

## The Other Side of the Street December 9, 2007

### Comments

Another new look

The OSS started as an organizational document for me to track news for my investment needs. I began circulating it to a few and it eventually developed into a product sent to the many. I have always liked citation to authority so it was clear where I was getting info. I shall continue to do so in the web link section. However, I now am doing lots of non-web reading such as WSJ, FT, IBD, etc. I wish to continue to share my work product with anyone who is interested. To benefit us all, I am going to begin a tri-part document. The first section will be my editorial. The second, notes that may or may not be cited to authority and will be used primarily by me in decision making, trend following and note taking. Then the last piece will be the traditional web link section.

Well, another weeks entertainment in Fantasyland is in the books.

The markets are now up as follows: Dow is currently up +9.3%, Nasdaq, +12.0%, S&P 500 +6.1%, think about the year in review. Does it make any sense to you that these market should be up? Is the economy in better or worse shape? Is credit more or less available? Is the financial health measured in debt better or worse? If your answer to the foregoing questions is that things are much worse, what does that tell you about the likelihood that equities are headed higher from here?

Markets can and are manipulated in the short run. They can't be in the long run.

That insanity prevailed yet again in 2007 makes it less likely, not more likely that the same will happen yet again in 2008.

The credit markets have ignored the Fed, Super SIV, and the abrogation of contract being pushed by Treasury. The equity markets have run up 7% in the last nine days. There is a widespread belief that the Fed cut next week will launch yet another wild run into year end. Your correspondent does not share that view. I think the more likely scenario is that we are looking at a classic sell the news scenario. The roadmap would be a flat Monday and pre-Fed Tuesday and then a significant sell off either Tuesday afternoon or Wednesday. Should that happen, there will be substantial pressure on funds to begin locking in whatever gains they have and an unusual amount of pre-year end selling pressure. None of which matters a whit to those with a long term perspective. Long term, everyday is the right day to get out.

Meanwhile watch Asia, I still expect the tsunami to roll in from there.

It is after noon in Jellystone Park . . . .

## Notes

- **Kirk report comment** - With just 15 trading days left of 2007, for the year the Dow is currently up +9.3%, Nasdaq, +12.0%, S&P 500 +6.1%, and the Russell 2000 -0.3%. Considering all of the problems in housing, credit markets, energy prices, consumer spending, and overall health of the economy, the market is holding up pretty well in comparison. [correct, if the “market” is holding up despite horrible news what does that mean? Either the economy is about to get much better or the equity markets are not “pricing in” things]
- **Credit** - How bad are things? We were shocked at the price of two recent deals – the large land sales and the fire sale of ETrade's \$3 billion in asset-backed securities. First, Lennar sold 11,000 lots to a Morgan Stanley real estate fund for \$0.40 on the dollar. In the ETrade situation, the company was forced to liquidate a \$3 billion portfolio of asset-backed securities for only \$0.27 on the dollar to a hedge fund (Citadel). These are Great Depression-type prices. Consider the analysis Andrew Sorkin, of *The New York Times*, did on the ETrade deal. Sorkin says only \$450 million of ETrade's securities were risky stuff – like second liens and subprime mortgages. The rest of the securities – \$3.6 billion – were investment-grade assets. And according to an October SEC filing, \$1.35 billion of these securities were prime, first lien, residential mortgages.
- **Credit** – GS estimates that the mortgage crisis has already caused \$66 billion of losses at the world's banks and that losses in credit markets worldwide could hit \$726 billion
- **China** - How to measure the extent of the China bubble? Let us count the ways. Here's one: Ping An Insurance is close behind American Insurance Group in the race to be the world's second-biggest insurer in terms of market capitalization. Ping An's shares trade for 41 times earnings. AIG trades for 9.2 times earnings. And AIG collects nearly as much in premiums per month as Ping An does all year.
- **Housing finance** - For instance, rates on 30-year fixed-rate mortgages fell to a two-year low of 5.96% this week, down from last week's average of 6.10% and 6.11% a year ago, according to Freddie Mac. [what really matters here is that the prior 75 BPS has dropped fixed morts 15 BPS]
- **Credit** Finally, there is the most scrutinized interest rate on earth -- the Federal Reserve's target for federal funds, which is the cost for overnight interbank loans. Uniquely in a free-market system, the price of overnight money is set by government diktat. In normal times, all money-market rates closely follow the fed-funds rate, currently pegged at 4.5%. These are anything but normal times. The three-month Treasury bill hovers just above 3% while the three-month London interbank offered rate costs about 5.15%. **Libor isn't some exotic foreign interest rate but the basic cost of money for banks and, perhaps more importantly, the base for ARM rates for many American homeowners. In other words, Libor is the real-world cost of money.** And the fed funds rate? In the words of veteran observers such as James Bianco, head of the eponymously named Bianco Research, the funds rate has become a rate with no meaning. Banks can borrow overnight at that rate, but no longer.

- CFO survey – a survey from CFO magazine showed optimism to be the lowest in 6 years. Bears outnumbered bulls 8 to 1. 72% were more downbeat than 3 months ago. They cited weak consumer demand, high labor costs and the credit market problems. One third reported accredit pinch. 20% reported a step up in employee withdrawals from 401K plans. This survey is significant as the survey has “a track record of predicting future economic activity, and their predictions run one or two months ahead of other common economic indicators.” **Barrons**
- Employment is up 1.1% this year, the weakest since early 2004. **Barrons**
- Home equity loan rates have risen to 8.05% from 7.69% in June. One year ARMS are now 5.63% up from 5.5 in June **Barrons**
- The number of mortgages at least 30 days past due in the 3Q was at its highest rate since 1986 per the **Mortgage Bankers Association**
- From January 2006 to mid-2007, companies with the most aggressive buy back strategies had the worst stock price results. **Barrons**
- Consumers are having more trouble paying back student loans, adding to problems seen with car and home debt. **Student Loan Problems ass to debt worry WSJ A3 10/8-9**
- With portfolios of almost \$3 trillion, capital of \$65 billion and no end in sight to the fall in home values, FNM and FRE’s continued solvency is in question. **Don’t Bail Out Fannie and Freddie WSJ A 19 11/29/07**
- If US consumers had saved more, spent less and filled up their SUVs less frequently they might not be in this position FT 12/2/07
- Under the terms proposed by President Bush and Treasury Secretary Hank Paulson, **subprime borrowers who are in danger of losing their homes during the next wave of rate resets could be eligible for a five-year rate freeze.** The White House claims this sweet spot of qualified candidates could entail up to 1.2 million homeowners. Analysts from Barclays and the Center for Responsible Lending estimated yesterday that only between 145,000-240,000 borrowers will qualify for the freeze.
- **The number of Americans who fell behind on their mortgage payments rose to a 20-year high in the third quarter,** reports the Mortgage Bankers Association today. An incredible 5.59% of all homes loans in the U.S. are at least 30 days late on one or more monthly payments, the worst delinquency rate since 1986. One in five subprime ARMs had a late payment during the quarter.
- So far, housing prices ARE going down. The last figures we saw showed U.S. housing prices down 13%. Robert Shiller, who probably knows more about housing cycles than anyone, says they’ll probably go down 30%-40%. In Britain, houses just registered their third losing month in a row – with many more to come. DR
- Yesterday, the number one man at Legg Mason said that credit markets were in the worst shape in 47 years. And a *Washington Post* writer opined that it was the “biggest mess since ’29.” DR
- **“We always expected the Fed to pull out all the stops when the U.S. economy began to slip into the void, but we never could have imagined the spinmeisters would invent ‘mortgage welfare’ even before recession had been officially declared. Treasury’s latest plan is designed to make it easier for certain ARMs borrowers to temporarily freeze their starter rates to avoid foreclosure. We know the situation is dire because the big lenders are signing on without even having their arms**

**twisted...Paulson's plan is not merely being fast-tracked, it is being shot out of a legislative cannon."** DR

- **The U.S. housing market will fall into deep recession next year, with home prices dropping up to 35%**, says Moody's today. A report from Moody's Economy.com estimated home prices will fall, on average, 13% from their 2006 peaks by early 2009. The report also suggested that some markets in Florida and California will fall as much as 35%. "This is the most severe housing recession in the post-World War II period," said Mark Zandi, the report's author.
- Household debt expanded at an annual rate of 7 percent in the third quarter of 2007, slightly below the pace in the first half of the year. In the third quarter, home mortgage debt increased at an annual rate of 6-3/4 percent—the slowest quarterly growth rate since mid-1998. In contrast, consumer credit increased at an annual rate of 6 percent in the third quarter, a somewhat faster pace than in recent quarters. Fed flow of funds 3Q report

### Web links

#### Credit

- Dec. 10 (Bloomberg) -- The key to whether the Federal Reserve continues to cut interest rates after this week may hang on the wall behind economist Brian Sack's desk in Washington. **Sack, head of monetary and financial market analysis at the Fed in 2003 and 2004, uses a chart that plots forward rates measuring investor expectations for inflation in five years.** The gauge is so accurate that Sack and his colleagues persuaded the central bank to use it to help set policy. The chart is autographed by former Fed Chairman Alan Greenspan. Right now, it shows current Fed Chairman Ben S. Bernanke may have less room to lower borrowing costs than investors in Treasuries anticipate, potentially setting bondholders up for a fall. **The expected inflation rate, which Sack says replicates what Fed officials use, reached 2.91 percent last week, the highest since 2004, when the central bank began the first of an unprecedented 17 rate increases. The measure was at 2.79 percent on Nov. 1.** "One of the defining features of the Bernanke Fed to date is its emphasis on measures of longer-term inflation expectations," said Sack, whose partners at Macroeconomic Advisors include former Fed Governor Laurence Meyer. "The Fed is willing to tolerate short-run movements in inflation, but only as long as those movements don't appear to be dislodging long-run inflation expectations." Any evidence that accelerating inflation is becoming entrenched may heighten the Fed's debate as policy makers consider cutting rates to keep the worst housing market in 16 years and mounting losses in securities related to subprime mortgages from tipping the economy into recession. **Futures on the Chicago Board of Trade show a 100 percent chance the Fed will lower its target for the overnight lending rate between banks by at least a quarter-percentage point to 4.25 percent, the third cut since September.** The chances are at least 50 percent that the Fed will cut again at its next two meetings, on Jan. 30 and March 18, to as low as 3.5 percent. The gauge used by Sack, dubbed the five-year five-year forward breakeven inflation rate, suggests bets on lower Fed funds rates may be too

bold. The fact that the rate stayed steady for much of the past two months as pessimism about the economy grew bolsters that view, said Michael Pond, an interest-rate strategist in New York at Barclays Capital Inc., one of the 20 primary dealers of U.S. government securities that trade with the Fed. A cooling economy typically tempers inflation concerns. "The market, by keeping the same inflation expectations while lowering growth expectations, is implying there are inflationary pressures," Pond said. He held to that view even as the forward rate fell last week. **Breakeven Rate Bond investors are demanding about 1 percentage point more in yield to own Treasuries maturing in 10 years than due in two years to compensate for the risk that consumer prices will accelerate. There was no difference as recently as June.** Sack and other analysts derive the measure of inflation expectations from yields on five- and 10-year Treasury Inflation Protected Securities and Treasuries. Five-year TIPS yield 2.15 percentage points less than five-year notes. This so-called breakeven rate is the average inflation rate investors expect over the next five years. The forward rate projects what the breakeven will be in five years, smoothing blips in inflation expectations from swings in oil prices or other events. The five-year TIPS' breakeven rate rose to a six-month high of 2.47 percent Nov. 27, the week after oil climbed to a record \$99.29 a barrel, from about 1.9 percent on Aug. 31. As crude fell to a six-week low on Dec. 6, the breakeven rate declined and Sack's measure dropped to 2.85 percent. Fed's 'Playbook' Investors seeking a haven from subprime-related losses have looked past signs of inflation, driving the yield on the benchmark 3 1/8 percent note maturing in November 2009 to 2.79 percent on Dec. 4, the lowest since 2004. "The Fed has recently had to change its playbook slightly to address stability," said John Brynjolfsson, who runs the \$11.3 billion Real Return Fund at Pacific Investment Management Co. in Newport Beach, California. **"I don't think the Fed has a choice because the gravity of the situation domestically is clear."** Bernanke mentioned the forward rate in a 2004 speech. Simon Kwan, a vice president at the San Francisco Fed, singled out the measure in a 2005 report, saying it "captures the market's assessment of how well the Federal Reserve promotes price stability in the long run." Gaining Steam Most analysts expect the economy to gain steam through 2008. Growth will slow to 1.5 percent this quarter from a 4.9 percent annual rate last quarter, and rise to 2.6 percent by 2009, according to the median forecast in a Bloomberg survey from Nov. 1 to Nov. 8. The dollar, which is poised to depreciate against the euro for a second straight year, is also fueling inflation concerns. The currency's drop and oil's climb pushed import prices up 1.8 percent in October, the most in 17 months. **The government may say this week that consumer prices, which set TIPS rates, increased 4.1 percent last month from this year's low of 2 percent in August and the biggest rise since July 2006, according to the median estimate of 19 economists.** Food, imports and energy prices may raise inflation expectations, Bernanke said in a Nov. 30 speech in Charlotte, North Carolina. Not Going Away "Inflation will not go away as an underlying concern for the Fed, and that is one reason we are expecting a 25-basis-point cut, rather than 50 basis points," said Sarah Hewin, a senior economist in London at American Express Bank Ltd., a unit of credit-card company American Express Co. "For now, growth takes priority." A Commerce Department index tied to spending patterns that excludes food and energy costs, the Fed's preferred measure, increased 1.9 percent in October from a year earlier. That matched the upper end of the 1.7 percent to 1.9 percent range the Fed projects for the next two years, according to

estimates released last month. The current level of the five-year five-year breakeven inflation rate has the Fed "on yellow alert," Sack said. "It is on their radar screen." **Fed's Inflation Measure Says Rates Can't Fall as Traders Expect**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=a\\_fz9yFswePE&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=a_fz9yFswePE&refer=home)

## Commercial Real Estate

## Commodities

## Currency

- Dec. 8 (Bloomberg) -- The dollar rose to a one-month high against the yen after a U.S. government report showed yesterday that November job growth exceeded forecasts, reducing concern the world's largest economy will head into a recession. The U.S. currency posted a second weekly gain versus the yen as traders pared bets the Federal Reserve will cut borrowing costs by a half-percentage point on Dec. 11. The British pound and the Canadian currency fell against the dollar and euro this week after central banks in the U.K. and Canada reduced interest rates. The European Central Bank kept its rate unchanged. "The U.S. economy is slowing down, but not heading into a recession," said Paresh Upadhyaya, who helps manage \$29 billion in currency assets at Putnam Investments in Boston. "The report doesn't justify an aggressive rate cut from the Fed. Investors are feeling more comfortable selling the yen" against the dollar in this environment. **[this is included to show how silly it is to place any emphasis on any one piece of information]** Currency Forecasts The U.S. currency will rise to \$1.40 per euro by the end of 2008, according to the median forecast of 42 economists in a Bloomberg survey. U.S. employers added 94,000 jobs last month, compared with a revised 170,000 in October, the Labor Department said in Washington yesterday. The total compared with the median forecast of 80,000 in a Bloomberg News survey of 82 economists. The Fed trimmed its target rate for overnight loans between banks by a quarter-percentage point to 4.5 percent on Oct. 31, following a half-point reduction a month earlier. **Futures contracts on the Chicago Board of Trade show a 28 percent chance the Fed will lower its key interest rate by 0.5 percentage point to 4 percent next week, and 72 percent odds of a cut to 4.25 percent.** The odds were 34 percent and 66 percent, respectively, before the payroll data was released yesterday. "The U.S. economy isn't falling off a cliff yet," said Robert Fullem, vice president of U.S. corporate currency sales at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York. **Dollar Rises to One-Month High Versus Yen on U.S. Job Growth**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aj8XyMmPIUhs&refer=home>

## Diversification

## Derivatives

## Housing

- **The U.S. housing market will fall into deep recession next year, with home prices dropping up to 35%**, says Moody's today. A report from Moody's Economy.com estimated home prices will fall, on average, 13% from their 2006 peaks by early 2009. The report also suggested that some markets in Florida and California will fall as much as 35%. "This is the most severe housing recession in the post-World War II period," said Mark Zandi, the report's author.
- **This morning, luxury homebuilder Toll Brothers posted its first quarterly loss in 20 years.** "By many measures," Chairman Robert Toll said in a statement, "Fiscal 2007 was the most challenging of the 40 years that Toll Brothers has been in business. 1974 was perhaps rougher, but the difficult times only lasted one year."

## Housing Finance

- Dec. 7 (Bloomberg) -- U.S. Treasury Secretary Henry Paulson's plan to prevent as many as 1.2 million people from losing their homes by freezing interest rates on subprime adjustable-rate mortgages will bring no benefit to the depreciating housing market. **At best, it may stop some of the hemorrhaging of the housing market, but it doesn't necessarily turn things around,** said Nicolas Retsinas, director of Harvard University's Joint Center for Housing Studies in Cambridge, Massachusetts. **The fundamental problem with housing is oversupply.** Existing home prices may fall as much as 15 percent by 2009 from their peak last year, even if interest rates are frozen on one fifth of 2006 subprime loans resetting next year, said Mark Zandi, chief economist at Moody's Economy.com, a unit of New York-based Moody's Corp. About 2.8 million mortgage loan defaults will occur in 2008 and 2009, Zandi said in Dec. 5 testimony before the U.S. Senate Judiciary Committee. President George W. Bush agreed yesterday to a plan led by Paulson that freezes interest rates on some subprime mortgages for five years. The agreement focuses on borrowers who will fall behind on payments as low rates reset at higher levels. **It's long overdue that someone puts something on the table that's enforceable and real and not just a press release,** [nice quote until you realize the plan is voluntary] said Prentiss Cox, a former assistant Minnesota attorney general who prosecuted predatory lending cases. He's now an associate professor of clinical law at the University of Minnesota in Minneapolis. Rising Defaults **Paulson's plan is being introduced as the number of Americans who fell behind on their mortgage payments rose to a 20-year high in the third quarter, the Washington-based Mortgage Bankers Association said in a report yesterday.** [and this plan excludes ALL of them] Analysts at Credit Suisse Group estimate more than 30 percent of borrowers with subprime adjustable-rate mortgages are behind on their payments before their loans reset higher and 775,000 homes with \$143 billion of mortgage debt will go into foreclosure through the middle of 2009. The forecast was made before Paulson's plan was disclosed. "It'll be the biggest housing recession we've known," said Allen Sinai, chief global economist at New York-based Decision Economics Inc. "Even if we figure this part of it out, we are not through it." Wary Buyers The government-led initiative

may "reduce the severity of the decline," said Robert Shiller, chief economist at MacroMarkets LLC and a professor at Yale University in New Haven, Connecticut. Still, "if past cycles are a guide, we could have weak or declining markets for five to 10 years," Shiller said. **Sixty-one economists said in a letter to Congress yesterday that they oppose the Paulson plan and urged "against excessive new regulations or federal interventions as a response to current trends in the housing market."** The economists sent the letter with FreedomWorks, a non-profit group that supports less government and lower taxes. Its chairman is Dick Armey, a former Republican representative from Texas and House majority leader. Home Prices Fall Zandi estimates new and existing home sales will bottom at an annualized rate of 5.25 million units in early 2008 from a peak of 8.5 million homes in mid-2005. New home sales are projected to fall 13 percent in 2008, according to estimates from the National Association of Realtors in Chicago. Part of the success of the Paulson plan may hinge on loan-servicing companies' ability to handle the workload of modifying terms of existing mortgages, Zandi said. Mortgage service companies are authorized to negotiate with borrowers, though so far only about 1 percent of loans surveyed by Moody's Investors Service have been changed. "It's only recently that Washington has focused on the fact that the critical players in making this kind of remedial program succeed are the investors as opposed to the banks," said H. Peter Haveles Jr., a New York-based partner at the law firm Arnold & Porter LLP, who represents investment banks and mortgage companies in regulatory investigations and civil litigation. **Paulson Mortgage Plan Surfaces Too Late to Stem Housing Slide**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aciMj4GVKuEY&refer=home>

- For instance, rates on 30-year fixed-rate mortgages fell to a two-year low of 5.96% this week, down from last week's average of 6.10% and 6.11% a year ago, according to Freddie Mac. The old rules said you had to scrape together a downpayment of 20%; build up a credit history that demonstrated your responsible use of credit; and show that you had sufficient income and assets to pay the mortgage and the property taxes, plus have a cushion for the inevitable things like leaky roofs or water heaters. And, if you opted for an ARM, you had to show you could handle the loan when rates moved up, not just the initial teaser rate. Time was, that's what you had to do to get a mortgage, period. Then came subprime, which lenders found could be vastly more lucrative. Indeed, making loans that conform to those strictures for sale to Freddie Mac and Fannie Mae is a loss leader to major lenders. **And that 5.96% average 30-year fixed rate is for loans that Fannie and Freddie can buy, which are capped at \$417,000 and would finance at \$520,000 house with 20% down.** For those lucky enough to live in high-priced Blue States, that will buy something barely habitable. **"Jumbo" mortgages above that \$417,000 limit typically had cost only about an eighth to a quarter percentage point more than conforming loans. No more. Since the credit crisis exploded last summer, that spread has widened to nearly a full point.** On a \$1 million 30-year loan, a 1% rise in interest rate translate into a 10% rise in monthly payments, from about \$6,000 at 6%, to \$6,650 at 7%. And that \$1 million loan won't buy you anything special in Manhattan or the New York area suburbs. **Barrons**  
<http://online.barrons.com/article/SB119705088781817336.html?mod=djemBF>

- Dec. 5 (Bloomberg) -- MBIA Inc. fell the most in more than 20 years in New York trading after Moody's Investors Service said the biggest bond insurer is "somewhat likely" to face a shortage of capital that threatens its AAA credit rating. A review of MBIA and six other AAA rated guarantors will be completed within two weeks, Moody's said in a statement today. Moody's revised its assessment from last month that MBIA was unlikely to need more capital after additional scrutiny of the Armonk, New York-based bond insurer's mortgage-backed securities portfolio. "The guarantor is at greater risk of exhibiting a capital shortfall than previously communicated," New York-based Moody's said. "We now consider this somewhat likely." The loss of MBIA's top ranking would cast doubt over the ratings of \$652 billion of state, municipal and structured finance bonds that the company guarantees. MBIA is among at least eight bond insurers seeking to ward off potential credit-rating downgrades by Moody's, Fitch Ratings and Standard & Poor's. The insurers guarantee \$2.4 trillion of debt and downgrades could cause losses of \$200 billion, according to Bloomberg data. "Clearly it's not a good development for the company," said Rob Haines, an analyst at CreditSights Inc. in New York. "The agencies have better visibility about the companies and maybe they've seen something that's troubling or it's just general deterioration in the market." Ambac Financial Group Inc., the second-largest bond insurer, Financial Guaranty Insurance Co., the fourth-largest, and Security Capital Assurance Ltd. are also "somewhat likely" to have a capital shortfall, Moody's said today. CIFG Guaranty, considered the most likely to fall below the benchmark, was bailed out by parents Groupe Banque Populaire and Groupe Caisse d'Epargne. Slide in Quality Moody's, Fitch and S&P are examining the insurers, known as monolines, on concern that a slide in the credit quality of some of the 80,000 securities they guarantee requires them to hold more capital to justify their AAA ratings. **The insurers wrote contracts on almost \$100 billion of collateralized debt obligations backed by subprime-mortgage securities as of June 30**, according to Fitch. Those CDOs, which are created by packaging debt or derivatives into new securities with varying ratings, tumbled in value as defaults on subprime mortgages soared. Moody's said it may downgrade some ratings without placing them on a formal review. The company also plans to take into account any prospective loss of business because of declining investor confidence. Excess Capital MBIA had excess capital of about \$1.2 billion over what Moody's requires as of Sept. 30, according to company documents. Raising capital would require the insurers to reinsure bonds they have guaranteed, sell preferred stock, common stock, or even slow down their underwriting, the companies said in presentations last week. "The company has to address this," Haines said. "They can't simply sit on their position right now. They've got to be cranking up reinsurance. They've got to be changing the risk profile of the new business they write. They've got to be considering some other soft capital kind of arrangements." MBIA and Ambac executives last week said they are considering new financing to defend their ratings. "If any major monoline were to have a rating change it would have a real impact on all of the business of the monolines," MBIA Chief Financial Officer Chuck Chaplin told a Bank of America conference in New York on Nov. 27. \$4 Billion Egan-Jones Ratings Co., a credit researcher, estimates that MBIA will need to raise more than \$4 billion, managing director Sean Egan said. That compares with the company's market capitalization of \$3.4

billion. **``It's Moody's firing a warning shot saying `you have two weeks, so do something,'''** said Paul Berliner, a trader at Schottenfeld Group, which manages \$100 million in New York. ``The drama behind MBIA and Ambac should be the most important focus for the entire financial sector right now. Everyone should be on the edge of their seats wondering how this plays out." Credit-default swaps tied to MBIA's bonds climbed to the highest in two weeks after the announcement, widening to 480 basis points from 400 basis points earlier today, according to broker Phoenix Partners Group in New York. The contracts, used to speculate on a company's ability to repay its debt or hedge against the risk it won't, rise as investor confidence falls. A basis point on a contract protecting \$10 million in bonds from default for five years is equivalent to \$1,000 a year. Bondholders may lose about \$9 billion on municipal bonds if the insurers falter, according to data compiled by Bloomberg and Lehman Brothers Holdings Inc. indexes. More than \$30 billion would disappear from the value of CDOs held by banks, based on the values that Citigroup Inc. and Merrill Lynch & Co. assigned to their holdings in the past month. Another \$150 billion may evaporate from bonds backed by home-equity lines of credit and other mortgages and loans, according to investors and traders. **MBIA Shares Drop After Moody's Says Capital in Doubt**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a0R5BgHj6dZo&refer=home>

- Dec. 5 (Bloomberg) -- Federal regulators and U.S. lenders agreed to freeze interest rates on subprime mortgages for five years to stem rising foreclosures, said a person familiar with the measure. President George W. Bush will announce the accord tomorrow, which was negotiated by officials including Treasury Secretary Henry Paulson. Paulson will hold a press conference at 1:45 p.m. in Washington to discuss the plan, Treasury said in a statement. ``We have got to do something drastic, and we have to do something quickly," said Representative Elton Gallegly, a Republican from California. ``I don't like the government getting involved in the private sector, but we have potential problems we are already seeing come to pass." **Paulson finalized the deal as the housing recession entered a third year, threatening the economic expansion. [this is funny. An acknowledgement that the problem is 3 years old. How come nothing was done until now?]** The collapse in the market for securities backed by subprime mortgages cost the chief executive officers of Merrill Lynch & Co. and Citigroup Inc. their jobs, roiled markets from Auckland to New York and forced the Federal Reserve to cut interest rates twice. More than 30 percent of borrowers with subprime adjustable-rate mortgages are behind on their payments before their loans reset higher and 775,000 homes with \$143 billion of mortgage debt will go into foreclosure over the next two years, according to estimates from analysts at Credit Suisse Group. Stocks Rally Financial shares in the Standard & Poor's 500 Index climbed after negotiators reached a consensus on the freeze. Freddie Mac, the second-largest provider of money for U.S. home loans, gained 3.8 percent. Washington Mutual Inc., the largest American savings and loan, advanced 2.5 percent. The freeze may apply to mortgages issued between January 2005 and July 2007 that are scheduled to reset between January 2008 and July 2010, said a person familiar with the plan. Borrowers whose credit scores are below 660 out of a possible 850 and haven't risen by 10 percent since the loan was sold will be given priority. Those with scores above 660 will be more closely scrutinized to determine whether they are eligible or must continue making payments under existing terms, said the person. Most U.S.

banks use FICO credit scores, a product of Minneapolis-based Fair Isaac Corp., to judge a borrower's ability to repay loans. Scores determine the interest rate charged to a customer. Officials and company executives spent much of the past week negotiating over how long to extend starter rates on subprime mortgages, which are usually given to people with poor or incomplete credit histories. Legislators were briefed today. **One challenge will be to craft a deal minimizing lawsuits from investors in bonds backed by the mortgages being rewritten, analysts said.** The longer that lower rates are extended, the more risk posed to the bonds' values. Republican Representative Mike Castle of Delaware has proposed legislation offering a "safe harbor from legal liability" to mortgage servicers. **Subprime Rate Five-Year Fix Agreed by U.S. Regulators (Update8)**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a6kfa.n46Obo&refer=home>

## Macro Economic

- Dec 9 FT China is to treble the amount of money that foreigners can invest in the mainland capital market, making the long-awaited announcement on the eve of this week's high-level economic summit between Chinese and US policymakers. The State Administration of Foreign Exchange, the country's foreign exchange regulator, said on its website on Sunday that the quota for registered foreign investors would be increased from \$10bn to \$30bn. It could take several months before institutional investors secure fresh quotas. **[this is nonsensical in light of the story the day before that China is trying to dampen speculation by raising reserve rates. Story hit just as I was about to send this out. I must be missing something obvious. I guess we will see.] China raises foreign investment quotas** [http://www.ft.com/cms/s/0/fc86f6fa-a688-11dc-b1f5-0000779fd2ac.html?nclink\\_check=1](http://www.ft.com/cms/s/0/fc86f6fa-a688-11dc-b1f5-0000779fd2ac.html?nclink_check=1)
- Dec. 8 (Bloomberg) -- China ordered banks to increase reserves by the most in four years to try to prevent the world's fastest-growing major economy from overheating. **Lenders must put aside 14.5 percent of deposits as reserves, starting Dec. 25, up from the previous 13.5 percent, the People's Bank of China said today on its Web site. The ratio is the highest since at least 1987 when the data began and the increase is twice as much as the nine others this year.** The decision comes before a visit to Beijing next week by U.S. Treasury Secretary Henry Paulson, who said Dec. 5 that China's government should allow the yuan to appreciate at a faster pace to reduce the nation's record trade surplus. China's surging exports are pumping cash into the financial system, fueling inflation and concern the economy will overheat. The larger-than-usual increase "reflects the urgency of inflation concerns of the government," said Liang Hong, an economist at Goldman Sachs Group Inc. in Hong Kong. "The move will help strengthen the credibility of the central bank and anchor inflationary expectations." Today's move will take about 380 billion yuan (\$51 billion) out of the banking system. Local-currency deposits stood at 37.9 trillion yuan at the end of October. Chinese leaders and officials, during a three-day annual economic work conference this week, highlighted economic overheating and "evident" inflation as key risks for 2008, after the world's fourth-largest

economy expanded more than 11 percent over the past three quarters. **“The increase is in line with a tightening monetary policy after the central economic working conference, and aims to strengthen liquidity management and curb overly fast credit growth,”** the central bank said in the statement today. Higher Prices China's consumer prices jumped 6.5 percent in October from a year earlier. Inflation is accelerating because of higher food, energy and labor costs. Faster inflation makes it harder for the government to prevent asset bubbles because people would rather put money in stocks or property than leave it in the bank to lose value. Household savings fell by 506.2 billion yuan in October from September. **Today's “more aggressive tightening will likely put downward pressure on China-related assets in the short term,” Goldman's Liang said.** The key CSI 300 Index of shares has **climbed 147** percent this year even after declines since mid-October. House prices in 70 major cities jumped 9.5 percent in October from a year earlier, the biggest increase since records began in August 2005. The People's Bank of China has raised interest rates five times this year, boosting the key one-year lending rate to 7.29 percent, the highest since 1998, and the deposit rate to 3.87 percent. Curb Lending It also sells bills to drain cash from the financial system and has instructed banks to curb lending. “The big increase in the reserve ratio suggests the start of a tightening monetary policy,” said Lian Ping, chief economist at Shanghai-based Bank of Communications Ltd. The banking regulator will set a stricter cap of 13 percent on commercial lenders' loan growth in 2008, down from the 15 percent target this year, the China Business Journal reported on Dec. 3. “Raising reserve requirements to control liquidity is easier and less expensive” than selling bills, Sun Mingchun, an economist at Lehman Brothers Holdings Inc., said before today's decision. “The cost is its bad effect on bank profitability.” The central bank pays 1.89 percent interest on the reserves it requires banks to set aside. Target Breached Money supply grew 18.5 percent in October from a year earlier, breaching the central bank's annual target of 16 percent for the ninth straight month. Banks have extended 3.5 trillion yuan of new loans so far this year. Seven banks including Agricultural Bank of China are banned from making new loans this year, the official Shanghai Securities News reported Nov. 29. Loan growth, soaring company profits and cash raised in buoyant stock markets have fueled an acceleration in factory and property spending. Fixed-asset investment in urban areas increased 26.9 percent through October from a year earlier. That was up from 24.5 percent in all of 2006 and raises the likelihood of idle factories and bad loans in a slowdown. **China Tells Banks to Raise Reserves to Cool Economy** [http://www.bloomberg.com/apps/news?pid=20601087&sid=ax5dSlsZH3\\_4&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=ax5dSlsZH3_4&refer=home)

- Dec. 8 (Bloomberg) -- Treasuries posted their first weekly decline since October as the government introduced a plan to freeze some subprime mortgages, reducing the safe-haven appeal of U.S. debt. Yields on 10-year notes rose the most since March 2006 after the Labor Department reported that employers added more jobs last month than forecast, suggesting that the economy is weathering the housing slump. Traders reduced bets that the Federal Reserve will cut borrowing costs a half-percentage point at its meeting next week. “Everyone is assuming the Fed is ready to play their hand and will be successful in averting a recession,” said Joseph Balestrino, a senior portfolio manager in Pittsburgh at Federated Investors Inc., which oversees about \$21 billion. **“They're going to help markets and want to keep sending the message that they are helping.” [this is true. However, it is not the mission of the Fed to “help markets” is it]** Ten-year note yields

rose 17 basis points, or 0.17 percentage point, to 4.11 percent in New York this week, according to bond broker Cantor Fitzgerald LP. It's the biggest weekly gain since March 2006. The price of the 4 1/4 percent coupon due in November 2017 fell 1 10/32, or \$13.13 per \$1,000 face amount, to 101 5/32. Almost 'Sure Thing' Fed funds futures contracts on the Chicago Board of Trade indicated a 26 percent chance that policy makers will lower the 4.5 percent target rate for overnight lending between banks by a half-percentage point at their meeting Dec. 11, compared with a 38 percent likelihood a week earlier. The odds of a quarter-point cut were 74 percent. **``It's almost a sure thing the Fed will cut interest rates, but I'd be surprised if they go 50 basis points,"** said Scot Johnson, who manages \$2.1 billion of government bonds in Houston at AIM Capital Management Inc. Two-year note yields increased 9 basis points to 3.10 percent this week after falling to 2.79 percent on Dec. 4, the lowest since November 2004. Ten-year note yields decreased to 3.79 percent on Nov. 26, the lowest level since March 2004. Merrill Lynch & Co.'s MOVE index, a measure of expectations for Treasury volatility, rose to 142 on Dec. 4, the highest since 2003. President George W. Bush announced a plan on Nov. 6 to freeze interest rates on some subprime mortgages to prevent a wave of foreclosures from undoing the six-year U.S. economic expansion. The agreement that Treasury Secretary Henry Paulson negotiated with lenders may force investors in the \$6.3 trillion market for home-loan bonds to revalue their holdings. 'Year-End Issues' **In a sign that banks are still reluctant to lend to each other before the end of the year, the London interbank offered rate for borrowing dollars for one month rose to 5.25 percent on Dec. 4, the highest level in almost three months.** One-month Libor was little changed at 5.24 percent yesterday, according to the British Bankers' Association. ``We still have year-end issues and still have high Libor rates," said Andrew Brenner, co-head of structured products in New York at MF Global Ltd. ``There's still a desire to have Treasuries on your books." **Three-month Libor for dollars was 208 basis points above three-month Treasury bill yields. The so-called TED spread widened to 216 basis points on Nov. 29, the biggest difference in more than three months.** Three-month bill yields fell 7 basis points to 3.07 percent this week. The Fed may cut the 5 percent discount rate charged on its direct loans to banks by more than the cut in benchmark borrowing costs to increase credit availability. The central bank unexpectedly reduced the difference between the discount rate and the federal funds target to a half- percentage point on Aug. 17, between regularly scheduled meetings of the policy-setting Federal Open Market Committee. The gap was previously 1 percentage point. The Fed may lower the discount rate's penalty compared with the federal funds rate to 25 basis points or less, easing the stigma of borrowing from the central bank, said T.J. Marta, a fixed-income strategist in New York at RBC Capital Markets. ``It would be that much better if the discount rate is cut by more than the fed funds rate," he said. RBC expects the Fed to cut its target rate by 25 basis points and the discount rate by 50 basis points. **Treasuries Post First Weekly Drop Since October on U.S. Rescue** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aX4yK9ShX43w&refer=home>

- Dec. 7 (Bloomberg) -- **It turns out the U.S. economy matters after all.** The credit collapse and dollar decline that followed a surge in U.S. home foreclosures jeopardize expansions in the U.K., Canada and Germany, economists said. They also debunk ``decoupling," an argument advanced by analysts at Goldman Sachs Group Inc. and

Morgan Stanley that the world wouldn't suffer as it did during U.S. slowdowns in previous decades. The Bank of England and Bank of Canada this week followed the Federal Reserve in cutting interest rates, and the European Central Bank lowered its growth forecast for next year. British policy makers reduced their benchmark rate yesterday, even after Governor Mervyn King expressed concern about inflation just two weeks earlier. "Two thousand and eight will be the year of 'decoupling'," said Peter Berezin, an economist at Goldman in New York, explaining his firm's about-face. **"What began as a U.S.-specific shock is morphing into a global shock."** Of the 38 countries they monitor, Goldman economists expect growth to slacken in 26 and strengthen in a dozen. That will cause global growth to slow to 4 percent next year from 4.7 percent this year, with Europe and Japan fading faster than the U.S., they say. "There are a lot of risks out there," Goldman Chief Economist Jim O'Neill said in an interview today. Market lending rates have risen worldwide in the last three weeks as \$70 billion of writedowns linked to defaults on U.S. subprime mortgages fanned international concern about the strength of financial institutions. Roach Skeptical Decoupling is "a good story, but it's not going to work going forward," Stephen Roach, chairman of Morgan Stanley in Asia, said in an interview in New Delhi on Dec. 2. His colleague, Stephen Jen, said in a report the previous week that because the possibility of a U.S. recession has increased, so has the chance that the rest of the world will falter. Higher market rates pushed up the cost of lending everywhere, making it costlier for companies and consumers to fund new spending or investment. The cost of borrowing euros for three months, for example, this week rose to a seven-year high "The American consumer is the big gorilla on the demand side of the global economy," Roach said. "As the slowdown goes from housing to consumption, we'll find the world is not as decoupled as it thinks." "Need to See" Bank of Japan Governor Toshihiko Fukui said this week that "we need to see how the U.S. consumer is affected" as he holds his key rate at 0.5 percent, the lowest among industrialized nations. Waning U.S. demand meant the Japanese economy grew an annualized 1.5 percent in the third quarter, almost half the preliminary estimate, the Cabinet Office said in Tokyo today. On the other hand, Alex Patelis, head of international economics at Merrill Lynch & Co., is confident "the time has not yet come to call the end of this global upturn," citing demand in emerging markets such as China and Russia. Patelis predicts the world economy will grow 4.7 percent next year and 5.6 percent if the U.S. is excluded. John Llewellyn, a senior economic policy adviser at Lehman Brothers Holdings Inc. in London, is unconvinced, arguing that if U.S. consumers buckle, so will growth elsewhere. "Decoupling is a lovely idea, but I'll only believe it when I see it," he said. **Decoupling' Debunked as U.S. Collapse Infects World**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aTgOOOrIAkurY&refer=home>

## Retail

- Dec. 7 (Bloomberg) -- U.S. retailers may struggle to boost sales this month as consumers grappling with lower home values and higher food and energy costs shun full-priced goods. Target Corp., the second-largest U.S. discount chain, said yesterday that it needs sales to "meaningfully improve" in December to achieve fourth-quarter profit growth.

J.C. Penney Co., the third-biggest department-store chain, expects sales at stores open at least 12 months to fall for the five weeks through Jan. 5. **Retailers may cut prices further during what the National Retail Federation in Washington forecasts will be the slowest holiday shopping season in five years.** Consumers contending with defaults on mortgages and higher costs for milk and gasoline may wait until closer to Christmas to spend, hoping for discounts of 50 percent or more on sweaters and electronics. "I don't think there's going to be anything that's going to take the focus away from price," said Christian Andreach, who helps manage more than \$15 billion at Manning & Napier Advisors Inc. in Fairport, New York. "Everyone's pretty much aware of the negatives." The NRF projects November and December sales will rise 4 percent, the smallest gain since 2002. That year sales added 1.3 percent. Same-store sales at Nordstrom Inc. and Macy's Inc. benefited in November because an early Thanksgiving this year moved extra holiday shopping days from December. Cincinnati-based Macy's, the second-largest department store chain, said same-store sales may drop 4 percent to 7 percent in December because of the calendar shift. "It seems that the consumer was lured in by some of the discounts at Wal-Mart," said Andreach. "They've certainly gotten their low-price strategy out in front of the consumer this year." Same-store sales are considered a key measure of a retailer's performance because they exclude locations that have recently opened or closed. **U.S. Retailers May Struggle to Boost December Sales** <http://www.bloomberg.com/apps/news?pid=20601109&sid=a7Kcm51zjQHY&refer=home>

- NEW YORK (MarketWatch) -- U.S. retailers posted mixed November sales results, with scarcity of must-have fashion items and no shortage of macroeconomic concerns battering many U.S. apparel retailers, while value-seeking shoppers and a calendar shift aided wholesale clubs and department stores. Consumers concerned about higher gasoline, food costs and declines in housing and credit markets have curtailed discretionary spending on items such as apparel, analysts said. They sought bargains and consolidated trips to wholesale clubs and discounters and went out for Black Friday door-buster specials on flat panel televisions or laptops. Retailers may need to pull out more stops and be forced to offer profit-hurting promotions to entice budget-pinched shoppers who also increasingly delay their holiday purchases, analysts said. "Consumers are simply not out there in force," said Michael Niemira, chief economist of the International Council of Shopping Centers. "The wholesale club is doing a lot better simply because the consumer is facing more difficult times and there's been a shift to more value oriented retailers." An extra holiday shopping week because of a calendar shift lifted demand at department stores and retailers such as Target Corp., which is expected to hurt results in December, analysts said. Forty-four percent of 43 retailers that reported November sales results beat analysts' estimates, while 51% of them missed, according to Thomson Financial. November sales at stores open at least one year, an industry performance measure that excludes results from closed and new stores, rose 3.5%, better than the original projection of 2.5%, with three quarters to as much as a percentage point of the upside from a shift in calendar, Niemira said. The November reporting period included nine post-Thanksgiving shopping days versus two days last year. **Retailers post mixed November sales** <http://www.marketwatch.com/news/story/retailers-post-mixed->

## **Retirement**

## **Risk**

## **Savings Rate**

## **Tech**

## **Wall Street**

## **Don't Fight The Fed**

## **I Disagree . . . and why**

### [Article of the week:](#)

In reference to [Little Hope For Hope Now Alliance](#), I misread one of the eligibility requirements. In fact a key one.

The plan pertains to those with LTVs higher than 97%, not lower. I read the statement as at least 3% equity was required for the freeze, instead it is at most 3% equity is allowed for the freeze.

I had this Email exchange with [CalculatedRisk](#):

*Mish, those eligible have to have a LTV higher than 97%.*

*Many of these people have negative equity. They can't refi - they can't sell - and when their loan resets, they probably can't make the payment. They are stuck, and foreclosure is the only way out.*

*This is a plan for investors!*

*The idea is to get people to keep making mortgage payments on a loan that is worth more than the collateral. A neat trick! If these "homeowners" really crunched the numbers, they would realize it's better to walk away, and rent for less money, rather than to keep making the mortgage payment.*

*The plan is sold as helping homeowners. It is designed to help investors.*

## **Sucker Trap For Homeowners**

While there is nothing new or shocking in the statement about who the plan was designed to help

(we all knew who the plan was designed to help before), this is even a bigger sucker trap than I first thought. This plan was purposefully and carefully constructed to help virtually no one but lenders. The very last thing the lenders want is to foreclose on homes that are hugely underwater.

### **What Homeowners Benefit?**

This plan will benefit homeowners who meet ALL of the following requirements.

- The homeowner has at most 3% equity.
- The homeowner is not hugely underwater on current loan to value.
- The home is in an area where home prices are not apt to plunge over the next few years.
- The freeze will permanently prevent foreclosure.

It takes all four conditions before homeowners will benefit. The plan has negative benefit for nearly everyone in the small select group of people that meet the carefully crafted eligibility requirements. I find this plan galling.

Nonetheless my previous conclusions were correct:

Fix on top of fix on top of fix are being proposed and none of them will work because it is in the best interest of those underwater on their loans to make sure the plan fails.

Now that the details are finalized, we can clearly see that very few people percentage wise will be helped by this bailout proposal. The real damage lies ahead with pay option arms, Alt-A, and second mortgages.

<http://www.minyanville.com/articles/hope-homeowners-lenders/index/a/15141>