

The Other Side of the Street December 3, 2007

Comments

The market “climbs a wall of worry” or stupid is as stupid does?

Monday night in Dallas, Tuesday market open in Japan and Hong Kong, things were looking quite grim indeed. The Hang Seng was down 1000+, the Nikkei down 350+ and the floor was quickly disappearing. Tuesday US papers were printed and included headlines “Stocks Sink Into Correction as Credit Fears Take Toll”; It’s Official: Wall Street Correction Fed Acts to Calm Jitters, Ease Pressure on Banks As Credit Crisis Deepens”;

By Saturday morning in Ann Arbor, headlines blared: “Stocks Rally . . . Finish Big Up Week”; “The Dow Rallies 3%, its biggest weekly gain since March”; Treasury, Fed Ride to Rescue Lenders, Subprime Borrowers, etc. . .”

What wonderful news came out that changed the world from dour to endless blue skies? Well for one, a country drowning in wad of US dollars it really does not want peeled off a few ones and threw them at Citibank. In exchange, the country got 11% interest and an option to buy 5% of the company at about 10% above the Friday close at any point in the next 3-4 years. This was sufficient for “the bottom to be in” version 175.01. Then the news no one could possibly have seen coming and certainly could never have been priced into the equity market . . . drum roll . . . the Fed MIGHT cut interest rates on December 11 (mind you, at the time this earth shattering news began to percolate, the credit markets had priced in a 100% chance that the Fed would cut 25 bps and a substantial chance of a 50 bps cut). Naturally when this news leaked, the markets jumped more than 5% in 2 days. If only one could have had the foresight to imagine the Federal Reserve might continue the same irresponsible monetary policy it has engaged in for 20 years, one might have been out ahead of this completely unforeseeable event.

Thus, the pattern of wild buying on any unsubstantiated pronouncement that “things will be getting better soon” once again was cause to party like there will never be another economic downturn and that a government agency that has so thoroughly destroyed the long term economic health of this country would “Save the world” once again.

Since a small child could see the foregoing is ridiculous, let’s try to figure out what really happened in the past five days.

- Well first of all, to indicate anything rational occurred is to waste the time of anyone with common sense. There is nothing rational going on in the equity markets. Instead, what is happening is that computer programs that are based on recent historical behavior of equities are manically moving tens if not hundreds of billions of dollars in and out in an instant. I suspect that those programs triggered a buy when the 10% “official correction” level was hit on the Dow and SP500. Why? Because stocks ALWAYS go UP, just as Real Estate ALWAYS goes up (oops my bad, I forgot that is so 2005ish). Further buying was triggered on the CITI news, why I am not sure, but I do know that both the Nikkei and Hang Seng

jumped hundreds of points in minutes after that news hit the tape. From there, the “bottom is in” quant funds went nuts.

- Next, we were in the last week of the month. The boys on the Street had been beaten like a redheaded stepchild. Accordingly they were desperate for a month end rally.
- On a like note, we are on the cusp of obscene bonus time and pump the year end numbers month.
- Perhaps more importantly, once the markets started to move, the benchmark pegs started up too. This pressured “[p]rofessional investors who [were] lagging behind the market [into taking] chances to improve their performance into the end of the year”.¹ It seems “their bonuses depend on beating different benchmarks. One simple way to try for a year end lift [is] to put money on the stocks doing the best and hope they will keep outperforming.” Doesn’t happen you say? BIDU, one of the year’s darlings went from 310 last Friday to almost 400 in about 30 trading hours.
- And then there are the little guys who heard “stocks ALWAYS go up at the end of the year” and “Don’t Fight the Fed” (and for heavens sakes don’t look at what happened to those non-Fed fighters earlier in November).

So what to conclude?

How about this:

This week was a text book bear market rally complete with short covering and mindless misallocation of capital. It was a text book year end bonus/benchmarking rally complete with mindless misallocation of capital. AND it was a wonderful example of moral hazard as computer programs triggered the foregoing because mindlessly misallocating capital has been rewarded time and time again by the Federal Reserve bailing out market manipulators.

So, you say, if this is the way it is, shouldn’t I stay “in it for the long haul” and have the charlatans on my side? You say that certainly has worked the past many years.

Yes, I say, it has worked the past many years. Just as flipping real estate worked for many years and buying dot-bombs and buying tulip bulbs did in days of yore.

It is after noon in Jellystone Park . . .

¹ November Slump Chills Hopes for End of Year” WSJ Nov 26, 2007

Credit

Commercial Real Estate

Commodities

Currency

- Dec. 1 (Bloomberg) -- The dollar gained the most in almost three years versus the yen and Swiss franc as global stocks rallied and traders boosted bets the Federal Reserve will cut borrowing costs a half-percentage point this month. **[the US economy is in freefall, the return on the dollar equally gloomy and it rallies. Simply amazing]** The U.S. currency posted its largest weekly gain since August versus the euro after Fed Chairman Ben S. Bernanke signaled he may lower interest rates to bolster growth, reducing the market's concerns about a U.S. recession. Reports next week are forecast to show slowdowns in hiring and the service sector. **“People are starting to think that the Fed will get ahead of the curve and use aggressive easing to keep us out of recession,” [should anyone actually believe that this Fed its out ahead of anything is financial malpractice. The time to be “out ahead of this issue lapsed in 2003 or 2004]** said Jay Bryson, global economist with Wachovia Corp. in Charlotte, North Carolina. “That's fueling both risk appetite and speculation about whether the dollar is starting to turn here.” Japan's currency weakened 2.7 percent this week to 111.24 per U.S. dollar, from 108.29 on Nov. 23. It was the dollar's biggest gain since the period ended Dec. 10, 2004. The dollar rose 1.4 percent to \$1.4633 against the euro, from \$1.4837 on Nov. 23, its largest increase since the period ended Aug. 17. The Swiss franc fell 2.7 percent to 1.1318 per dollar, from 1.1021 on Nov. 23. It was the franc's biggest weekly decline since the period ended March 25, 2005. **Dollar Gains Most in Almost 3 Years Versus Yen, Franc on Stocks**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aNhpVTJhs2A0&refer=home>

Diversification

Derivatives

- Dec. 1 (Bloomberg) -- Moody's Investors Service may cut the top ratings on six of Citigroup Inc.'s seven structured investment vehicles as part of a review of \$130 billion in SIV debt. **The net asset value of the \$64.9 billion in Citigroup SIVs dropped to below or near 60 percent, prompting the ratings action,** Moody's said in a statement yesterday. The junior notes of three of the funds have been downgraded to below investment grade. SIVs, which sell short-term debt to buy longer-term, higher-yielding

assets, were shut out of the short-term market as losses on subprime mortgage securities prompted investors to retreat from all but the safest of securities. Unable to finance themselves, three SIVs have defaulted and others are being bailed out by their sponsors. The world's 30 SIVs have more than \$300 billion of assets. **“In recent weeks, Moody's has observed material declines in market value across most asset classes in SIV portfolios,”** the ratings company said in the statement. Moody's said it surveyed 20 SIVs since Nov. 7 and expanded its review after noticing **“significant additional deterioration”** in asset values. Moody's cut \$14 billion in debt in all, mostly capital notes that rank below commercial paper and medium-term notes and are usually the first to absorb losses, Henry Tabe, managing director in charge of structured finance, said in a telephone interview. **The ratings company placed \$105 billion of debt on review for a downgrade** and confirmed the ratings on \$11 billion, Tabe said. Links Finance Corp., a SIV sponsored by Bank of Montreal with \$19.1 billion of debt, also had its junior notes cut and may have the remainder downgraded, Moody's said. “Continued Deterioration” SIV assets on average are 38 percent financial institution debt, 16 percent asset-backed securities and 12 percent collateralized debt obligations, Moody's said. The downgrades are “a reflection of the continued deterioration in market value of SIV portfolios combined with the sector's inability to refinance maturing liabilities,” Moody's said. **Net asset values have slumped to 55 percent from 102 percent in June,** Moody's said, including the NAVs of the three defaulted SIVs. **Citigroup, the largest U.S. bank by assets, provided \$7.6 billion of emergency financing to the seven SIVs it runs earlier this month after they were unable to repay maturing debt. [keep in mind the huge rally was sparked by a \$5B “investment” – thus net net citi is out 2 billion this MONTH]** Citigroup, based in New York, created the first SIV in 1988 and is the largest manager. The SIVs' struggle for survival, and the threat of having their assets dumped on the market, prompted Treasury Secretary Henry Paulson to broker talks with Citigroup, JPMorgan Chase & Co. and Bank of America Corp. to form an \$80 billion fund to help bail them out. Citigroup said in a Nov. 5 regulatory filing that it “will not take actions that will require the company to consolidate the SIVs.” The strategy “remains unchanged from the disclosures in the third quarter” filing, spokesman Jon Diat said yesterday in an e-mail statement. “We continue to focus on liquidity and reducing leverage,” Diat said. Citigroup's SIV assets have dropped to \$66 billion from \$83 billion on Sept. 30, Diat said. Centauri Corp., the largest SIV run by Citigroup with \$16.9 billion of debt, had its P1 commercial paper rating placed on review for downgrade as well as its AAA medium-term note program, Moody's said. Centauri's net asset value dropped to 60 percent from 85 percent since Sept. 5, Moody's said. Beta Finance Corp., the second-largest Citigroup SIV with \$16 billion of debt, had its senior debt ratings placed on review for downgrade after its net asset value declined to 60 percent from 87 percent, Moody's said. Sedna, Dorada Four other Citigroup SIVs, Sedna Finance Corp., with \$10.7 billion of debt, Five Finance Corp., with \$10.3 billion, Dorada Corp. with \$8.5 billion, and Zela Finance Corp., with \$2.5 billion, had their P1 commercial paper rating and AAA medium-term note programs placed on review, Moody's said. Sedna's net asset value dropped to 56 percent, Five's declined to 63 percent, Dorada dropped to 62 percent and Zela's fell to 61 percent. A seventh Citigroup SIV, Vetra Finance Corp., wasn't part of the review. The capital notes of Dorada, Beta and Centauri were reduced 11 levels to Caa3 from Baa1. Orion, Links Orion Finance Corp., a SIV managed by Eiger Capital with \$835 million of

debt, had its P1 commercial paper ratings downgraded to Not Prime, and its AAA medium-term note program to Baa3. Orion's net asset value dropped to 54 percent from 61 percent since Sept. 5, Moody's said. Links Finance's net asset value declined to 78 percent from 94 percent since a Sept. 5 review, Moody's said. The SIV's AAA ratings may be cut after a review that will be completed within a week, Moody's said. Links' standard capital notes were cut 11 levels to the fourth-lowest ranking. Separately, Moody's downgraded \$470 million in notes issued by Duke Funding High Grade II-S/EGAM I Ltd. and Duke Funding High Grade II-S /EGAM I LLC, managed by Greenwich, Connecticut- based Ellington Global Asset Management LLC. Duke's capital net asset value declined to 21 percent on Nov. 23 from 69 percent Oct. 26. Moody's cut \$170 million of Duke's notes from Aaa to Caa2 the fourth-lowest junk rating. Duke is known as an SIV- lite, which are designed as temporary vehicles.

- Nov 26 WSJ *The Nine Lives of CDOs* – CDOs are responsible for nearly 50 billion dollars in write-downs at major WS firms this year. How did such a potentially toxic product get so out of hand? If handled correctly, CDOs can serve useful purposes. For example, one species, collateralized loan obligations, or CLOs, buys loans from banks, giving them capital to make more loans. To fund the purchase of the loans, the CLO issues debt, which offers higher returns than traditional bonds. That is usually because the combined face value of the loans it buys is greater than the face value of the debt it issues. CLOs have performed well for a decade or more. So it seemed natural for Wall Street to extend this model to other types of assets. **The trouble is, every time investment banks did so, excess soon took over. In the late 1990s, they rolled out deals backed by manufactured-housing debt -- loans to trailer parks, essentially. Others stuffed with high-yield bonds lured investors until 2001. Both types subsequently crashed. In the aftermath, investors complained about bad structures, overselling and ratings-company incompetence -- the same things investors believe caused today's subprime-mortgage CDO meltdown. Why the repeat performances? It is a mixture of greed and need. CDOs become most popular when bond markets are going gangbusters and institutional investors are desperate to find high-return investments to help them beat the indexes they are measured against.** But the fatal flaw with CDOs is that as investor demand for them increases, they need to compete for assets, which get more expensive. The best of the latest iteration of CDOs, which bought asset-backed securities and are known as ABS CDOs, were created three or four years ago before the housing boom became a bubble. This was also when all manner of assets were cheap enough, whether bonds backed by student loans, car loans or credit-card debt. More recently, only subprime-mortgage bonds -- and other CDOs -- offered enough juice. **As the market boomed, greed set in. By 2006, investors buying the riskiest slices of ABS CDOs, called the equity, could virtually dictate their own terms. And investment banks were willing to bend over backward if it helped win the business of arranging a deal. One example: Rather than funding the highest-rated portion of a CDO with long-term debt, banks often used much cheaper short-term commercial-paper programs.** That saved the CDO money, meaning more interest could be paid to the equity investors. Some banks even agreed to step in if lenders suddenly snubbed the short-term debt. That is exactly what happened, and this "liquidity put" has landed Citigroup with \$25 billion, and **Bank of America** with \$15 billion, of

exposure to commercial paper backing CDOs. Others, like Merrill Lynch, set up auction-rate note programs, where every month the rate on the notes was set by an auction. But if no one bids, the notes morph into longer-term debt, which stays outstanding as long as the CDO does. **Whoever holds the paper when the auction fails gets stuck with it.** Those are two mechanisms that have helped spread the CDO pain throughout the financial system. The extent of the suffering makes it hard to imagine, during this third and largest crash, that CDOs aren't at death's door. But perhaps they can be salvaged -- if arrangers, lenders and investors accept that CDOs are better suited to less rampant markets. But judging from past experience, once the credit bulls start running, the lessons of 2007 could be conveniently forgotten.

Housing

Housing Finance

Macro Economic

- Dec. 1 (Bloomberg) -- European two-year government notes posted their first monthly gain since August as stocks declined and as concern about further credit-related losses fueled investor demand for the safest assets. Short-dated German notes snapped two months of declines as European equity markets slipped in November, encouraging safe-haven buying of fixed-income debt. The cost of borrowing euros for three months rose to the highest since May 2001 yesterday and the region's central bank announced additional steps to counter tensions in the region's money markets. "We have seen a very strong rally especially in the government bond market," said Karsten Linowsky, a fixed-income strategist at Credit Suisse Group in Zurich. "**Volatility and uncertainty are very high.**" Bunds fell yesterday, paring their monthly advance, after a **European Union report showed inflation in the euro region accelerated to 3 percent in November**, and as equities rallied. 'Upside' Risks European Central Bank council member Klaus Liebscher yesterday said inflation risks are "clearly on the upside." Crude-oil prices rose to near \$100 a barrel in November and were at \$89.25. At the same time, while economic growth remains "robust," **the downside risks are "predominant,"** Liebscher said. The inflation data "ties the ECB's hands to react to the growth slowdown that's inevitably about to take hold," said Christoph Rieger, a fixed-income strategist at Dresdner Kleinwort in Frankfurt. "We remain very bullish on bonds" and 10-year yields will drop below 4 percent by year-end. The ECB has kept its benchmark rate at 4 percent since June as it assesses risks to economic growth, including the euro's appreciation to a record against the dollar and a U.S. housing slump, which has pushed up credit costs. Money-Market Tension Bunds were also buoyed as rising short-term bank lending rates stoked credit-market concern. The rate banks charge each other for euros over three months rose to the highest since May 2001 yesterday, according to the British Bankers' Association. The London interbank offered rate climbed 3 basis points to 4.81 percent, its 13th day of gains. That's 81 basis points more than the ECB's benchmark rate, the biggest gap ever.

The ECB earlier extended the maturity of its regular refinancing operation to two weeks from one to "satisfy the banking sector's liquidity needs" before year-end. "Funding pressures persist and there are rumors of more financial problems," said Nick Stamenkovic, a strategist at RIA Capital Markets in Edinburgh. "The bund market is trading in a choppy fashion." Sales at German retailers dropped by the most in almost a year in October, adding to evidence Europe's largest economy is losing momentum and supporting bonds. German retail sales, adjusted for inflation and seasonal swings, fell by 3.3 percent from September, the Federal Statistics Office said on Nov. 30. Economists surveyed by Bloomberg News forecast a drop of 0.4 percent. European government debt has underperformed the equivalent U.S. securities as traders wager the Federal Reserve will cut interest rates next month by as much as half a percentage point, while the ECB keeps its refinancing rate unchanged. Benchmark German bonds have returned investors 1.2 percent in November, compared with 3.2 percent for Treasuries, according to indexes compiled by Merrill Lynch & Co.

Retail

Retirement

Risk

Savings Rate

Tech

Wall Street

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

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