HAYMAN ADVISORS

October 14, 2008

'The ultimate result of shielding man from the effects of folly is to people the world with fools.'

Herbert Spencer

What's Next?

It is the "what's next" that scares us the most. There is no doubt that many books will be written chronicling the times we are living through today. When we wrote to you in July 2007, we really meant "feet first"! The common denominator of everything that has gone wrong so far has been reckless amounts of leverage. The system both nationally and globally is still trying to de-lever as fast as possible, the problem is that everyone is being forced to do it at the same time. 3-month LIBOR is off the charts - not as many believe, because banks don't trust each other - but because THERE IS NO MONEY LEFT FOR THEM TO LEND TO EACH OTHER. We have argued for years now that there is not enough money at the bottom of the levered pyramid scheme the world has put together. In the U.S. alone, with Lehman, AIG, Bear Stearns, Fannie, Freddie, WaMu, IndyMac, Countrywide, and the rest of the companies that have failed to date (any many more "on deck"), there are $8 TRILLLION of assets already in receivership, conservatorship, liquidation, or "parked" with a big brother. Do you think the Government will be successful in purchasing illiquid assets off of the balance sheets of troubled companies? The odds (and the assets) are against them. Even if the Government invests equity to fill the "hole" that is created upon the sale of these assets, it leaves the same nefarious management teams in place to continue the problem by taking the money and levering it up again. The only way to solve this problem is to go THROUGH IT. We know it isn't politically popular or even popular on Wall St, but the fact is that the U.S. and the world need a Darwinian flush to rebuild our foundations and become even stronger on the backside of this mess.

$700 Billion is Not Enough

Let's do some quick math. We realize that there are many moving targets, but we must attempt to put things into perspective for those of you at home. To date, some $550 Billion has been written down by the world's financial institutions. In the United States alone, there is $10 TRILLION of "Prime" mortgage debt, $1.5 TRILLION of Alt-A mortgage debt, and $1.2 TRILLION of Subprime mortgage debt. Based on our assumptions, we believe we will see cumulative losses of AT LEAST 25% in Subprime, 20% in Alt-A, and 5% in Prime. Our expected default rates and severities imply that over $2.2 TRILLION of defaulted mortgage loans would result in AT LEAST $1.1 TRILLION of **REAL LOSSES** in mortgages IN THE U.S. ALONE. For those of you that want to talk implied roll rates, defaults, and loss severities, just give us a call. We review almost all securitization data each month. Many other countries around the world have actually lent even more aggressively than the U.S. Australia, for example, has lent on home values at 9 times median income! Historically, 3.5X is the number that actually allows borrowers to afford to pay (fathom that). The math for the rest of the world is pretty scary.

Levered Loans and Corporate Defaults

There is approximately $7 TRILLION of total corporate debt in the United States. An ever increasing trend of this debt is that more and more of it is rated below investment grade. As of today, over $1 TRILLION of all corporate debt is rated BB or lower. In the mini-recession of 2002, we saw 12% cumulative corporate defaults and BB spreads to Treasuries reach a historic 1400 basis points. The bad news is that it was just a "warm-up" for where we are headed. Standard and Poor's recently penned a report that they expect up to 23% cumulative corporate defaults by 2010. BB spreads are headed to at least 1500 basis points over their current level of roughly 1000 bps. This suggests that we will see at least $1 TRILLION of corporate debt default over just the next 2 years. In addition, all financing costs for non-financial corporate borrowers will be substantially elevated and pose an ongoing severe headwind to corporate earnings.

The Lehman Disaster

After living through the Lehman disaster first hand, we have a pretty good idea of what it looks like staring down the barrel of the gun. We believed that, without a doubt, the Treasury and the Fed knew how important it was to preserve the structural integrity of the global derivatives system. We could not have been more wrong (and neither could they). When they decided to let Lehman file bankruptcy, they gravely underestimated the havoc that they would wreak on the global financial system. This one decision will likely go down as the single biggest error made by the Government in this crisis. Money market funds immediately "broke the buck" leading to epic withdrawals from money markets into Treasuries. Commercial paper markets froze and back-up lines of credit were hit at the banks (who didn't even have the money to lend). Today, there are $6 TRILLION of untapped bank lines of credit not included on U.S. bank balance sheets (with very little reserved for them). This represents more than 6x the total equity of the entire U.S. banking system. The banks simply DONT HAVE THE MONEY TO LEND. This decision signed the death warrants of the "independent" broker-dealer model. Goldman Sachs and Morgan Stanley immediately converted into bank holding companies to allow the Fed to inject capital directly into them when necessary. Concurrently with the filing of the Lehman bankruptcy, Merrill Lynch was sold (at a premium no less) to possibly one of the worst dealmakers this world has ever seen. For those of you who were participants in the late nineties, remember what Greentree ended up doing to Conseco?

What is the New Model?

We are not sure that we understand exactly what the new model is for these companies. Much of bulge bracket firms' profit is derived from using significant amounts of leverage and investing on a principal basis. The proprietary trading groups and principal investments represent a large portion of their profitability. How can bank holding companies use prop trading? What leverage levels will be allowed in the new world? Our guess is that it doesn't rhyme with 40. What will the new ROAs and ROEs be with only 12x (or less) allowable leverage? We believe recent investments made in these companies were made in haste and without the customary due diligence (based almost solely upon the perceived "global franchise" value of these firms). We don't mean to second guess the Oracle, but we believe that even he isn't infallible. We have seen many such investments this year by "deep value" investors (with apparently less due diligence than they have ever exercised before) that simply don't understand the leverage to tangible equity ratio that has become ever so important.

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Where's the Beef? The LIES about BOOK VALUE

Washington wonders why the investing public has lost faith in the numbers. Let's review a couple of case studies to help understand that book value isn't worth the paper it's printed on. How did Lehman, a firm with a STATED TANGIBLE BOOK VALUE of $15.1 billion, go from this number to ZERO overnight? The CDS auction of their senior unsecured liabilities just ended at 8.625c on the dollar. When Lehman filed, they said they had $650 Billion in assets. It wasn't even worth $340 billion the very next day. **WHERE DID THE $310 BILLION DOLLARS OF ENTERPRISE VALUE GO?!?!?!?!?!?!? BOOK VALUES MEAN NOTHING TODAY**. There should probably be an asterisk next to the "tangible book value" entry on the balance sheet. It should state that, "this number is obtainable if all of our assets could be sold in a perfect world based upon our models, hopes, and dreams." We think there should be an additional line item on the balance sheets of financial companies titled "Book Value - if we had to liquidate". We will hazard a guess that this number would be zero for many financial firms today.

We believe that suspension of mark-to-market accounting rules will only hide the problem. Ask the shareholders of Lehman whether "don't ask, don't tell" accounting rules would have helped them understand the true risk in Lehman.

The case of IndyMac is also very illuminating. At the end of their March quarter, they touted themselves as massively overcapitalized with a Tier One risk based capital ratio of 9% which far exceeds required minimums.

Here is an excerpt from their March Q1 2008 conference call that was held on May 12, 2008:

Michael Perry, Chairman and CEO - "One of the big issues that really affected our GAAP shareholder's equity book value per share, and even our regulatory capital was the significant fair value marks that we took on our prime jumbo and Alt-A investment grade MBS portfolio which is almost 90% AAA securities. In my opinion, these fair value marks in no way represent the economic value of these securities...**The bottom-line is if you add those amounts back, because I think we'll get them back over time, our common shareholders equity on an adjusted basis would be $1.367B and our economic book value per share [sic] at the end of the quarter would be $1.556B**. As a relatively large shareholder myself, this is the book value that I really look at in terms of what we are trying to preserve at IndyMac…On the capital front, on the positive side we remain well capitalized on all three capital ratios; we'll walk through the capital ratios in just a minute pretty extensively."

Here is the first thing the FDIC said on July 11th (two months later):

"IndyMac's failure will cost the FDIC/US Taxpayer about **$4 to $8 BILLION**."

The FDIC stated that they expect it to cost taxpayers $8 BILLION on $32 BILLION of assets! That number makes sense based upon realized losses for the FDIC in the prior S+L crisis. They realized losses of approximately 25% of assets over the 1,600 banks they took over. The real question is: **How did they go from significantly positive book value to costing the FDIC $8 billion basically overnight?!?!!?!** The answer is simple...**WE BELIEVE THEY WERE MAKING IT UP**. We have a lot to fear today. Below is a list of leverage ratios for several presumably solvent institutions. We like to look at ASSETS to TANGIBLE EQUITY (as we don't think financial Goodwill is worth much today):

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Financial Institution	Tangible Equity	On-Book Assets	Off-Book Arrangements **	On-Book Leverage Ratio	Total Leverage Ratio	Latest Reported Quarter
Barclays	$ 24,660	$ 2,378,833	$ 335,558	96.5 x	110.1 x	Jun-08
DB	$ 31,297	$ 2,706,212	$ 128,042	86.5 x	90.6 x	Jun-08
BofA	$ 24,834	$ 1,831,177	$ 1,496,104	73.7 x	134 x	Sep-08
UBS	$ 27,221	$ 1,827,456	$ 418,778	67.1 x	82.5 x	Jun-08
Citi	$ 42,053	$ 2,100,385	$ 1,606,695	49.9 x	88.2 x	Jun-08
ING	$ 38,145	$ 1,862,305	$ 185,255	48.8 x	53.7 x	Jun-08
Wamu	$ 8,915	$ 309,731	N/A	34.7 x	34.7 x	Jun-08

* in millions of USD

** off-book arrangements include transactions where the companies have significant risk or exposure (derivative exposure and SPEs/VIEs may be shown gross or net) and un-drawn credit lines which may be cancellable by the issuer in some instances. Off-book exposures are from the most recent 10-Q or 20-F.

Now, isn't it easy to understand the shotgun marriages of WaMu with JP Morgan and Wachovia with Wells Fargo? If the FDIC had to take them over, they would have had to estimate losses to the taxpayer/FDIC in doing so. With WaMu alone, it would have cost the FDIC over $80 BILLION. They had $320 billion of some of the worst possible assets you could put together. They were basically Countrywide with a horrible credit card portfolio. Imagine the headline that morning..."FDIC steps in to take over WaMu. They estimate that it will cost the taxpayer $80 billion even though there is only $45 billion left in the FDIC insurance fund." Imagine the bank run we would see if the public knew that the FDIC doesn't have the money to cover depositors. So, each deal that has been done recently has a clever scheme behind the scenes for the Government to take the losses without admitting the emperor is already naked.

A TRILLION here, a TRILLION there… pretty soon it starts to add up

Much has been said and written about the CDS market and its effect on the financial markets. We don't intend to vilify this market... We simply want to lay out for you how much we think it will cost those who have written these contracts. The CDS market was about $58 TRILLION following on the heels of Lehman's bankruptcy (yes, more than 4x the entire U.S. GDP). We are going to make some broad based assumptions here to make a point. If we assume that CDS is evenly distributed (although Lehman just proved it isn't), and that we will see S&P's predicted 23% cumulative defaults on speculative grade non-financials by 2010, then we will see approximately $2.6 Trillion of CDS in default (we think this number is low). If we use a 60% recovery rate (Lehman's was only 8.625%), we could see at least ANOTHER $1 TRILLION of losses in CDS contracts alone. We would argue that CDS contracts are written on more dubious assets by nature. Lehman had $150 Billion of senior unsecured bonds and $400 billion of CDS was written against it producing $360 billion in losses to those contracts alone.

World financial institutions just don't have another SPARE TRILLION (on the low side) dollars lying around. There is much more pain ahead. The remaining broker dealers are the bookies for the CDS markets, and in some cases; they are even the participants playing with proprietary capital. The recent almost failure of AIG would have eliminated the counterparty on the insuring side of $441 billion of these contracts. Guess who would have been left holding that bag? The bookies would have to make good on AIG's bets. That would have all but ensured the collapse of everyone left standing in the CDS marketplace. Ah…the twisted web that has been woven.

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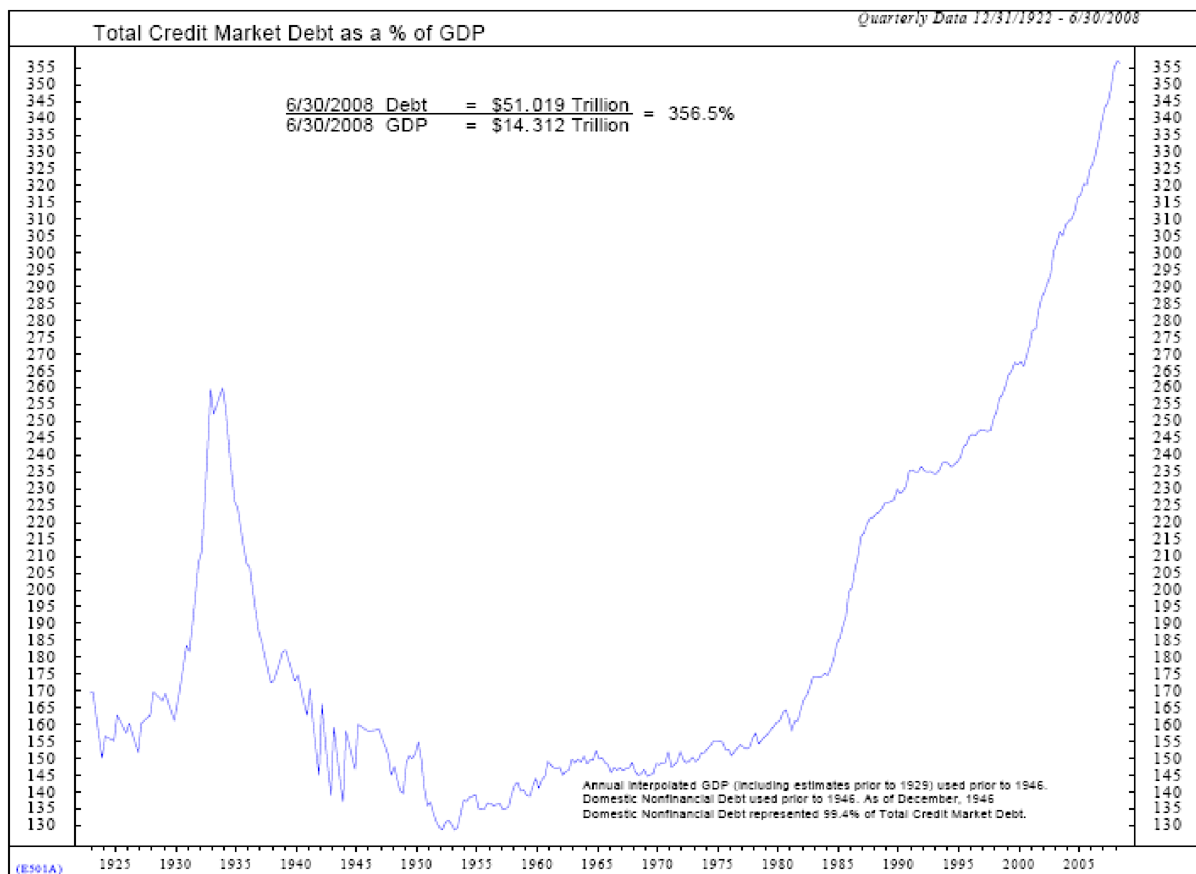
We Have Already Hit the Iceberg

The world economies have already hit the iceberg. As we all know, what we see on top of the water is only 10-20% of the mass of the full iceberg. In the grand scheme of it all, there is really nothing that can be done. Both the US and the world economy are headed for a financial winter the likes of which we have never seen before (unless you happen to have been alive in 1929). We are not saying we will see bread lines - the enormity and severity of this crisis is somewhat balanced by the students of history like Bernanke and Paulson on the other side. However, the most frightening chart we have seen is one that compares total credit market debt to U.S. GDP. The average of this ratio over the last 100 years has been around 155%. This ratio peaked first heading into the Great Depression at 260% (after then falling back to 130%) but has now risen to an unprecedented 350%! We would imagine that Paulson has a calendar on his wall with a red marker marking off each day with a big red "X" on it. He has January 20th circled with party hats, confetti, and champagne on it. His last day won't come fast enough. Not even Hillary Clinton could imagine how many times he has had to answer his phone at 3 a.m. this year with the next emergency crisis waiting to be solved.



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Our Best Guess on the Forecast: "The Beatings Will Continue Until Morale Improves"

How long and deep will this recession be? To develop an educated guess, we must study historical OECD housing busts and their implications for the broader economies and local banking systems. According to a masterful piece by Goldman Sachs Global Economic Team, there have been 24 housing price busts since the 1970's. Each bust saw at least a 15% real home price decline. The average decline in this sample set is just over 30% with a bottoming after 6 years. Housing busts are generally prolonged experiences with severe economic and banking implications. We believe house prices will drop approx 34% from peak to trough and the economic decline will take at least another 2 ½ years. The average home price decline of the 24 that were studied was 31% and the average duration was a staggering 25 quarters (just over 6 years)! A few other observations from past housing crisis: 1. Sharp declines in GDP growth (output gaps become deeply negative), 2. GDP growth bottomed several quarters after the busts began, 3. Growth recovered much more slowly but output gaps lagged for longer, 4. There is significant damage in the "Big Five" banking crises (GDP fell 6.6 percentage points and the slowdown lasted for 5 years), 5. Interest rates rose going into the bust and then fell, 6. Credit growth generally slowed (in the current case, credit growth has come to a crashing halt).

We think we will see 10-12% unemployment, a 4-5% decline in GDP, and the equity markets could drop at least 70% from peak to trough. Remember, the capital structures of most of America's companies have taken on more and more senior debt, subordinated debt, preferred, convertible preferred, trust preferred, and God only knows what else in front of equity. This means the "equity" piece of the cap structure is enormously positively or negatively leveraged to changes in funding costs and enterprise values. A drop of 70% for the S+P is absolutely possible. Remember, all of the loss estimates we have reviewed have really ignored the coming losses in credit card debt, commercial and industrial loans, commercial real estate loans, CDS contracts, auto loans, and unsecured personal loans. We are experiencing the global deflationary bust of all time. It will deflate the values of just about all assets. Anything and everything we own will decline precipitously in value. We are not perma-bears like some others, but we must be realistic about facing this terrible economic environment.

Unlike many, we don't believe the problem is either isolated from the "real" economy, or limited to the U.S. or that the world will be rescued by the invincible Chinese economy.

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As the chart above depicts (global equity capitalization), **THE WORLD HAS LOST HALF OF ITS EQUITY MARKET WEALTH ($29 TRILLION)** since last October. The negative wealth effect will be **DEVASTATING**.

In the U.S., we are only just beginning to see the strain of tighter credit on consumer spending. As corporate earnings decrease and workers are laid off, the cycle of delinquencies and defaults will get worse. In Europe, the "real" economy is already in recession in many countries, and there is a guillotine hovering above the necks of most of the Eurozone. Despite the popular belief that European households are not highly levered – many countries including Ireland, the U.K., Denmark and the Netherlands have more household debt than their national GDP and European banks have been as bad or worse than U.S. banks in terms of overleveraging themselves. The same cycle of lower earnings, higher unemployment, lower spending, and higher delinquency rates will pervade Europe. We believe that the structural nature of the European economy and public policy will only exacerbate the problem.

Meanwhile the Chinese equity markets have dropped like rocks this year, and domestic demand for raw materials is slowing substantially – a clear sign that the Chinese government might be optimistic about it 8-9% growth targets. Even if China's internal demand grows at 10% this year, it will only offset about 0.75% of world GDP decline.

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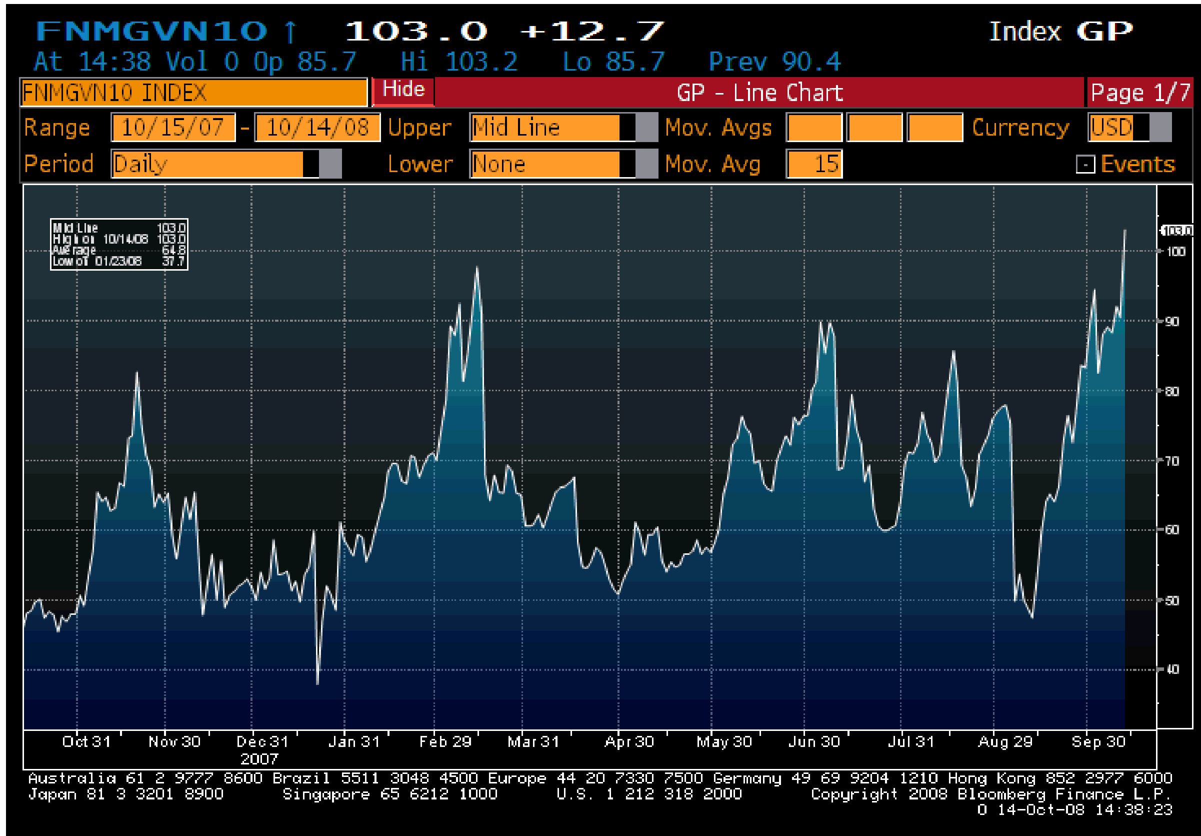
Uh Oh…

Now that the Fed and Treasury have basically guaranteed that the sun will come up in the West, there is a new problem showing itself. Below, Fannie and Freddie spreads to US Treasury bonds have hit their highest levels **EVER** today. Now that they are nationalized and explicitly guaranteed, shouldn't they trade at the narrowest spread ever? The bottom line is that there is no money in the global system to buy this stuff. Globally, investors are tapped out, and the leverage in the system has to come down. We have no idea how this is supposed to happen in an "orderly" fashion. What this means is that the cost of obtaining a mortgage is going up. With the Government issuing new Treasury bonds like it is the national pastime, the 10-year rates have rocketed up to over 4%. Conforming mortgage loans from the Government (that is all that is left in the mortgage market) have moved up half of a percent in the past few days. They won't be able to control the 10-yr rates as they issue more and more Government debt to pay for the promises of guarantees to the banks. I guess we will just have to worry about that later.



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The Hayman Fall-Out Shelter…

At Hayman, we are positioned with the global deflationary bust in mind. We have only 20% of our equity portfolio long and massively hedged, while we have 50% short equities that we think have untenable balance sheets for this environment. Our credit portfolio is actually all short in a few areas that we expect stress to begin to accelerate. One significant addition to our strategy is currency. We have added three world currencies that we believe will endure significant devaluation versus the U.S. Dollar over the next year (similar to Iceland). The U.S. dollar may not seem the best choice given our macro views, but we consider it the tallest midget amongst the rest of the world. These countries are basically bankrupt - a lot like portfolio companies can be insolvent. These positions are crafted with the same types of asymmetric risk and reward that we strive to accomplish in our portfolio construction.

The last thing we will leave you with is a thought on how long this will probably take. Remember, the FSLIC was declared in solvent in December 1986. Over the next 6 years over 1,600 S+Ls went bust. The GAO concluded that the price tag for the crisis was $147 billion ($120 billion to the taxpayer and $27 of equity) in an economy where GDP was half of what it is today. This problem is multiples of that one with many more turns of leverage on top of it. This deflationary bust will take MANY YEARS and MANY BANKRUPTCIES to play out. We are but one year into the mother of all credit crunches and two years into a housing decline. Don't be seduced by anyone telling you that "all will be fine" anytime soon.

Over the last 10 days, we have seen Hank Paulson and his international colleagues put away their policy bazookas and reach for the red button to launch ICBMs, but the fundamental flaw in the governmental response is that it is trying to re-lever an already massively overleveraged system in a short-term attempt to halt an unavoidable cycle of asset price deflation.

This policy prescription is like treating the withdrawal symptoms of our global credit addiction with another hit of heroin. Like any addict, one hit is never enough and the only question remains is how long it takes the global economy to ask for just one more…

Sincerely,

J. Kyle Bass
Managing Partner

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