

The Other Side of the Street April 19, 2009

Comments

I'm back . . .

I am in the process of trying to figure out better ways to communicate, but simply so I can track stories of interest to me, I am going back to the original format. Hopefully I will have something much more condensed soon.

In the meantime, I have the following thoughts:

We are in a bear market rally that will last as long as it lasts. Could be weeks, months or years. There is however little doubt in my mind that we will break down again at some point and I suspect that "some point" will be the fall. Between now and then we will see sell offs and dip buying and the famed higher highs and higher lows. This will further embolden the bottom callers. We will also see each bit of "positive" economic news touted as supporting the "bottom is in" prognosticators.

I do not believe we are in a new bull market. Instead I believe we are seeing what happens in markets and has happened in markets for centuries. Nothing goes straight up or down. The market does not "see nine months ahead" – if it did then how did the market reach new highs in late 2007 as the economy went into recession? Several things underlie the current rally:

- Short covering – much like bull markets suck in the marginal players, so do bear markets. The marginal players saw the pros make lots of money shorting last year and now want to get some of that "easy money". Alas there is never any easy money and shorting is much more difficult than riding up a bull market. In shorting, timing is critical and good shorting requires taking small losses frequently in order to avoid being run over by short squeezes.
- Quant programs – while the volume has been respectable, it has been very focused in a small number of bank and other heavily shorted stocks.
- Performance anxiety – one of the significant flaws in the current system is the reliance on "benchmarking" in which a money manager is judged by the performance of the market. Thus while there are abundant reasons to be cautious, those who exercise restraint are falling behind those who are running things up. The longer this happens, the more pressure those out of the market feel the need to jump in. We are most definitely at that point, which is why I think a pull back at this point will get bought.
- Spinning economic news and earnings results – as noted above nothing goes straight down or up. With all the money being thrown at things, it is natural that at some point results either decelerate in the downside or move up modestly.

There is nothing to indicate this is sustainable. If it is not sustainable we will see the collapse at some point of this rally.

At this point, I am largely on the sidelines. I am willing to wait for clarity on when this market runs out of steam (likely) or if there actually will be sustainable economic growth. I have learned that there will always be investing opportunities and the only thing to do when the markets are confusing to me is to limit exposure. As most of you know I am a big advocate of gold. I remain an advocate but will admit it is trading very poorly. Thus I have my lowest exposure to gold in years, but will watch carefully for a time to bargain hunt.

In closing, I intend to once again begin sharing my thoughts on a regular basis. I will remind all that they are simply my views and that wise investing requires looking at a variety of views and personal assessment as to which of those make sense to you.

PS If you did not catch the 60 minutes piece tonight on 401K plans, it is worth reading the transcript. Very harsh reality at the end, but that is in fact reality.

Notes

Stocks

- We said **just the other day** that the folks buying the common stock of MGM must not be very good at math. You'll recall our reasoning: The company's bonds were trading for 40 cents on the dollar. Meanwhile, the company isn't earning enough money to pay for the interest on its debts and has been forced to sell assets to meet principal payments. Oh... and the company's debts equal 13 times the equity, even if you assume MGM's assets are still worth what they were in 2007. Our point: Stock investors should pay a lot more attention to the bond market and avoid stocks whose debts trade well below par, as these situations almost always end with the common stock being completely wiped out. Coincidentally, about the time we were writing that piece, Carl Icahn was thinking the same thing and actively buying MGM bonds. The move sets him up as the likely future controlling stakeholder of MGM's assets. MGM is currently controlled by its largest equity investor, Kirk Kerkorian. But not for long... MGM has \$227 million of bonds coming due in July and \$821 million in October. If the company is unable to make those payments, Icahn and another recent large buyer of MGM's debt, Oaktree Capital Management, could force MGM into bankruptcy. Icahn has traded Las Vegas properties successfully before, selling the Stratosphere and three other casinos at the top of the market in early 2007 for a \$1 billion profit. It's also likely Icahn owns derivatives or credit default swaps that will increase in value if MGM goes bankrupt. The math is compelling when you know there's zero intrinsic value in the equity. You can short the stock with leverage and use the proceeds to buy more of the debt. Then, you foreclose, and you get the assets for

pennies on the dollar. And that's why, dear subscribers, you ought never buy a heavily leveraged operating company. S & A Digest

Weblinks

Credit

- April 19 (Bloomberg) -- President [Barack Obama](#) said he'll demand "accountability" from any U.S. banks that require additional taxpayer money following "stress tests" being conducted by regulators. **"We'll try to use as light a touch as we can, but I'm not going to simply put taxpayer money into a black hole where you aren't going to see results or some exit strategy so the taxpayers ultimately are relieved of these burdens,"** Obama said at a news conference today in Trinidad and Tobago as he wrapped up his first [Summit of the Americas](#). The U.S. Treasury and financial regulators have set a May 4 deadline for disclosing results from the stress tests of 19 U.S. financial companies including [Citigroup Inc.](#), [Bank of America Corp.](#), [JPMorgan Chase & Co.](#), [Goldman Sachs Group Inc.](#), [GMAC LLC](#) and [MetLife Inc.](#) The tests are being used to determine whether the firms have enough capital to cover losses over the next two years should the economic downturn worsen. The stress tests will show "different banks are in different situations," Obama said today. **"They are going to need different levels of assistance from taxpayers, [if they all are going to "pass" they why is any assistance needed?]** and as I've said before, if taxpayer money is involved I've got a responsibility **to ensure some transparency [then why did we get rid of market to market?]** and accountability." Private Markets Banks that require additional capital will first have to rely on private markets, National Economic Council Director [Lawrence Summers](#) said today on NBC's "Meet the Press" program. **"The first resort for more capital is going to the private markets directly to raise equity,"** he said. Summers, Obama's top economic adviser, said options for adding private capital go beyond issuing new stock to investors and include **"so-called asset-liability swaps that would have the effect of perhaps diluting some shareholders, but also fortifying the level of capitals."** He didn't elaborate. 'Positive Indicator' Recent economic data have shown improvements in the economy "after a period when there was literally no positive indicator to be found." Summers said today. Even so, "We've got a long way to go in terms of supporting this economy," he said. "There are still substantial risks." A consumer confidence report last week showed signs the longest U.S. recession since World War II may be easing. **An improvement in sentiment may help stem the slide in consumer spending, [sentiment improved because the stock market went up, this will not be long lived]** which accounts for 70 percent of the economy, and boosts the odds the recession will end this year. Summers said that while the administration welcomes repayment, **"We don't want people to be paying back the government in ways that would put themselves right back in trouble, and leaving themselves with inadequate**

capital.”

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- April 17 (Bloomberg) -- **The Obama administration’s bank- rescue efforts will probably fail because the programs have been designed to help Wall Street rather than create a viable financial system,** Nobel Prize-winning economist Joseph Stiglitz said. “All the ingredients they have so far are weak, and there are several missing ingredients,” Stiglitz said in an interview yesterday. The people who designed the plans are “either in the pocket of the banks or they’re incompetent.” The Troubled Asset Relief Program, or TARP, isn’t large enough to recapitalize the banking system, and the administration hasn’t been direct in addressing that shortfall, he said. Stiglitz said there are conflicts of interest at the White House because some of Obama’s advisers have close ties to Wall Street. “We don’t have enough money, they don’t want to go back to Congress, and they don’t want to do it in an open way and they don’t want to get control” of the banks, a set of constraints that will guarantee failure, Stiglitz said. **Rather than continually buying small stakes in banks, weaker banks should be put through a receivership where the shareholders of the banks are wiped out and the bondholders become the shareholders, using taxpayer money to keep the institutions functioning, he said.** Nobel Prize Stiglitz, 66, won the Nobel in 2001 for showing that markets are inefficient when all parties in a transaction don’t have equal access to critical information, which is most of the time. **The Public-Private Investment Program, PPIP, designed to buy bad assets from banks, “is a really bad program,” Stiglitz said. It won’t accomplish the administration’s goal of establishing a price for illiquid assets clogging banks’ balance sheets, and instead will enrich investors while sticking taxpayers with huge losses. “You’re really bailing out the shareholders and the bondholders,”** he said. “Some of the people likely to be involved in this, like Pimco, are big bondholders,” he said, referring to Pacific Investment Management Co., a bond investment firm in Newport Beach, California. **“The statement from Sheila Bair that there’s no risk is absurd,”** he said, because losses from the PPIP will be borne by the FDIC, which is funded by member banks. **“We’re going to be asking all the banks, including presumably some healthy banks, to pay for the losses of the bad banks,” Stiglitz said. “It’s a real redistribution and a tax on all American savers.”** Stiglitz was also concerned about the links between White House advisers and Wall Street. Hedge fund D.E. Shaw & Co. paid National Economic Council Director Lawrence Summers, a managing director of the firm, more than \$5 million in salary and other compensation in the 16 months before he joined the administration. Treasury Secretary Timothy Geithner was president of the New York Federal Reserve Bank. ‘Revolving Door’ “America has had a revolving door. People go from Wall Street to Treasury and back to Wall Street,” he said. “Even if there is no quid pro quo, that is not the issue. The issue is the mindset.” **Stiglitz was head of the White House’s Council of Economic Advisers under President Bill Clinton before serving from 1997 to 2000 as chief economist at the World Bank.** He resigned from that post in 2000 after repeatedly clashing with the White House

over economic policies it supported at the International Monetary Fund. He is now a professor at Columbia University. Stiglitz was also critical of Obama's other economic rescue programs. He called the \$787 billion stimulus program necessary but "flawed" because too much spending comes after 2009, and because it devotes too much of the money to tax cuts "which aren't likely to work very effectively." "It's really a peculiar policy, I think," he said. Plan Deficient The \$75 billion mortgage relief program, meanwhile, doesn't do enough to help Americans who can't afford to make their monthly payments, he said. It doesn't reduce principal, doesn't make changes in bankruptcy law that would help people work out debts, and doesn't change the incentive to simply stop making payments once a mortgage is greater than the value of a house. Stiglitz said the Fed, while it's done almost all it can to bring the country back from the worst recession since 1982, can't revive the economy on its own. **Relying on low interest rates to help put a floor under housing prices is a variation on the policies that created the housing bubble in the first place, Stiglitz said.** "This is a strategy trying to recreate that bubble," he said. "That's not likely to provide a long run solution. It's a solution that says let's kick the can down the road a little bit." While the strategy might put a floor under housing prices, it won't do anything to speed the recovery, he said. "It's a recipe for Japanese-style malaise."

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Commercial Real Estate

Commodities

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Derivatives

Housing

Housing Finance

Macro Economic

Retail

Retirement

Risk

Savings Rate

Tech

Wall Street

Don't Fight The Fed

- April 19 (Bloomberg) -- Two of the [Federal Reserve's](#) top policy makers defended the Fed's emergency lending, saying the programs won't cause an inflationary surge or create "significant" risk for taxpayers. Vice Chairman [Donald Kohn](#), speaking yesterday in Nashville, Tennessee, said the Fed has loaned to "sound" borrowers and plans to disclose more about such credit. New York Fed Bank President [William Dudley](#), speaking at the same conference, said he's "not worried at all that" a doubling in the central bank's balance sheet to \$2.19 trillion will spur inflation. **The increased credit has provoked concerns prices will surge. Central bank officials are "dramatically underplaying the risks and liability side of the balance sheet,"** former St. Louis Fed President [William Poole](#) said in an interview at the conference. Former Fed Chairman [Paul Volcker](#) said Congress will probably review the authority granted to the Fed following the expansion in its assets. Political Reaction **"I don't think the political system will tolerate the degree of activity that the Federal Reserve, in conjunction with the Treasury, has taken,"** Volcker, head of President [Barack Obama's Economic Recovery Advisory Board](#), said in remarks to the conference at Vanderbilt University. No 'Fundamental Change' While the central bank may be channeling credit to some markets more than others, "we are not

taking significant credit risk that might end up being absorbed by the taxpayer,” Kohn said. “For almost all the loans made by the Federal Reserve, we look first to sound borrowers for repayment and then to underlying collateral.” **The TALF, aimed at supporting financing of loans to credit card borrowers, students, car buyers and small businesses, is off to a “slow start,” Dudley said, recording just \$6.4 billion in loans.** Investors have shied from joining some emergency credit programs after lawmakers criticized the compensation practices of financial companies that accepted taxpayer funds to shore up capital, Dudley said.

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- April 10 (Bloomberg) -- The U.S. Federal Reserve has told [Goldman Sachs Group Inc.](#), [Citigroup Inc.](#) and other banks to keep mum on the results of “stress tests” that will gauge their ability to weather the recession, people familiar with the matter said. The Fed wants to ensure that the report cards don’t leak during earnings conference calls scheduled for this month. Such a scenario might push [stock prices](#) lower for banks perceived as weak and interfere with the government’s plan to release the results in an orderly fashion later this month. “If you allow banks to talk about it, people are just going to assume that the ones that don’t comment about it failed,” said [Paul Miller](#), an analyst at FBR Capital Markets in Arlington, Virginia. “No matter what the result, the stress tests are going to move markets,” [Camden Fine](#), president of the Independent Community Bankers of America, said in an interview yesterday. “That’s the tricky part. If they don’t give out enough information or the information is presented in the wrong way, that could cause markets to plunge.”

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I Disagree . . . and why

[Article of the week:](#)

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Best of the Dog