out.

Opening night was last Thursday. The newspaper on Saturday morning had what you could only call a 'rave,' giving it 4 stars out of a possible 5. The comments on the kids were particularly strong. Let me just say, there was some buzz amongst the involved parties and even in the public. So much so, ticket sales picked up, and the company even added an additional performance. While not all shows are sold out, there is only 1 ticket remaining for this evening, as I type, and 2 out of the next 3 are hard sell-outs. Trust me, that review helped a lot.

Why? It is human nature to want to have someone else test out something before you do; to analyze it, and pronounce it fit for consumption. That is why people pay heed to theater and movie reviews. That is also why investors have long paid arguably too much attention to the ratings organizations.

Tables & Data Points

Release	Survey	Actual	Prior	Comments
Housing Starts (June)	576K	549K	578K	Um....some analytical firms are calling for a double dip in the housing market. You know, to have a double dip, you would have to have some sort of expansion at some point. Ha. Really, this is going to be protracted, as high unemployment and restricted access to capital for both buyers and homebuilders will keep this on the side for a while. That doesn't mean it won't ADD to the GDP equation; it very well could. However, the levels of activity here won't lead to an impressive amount of jobs or a spike in appliance purchases.
Initial Jobless Claims	445K	464K	427K	Labor market remains almost as is. We probably will have created a few jobs during the month. However, we probably also didn't create enough new jobs to make much of a dent in the true unemployment picture. Any changes to the unemployment rate in July will be due to the change in the size of the labor force as opposed to the number of jobs created.
Existing Home Sales (June)	5.10M	5.37M	5.66M	Decent number on a relative basis....but still not overly strong on an absolute one. What to tell you? See my comments on housing starts to get an idea of the housing market in general. With prices having fallen AND mortgage rates as low as they are, there must be a couple of things afoot: 1) prices are still high and need to continue to fall, or; 2) the secondary market for mortgages still isn't completely healthy, or; 3) the consumer either can't get good access to credit OR doesn't want
Leading Indicators (June)	-0.3%	-0.2%	0.5%	Doesn't tell me much. A negative sign is never good, but I guess it could have been worse. Yield curve remains insanely steep. However, a dismal month for stocks in June and a relatively tepid money supply will keep leading indicators on the sideline.

Important Economic Releases

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/08	8,776.39	903.25	1,577.03	499.45	8,859.56	2,447.62
12/31/09	10,428.05	1,115.10	2,269.15	625.39	10,546.44	2,964.96
7/1/10	9,732.53	1,027.37	2,101.36	604.76	9,191.60	2,518.65
7/8/10	10,138.99	1,070.25	2,175.40	620.27	9,535.74	2,666.42
7/15/10	10,359.31	1,096.48	2,249.08	634.62	9,685.53	2,702.81
7/22/10	10,322.30	1,093.67	2,245.89	635.48	9,220.88	2,714.21

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/08	0.08	0.26	0.77	1.55	2.21	2.68
12/31/09	0.05	0.19	1.14	2.68	3.84	4.64
7/1/10	0.17	0.22	0.63	1.80	2.95	3.90
7/8/10	0.15	0.19	0.62	1.81	3.03	4.01
7/15/10	0.15	0.19	0.61	1.76	3.00	3.99
7/22/10	0.15	0.19	0.56	1.68	2.94	3.95

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil— WIT/brl.	\$/Euro	JPY/\$	\$/GBP	CAD/\$
12/31/08	4.00	0.25	1.43	884.30	44.60	1.396	90.72	1.460	1.222
12/31/09	3.25	0.25	0.24	1,096.20	79.36	1.433	93.14	1.615	1.046
7/1/10	3.25	0.25	0.53	1,206.70	72.95	1.244	87.580	1.510	1.062
7/8/10	3.25	0.25	0.53	1,196.10	75.44	1.265	88.400	1.512	1.045
7/15/10	3.25	0.25	0.52	1,208.30	76.62	1.288	87.450	1.536	1.041
7/22/10	3.25	0.25	0.50	1,195.60	79.30	1.289	87.060	1.526	1.037

Disclosure

This report does not constitute an offer to sell or a solicitation of an offer to buy or sell and securities. The public information contained in this report was obtained from sources and vendors deemed to be reliable, but it is not represented to be complete and its accuracy is not guaranteed.

This report is designed to provide an insightful and entertaining commentary on the investment markets and economy. The opinions expressed reflect the judgment of the author as of the date of publication and are subject to change without notice; they do not represent the official opinions of the author's employer unless clearly expressed within the document.

The opinions expressed within this report are those of John Norris as of the date listed on the first page of the document. They are subject to change without notice, and do not necessarily reflect the views of Oakworth Capital Bank, its directors, shareholders, and employees.