

BROOKMONT CAPITAL MANAGEMENT WEEKLY MARKET REVIEW

September 29, 2008

No Need for Panic

If I had more room to make the title above even bigger, I would have done so. Tonight, and tomorrow morning you are going to see the media turn today's market action into a major circus atmosphere. You will hear every market statistic thrown at you over and over. Forget the statistics, what we saw today was a display of human psychology and how it can affect stock prices in the short-term. Today's decline throws the argument of "efficient market theory" right out the window as stocks were trading on fear and uncertainty, not fundamentals or rational thinking.

Make no mistake about it, today's market reaction to the failed bailout proposal was quick and violent. By not passing the bailout package, investors lost more than \$1 trillion in market value. Investors unloaded stock positions with no discernable strategy in mind. We should expect a similar reaction tonight from stock markets around the world. Many of them had rallied when a bailout agreement seemed to have been reached and will be just as disappointed as the U.S. market.

For the day, the NASDAQ fell more than 9%, the S&P 500 was down 8.8%, and the Dow Jones dropped 7%. The Brookmont Dividend Equity Strategy declined 6.20% for the day versus a 9.32% decline by its benchmark, the Russell 1000 Value. Year-to-date, the S&P 500 and NASDAQ are both down 25% and the Russell 100 Value is lower by 24%. The Brookmont Dividend Equity Strategy is now down 7% for the year.

Today's Losers			
Wachovia	-81%	Schlumberger	-15%
National City	-63%	Ford Motor	-13%
Fifth Third Bank	-43%	Intel	-10%
Regions Financial	-41%	Dell	-9%
State Street	-28%	Walt Disney	-9%
SunTrust Bank	-23%	Oracle	-9%
Northern Trust	-18%	Microsoft	-9%
Apple	-18%	Amgen	-8%
Occidental Petro	-16%	Philip Morris	-8%
"Winners"			
Kellogg	-3.7%	PepsiCo	-2.9%
JNJ	-3.6%	HJ Heinz	-2.5%
Southern Co.	-3.5%	General Mills	-2.2%
Abbott Labs	-3.3%	Campbell Soup	0.3%

The bulk of today's losses were felt in the Financial, Energy, and Technology sectors. Regional banks got hammered as many now face an uncertain future not unlike Washington Mutual or Wachovia. Energy stocks reacted to a steep drop in oil prices while Tech stocks were sold due to concerns about upcoming earnings announcements. On the other hand, sectors that outperformed on a relative basis were true to history: Consumer Staples, Health Care, and Utilities.

The question of "when will the markets recover from today's drop" can only be known when Congress and the White House reach an agreement on a bailout proposal. Until that happens, Wall Street will continue to be under extreme pressure as investor confidence wanes. The worst thing that could happen is a delayed agreement by Congress that results in more bank failures or liquidations.

The Federal Reserve has indicated that it has its hands full with Fannie Mae, Freddie Mac, and AIG and cannot handle another large takeover. There are not many U.S. commercial banks that are healthy enough to acquire a Super Regional bank, either. The ones that do fit into that category already have large acquisitions on their plates, including JP Morgan (Bear Stearns and Wamu), Bank of America (Merrill Lynch), and Citigroup (Wachovia). Private equity companies watched Texas Pacific Group get burned on its major investment in Wamu and will probably stay out of the equation. As a result, look for potential help coming from banks based in Spain, Canada, or Continental Europe.

How Did We Get Here

You see it on the news every day but may not really understand how we got into this financial mess with banks, insurance companies, and mortgages. Here is the quickest Cliff Note version I could think of:

2002 – The Federal Reserve cuts short-term interest rates to the bone and real estate prices soar. Alan Greenspan announces that American homeowners do better with adjustable rate mortgages than 30-year fixed. President Bush encourages more Americans to become homeowners.

Inexperienced mortgage brokers offer new “pay-option” mortgages with no down-payment, very low initial interest rates, and no documentation for income and net worth. Fannie Mae facilitates the process which allows homeowners to buy homes that are well above their means.

2003 – Brokers immediately sold their mortgages to banks across the country, which then turned around and sold them to major Wall Street brokerage firms.

2004 - Wall Street brokerage firms realized that many mortgages were sub-prime and potential foreclosure risks. They develop a new investment product called Collateralized Debt Obligations (CDO) which are backed by a large pool of individual mortgages of fixed income products. The CDO's are broken into individual “tranches” based on their quality. The brokerage firm buys insurance protection for the highest quality tranche and then hires the ratings agencies to give its analysis. Since the highest tranche includes an insurance wrapper, the agency will give it an A-AAA rating. The second tranche of the CDO includes lower quality notes but receives a credit rating between B-BBB.

The lowest traunch would not be rated. Instead, the brokerage firms would hold them and reap a very high interest rate. Since accounting rules allowed them to be held “off the balance sheet” and within a Cayman Island shell company, they would remain out of shareholder's sight. These became known as “Special Purpose Vehicles,” or SPV.

In effect, the Wall Street firm has now taken a group of low quality mortgages that would normally receive a credit rating of C or lower, wrapped it in an insurance guarantee, and offered it as an A rated security. Investors would be promised an attractive interest rate with principal repayments as mortgages were paid off. And since home prices had nowhere to go but up, it was a sure bet.

2004-2006 – Institutional Investors (such as insurance companies, municipalities, and banks) bought the highest quality tranches with the assumption that they were “A” rated securities and guaranteed by insurance protection. For the first couple of years, the strategy worked since home prices continued to rise.

2007 – Home prices plateau and begin to fall in overvalued markets. At the same time, the artificially low interest rates on “option pay” mortgages reset higher by as much as 6%. Homeowners start making the lowest mortgage payment option, which drives their outstanding mortgage balance higher and higher. As home prices begin to fall nationwide, many homeowners now owe more than the value of their home and the foreclosure rate jumps. Insurance companies have a difficult time covering the monthly payments that they have guaranteed for the highest quality tranche.

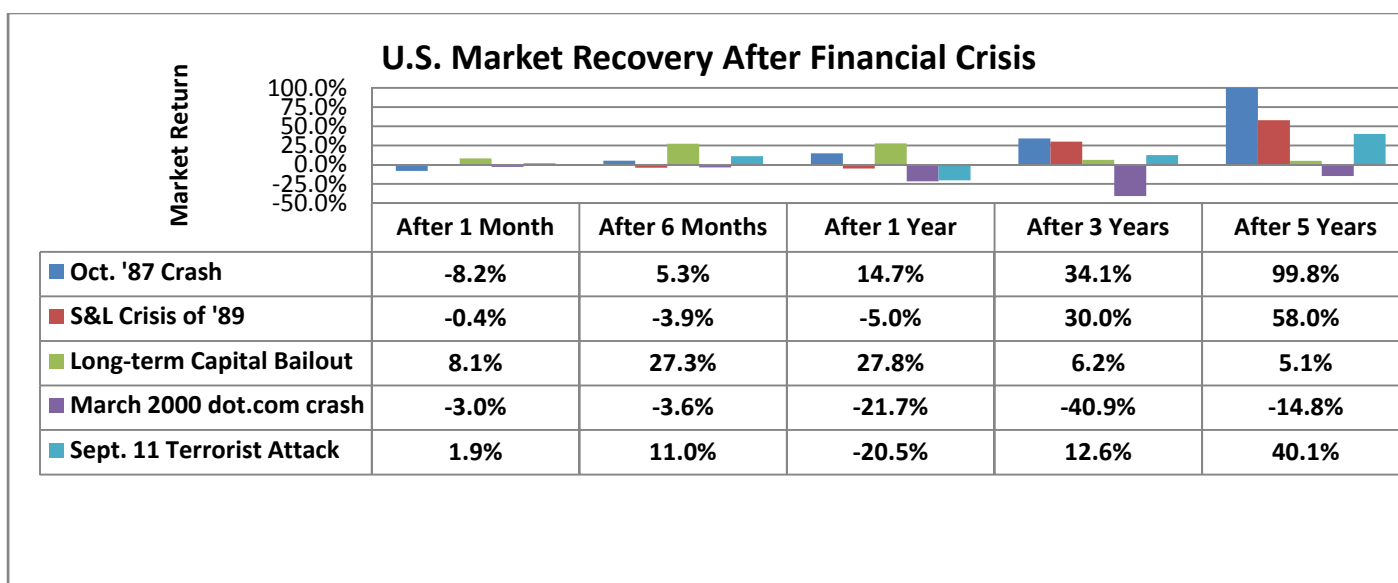
2007-2008 – Monthly payments begin to decline on CDO's, even for the highest quality tranches that include an insurance wrapper. Defaults ensue as homeowners are unable to refinance their mortgages.

2008 – Worthless CDO’s are thought to exceed \$1 trillion with the number going higher as offshore “shell companies” become public knowledge. Insurance companies, brokerage firms, and banks are forced to write-off billions of assets and the drop in cash flow from worthless CDO’s leads to a major liquidity crisis.

It should come as no surprise that the top underwriters of CDO’s included Bear Stearns, Merrill Lynch, and Wachovia Bank. All along, the Federal Reserve, the SEC, the Accounting Standards Board, and Washington were either oblivious or misled to what was going on in the financial markets. So, pointing fingers at who is to blame is a waste of time.

We’ve Been to this Rodeo Before

Although no financial crisis is exactly alike, the U.S. has seen several financial crises during the past twenty years. Only once has the market not recovered from a major sell-off within the next three years, and that occurred during the worst bear market since the Great Depression. Since we do not know the actual depth of our current financial mess, predicting when the market will recover from this year’s losses is anyone’s guess. Investors can take heart, however, that the markets have always recovered from recessions, wars, bank failures, and crashes. Always...



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