WEEKLY MARKET REVIEW

Week ended March 27th

Stocks Rise on Stabilization Hopes

By Dr. Jerry Webman, Ph.D, CFA
Chief Economist, OppenheimerFunds, Inc.

Stocks rose last week, pushing the S&P 500 Index toward its largest monthly rally since 1987. Helping drive the gains were the Treasury Department's latest plan to help remove toxic assets from bank balance sheets and tentative signs of slowing rates of decline among some economic indicators. While I view both factors with cautious optimism, much work remains to be done to fix the financial system, which is why I am certainly hesitant to sound the all-clear.

Like most investors, I'm relieved to see some improvement in the markets, but I'd point out that from 1929 to 1932 (the early phase of the Great Depression), there were four rallies of 20% or more. There were another three such rallies later in the crisis, from 1937 to 1942. More recently, we saw two 20%+ rallies during the 2000–2002 bear market.
The good news, as I wrote at the beginning of 2009, is that only modest improvements in economic conditions are likely necessary to generate positive returns amid the current turmoil, given the extreme levels of fear and pessimism in the markets.

A look at the Treasury's Public-Private Investment Plan

Introduced by Treasury Secretary Tim Geithner last week, the Public-Private Investment Plan (PPIP) calls for the Treasury to use up to $100 billion from the Troubled Asset Relief Program (TARP), coupled with private funds, to purchase between $500 billion and $1 trillion in loans from banks, and securities from the broader marketplace. The plan has two main parts:

- Legacy Loan Program This is designed to cleanse bank balance sheets of distressed ("legacy") loans and other assets by encouraging banks to auction pools of loans to private institutional investors working in partnership with the government. The program provides the highest bidder with substantial incentives for the purchase, including a guarantee of up to 85% of the borrowings the public-private partnerships will need to buy the troubled assets, plus 50% of the required equity funding
- Legacy Loan Securities Program The aim of this part of the plan is to restart the securitization process by creating a liquid market for pools of formerly AAA-rated commercial mortgage-backed and

Dr. Jerry Webman is Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities.

For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, a financial advisor and a portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago, where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

residential mortgage-backed securities issued prior to 2009. The Treasury will initially select approximately five potential partners in the program. Approved managers will have a period of time to raise capital and will receive matching equity funds from the Treasury. The Treasury will also consider requests from the fund manager for additional loans

By providing incentives and government guarantees to private investors, the federal government is hoping to realize high enough sale prices for toxic assets to maximize recovery rates for ailing financial institutions. And because private investors have to put up equity of their own, I see only limited risk of overpaying for the loans and securities, reducing the likelihood of losses for taxpayers.

Will it work?

If the plan is fully implemented, I believe it will have a material impact on cleaning up banks' balance sheets and could help restart the securitization process for real-estate related assets. This would bring the financial sector closer to stability. The "if" is a big one. At this point we'll have to wait to see how enthusiastic private investors are to participate, and how willing banks will be to sell toxic assets at the auction-determined prices.

Ultimately, no recovery is sustainable without free-flowing credit within the private sector, regardless of the size and the terms of the fiscal stimulus plan. If the Treasury's plan bears fruit, we may see significant progress in that direction. If it runs into trouble, the credit crisis could take a turn for the worse.

This possibility shouldn't be ignored. While I view the plan as cleverly designed and the first transparent attempt in two years at providing a realistic pricing mechanism for bank assets, an esteemed colleague here at OppenheimerFunds believes it will "fail miserably," given limited incentives for banks to sell toxic assets at potentially steep discounts to their current valuations. In other words, if investors' "bids" are too far below banks' "asks," banks would rather hang on to the assets than sell them for a loss. If government guarantees and cajoling only succeed in reducing extremely wide bid-ask spreads to wide bid-ask spreads, the volume of actual transactions may still be too small to restore normal credit markets.

WEEKLY MARKET REVIEW

In reality, the plan will probably end up falling somewhere between a cure-all and a miserable failure and will result in a form of triage for the financial sector. For the banks that are well-capitalized and can sustain a potential loss on their toxic assets, the plan provides an opportunity to clean-up the balance sheets and resume lending at today's attractive spreads. Banks stuck with particularly toxic assets or thin capital buffers may still find a potential write-down at market-clearing prices prohibitive and some might need to be recapitalized after taking the hair cut. Treasury Secretary Timothy Geithner said over the weekend that some large banks could still be in need of "large amounts" of government assistance should the auctions price the assets below what the banks consider to be fair value.

For its part, the stock market has reacted favorably to the plan's announcement, but the credit markets have barely budged; spreads are still extremely wide. Only time will tell whether my cautiously optimistic outlook is justified.

Key economic indicators may be leveling off

The stock market also cheered the release, for the second week in a row, of some relatively upbeat economic reports. As I've written before, a few good data points don't make a trend. However, after months of relentlessly negative news, any potentially positive signals are welcome.

In the housing market, **existing home sales** unexpectedly rose 5.1% in February, and median sale prices inched higher. **New home sales** jumped 4.7% in the month, though prices fell somewhat. The reports may reflect the government's increasingly aggressive actions to shore up the housing market and reduce mortgage rates, which hit 60-year lows last week. Of course, inventories of unsold homes remain very high.

The manufacturing sector also had some good news. **Durable goods orders** rose a strong 3.4% in February, or 3.9% excluding the volatile transportation component. New orders rose for the first time in seven months. Additionally, a drop in inventories may help set the stage for eventual recovery at the nation's factories but will depend on significant improvements in consumer and business demand.

Not all of last week's economic news was positive, however. **Initial claims** for unemployment benefits rose 8,000 to 652,000 in the week ended March 21, while **continuing claims** rose 122,000 to 5.56 million—another record

WEEKLY MARKET REVIEW

Week ended March 27th

high. Historically a peak in jobless claims has signaled the end of a recession. Clearly we are not there yet.

Indeed, U.S consumers remain under pressure. Witness a –0.2% drop in **personal income** in February, driven by a –0.4% fall in wages and incomes. **Consumer spending**, which represents about 70% of the U.S. economy, slowed to a 0.2% gain from a 0.6% rise in January. Meanwhile consumer prices crept higher, with a key gauge of inflation increasing 0.2%. Inflation is unlikely to be a near-term issue as long as wages continue to trend lower.

First quarter 2009 Gross Domestic Product (GDP) is likely to be ugly, but I expect improvements by the second half of the year, as the stimulus plan and other government initiatives begin to take fuller effect. Such growth will come off of very low levels and is likely to still feel recessionary for many Americans.

WEEKLY MARKET REVIEW

Week ended March 27th

Oppenheimer funds are distributed by OppenheimerFunds Distributor, Inc.
Two World Financial Center, 225 Liberty Street, New York, NY 10281-1008

MJL-1-3-30-09 March 30, 2009