Comments

September 9, 2007

September 2, 2007

Because America's economic brain is a myopic computer programmed for instant gratification, not long-term planning. Years of brainwashing focuses on the latest fashions, today's store sales, Wall Street's relentless minute-to-minute trading. We assume that "tomorrow will take care of itself," and that the government will bail us out, like the Fed did recently with the discount rate. But, Walker warns, you can't trust government with your future: **[for the rest of this article go down to article of the week]**

The exhibition season has drawn to a close. The veterans will be playing for keeps starting this first full week of September. The bit players will return to the bench. Their meaningless late August play quickly forgotten. We shall soon be seeing Hail Mary's that matter. Oh and pro football is about to start.

In the real game played at Wall and Broad, the time for atonement has arrived.

First - personal updates. Belle continues her own personal rally. She has a phenomenal fighting spirit and is back to at least 80%. Doubtful she makes it back the full 100, but I wouldn't count it out either. As many of you know, she has a spot under my desk we call "work." The little soldier showed up for work a few days ago. On her own. Just punching in. I have also reached a milestone having finished the first MBA school year. The following is based in part on knowledge acquired in Ann Arbor. Most of it is based however not on learning about business but instead learning about economics, psychology and history. Those disciplines, not the efficient market theory and other B-school buzz words dictate what is about to happen IMO.

And what I believe is about to happen is a once in a generation or so collapse. This will not be the fabled "dip buying" opportunity. It will instead be a NASDAQ 2000-2 bloodletting from which many never recover. The whys have been documented herein for months. The timing an educated guess. The underpinnings of the guess:

The big boys are already headed for the exits. The volume shows it.

The veterans have been moving out for months. The rookies stepping up.

The Fed meets on September 18. The wishers and hopers think the market can't drop before then. We will watch and see.

My money says the short term debt rollovers will not go well. Lots of sellers few buyers. This will soon overwhelm the central bankers' efforts to keep hope alive.

The warnings season will start very early (it actually already has). This time pulling down the numbers will matter. Just like in 2000, things will go from rosy to awful because of just in time inventories and other such advancements.

The accelerant on all of this will be the exotic derivatives as well as the mispriced equity derivatives (Black Scholes assumes volatility is constant – it won't be and the horribly mispriced outliers will explode like fireworks on the 4th of July).

The fallacy of mark to model will be exposed for the fraud it is. This will be the beginning of a loss of wealth unseen in terms of dollar amount. It will also be the creation of wealth for those who play it correctly.

October equity options expire October 19. Seven weeks. Intel closed above 25 last Friday. I have a range of October puts going as low as 17.50 Says here the 17.5s are in the money two Fridays after Columbus Day.

Mister Sunshine indeed.

We will see . . .

August 26, 2007

In the finest of the current generations "fifteen minutes" of focus. Markets rallied last week, victory was declared and it was time to start figuring out those year end bonuses on Wall Street.

Unfortunately for the investing public, this is not a sprint, it is a marathon. The underlying news continued to get worse. The "dip buying" of late August on light volume without regard to the real world will prove to be as profitable as throwing money into the wind.

Things are about to become extremely ugly.

August 19, 2007

"Alan Greenspan freely admitted that by orchestrating a rescue of Long Term, the Fed had encouraged future risk takers and perhaps increased the odds of a future disaster. 'To be sure, some moral hazard, however slight might have been created by the Federal Reserve's involvement,' the Fed chief declared." - *When Genius Failed – The Rise and Fall of Long Term Capital Management* p. 229-30

For immediate release August 17, 2007 8:23 a.m.

Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. . . . **the Federal Open Market Committee judges that the downside risks to growth have increased appreciably**. **The Committee is monitoring the situation** . . . [hopefully better than prior to August 7] http://www.federalreserve.gov/boarddocs/press/monetary/2007/20070817/default.htm

August 16, 2007 - Federal Reserve Bank of St. Louis President William Poole **said late yesterday** that there is no sign that the subprime- mortgage rout is harming the broader economy and an interest-rate cut isn't yet needed.
http://www.bloomberg.com/apps/news?pid=20601109&sid=anhB9UfTZEIU&refer=home

Aug 16 TEL AVIV (MarketWatch) -- U.S. Treasury Secretary Henry Paulson said the recent turmoil and downturn in the financial markets will hurt U.S. growth but won't prompt a recession **since the U.S. economy is "strong enough to absorb the losses**," The storm in the markets comes when **the global economy is "very healthy" with "strong fundamentals**," . . .the recent "reassessment or repricing of risk" -- was "inevitable" and "**shouldn't surprise anyone**," the paper said. [except apparently the fed if you believe Poole] **Paulson says turmoil won't prompt U.S. recession:** http://www.marketwatch.com/news/story/paulson-says-turmoil-wont-prompt/story.aspx?guid=%7B5283832B%2DDDE5%2D4FDB%2D88BF%2D908498C4C1A3%7D

For immediate release August 10, 2007 9:19 a.m.

The Federal Reserve is providing liquidity to facilitate the orderly functioning of financial markets. [They seemed to function in an orderly manner this week, just in the wrong direction apparently]
http://www.federalreserve.gov/boarddocs/press/monetary/2007/20070810/default.htm

For immediate release August 7, 2007 2:15 p.m.

[T]he economy seems likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in employment and incomes and a robust global economy. . . . Although the **downside risks to growth have increased somewhat**, the Committee's **predominant policy concern remains the risk that inflation will fail to moderate** as expected.
http://www.federalreserve.gov/boarddocs/press/monetary/2007/20070807/default.htm

The gun is now nearly empty. The clip nearly spent.

The much ballyhooed fed cut has arrived. Although it really wasn't a cut because it was the discount rate not the fed funds rate, right? Even anticipating the foregoing argument (which will be raised when this cut fails to curb the freefall), most would agree that whatever the Fed will do to "save" the speculators and credit abusers is now firmly underway. Prior to addressing the "what changed in 8.5 business days" question, let's look at what the "Save the Day" Fed actions have done thus far:

Thursday August 9, 2007 Dow 13,271 (down 386); SP500 1,453 (down 44); Naz 2,556 (down 56)

Friday August 10, 2007 Dow 13,240 (down 31); SP500 1,454 (up 1); Naz 2,545 (down 12)

Friday August 17, 2007 Dow 13,079 (up 233); SP500 1,446 (up 35); Naz 2,505 (down 54)

Bring you any comfort that the smart money is "buying the dip"? How about any thoughts that the ages old tradition of the smart money handing the bag off to the little guys is now well underway?

By the way, if you missed the Friday Nikkie numbers (pre-Fed Rescue II), it was down 874.81. No, that is not one of my usual typos. It did in fact drop nearly 900 points from 16,147 to 15,273. In one day. Closed last Friday at 16,765 . . . Down 1,492 for the week. . . . Down from the all time high of 38,915 . . . Reached in September . . . September 1990. Folks in Tokyo at that time said there was nothing but blue sky and champagne ahead. Seems asset prices had soared in the prior years . . .

But that could NEVER happen here . . . Right?

We will see . . .

[As a housekeeping matter, the comments herein were largely entered the day the story was published. As a result some may appear dated (and/or prescient I hope)]

August 12, 2007

One day's goat another day's hero?

The same group that on Tuesday did not even know there was a problem became the saviors on Friday. Please forgive any guffaws that might ring out during the course of this commentary, but why anyone would believe the Federal Reserve has any credibility at this point amazes me.

Since I am short on time, having just arrived home from a ten day journey, suffice it to say that I am NOT one of the true believers.

The stakes of the game however have risen appreciably. Now that the Fed is **perceived** to be coming to the aid of the irresponsible yet again, **it had darn well better work**. The sole reason the Dow did not drop substantially on Friday in my opinion is the wishers and hopers now think the Federal Reserve will save the day.

Instead, when it becomes apparent that the Fed is several days late and many dollars short, the fall will be dramatic. Last week I thought within 75 days, now I think within 45 more likely. "Any day now" is also a growing possibility.

Of course, maybe the Wall Street Journal is right and this is the umpteenth greatest BUYING opportunity – see "S & P Looks On Cheap Side Amid Turmoil." The only reasonable explanation I can think of for this article on page B1 of the August 11-12, 2007 edition is that, with the Murdoch takeover, Homer Simpson is now writing for the WSJ.

We will see . . .

July 29, 2007

This is a wonderful example of what is wrong with Wall Street. It is Thursday afternoon and I am reading one of the many daily newsletters I receive. After today's across the board "pummeling", there is still very little fear. Instead, it is the standard "buying opportunity":

Our cautious optimism is leaning much more to the cautious side after the market was pummeled today. Housing data-points over the last few days have shown that the housing market is in much worse shape than most pundits believed (remember, former Fed Chief Alan Greenspan called a bottom in home sales on March 7th), elevating credit risk. While this is a clear negative to the financials and one reason they remain under pressure, the yield curve is now at its steepest since October 2005. Thus, while our bullishness of the sector appears to have been early, we would continue to selectively accumulate shares of "Buy"-rated financials on the Recommended List.

OR from the Street.com's Jim Cramer:

Jim Cramer and Farnoosh Torabi
Find out Jim Cramer's take on when to buy homebuilding stocks and the financials.

OR

How about this from Sunday:

``The fundamentals in my opinion are quite strong,'' said Lincoln Anderson, who helps manage $150 billion as chief investment officer of LPL Financial in Boston. ``The second-half earnings outlook is pretty doggone good. I look at this period as more of a buying opportunity.

My view - this "buying op" will be as effective a strategy as would have been buying real estate in March. The idea that things are a "good buy" because they are lower than they were recently was soundly disproved in 2001-2. Why memories are so short escapes me.

We will see . . .

July 22, 2007

The CDO derivative train is over the cliff. The sole remaining question is how long until it hits the ground.

The dollar is in a similar free fall

Housing values will drop for years

High yield is imploding

None of these stories are new. All were easily foreseeable.

Dow 14000.

Wall Street shills and University finance professors would have you believe the market is always right. But which market?

We will see . . .

July 15, 2007

Happy 14000!

It took only a day last week to blow out my "failed rally" theory.

I yet again attempted to apply reason in a financial world without any (currently).

As you will read below, the "new all-time Dow" high stands in stark contrast to economic news. There is at least one "bright" spot. Retail spending rose 3.4% last week. God Bless the American consumer. What is that you say? The retail spending was up because **"[r]ising food prices caused more shoppers to purchase groceries at discounters**". So it is a good thing that food costs more and people need to buy it in bulk at Sam's instead of Tom Thumb? Will the good news ever end?

On the less cheery front, those pesky Bear Stearns funds are back in the news. It seems the investors lost **ALL** their money. It also brings up a question or two. Since Bear Stearns is widely lauded as one of the best in the field, how could they **lose 100%** of their investors' money? **IN JUST A FEW MONTHS**. There are two equally frightening possibilities.

Either:

- These experts really did not understand the risk in the investment

OR

- These experts really did not understand the risk in the leverage they applied to the investment.

Which ever way you chose, what do you the chances are that those less sophisticated and with less inside information made better choices (and yes I am referring to the multitudes of billion dollar hedge funds run by New Era money managers who think risk is missing a dip buying opportunity)?

For those of you who received the July 2006 packets setting forth the disaster scenario, dust them off. The winner of the derivative game has been decided and it is not the ones who shorted the risk. The only question remaining is the timing of the collapse.

We will see . . .

July 10, 2007

Happy July 10th. Steve DiMaria (deserved senior class president Bay High 1975), man-made satellites and I (disgruntled senior class presidential candidate – think George Serb - Bay High 1975), all turn 50 this year. For Steve and I today is the magic day. Looking at the index charts, I wonder if today might also become known in future eons as the day the rally died.

As we have seen the past many years, one down day, week or month are meaningless in the grand scheme of things. So why would I be so bold as to make the statement in the prior paragraph? Too much refined sugar in the birthday cake or heat exhaustion from the candles are likely reasons. I would like to think, however, that it might also be a little bit more.

You may recall in past issues, I mentioned the "failed summer rally" as a possibly significant indicator. This is basically a situation where a market rallies for an extended period of time, then pulls back, rallies again but fails to make new highs. I am not certain whether Wall Street technicians would say the pattern fits if we drop from here, but 4 out of 4 retrievers on Willow Wood Lane think it might.

Putting away the Ouija board, there are also many other reasons to hope the return to sanity may be near. In no particular order . . .

- Research in Motion's 30% run and gun on a 3 for 1 stock split and very questionable "earnings beat" announcement (channel stuffing, extending payables, and manipulating analysts on the tax rate might be another way to look at it). This is a page straight out of the spring of 2000. As is the exhaustion gap and record volume. Think back to the "final blaze of glory" many dot bombs and other ridiculously priced techs experienced on their way to 90-100% collapses in the ensuing months.

- The speed with which is was determined that the Bear Stearns hedge fund blow ups were non-issues. This is yet the latest iteration of everything is a buying opportunity. As we will see, it is until it isn't.

- The suck of liquidity being pulled out of the system (i.e. banks tightening and junk debt going unloved)

- The pain of being overly leveraged in a non-liquid asset. See structured debt and the Bear Stearns hedge funds

- The ubiquitous calls that the economy is fabulous in response to any bit of bad news

- The years late recognition by the "ratings agencies" (soon to be know as "aiders and abettors" in plaintiff's pleadings in a neighborhood near yours) that this isn't your father's AAA debt.

- The implosion in housing has finally reached a point where even the cheerleaders can't put any lipstick on it.

As always, we will see . . .

Happy Birthday Steve!

June 24, 2007

Hello again!

Sorry for the extended sabbatical. As previously stated, I am not sure it mattered in terms of sharing ideas. Basically, the economic situation in particular housing and housing finance continued off the cliff while the Street continued to party like it was 1999.

The significant story of the week past is the still developing implosion of the Bear Stearns structured debt hedge funds. Whether or not this leads to a significant dislocation, this is the type of event that eventually will become uncontrollable. The elementary school explanation is that there are trillions of dollars (notional value) of debt that is either thinly traded or not traded. This debt is currently priced at or near where it was sold, not where is could be sold. An imperfect analogy can be drawn to the housing market. The people who bought houses at the top paid let's say $100,000. Now that there are fewer buyers, the house can only be sold for $80,000 if given time to sell and only $70,000 if the owner has to sell immediately. If the owner paid cash, the owner is out $20,000 because the owner can wait out the market. However, if the owner borrowed against the house, say for $80,000 and the house is in foreclosure, the owner will be out the $30,000.

What has happened in the credit markets is that the "owners" have not $100K or $20K, but instead as low as $1K. As long as no one is selling at the low price, all the owners can continue to "borrow" at the initial sales price of $100 and everyone is happy. However, once transactions begin to occur and these securities reprice at the $70K example, the lenders will demand repayment of the full $99K loan. Further, unlike the housing market, there are very few potential buyers and ALL the buyers know the owner has to sell.

In a nutshell, this is why there was so much effort to prop up these funds without a fire sale. The propping can be done as long as the effort can be reasonably financed. The propping also requires cooperation among rivals, something akin to hoping the lion and the lamb can work together. However, once it is perceived that the house of cards can not hold up, there is a race to the exits. In effect Merrill's threat to liquidate the bonds to cover its loan was such a move to the exits. The Bear is now putting 3.2B in a fund that had an equity value of less than $600M a few weeks ago shows how much fear it has that the house of cards is coming down.

As stated at the start, it is not possible to know whether this will be THE event that re-instills sanity in investing.

We will see.

June 9, 2007

Notes from our last edition (May 6, 2007)

It's not different this time.

I was amazed to hear that certain pundits have pulled out that tired old explanation that valuations make sense because there has been a fundamental change. It's been almost seven or so years since that was widely touted (as in the "New Economy"). Everyone recall how that turned out for the New Economy faithful?

While in the amusing news department, I saw last night on Bloomberg that Asian was rallying on the hope of rate cuts in the US. I couldn't make this stuff up.

The weekly review will be less voluminous until things begin to make sense again. Suffice it to say that conditions continue to build towards a calamitous collapse. My latest wild guess would be sell off soon, summer rally, fall collapse.

We will see . . .

Due to a number of unforeseen events, including but not limited to internet connectivity issues, there has been a brief hiatus in the weekly updates. The timing was perfect because not much has happened in the interlude. The market continued to run and the economy continued to deteriorate. This weeks selling was to be expected, as will a summer rally of some type. I continue to believe the best time to get out of US equities is now. A view that would have "cost" you a robust return the past year, but in the multi-year focus will have saved you a bundle IMO.

June 13 update:

Things continue to be wild at my end. However in light of today's market insanity, I wished to simply get something out. The following is from Bill Fleckenstien's column today. Further evidence that as Wall Street fiddles the world burns.

Likewise, those of my friend in London (the lord of the dark matter), who in an email to me wrote: "Yesterday afternoon [Tuesday], someone tried to liquidate a $3.8 billion list of AAA and AA bonds. It was made up of (1) cap corridor floaters, (2) subprime, (3) Alt-A, (4) scratch and dent. Eyeballing the list, it seemed heavily skewed toward the cap corridors and Alt-A collateral, and was primarily 04 and 05 issuance -- i.e., paper created before things went bad. It contained 149 separate securitizations. The takeaway is this: Not even during the February subprime meltdown did you see a portfolio of this size liquidate, let alone AAA and AA collateral. This is new, and explains why ABX got whacked again yesterday. "

May 6, 2007

It's not different this time.

I was amazed to hear that certain pundits have pulled out that tired old explanation that valuations make sense because there has been a fundamental change. It's been almost seven or so years since that was widely touted (as in the "New Economy"). Everyone recall how that turned out for the New Economy faithful?

While in the amusing news department, I saw last night on Bloomberg that Asian was rallying on the hope of rate cuts in the US. I couldn't make this stuff up.

The weekly review will be less voluminous until things begin to make sense again. Suffice it to say that conditions continue to build towards a calamitous collapse. My latest wild guess would be sell off soon, summer rally, fall collapse.

We will see . . .

April 22, 2007

Wednesday April 18, 2007 at the close overheard on Bloomberg News Channel:

Bloomberg Anchor, "so what is it that is driving this market higher? Is it earnings or what?"

Guest "expert" - "people want stocks and they are going to go get them no matter what they cost" Harry Clark, Clark Capital Management

That folks says it all. The statement was equally applicable in 1929 and in 1999.

April 30 UPDATE – Yes I have shameless waited for a down day to send this out. Just kidding. Actually I have been swamped with MBA things, they expect me to use complex math forgetting that guys my age had geometry in 10th grade not first like my nephew. In any event, the economic news continues to be dismal, the pain is being felt on Main and the party continues on Wall unabated. Oil is a real issue as will be power this summer. The failure to build reserves the last month places gas shortages and 4 bucks a gallon gas on the front burner as early as July IMO.

I will be back on schedule end of this week and will include anything of great interest I missed the last couple.

April 15, 2007

AMD warns – in effect business off 20% – stock rockets higher.

No need for any intellectual comments in a market like this

April 8, 2007

It's all good right?

April 6 - "U .S. payrolls added 180,000 jobs in March, pushing the unemployment rate down to 4.4% for the month, according to a report from the Department of Labor. The last time that the unemployment rate was lower was in May 2001, The unemployment rate fell 4.5% in February and 4.6% in January."

More good news right? Maybe not. A few things jump out to me. First the reference point May 2001. In May 2001 we were in the middle of the 70 plus percent drop in the NASDAQ and the economy was far from humming along. Second and IMO more importantly, if we are at record foreclosures in one of the rosiest times for employment, what will happen if things get less rosy????

We will see . . .

P.S. Sticking my head in the lion's mouth yet again, I have prepared another were-we-are-where-I-think-we-are-going missive. I've attached it as well as my most recent SVan article for your reading pleasure.

April 1, 2007

"What is endangering America's money is the same thing that is undermining its position in the world - slipping standards." From the 3/29 Daily Reckoning http://www1.youreletters.com/t/1216996/1469639/23/0/

A little snippet of the rot that underlies many of the "popular" names in US equities was revealed by DELL after hours Thursday:

> An audit committee of the company's board of directors "has identified a number of accounting errors, evidence of misconduct and deficiencies in the financial control environment," the company said in a statement.
>
> Dell's accounting practices are also being investigated by federal securities regulators.

I'm not sure I need to add anything

March 24, 2007

The insanity continues. No matter how bad the news, the "buy the dip crowd" continues to show up. While the party continues on A deck, the water continues to surge into the hold.

The party goers all seem to think that before the water gets to them they will find a lifeboat.

We will see . . .

March 17, 2007

On Monday I came across an article that discusses several issues we are learning about in our finance class. The author effectively makes and supports points I have attempted to set forth previously. The article and link are at the end of this collection, but some of his points I think well suited for everyone's consideration:

I am increasingly losing confidence that Wall Street operates on a well-defined base of knowledge. **Instead, I am struck by the number of platitudes and false constructs that seem to dominate the investment management industry**.

I'm similarly convinced that Wall Street has no idea what it's talking about when it uses the word "liquidity." **While using the phrase "global liquidity" lends a further element of worldly sophistication, Wall Street still hasn't the slightest idea what it's talking about**. **The phenomenon that's being called "liquidity" is nothing more than a combination of fiscal irresponsibility and risk blindness, and will ultimately prove itself to be the time-bomb that it is when investors begin to "re-price" that risk.**

Now consider government and foreign trade. The U.S. is currently running massive federal deficits, and massive current account deficits. What's really happening here is that we are, in aggregate, consuming more than we produce, and foreigners are producing more than they consume. This difference requires the issuance of a huge volume of new securities to enact that ***transfer*** of purchasing power. The resulting mountain of issued securities does not represent newly created money looking for a home, or looking to be spent. It has ***already*** been spent! And we've spent it.

This will end badly. "Global liquidity" is not a positive for U.S. markets. It is simply evidence of the existing claims of other nations against our future prosperity. There will be an increasing amount of apparent "money on the sidelines" in the years ahead, for the simple reason that the U.S. government will keep issuing securities and somebody will have to hold them.

. . . . .

Neither of these cases [see below, the numbers are returns on equities of 5.4 or 4.0% annually the next ten years] require particularly negative or bearish assumptions, *but they imply quite unsatisfactory long term returns, which underscores the point that rich valuations rarely deliver pleasant long-term results.*

In order for the S&P 500 to achieve a "normal" annual return of about 11% over the coming 5 years, we have to assume a maintenance of *record* margins, sustained *top-of-channel earnings growth* **(which has never before been sustained for such a period),** and an *expansion of valuations* to a multiple of 20 times peak earnings **(the same multiple as at the 1929 and 1987 peaks, which is *double* the average historical multiple on top-of-channel earnings).** *Investors should think now about whether these assumptions are plausible, because they may find themselves wondering later why they ever did.*

Currently, the likely range for S&P 500 returns over the coming decade is between a -3% annual loss and a 5% annual return, centering in the low single digits.

. . . .

Unless investors anticipate a repeated excursion into similar valuation extremes, it would be a good idea for them to recognize now, rather than later, that stocks are unlikely to produce satisfactory *long-term* returns from current valuations.

The "Money Flow" Myth and the "Liquidity" Trap *John P. Hussman, Ph.D.*

http://www.hussmanfunds.com/wmc/wmc070312.htm

March 10, 2007

New Century Financial closed Feb 7 at 30.16. It closed at 3.21 on March 8. IMO NEW will file bankruptcy as soon as Monday morning. The common shareholders will get nothing. I shorted the stock last year at 48, 46 and 44. I shorted a significant number of August NEW calls last week. I have no doubt I will never have to cover the common and the calls will expire worthless.

Wall Street analysts had the following rankings last month on New Century: 3 Buy, 6 Hold, 3 Sell and 1 Strong Sell. Today those same analysts, after a 90% drop, and with a likely drop to zero, rate NEW 1 Buy, 4 Hold, 3 Sell and 3 Strong Sell. From Feb 13 to March 1, there were three analysts' actions on the stock. Stifel Nicoluas, UBS and Bear Stearns all **UPGRADED** NEW. *UBS's February 2007 UPGRADE is particularly interesting in light of its March 2007 revelation "that it had as much as $1.5 billion in exposure to troubled sub-prime lender **New Century Financial".*** The **Current** Wall Street price targets on NEW range from a low of $4 to a high of $42. The current P/E is .48 (average PE on the S & P is about 17). The profit margin is 29%, operating margin 36%, diluted EPS $6.72, cash per share $7.38 and ROE 18.8%.

The purpose of the foregoing is not to gloat. I get plenty wrong too. The purpose is to illustrate how meaningless historical data and Wall Street analysis can be. You all know that the sub-prime issue has been easily recognized since the middle of last year. You also know that until very recently the media and Wall Street have claimed there was no problem with sub-prime. Those same sources now say sub-prime's problems will not spread. THEY say the economy is healthy. THEY say buy the dips, it is just a correction. THEY say last years earnings were great and we think next years will be too. THEY say ignore the man behind the curtain.

Maybe THEY will be right for a while longer. Maybe the dip buyers and liquidity will prevail one more time. Maybe NEW is worth $42 per share. Maybe common sense and basic economics will take longer to assert themselves. Your question should be "is it worth risking my life's savings to wait around and see if THEY are right?"

Those who say the sub-prime issue will be contained are as wrong as when THEY said the sub-prime issue did not exist. There are already problems with Alt A, the next level up. The problems with sub-prime were more about poor underwriting than interest. The same greedy unethical shysters who shoe horned debtors into sub-prime did the same all the way up the pipeline. It is now merely a matter of time. We are entering into a major bear market that will see horrific losses.

Just as with New Century investors, you need to decide before the losses mount what to do. Once you see it in the paper . . . Once your neighbors begin to talk about it . . . . Once it becomes clear what is happening . . . It will already be too late.

We will see . . . .

P.S. A quote from Al on the benefits of sub-prime financing (courtesy of Ask Fleck):

> "Innovation has brought about a multitude of new products, such as sub-prime loans and niche credit programs for immigrants. . . . With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. . . Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in sub-prime mortgage lending . . . fostering constructive innovation that is both responsive to market demand and beneficial to consumers."

Alan Greenspan, April 8th, 2005

March 2, 2007

Once again a week has whisked by and I have had little time to gather links. However, rather than wait, I felt like there are some things I want to convey. I had written the following Thursday night:

> Despite what the pumpers are saying, this is not some simple dip to buy. What it is remains to be seen, but at a minimum it is a real time test of the derivative/hedgefund/leverage complex as well as the correlation among sectors. My guess and at this time it is a guess is that the first will fail and the later will provide highly correlated among the domesticequity/realestate/foreingequity categories.
>
> I guess what amazes me is the complete lack of concern about the drop and proliferation of "buy XYZ on the correction/crash/plunge" articles. No discussion that in light of such a big downward move caution might be your first thought.

Obviously Friday did not turn out well for the bulls. However, the headline on Barrons says "Stick with the Bull" and there is little fear evidenced in either the weekend journal, the financial times or investors business daily. Far from being heartening, this IMO is an additional reason to believe there is plenty more downside. As most of you know I thought the market was going to collapse last summer. One of the reasons it did not was that my opinion was actually fairly wide spread. That left lots of nervous money on the sidelines and when things did not keep going down, there was lots of money to take it up. I think this time is much different. The bull money is pretty much in. The leverage and derivatives risk is not only now much higher, but also the sub-prime situation has had another six-nine months to fester. This time there is little I see that can hold things up. In fact I suspect with the recent drop there are now significant losses at some large hedge funds (I have no idea who and what, I am merely relying on my belief that speculation was and is rampant and that human nature being what it is there are real problems now).

We will see (sooner than later now I think) . . ..

February 24, 2007

Sometime last week I had the sound on Bloomberg TV. As a result of what I am sure was a scheduling error, they had on someone who was not an overt cheerleader. This money manager actually thought it best to avoid US equities, thought the dollar was in for a substantial drop and was investing in foreign utility stocks for the yield. The Bloomberg anchor after hearing this said "well aren't you concerned that if the dollar drops like you think the yield will get eaten up by the currency conversion?" The manager for a brief moment looked like he might say "aren't you concerned that you have no idea about what you are talking about?" Instead he said, "Well actually a drop in the dollar would enhance the yield in dollar terms"

Why that story now?

Because this morning the "media" had on any number of "traders" saying it was great the DOW would open down 100 because it would allow intuitional "investors" to get in. This is the type garbage that is cable financial reporting.

What is relevant to all of you is that the events we have been discussing for months are unfolding. In particular, the volatility is exploding, spreads are widening and the market is having a major stress test. We will see shortly how all those short the outliers will cover.

This is the real deal folks. Ignore the televisions reporters and look at your risk in the event of a sustained drop in US equities.

Sorry about the lack of a review this week. It was a U Mich weekend and today's market move takes precedence over last week's stories.

February 17, 2007

From the Schwab nightly summary on Feb 15:

> The Dow Jones Industrials closed at another record high as traders looked past several weak economic reports and focused instead on comments from Fed Chairman Ben Bernanke that moderate growth and a slowly diminishing rate of inflation will likely keep interest rates in check.

In other words "investors" ignored reality and placed there hope in projections. This applies very much to the market as a whole and many sectors and individual stocks I follow. Were we coming off bear market lows there might be some argument such a strategy made sense. Given that the Feb 15 VIX once again dipped near single digits and the equity put call dropped near .5 in with the Dow "at an all time high" (if you haven't heard this repeatedly for weeks, you must religiously avoid mass media), the "buy the hope" is a pretty high risk "strategy".

We will see . . .

February 10, 2007

The following is quoted directly from Bill Fleckenstein in the Daily Rap 2/8/07 (a subscription daily newsletter I read religiously and highly recommend):

> Today's troubles started after the close yesterday, when New Century announced that their financials were basically no good[i] and that they hadn't been properly accounting for loans that might be put back to them. In addition, and more importantly, HSBC, which is thought to be a good operator, announced after a board meeting that they were going to take their mortgage loan-loss reserves from $8.8 billion and change to $10.6 billion and change. The disconcerting conclusion reached by HSBC is described by today's Wall Street Journal, in a story titled *In Home-Lending Push, Banks Misjudged Risk*: "**Its systems for screening subprime borrowers and for assessing the default risk they posed were flawed. Many of those loans have soured, sometimes quickly. The percentage of HSBC mortgages more than 60 days past due is climbing.**[ii] Fraud by borrowers has been higher than expected." I encourage everyone to read this article, and another one in the Journal titled "Mortgage Refinancing Gets Tougher." **In reading these articles carefully, I think you will realize that we are at a major inflection point.**
> https://www.fleckensteincapital.com/dailyrap.aspx

I've written since last spring about the connection between the housing finance rot and the huge leverage/derivative problem (**and, in full disclosure, inaccurately predicted a more immediate negative equity market reaction as a result**). Now that a major lender, which monitors its own exposure, has recognized a significant flaw in the way it was assessing default risk, what do you think the chances are that the speculators with little or no experience in the industry have gotten it right? My guess is not much of a chance. We are now about to see if all the faith that has been placed in complex derivatives spreading risk and sheltering the financial markets was well placed or whether those derivatives will instead lead to a falling-domino-like negative chain reaction. My money is on the later.

We will see and probably will see faster than most would like . . .

February 4, 2007

- **US Public debt - 02/01/2007 $8,694,902,769,091.18 [this is up nearly 40% in less than 4.5 years (9/30/02 $6,228,235,965,597.16)]**
  http://www.publicdebt.treas.gov/opd/opdpenny.htm

How does the foregoing matter? It is hard number evidence that the current "growth" has little to do with "growth" and everything to do with irresponsible easy money. Assuming that the government can borrow at 5% (which will occur only so long as foreign entities support these artificial rates), the additional annual interest on the increase alone is 123 billion dollars.

On to the weeks (2) news, . . . For the first time ever, I missed a weekly report and have combined the missing with the current. Interestingly, it provides some perspective of how quickly things can change – for example the oil stories. There exists the same overall "base decisions on today's weather" attitude in the markets as a whole that were evident in the "drive oil below $50 because it was unseasonably warm in early January" that suddenly turned to "back up to $60, it's unseasonably cold in late January". What that means for the market as a whole is it continues to trade as if there will NEVER be another downturn. As we have discussed many times, those who fail to measure risk in a benign market will get crushed in a volatile one.

The clock ticks on . . .

For what it's worth -from everything I have read, from sources I consider to be very trustworthy, the fundamentals in (PC/cell phone/related semis) tech are in serious decline and will implode sooner rather than later.

From the "I really have not been making it up" department, there are a number of very learned folks who have articulated the risk issues, on which I have been ranting, much better than me. Please look at the Risk and Derivatives sections, if interested.

January 21, 2007

Hi all from Ann Arbor. We are adding a new section this week, after the article of the week. This new section will include information of interest from the MBA sessions and include some fundamental things that may be of interest (the focus will be on things that came up during MBA classes that week). Of interest to all of you will be the info showing the significant out performance of companies with superior ACSI scores. To view quickly what I am referencing, please go to page 33 of this presentation
http://cfmt.esperia.com/20060511_forum/02/relatori/vanamburg/adsl/appro.pdf

In addition to the information, we will also be adding many new readers this week. This document is a compendium of stories of interest from the prior week with attached reference links to my original source. Material in **bold** and material in red are my annotations. This review is not intended to be Fairy Tale time. For story time, tune to the Cheerleading and Nonsense Bullmarket Channel (also/known/as CNBC should/be/know/as Comedy Central) (i.e. if you want Goldilocks bedtime stories this will not be the place).

WARNING – I had no time to edit or add comments this week. I also had little time to select articles so this week relies inordinately on widely available news. Accordingly, read at your own peril ☺

January 14, 2007

The delusional behavior that is Wall Street today was evidenced by the trade in the two largest chip companies Friday. AMD, the number two company warned that 4Q results would be **substantially** lower than expected because of lower margins resulting from a price war with

Intel. As would be expected, AMD was hammered for ten percent plus. As one arguably would not expect, INTC opened lower and then rallied to **green** after a few hours **with the Street interpreting a price war crushing margins as a reason to load up the wagon.** So, as the OPM (other people's money) crowd on the Street continues to blissfully damn the torpedoes and "invest" Main Street's money full speed ahead, we share the following breaking heretofore unforeseeable news:

It will get cold in January, so apparently energy stocks won't go to zero after all.

It would be difficult to make up things so silly, but I guess truth truly can be stranger than fiction.

On a more positive note, if you are not aware of Canadian energy trusts, it might be worth something for you to get up to speed on. There are a number of factors negatively influencing their price currently that in my opinion will resolve to the upside for long term investors.

January 7, 2007

When there is a huge decline in a couple of days with no material change in fundamentals such as the collapse Wednesday and Thursday in crude, it raises the question as to whether one or more overleveraged players has/have made a bad bet. It is also a practical lesson in the hazards of shorting volatility or strategies that look for income by shorting the mathematically improbable derivative outliers. Such severe moves provide insight as to what can happen when liquidity on one side of a trade dries up – there are huge moves until parties willing to take the other side of the trade can be found.

A reason why the average investor should care about the foregoing is that such an event is more and more likely in the financial markets as a result of exotic credit derivatives and it will not be easily contained like incidents in discrete markets such as oil futures.

December 31, 2006

Articles of interest remain in low supply. The article of the week documents one of my continuous themes: the Street likes to buy Ferraris with YOUR money! Happy 2007. Will this be the year the party ends??????

December 24, 2006

I happened to have the radio on during the President's news conference this week. He said something that surprised and saddened me. After talking about recent retail sales figures, he said "I hope everyone goes out shopping". It is that mentality that has created the tremendous credit problem in this country. Until that "spend it today" mentality is replaced by a "save, invest and build for tomorrow" ethic, we will continue to sell out our future to those overseas.

This is a short week with little new. A good time to point out that markets are not about right and wrong. They are about risk and reward. In terms of performance was I wrong in saying that the time to exit was last summer? Absolutely. In terms of the risk involved in getting the extra return for the additional risk? I don't think so. For those of you who remain in the market, you have been given a huge gift. Take it now and be very glad that a high risk move paid off.

The compression of volatility and the risk being taken to chase any return can not continue on indefinitely. We are approaching a very interesting time where the "bonus" push is over. We will now go through the January effect and then we will see. I think even now, the weak end to the "Santa Claus" rally is interesting. IMO, there is little if any gas left in the bull tanks and the slide down will begin in earnest some time 1Q 2007. However, timing has been a futile endeavor, so I will simply restate that there is tremendous risk being taken and that is not likely to continue to pay off for the risk takers.

December 17, 2006

The joy continues unabated on Wall Street. Not so much joy on Main Street. Who will be right? We will see won't we

December 10, 2006

none

December 3, 2006

If there was a playoff system in college football, the one and two ranked teams would be in opposite brackets and would not play in round one. As of the end of the regular season those teams were Ohio State and Michigan. Further as of Saturday morning, the 1, 3, and 8 teams in the country were BIG TEN teams not SEC teams. Finally, USC lost to 9-4 and 7-5 teams yet trounced Arkansas 50-13, so spare me any "Florida deserves to play in the title game because the SEC is the greatest conference in the history of the world" whining.

The markets are just money. MEEEchigan football is LIFE ☺!

- Signed plane ticket purchased, hotel and car reserved, and now waiting for the clowns who vote to determine if I will be in Phoenix 1/8.

November 26, 2006

I do my best to simply set forth the news I see of interest. I have proven time and time again that I have no particular expertise in exact timing of major market moves. I believe this is in part because I approach things from a top down analysis and do not account sufficiently for the irrational behavior of the many. SO with trepidation I include the following:

Just as I was hitting the send button on the following email to those who have expresses an interest in my opinions, one of my mentors sent me a newsletter in which the author predicts the S&P will hit 2600 by the end of 2008 (a 85% increase from today's levels).

My response was as follows:

got your email of the letter predicting SP 2600 by 2008, just as I was pushing the send button on this.

A classic example of "difference of opinions makes markets" I guess. Looks like either he or I will be making some money and those of you in the middle will make money either way.

Hope you had a fun thanksgiving!

From: Mike Keliher [mailto:mkeliher@keliherconsulting.com]
Sent: Friday, November 24, 2006 8:08 AM
To: my distribution list
Subject: The wait is over

In the last two days those running other people's money ate turkey, watched football and planned on how to spend their 30% increase in bonuses at the Black Friday spending orgy. As Wall Street partied, the dollar has broken in Europe, the free-fall commenced. This time it **CAN'T** be fixed. In the ensuing months liquidity will dry up and a retreat from these self-centered, Wall Street bonus driven, equity highs will become a rout. See if anyone on comedy central . . . I mean CNBC is making that call today. My guess is no

My opinion is based on economics, the history of periods in which excessive risk was taken and a global macro view.

As best I can tell the newsletter writer bases his opinion on a belief that a drop in US interest rates will fuel a new boom, fancy charts and a desire to sell more newsletters to those who dream and hope.

We will see . . .

PS – tick tick tick"**The face value of derivatives based on corporate bonds, currencies, interest rates, commodities and stocks jumped 24 percent to $370 trillion, according to the Bank for International Settlements." $370,000,000,000,000.00, much of it traded by kids my nephew's age. I'm sure that will turn out well.**

November 19, 2006

This will not become a "trading" document. However in light of the insanity that is the current market where all news good bad and indifferent as well is no news is viewed as a catalyst for a higher market, I will point out two things:

1. the housing market is now imploding at an accelerating rate

2. the gambling by money managers to make year end bonuses is sick.

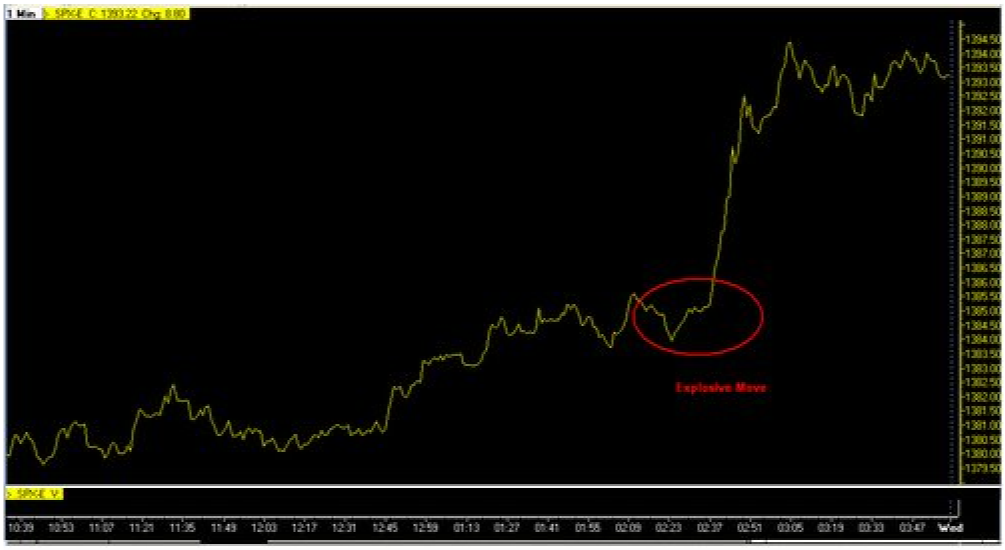
This is now what passes for investing:

Today's explosion: $4B emini covering

in Markets | Trading

I've checked the grapevine, and have it on fairly good authority: *Today's explosion was caused by a covering (or unwinding of) a 122k emini SPX contracts*.

That's a notational value of $4B.



http://bigpicture.typepad.com/comments/2006/11/todays_explosio.html

November 12, 2006

Sorry I did not get this out Sunday. I was out of town. Perhaps the most interesting item of the week past was a Bloomberg training seminar I attended. Bloomberg is a news and dat service that is the Cadillac of investment products and is used by many on the Street, particularly for fixed income. The last session I attended was a demonstration of the capabilities of the Bloomberg credit derivative products. Even I was stunned at the parsing of risk and leverage in the products themselves. The actual leverage is potentially dozens of times higher as the counterparties' leverage is not determinable. After hearing the presentation I am quite comfortable with my thoughts that a major blow up in the financial markets will be coming at some point in the next probably 12 months and could be as early as now. As always this is one person's opinion, but I do my best to make it an informed opinion.

Also a visual change. My words will be in red so there is no confusion between the reported story and my comments. I will continue to use black bold to identify those passages I belive to be of greatest importance for those skimming.

October 2006

I have been trying to figure out a way to collect for my use information I find interesting regarding the financial world. It occurs to me others might find some of this of interest as well, so I am sharing. I would like to do this on a weekly basis, so future versions will be much smaller. I have done my best to identify the courses of information and provided links where I had them. DR=Daily Reckoning a free daily email and MJK means it is something I calculated from the information

---

[i] New Century Financial Corporation (NYSE: NEW), a real estate investment trust (REIT), today announced that it will restate its consolidated financial results for the quarters ended March 31, June 30 and September 30, 2006 to correct errors the company discovered in its application of generally accepted accounting principles regarding the company's allowance for loan repurchase losses.

The company establishes an allowance for repurchase losses on loans sold, which is a reserve for expenses and losses that may be incurred by the company due to the potential repurchase of loans resulting from early-payment defaults by the underlying borrowers or based on alleged violations of representations and warranties in connection with the sale of these loans. When the company repurchases loans, it adds the repurchased loans to its balance sheet as mortgage loans held for sale at their estimated fair values, and reduces the repurchase reserve by the amount the repurchase prices exceed the fair values. During the second and third quarters of 2006, the company's accounting policies incorrectly applied Statement of Financial Accounting Standards No. 140 – Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. Specifically, the company did not include the expected discount upon disposition of loans when estimating its allowance for loan repurchase losses.

In addition, the company's methodology for estimating the volume of repurchase claims to be included in the repurchase reserve calculation did not properly consider, in each of the first three quarters of 2006, the growing volume of repurchase claims outstanding that resulted from the increasing pace of repurchase requests that occurred in 2006, compounded by the increasing length of time between the whole loan sales and the receipt and processing of the repurchase request.

Importantly, the foregoing adjustments are generally non-cash in nature. Moreover, the company had cash and liquidity in excess of $350 million at December 31, 2006.

Although the company's full review of the legal, accounting and tax impact of the restatements is ongoing, at this time the company expects that, once restated, its net earnings for each of the first three quarters of 2006 will be reduced.

In light of the pending restatements, the company's previously filed condensed consolidated financial statements for the quarters ended March 31, June 30 and September 30, 2006 and all earnings-related press releases for those periods should no longer be relied upon. The company expects to file amended Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30 and September 30, 2006 as soon as practicable, with a goal to file by March 1, 2007. The company also expects that the errors leading to these restatements constitute material weaknesses in its internal control over financial reporting for the year ended December 31, 2006. However, the company has taken significant steps to remediate these weaknesses and anticipates remediating them as soon as practicable.

The company's fourth quarter and full-year 2006 earnings announcement, originally scheduled for February 8, 2007, has been postponed to an undetermined future date, which will follow the company's filing of its amended Quarterly Reports on Form 10-Q for the quarters ended March 31, June 30 and September 30, 2006.

And on developments in the fourth quarter:

The increasing industry trend of early-payment defaults and, consequently, loan repurchases intensified in the fourth quarter of 2006. The company continued to observe this increased trend in its early-payment default experience in the fourth quarter, and the volume of repurchased loans and repurchase claims remains high.

In addition, the company currently expects to record a fair value adjustment to its residual interests to reflect revised prepayment, loss and discount rate assumptions with respect to the loans underlying these residual interests, based on indicative market data. While the company is still determining the magnitude of these adjustments to its fourth quarter 2006 results, the company expects the combined impact of the foregoing to result in a net loss for that period.

[ii] HSBC Says Bad-Loan Charges to Exceed Analysts' Estimates by 20%

By Christine Harper

Feb. 7 (Bloomberg) -- HSBC Holdings Plc, Europe's biggest bank, said it's increasing loan-loss provisions for 2006 because mortgages to risky borrowers in the U.S. are going bad faster than the company expected only two months ago.

Provisions will be 20 percent higher than the $8.8 billion that analysts now estimate, London-based HSBC said in an e-mailed statement.

``It is clear that the level of loan-impairment provisions to be accounted for as at the end of 2006 in respect of Mortgage Services operations will be higher than is reflected in current market estimates," the bank said in the statement.

HSBC, the world's No. 3 bank by market value after New York- based Citigroup Inc. and Charlotte, North Carolina-based Bank of America Corp., bought Household International Inc. for $15.5 billion in 2003. The purchase of the Prospect Heights, Illinois- based company, a lender to consumers with lower-than-average credit ratings, left HSBC more vulnerable a slowdown in house price growth.