

The Other Side of the Street December 14, 2008

In closing this note, none of the foregoing is uplifting. It is however my best input as to what I see as being likely. Should you want cheery outlooks, Google "Abbey Joseph Cohen". **You can hope her SP500 at 1650 by year end is the fairy tale ending for which you hope.** Too bad Goldman just canned her; I guess the day dream believers will need a new champion next year. – **Yours Truly March 16, 2008**

Since 2005, GM has lost a cumulative \$72.4 billion, had its debt downgraded to junk, watched its share of U.S. auto sales shrink by almost 1 million vehicles and shed 90 percent of its market value. – think about this when your broker tells you to invest in blue chips for the long haul

Comments

Integrity.

There is none on Wall Street and that is how we got here.

I am in the process of a review of how comments in this space are progressing. One such comment in July this year:

I then foresee another series of revelations as to criminal acts on Wall Street that will make Enron, Drexel, and even Ponzi pale in comparison.

As I am sure you all know by now, the largest Ponzi scheme ever was revealed this week. \$50 Billion LOST. This is the tip of the iceberg. The fraud on Wall Street has been rampant.

Why do I know? 25 plus years as either an auditor or an attorney defending the largest auditing firms. I can smell fraud. And this is only the beginning.

On the "market front" looks like the sale on gold and silver is coming to a close. As we have discussed, the dollar will be collapsing soon. The movement in gold is an indication that moment is at hand.

As the dollar implodes, don't expect the foreigners to take zero percent interest on treasuries. That market is about to implode as well. Should you be interested, there are multiple ETFs that can be used to take positions. I am long TBT at 42, which will go up as bonds go down and short the TLT which will go down with bonds. This may be the safest investment on the board.

Further, if you want to know what will happen to those of you who think sitting in fixed income will be a safe harbor, make sure you read the stories about what is happening in Russia.

An excerpt: **A decade ago, many lost their life savings after the ruble plunged 71 percent against the dollar.**

With that said, we are now in the final three weeks of the year and there will be lots of felonious manipulation of stock prices. However, in a year bookended by SEC Chairman Cox declaring all was well 3 days before BSC disappeared and revelations that an SEC registrant who had never been audited ran a \$50 billion fraud, don't be expecting anyone to be held accountable for cheating further the investing public.

Stock Notes

- Yesterday, Jamie Dimon, CEO of JPMorgan Chase, said his bank is having a tough fourth quarter after a "terrible" November and December. He believes unemployment will be the main driver of this crisis... "It's all going to be unemployment-driven," he said. "Unemployment will drive commercial losses, real estate losses, all consumer products' losses." Asked when the macro environment will improve, Dimon replied, "If we are lucky, we will have two more quarters of this and we will start to see a recovery... It's possible it's going to get worse and we're in for a tougher time." Remember, JPMorgan Chase is supposed to be the soundest bank around... Hours after Dimon's comments, Bank of America – the other "strong" bank – announced it would lay off at least 35,000 employees in the next three years (approximately 11% of the combined BofA/Merrill Lynch workforce).
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Notes

- **Americans filed over 573,000 jobless claims last week -- the most since 1982.** The Labor Dept. also said the number of people collecting unemployment reached a 26-year high too, 4,429,000. Unfortunately, we're just getting started if a study released this morning by UCLA is accurate. The Anderson School of Management predicts we will see negative GDP for the current and first two quarters of 2009... and the unemployment rate to reach 8.5%.
- **U.S. household debt shrank for the first time since 1952 as well.** Household debt, as measured by the Fed, fell 0.8% in the third quarter. We'd like to think Americans noticed their declining net worth and chose to pull back, save money and pay down their debts. But this is the "credit crisis," after all... there's an equally good chance that the pullback was involuntary, and fresh lines of credit were simply less available. Foreclosure is a "great" way to slash household debt too, and there's been no shortage of them this year.
- **Total household net worth fell \$2.8 trillion in the third quarter,** the biggest decline since records began in 1952. According to the Fed today, a combination of real estate

- European banks, including Spain's Grupo Santander and France's BNP Paribas, said their clients and shareholders face billions in losses on investments with Bernard Madoff, underscoring the global reach of the alleged Ponzi scheme run by the veteran New York money manager.
- The Federal Reserve denied a request by Bloomberg News to disclose the recipients of the \$2 trillion in emergency loans from taxpayers and the assets the Fed is taking as collateral. Bloomberg filed suit November 7 under the U.S. Freedom of Information Act, and the Fed responded on December 8 saying it's allowed to withhold internal memos and information about trade secrets. Of course if the Fed actually disclosed what it held, we'd know how much it stands to lose... and how much more money it will have to print.
- [U.S. households shrank their debt in the three months ended September 30 for the first time in more than 50 years](#) (since the government started keeping records). Household debt declined 0.8%, mostly as a result of a 2.4% decline in mortgage debt. Other consumer debt, including credit cards, rose 1.2%.
- The U.S. Census Bureau announced today that advance estimates of U.S. retail and food services sales for November, adjusted for seasonal variation and holiday and trading-day differences, but not for price changes, were \$355.7 billion, a decrease of 1.8 percent ($\pm 0.5\%$) from the previous month and 7.4 percent ($\pm 0.7\%$) below November 2007. Total sales for the September through November 2008 period were down 4.5 percent ($\pm 0.5\%$) from the same period a year ago. The September to October 2008 percent change was revised from -2.8 percent ($\pm 0.5\%$) to -2.9 percent ($\pm 0.2\%$). Retail trade sales were down 2.0 percent ($\pm 0.5\%$) from October 2008 and were 8.5 percent ($\pm 0.7\%$) below last year.
- **Americans filed over 573,000 jobless claims last week -- the most since 1982.** The Labor Dept. also said the number of people collecting unemployment reached a 26-year high too, 4,429,000. Unfortunately, we're just getting started if a study released this morning by UCLA is accurate. The Anderson School of Management predicts we will see negative GDP for the current and first two quarters of 2009... and the unemployment rate to reach 8.5%.
- If you're mildly interested in what it's costing for the government to "combat" this pernicious downturn, the **Treasury announced yesterday the federal government spent \$402 billion... for the first two months of the fiscal year.** That's \$53 billion shy of 2008's entire historically astronomical budget deficit.
- **The trade deficit expanded in October, too, up 1.1%, to \$57.2 billion.** Quants chained to their IBMs in the basement of Wall Street's investment banks were expecting the deficit to contract, as nations typically pull back during times of economic strife. But something curious happened. Oil and gas got a lot cheaper... and Americans used a lot more. Who would have thought that would happen? The U.S. imported almost 75 million more barrels of oil in October than in September, when the average price per barrel was \$107. Year to date, the trade gap exceeds \$590 billion

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- Dec. 11 (Bloomberg) -- Moscow resident Tima Kulikov banked on the full faith and credit of the U.S. government, not the [Kremlin](#), when he sold his biggest asset for cash. The 31-year-old director of a social networking Web site initially agreed to sell his apartment for rubles, then cringed at the thought of the [currency](#) weakening as it sat in a lockbox pending settlement of the contract. It wasn't until the buyer showed up with \$250,000 stacked in old mobile-phone boxes and stuffed in his pockets that Kulikov closed the deal. "The exchange rate we agreed on wasn't great, but I did it because the money's going to lie there for a month," Kulikov said. **"Put it this way, the ruble's more likely to have problems than the dollar."** Russians are shifting their cash into foreign currencies and buying things they don't need as the economy stalls and the central bank weakens its defense of the ruble, signaling a larger devaluation may be on the way. The currency has fallen 16 percent against the dollar since August, when Russia's invasion of neighboring Georgia helped spur investors to pull almost \$200 billion out of the country, according to BNP Paribas SA. **With the specter of the 1998 debt default and devaluation in mind, Russians withdrew 355 billion rubles (\$13 billion), or 6 percent of all savings, from their accounts in October, the most since the central bank started posting the data two years ago. Foreign-currency deposits rose 11 percent.** "Lately our clients are mostly those who buy real estate not to live in but to secure their investments," Polonsky said. **"No one wants to be left with pieces of paper."** Jewelry sales are also accelerating, particularly items made of gold and diamonds, said Vladimir Stankevich, advertising director at [Adamas](#), Russia's third-largest jewelry retailer. **"More cash appeared on the market and there's an opinion among shoppers that gold is a good investment in times of crisis," Stankevich said** "The Russian experience with saving is not that good and people prefer to consume and enjoy rather than save in pre-crisis situations," Tsepliaeva said. "Buy cash dollars and put them in mattresses or safe deposit boxes but not in accounts because most crises are accompanied by banking crises." **A decade ago, many lost their life savings after the ruble plunged 71 percent against the dollar.** Those fears prompted Prime Minister [Vladimir Putin](#) to pledge not to allow "sharp jumps" in the exchange rate, during a call-in television show Dec. 4. 'Ideal Time' [Troika Dialog](#), Russia's oldest investment bank, is betting the central bank will allow a one-time devaluation of the ruble of about 20 percent in January, following New Year's and Orthodox Christmas celebrations. "With the holidays at the beginning of January, companies won't be fully working and people will be spending more money," said [Evgeny Gavrilentov](#), Troika's chief economist and a former acting head of the government's Bureau of Economic Analysis. **"That means**

demand for rubles will increase and that means it's an ideal time to allow a devaluation." Russia has drained almost a quarter of its foreign-currency reserves, the world's third-largest, since August as it tries to slow the ruble's decline. The central bank has widened the trading band five times in the past month, effectively reducing its defense of the currency amid plunging oil prices. The 32-year-old mother of two from the southern city of Sochi plans to take her 8-year-old daughter, Dasha, to Moscow for the New Year's holiday, a trip that will cost twice her family's monthly income of about 30,000 rubles. "This way at least we'll have some memories," she said. **Russians Buy Jewelry, Hoard Dollars as Ruble Plunges**
http://www.bloomberg.com/apps/news?pid=20601109&sid=a_W0d8XewdGY&refer=home

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- Dec. 12 (Bloomberg) -- For **General Motors Corp.**, the question is no longer whether it will get a government loan or if Chief Executive Officer **Rick Wagoner** will be replaced. **It's whether anything can prevent the largest U.S. automaker from sliding into bankruptcy.** Even an offer by the Treasury Department today to provide temporary relief, after the Senate rejected a bailout plan approved by the House, **isn't likely to offset the Dec. 10 announcement that GM's 49 percent-owned affiliate, GMAC LLC, lacked the capital to become a bank holding company. That means the financing unit won't be able to access Treasury's Troubled Asset Relief Program to help make auto loans.** GMAC may now have to file for Chapter 11 protection, with or without a loan, joining GM's biggest parts supplier, **Delphi Corp.**, which is already in bankruptcy. **The Detroit-based automaker, leaking \$67 million a day** -- enough to buy a fleet of 1,800 Cadillac CTS coupes -- may soon be sucked into the vortex. **"GM already is bankrupt and should file for bankruptcy,"** said **David Littman**, senior economist for the Mackinac Center for Public Policy, a policy research organization in Midland, Michigan. "They have too much overhead and too little time left to reduce size to be a survivor in this industry." **To GM's critics, worries about cash are three years too late.** The financial crisis wasn't the culprit that brought the company to the brink of insolvency, as Wagoner told Congress last month. It was just the final straw in a succession of unresolved or unaddressed issues. Shrinking Sales, Value **Since 2005, GM**

has lost a cumulative \$72.4 billion, had its debt downgraded to junk, watched its share of U.S. auto sales shrink by almost 1 million vehicles and shed 90 percent of its market value. It introduced gas-guzzling vehicles as fuel prices rose, failed to slim down its product offerings and dealer networks quickly enough and wasn't able to cap its labor costs in time to stem the bleeding. In September 2007, the company won the right to hire new workers at lower wages starting in 2010 -- too far down the road to avoid the consequences of a recession and a credit crunch that engulf it now. **"We made mistakes," Wagoner conceded at a Senate hearing last week. Among the errors, he said, were "failing to build sufficient flexibility into our operations and not moving fast enough to invest in smaller, more fuel-efficient vehicles."** 100th Birthday Wagoner, 55, who has been CEO since 2000 and declined to be interviewed for this article, was also slow to see the impact of the credit crisis. **On Sept. 16, the day after Lehman Brothers Holdings Inc. filed the biggest bankruptcy in U.S. history, he told reporters at a party at Detroit's Renaissance Center marking the company's 100th birthday that he saw "no big impact" on consumers. The next month GM's auto sales in the U.S. plunged 45 percent.** After 77 years as the world's largest automaker, GM and its executives were unable to embrace change. The company continued to plow resources into sport-utility vehicles and make bad alternative-fuel bets, even after consumer buying habits shifted. It rejected an offer from Carlos Ghosn, CEO of Renault SA and Nissan Motor Co., to form a global alliance. And it dismissed calls for radical restructuring from former board member Jerome York and other critics. "Three years ago I thought GM had the time and financial resources to save itself," York, now CEO of Harwinton Capital LLC, said in an interview. "Now I'm not so sure. Who's responsible? Top management and the board of directors." Auto Bubble Although York's prediction was prescient -- GM has told Congress it will run out of cash by the end of the year if it doesn't get relief -- what no one could foresee then were two developments that sealed GM's fate: a run-up in gasoline prices and a credit-market freeze that followed Lehman's collapse. **The frozen credit markets signaled the end of an era of easy money that delayed GM's day of reckoning. In a parallel to the housing bubble, GM and its Big Three brethren enjoyed a decade of artificially inflated sales.** Finance companies did a booming business in **subprime auto loans**, a rarity in 2000, which accounted for 18 percent of new-car financing by 2005, according to CNW Market Research in Bandon, Oregon. And the automakers' own subsidiaries offered low-interest financing that helped move cars off dealers' lots. That did nothing to stem GM's steady loss of market share in the U.S., from 30 percent in 2000 to 22 percent today. It did help keep the industry's annual U.S. sales at or near record levels, topping 17 million vehicles. Managed for Cash **"They were trying to delay the draconian measures they needed to take,"** said Ashvin Chotai, managing director of Intelligence Automotive Asia Ltd., a consulting firm in London. GM gave the bubble a boost with a zero percent "Keep America Rolling" financing campaign started eight days after the Sept. 11 terrorist attacks. Sales jumped 42 percent in October. The program got the company even more hooked on incentives than it had been in the 1980s. "Keep America Rolling" was followed by "Employee Pricing," "Red Tag Specials" and other low-interest and rebate deals that made discounting the norm. **"It was a great initiative to prop up the market, but it's a trap they fell into,"** said Chotai, who estimates that annual U.S. auto sales would have fallen to 13 million to 14 million without incentives. **"Nobody believes list price anymore, so**

you've destroyed your pricing power and you've diluted your brand." That's only one way GM executives were short-sighted. It's not that Wagoner, who received an MBA from Harvard University in 1977, doesn't know management. It's that between dwindling liquidity and its sky-high fixed costs, the company was increasingly managed for cash, even at the expense of profit. 'Alternate Universe' **GM continued to build unprofitable models because it needed the cash to meet financial obligations, such as a roughly \$5 billion annual health-care bill for workers and retirees. In 2007, even though GM posted a \$38.7 billion net loss, it managed to generate \$189 million in free-cash flow. That's equivalent to burning the furniture in order to stay warm.** "These are not stupid people, but they had created an alternate universe," said James Womack, co-author of "The Machine That Changed the World," a book about the Toyota Motor Corp. production system that bested Detroit's. "They lived in a cocoon. GM was weak for reasons that were under the surface, and the financial crisis brought it all out. Shattered Illusion The illusion of prosperity would vanish when the era of easy money passed. **In the first quarter of 2005, after 12 straight years of profit, GM lost \$1.3 billion. The company's guidance on March 15 that a loss was coming startled Wall Street.** Investors beat down the company's shares by 24 percent over the next four weeks. On May 4, Kerkorian, 91, who had reaped \$3 billion on a 10 percent stake in Chrysler that he sold in 1998, **disclosed** that he had amassed 3.9 percent of GM's shares and was launching a tender offer for more. The next day Standard & Poor's knocked the company's bonds down to one grade below investment quality. GM, once the bluest of blue-chips, now had junkers for bonds. Others had come to a similar conclusion. A month after Wagoner's plan was announced, S&P again downgraded GM's debt and called **bankruptcy** "not far-fetched." Wagoner found the crisis talk overblown. He dismissed a flurry of Chapter 11 questions by saying there was "no plan, strategy or intention for GM to file for bankruptcy." In April 2006, Wagoner took charge of GM's North America division. That same month, he announced the sale of 51 percent of GMAC to New York-based private-equity firm Cerberus Capital Management LP for \$7.4 billion. The move was intended to improve GM's liquidity and protect GMAC's access to credit markets, which had been threatened by the parent company's ratings. **'Already Bankrupt' GM Won't Be Rescued by U.S. Loan** <http://www.bloomberg.com/apps/news?pid=20601170&refer=home&sid=ai5KpbywxqiQ>

- Dec. 11 (Bloomberg) -- Senate negotiations for a U.S. automaker bailout plan collapsed, in a blow to General Motors Corp. and Chrysler LLC, which may run out of cash early next year. "It's over with," Majority Leader **Harry Reid** said on the Senate floor in Washington. "I dread looking at Wall Street tomorrow. It's not going to be a pleasant sight." Reid said the Senate will take a procedural vote tonight on a House-passed plan, though he doesn't expect it to be approved. "This is going to be a very bad Christmas" for many people, Reid said. "The time for talking on this is over. We should vote and move on to something else." Asian stocks and U.S. index futures immediately began falling after Reid's comments. The MSCI Asia Pacific Index slumped 2.2 percent to 86.13 as of 12:33 p.m. Tokyo time, while March futures on the Standard & Poor's 500 Index slipped 3.4 percent. Connecticut Democrat **Christopher Dodd**, who was involved in the negotiations, said the final unresolved issue was a Republican demand that unionized

autoworkers accept a reduction in wages next year, rather than later, to match those of U.S. autoworkers who work for foreign-owned companies, such as Toyota Motor Corp. “More than saddened, I’m worried this evening about what we’re doing with an iconic industry,” Dodd said. “In the midst of deeply troubling economic times we are going to add to that substantially.” **Auto Bailout Negotiations Fail in Senate, Reid Says** <http://www.bloomberg.com/apps/news?pid=20601087&sid=awKd6fsQRiaA&refer=home>

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Wall Street

- Dec. 14 (Bloomberg) -- **Bernard Madoff's investment advisory business, alleged to be a Ponzi scheme that cost investors \$50 billion, was never inspected by U.S. regulators after he subjected it to oversight two years ago, people familiar with the case said.** The Securities and Exchange Commission hasn't examined Madoff's books since he registered the unit with the agency in September 2006, two people said, declining to be identified because the reviews aren't public. The SEC tries to inspect advisers at least every five years and to scrutinize newly registered firms in their first year, former agency officials and securities lawyers said. Madoff, 70, who had advised the SEC how to regulate markets and donated regularly to politicians, was arrested Dec. 11 and charged with operating what he told his sons was a long-running Ponzi scheme in the New York-based firm's business advising rich people, hedge funds and institutions. His ability to avoid detection may fuel debate about the SEC's effectiveness and the adequacy of its resources for policing money managers. **“Given what the SEC claims is the magnitude of the fraud, this is something you would hope an inspection would have uncovered,” said Mercer Bullard, a University of Mississippi law professor and former mutual-fund attorney at the SEC. “It’s hard to imagine a fraud of this alleged size not being accompanied by significant and pervasive compliance problems.”** The Inspectors The SEC's Office of Compliance Inspections and Examinations deploys teams from Washington and 11 regional offices to scout for fraud and gauge brokerages and investment managers' adherence to securities laws. Its roster of full-time employees peaked at 880 in fiscal 2006, according to agency budget requests. The regulator expects to have 796 full-time workers in its inspections office for the fiscal year ending next September. Madoff also operated a brokerage, and the SEC's inspectors examined it in 2005, finding three violations of so-called best-execution rules, which require that customer trades be made at the most advantageous prices, agency spokesman

John Nester said in a statement. The regulator's enforcement division completed an investigation involving the company last year without bringing a claim, Nester said. **The SEC opened that inquiry after tipsters and press reports said Madoff's purported investment returns may have resulted from front running, in which traders buy shares for their own account before filling customers' orders, a person familiar with the inquiry said.** The agency found no evidence that the brokerage did anything improper, the person said. Sixteen years later, on Dec. 11, the SEC and U.S. prosecutors announced in federal court in Manhattan that Madoff had confessed. **His advisory business was "all just one big lie," Madoff had allegedly said.** The business had been insolvent for years, with losses of more than \$50 billion, according to the SEC's account of his statement. Madoff delivered the confession to his sons, Mark and Andrew, who turned him in, according to **Martin Flumenbaum**, a lawyer representing the brothers. 'Just So Many' On the morning of Madoff's arrest, more than a dozen SEC inspectors assembled at his office in Manhattan and have since worked overtime to untangle the mess. The agency still hasn't determined the extent of the damage or whether others participated in the fraud, according to a person familiar with the review. Such a large Ponzi scheme -- in which early investors are paid with money raised from subsequent victims -- should prompt lawmakers to review how the U.S. polices brokerages, wealth managers and unregistered advisers, such as hedge funds, said **James Cox**, a securities law professor at Duke University in Durham, North Carolina. "There are just so many people out there who are and aren't registered that it really just overwhelms the system," Cox said. "There is no easy way to expand the regulatory net unless we're willing to put the might of the federal budget behind it to carry out more inspections." Committee Man **Barry Barbash, a former head of the SEC's investment management division, said the agency has tried to focus its inspections on money managers who pose the biggest risks. The regulator uses criteria such as which securities a firm is buying and who its clients are,** said Barbash, a partner at Willkie Farr & Gallagher LLP in Washington. "Given the state of SEC resources and given the way that they go about determining whether an inspection is necessary, it wouldn't surprise me that a newly registered firm wasn't inspected," Barbash said. **Any suspicions about Madoff may have been dampened because of his association with industry groups, watchdogs and politicians.** He sat on a committee of academics, regulators and executives formed in 2000 by former SEC Chairman **Arthur Levitt** to advise the agency on new stock-market rules in response to the growth of electronic trading. Madoff has led the trading committee at the Securities Industry Association, Wall Street's biggest trade group, and served as chairman of the Nasdaq Stock Market. 'Pull the Shades' **Since 2000, he has given at least \$100,000 to the Democratic Senatorial Campaign Committee and more than \$23,000 to the party's candidates, including Senator Charles Schumer of New York and Senator Frank Lautenberg of New Jersey, who leads a charitable foundation that invested with Madoff.** "You can see where people would pull the shades down over their eyes in terms of recognizing what could be one of the great frauds of our time," Levitt said in a Bloomberg Television interview. "I've known him for nearly 35 years, and I'm absolutely astonished." Levitt is a senior adviser to the Carlyle Group and a board member of Bloomberg LP, the parent of Bloomberg News. **Madoff Victims' 'Tragedy' Said to Have Escaped Scrutiny by SEC**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aPCGDhk9PtYQ&refer=home>

- Dec. 11 (Bloomberg) -- **Bernard Madoff**, founder and president of a New York firm that invested funds for wealthy individuals, hedge funds and other institutions, was charged with operating what he told employees was a long-running \$50 billion Ponzi scheme in what may be one of the largest frauds in history. Madoff, 70, head of Bernard L. Madoff Investment Securities LLC, was arrested today at 8:30 a.m. by the FBI and appeared before U.S. Magistrate Judge **Douglas Eaton** in Manhattan federal court. Charged in a criminal complaint with a single count of securities fraud, he was released on \$10 million bond guaranteed by his wife and secured by his apartment. Madoff, wearing a white-striped shirt, dark-colored pants and no tie, looked down as he left the courtroom with his wife, declining to comment. **“It’s all just one big lie,” Madoff told his employees on Dec. 10, according to the government. The firm, Madoff allegedly said to them, is “basically, a giant Ponzi scheme.”** Madoff faces as much as 20 years in prison and a \$5 million fine if convicted. His New York-based firm was the 23rd largest market maker on Nasdaq in October, handling a daily average of about 50 million shares a day, exchange data show. It specialized in handling orders from online brokers in some of the largest U.S. companies, including General Electric Co. and Citigroup Inc. ‘One of The Pioneers’ **“He’s one of the pioneers of modern Wall Street,”** said **James Angel**, an associate business professor at Georgetown University in Washington. Madoff’s firm was among the first to automate market-making, in which a dealer continually buys and sells stock. The company was among the largest to offer “payment for order flow,” or paying to handle customer orders. Madoff ran his investment advisory business from a separate floor of his firm’s office, keeping financial statements “under lock and key,” prosecutors said. Early in December, he told one employee that clients wanted to redeem about \$7 billion and that he was struggling to free up the funds, the government said. After he told another staff member Dec. 9 that he wanted to pay annual bonuses before the year’s end, two months early, a pair of senior employees asked to speak with him, prosecutors said. They had noticed he had been suffering from a “great deal of stress” and wanted to know what was happening, the U.S. said. When one of them challenged his explanations, Madoff invited them to his Manhattan apartment, saying he “wasn’t sure he would be able to hold it together” if they continued talking at the office, the government said. **While meeting the pair at his home yesterday, Madoff conceded that he was “finished,” that his advisory business is “all just one big lie” and “basically, a giant Ponzi scheme,” the government said. The business had been insolvent for years with losses of about \$50 billion, he told the employees, according to the criminal and SEC complaints.** Madoff said he had about \$200 million to \$300 million left and planned to distribute money to select employees, family and friends before surrendering to authorities in about a week, the government said. Confessed to FBI Madoff allegedly confessed to FBI agent Theodore Cacioppi on Dec. 11, saying there was “no innocent explanation,” the SEC said in its complaint. Madoff said it was his fault and he had “paid investors with money that wasn’t there.” He also said he was “insolvent” and he expected to go to jail, it said. The Madoff firm had about \$17.1 billion in assets under management as of Nov. 17, according to NASD records. At least 50 percent of its clients were hedge funds, and others included banks and wealthy individuals, according to the records. Madoff started his firm in 1960 with \$5,000 of savings and took advantage of securities-

law changes in the 1970s designed to spur competition in U.S. stock markets, according to a profile posted on the Web site Finance Tech. **Madoff's Web site advertises the "high ethical standards" of his firm.** "In an era of faceless organizations owned by other equally faceless organizations, Bernard L. Madoff Investment Securities LLC harks back to an earlier era in the financial world: The owner's name is on the door," according to the Web site. "Clients know that Bernard Madoff has a personal interest in maintaining the unblemished record of value, fair-dealing, and high ethical standards that has always been the firm's hallmark." The case is U.S. v. Madoff, 08-MAG-02735, U.S. District Court for the Southern District of New York (Manhattan) **Madoff Charged in \$50 Billion Fraud at Advisory Firm**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=anWXzISP4XCg&refer=home>

Editor's note: This is an advance copy of Liz Ann Sonders' newsletter article from the December 2008, issue of Schwab Investing Insights®, a monthly publication for Schwab clients.

Food for thought: The last day of a bear market is always the first day of a bull market. Put another way, the day in the bear market when losses are most severe and despair is typically most extreme is also the day in the subsequent bull market when return opportunities are greatest. I don't know whether the November 20 equity market low will ultimately hold, but a new bull run entered the record books with a 21% rally in the S&P 500 as of December 8.

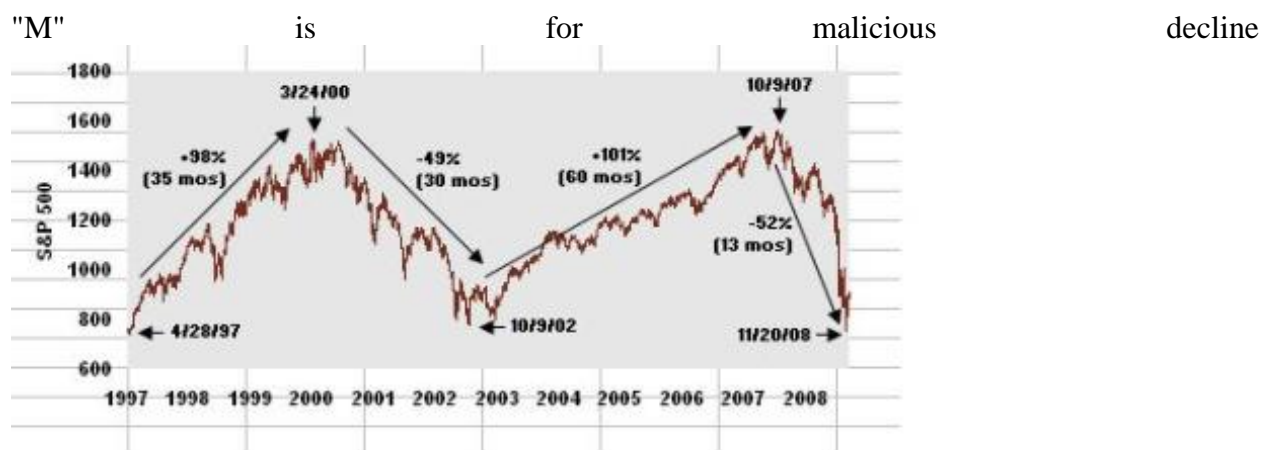
The drivers: larger-than-expected interest rate cuts globally; the coming fiscal stimulus plan from the Obama administration; exceptionally low cash yields; and the hope that we're sufficiently far enough through the recession to allow a market bottom to form. Volatility diverged from the market recently, too, not breaking out to new highs as the market sold off into the November low ... a possible sign of sellers' exhaustion.

So much that's unprecedented, or nearly so. Through the end of November, we experienced a very rare event, with the S&P 500 down 30% during three straight months of declines. Looking at the history of the market since its inception, there were only five prior cases where returns were this weak—four during the Great Depression. As you can see in "Market physics: rebounds have typically followed sharp drops" below, the market was higher during subsequent periods the vast majority of the time.

Market physics: rebounds have typically followed sharp drops

S&P 500 loss of greater than 30% in three-month period							
Date	3-month decline	Months after					
		3	6	9	12	18	24
11/30/1929	-34.0	11.3	17.1	2.2	-20.8	-37.8	-54.6
5/31/1932	-46.1	87.7	46.5	26.6	115.7	121.0	115.0
6/30/1932	-39.4	82.4	55.5	32.1	146.3	128.0	121.4
11/30/1937	-30.7	2.1	-16.6	8.6	14.6	4.4	9.8
11/30/1987	-30.2	16.3	13.8	13.6	18.8	39.2	50.2
	Average	39.9	23.3	16.6	54.9	51.0	48.4
	Median	16.3	17.1	13.6	18.8	39.2	50.2
	%Up	100	80	100	80	80	80

Losses occurred in three-month period with all months down. Source: Ned Davis Research, Inc.



As of December 10, 2008. Source: FactSet.

As the "M" graph above illustrates, a full decade's worth of returns has been erased due to the market's latest drubbing. But let's move the magnifying glass further out: The market's loss for the 10 years through the recent November 20 low nearly matches the worst 10-year performance in U.S. history. But as you see below, when 10-year annualized total returns fell to 1% or less, the next 10 years produced an average cumulative return of 175%—10.4% a year.

After wipeouts have come rebounds

Prior 10-year annual compound return	Subsequent 10-year period	Annual compound return	Total return
-3.65%	Q2 1939-Q2 1949	8.62%	129%
-2.79	Q1 1939-Q1 1949	9.12	139
-2.74	Q3 1939-Q3 1949	7.74	111
-2.54	Q1 1938-Q1 1948	11.76	204
-1.42	Q1 1940-Q1 1950	9.65	151
-1.42	Q2 1940-Q2 1950	12.19	216
-0.65	Q4 1938-Q4 1948	7.21	101
-0.10	Q3 1938-Q3 1948	8.12	118
0.18	Q3 1940-Q3 1950	12.57	227
0.20	Q4 1937-Q4 1947	9.61	150
0.23	Q4 1939-Q4 1949	9.09	139
0.44	Q2 1938-Q2 1948	9.52	148
0.49	Q3 1974-Q3 1984	15.58	325
0.71	Q1 1941-Q1 1951	14.47	286
	Average	10.38	175

Returns based on S&P 500. Source: The Leuthold Group.

Markets tend to bounce back. Markets have a tendency toward mean-reversion, or in other words, returning to their long-term average performance. Strong historical returns have typically been a signal of low future returns while low historical returns have tended to generate better subsequent returns. However, a plunging stock market has meant that investors who have naturally shied away from rebalancing (or have moved out of the market altogether) are now much less exposed to equities than they were at the market's top last year.

In fact, according to Hewitt Associates, the proportion of 401(k) plans invested in equities was at an all-time low of 53.8% as of October, compared with 74.2% at the market's high in 2000. Indeed, many investors were overexposed to stocks in early 2000 ... and they may be underexposed today.

Employment report: bad for workers, "good" for the market? I don't want to sugarcoat the bad news. The November jobs report was horrendous—a drop in payrolls of 533,000. Much is being made of the fact that it was the single worst month since December 1974. But we should always look at economic statistics in percentage, not absolute terms.

As shocking as a drop of a half-million jobs is for one single month, it's actually only the 41st-worst month for job losses in history based on percentage of the working population. Overall, 1.9 million jobs have been lost since the recession began, equal to 1.4% of the total payroll count. That's below four of the past five recessions—and all of them if the early 1980s back-to-back recessions are considered as one. During the 1973–1975 and 1981–1982 recessions, the peak was 2.7%.

It also may be instructive (or at least interesting) to discover that when the December 1974 jobs report was announced in January 1975 (three months before the recession ended), the market had already found its bear-market low (in October), from which it rose 53% during the following nine months.

Fast forward to the brutal 1981–1982 recession: The peak month for job losses was July 1982, which was reported in August (also three months before the recession ended). July was the month when the market bottomed, proceeding to enjoy a 62% bull run during the following 14 months.

Looking at the jobs data collectively, The Leuthold Group found that when nonfarm payrolls fell more than 0.9% year over year, there was a good chance the stock market was at or near its cyclical low (see below). This was the case in eight of the past nine recession-related bear markets. November 2008 payrolls have fallen 1.35% year over year.

Stocks have bounced after major job losses, too

	One-Year Change in S&P 500 Price-Only Return	
	After Drop of >0.9% in Non-farm Payrolls	All Periods
Average	19.9%	8.7%
Median	14.8%	9.5%

Rampant risk-aversion brings cash levels to extremes. Along with the extreme recent weakness in the stock market has come extreme strength in U.S. Treasury prices (as yields have plunged), thanks to the rampant risk-aversion prevalent among investors today.

But remember, at times of extreme investor pessimism like today, the public has historically proven wrong. Money market mutual funds relative to the total market value of all U.S. stocks hit a record high at the end of October (and will surely be higher once November's data is reported). When discounting this record liquidity for paltry yields, we see a compelling story of cash sitting on the sidelines. Once the mood shifts, we believe the flow back to equities could be dramatic.

It's already clear that investors have been doing a little bottom-fishing lately, with the most beaten-down, lowest-valuation names performing best from November 20 through December 7, according to Bespoke Investment Group (B.I.G.). It's also noteworthy that the stocks with the highest institutional ownership were also the best performers, indicating that perhaps hedge funds, mutual funds and other institutions have been getting back into the market—a sign that the deleveraging process could finally be easing.

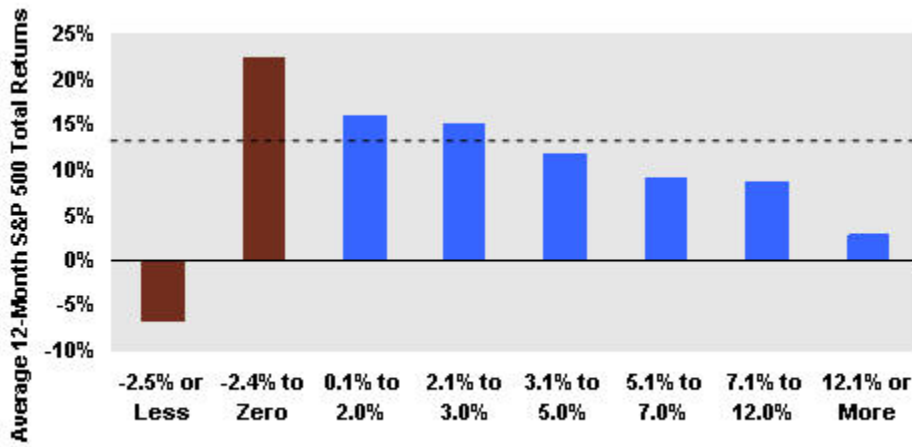
What say Treasuries about deflation, and deflation about stocks? Aside from risk aversion, we believe deflationary fear is also to blame for this flight to cash. The consumer price index (CPI) is poised to fall to deflationary ground by early 2009, with the latest reading on the Institute for Supply Management (ISM) price index (a forward-looking measure of manufacturing activity) the lowest since the second quarter of 1949. Interestingly, 1949 was

one of the most compelling bull market starts in history.

In fact, destructive deflation has only occupied one era in the United States—the Great Depression. But in light of aggressive policy responses, we believe a depression (and an accompanying deflationary spiral) will be avoided this time.

However, periods of mild deflation have been good for stocks, as you can see in the graph below. Although significant deflation was the most destructive environment for market returns, mild deflation produced the loftiest returns, with an annualized gain of more than 22%.

Stocks love mild deflation



Red bars represent deflation and blue bars represent inflation. Parenthesis represents number of quarters included in each inflation segment. Dotted line shows average total return. March 31, 1926 through September 30, 2008. Source: The Leuthold Group.

Bear markets end with a bang
 We've often noted that this bear market, with its wild swings, could bring sharp rallies at any time. So far, they haven't been of the sustainable variety, but we see new hope in a series of contrarian signals.

According to SentimenTrader.com, small traders have been buying the least amount of speculative call options (as a percentage of total volume) in years. Newsletter writers have shifted to selling the rallies, a marked change in strategy since the bear market began. SentimenTrader's "Dumb Money Confidence"¹ registered a lowly 13% in late November, the kind of level that's preceded other bear market rallies (though it has already rebounded significantly).

A positive noncontrarian sign is that corporate insiders are buying their stocks at a pace rarely seen in the past 40 years, with insiders more bullish now than at any time since 1975. And, for the first time since July, the market was able to make headway the first week in December and not immediately collapse after becoming overbought at the end of November. In addition, according to Birinyi Associates (which considers November 20 the low), the greatest declines in bear markets tend to occur in their last quartile (see "Bear markets are end-loaded" table below).

Bull markets start with a bang. Dropping below the November 20 low would only exaggerate the unprecedented fact that 67% of the overall decline has occurred in the last quartile of this bear market (see "Bear markets are end-loaded" table below). But remember the market's tendency on the upside, too.

According to Leuthold, in the Dow's 22 bull markets since 1900, price gains in the first three months have averaged more than 18%, with a median gain of 14%. One year after a bear market low, the gains are 46% and 41%, respectively. Most telling: The median first-year gain is nearly half the 84% median total bull market gain since 1900.

I'm not one to try to call bottoms—and no one knows what the next weeks may hold—but it's useful to note how bear markets typically end. The economy is not healthy, but bull rallies have often come when the news seems most dire. That said, we should heed the warning of 1930s, when multiple bull rallies played out within a bear market. Still, even then, the average bull run saw a gain of nearly 62% for the S&P 500® during 177 days, according to B.I.G.

So, be mindful of complacency ... but here's to a better 2009 ... we hope.

Bear markets are end-loaded

Percentage of S&P 500 bear market decline by quartiles					
Start	End	1	2	3	4
2/9/1966	10/7/1966	11%	30%	8%	51%
11/29/1968	5/26/1970	17%	17%	6%	59%
1/11/1973	10/3/1974	29%	7%	17%	48%
11/28/1980	8/12/1982	20%	35%	27%	18%
8/25/1987	12/4/1987	19%	15%	49%	17%
7/17/1998	8/31/1998	25%	18%	-1%	59%
3/24/2000	10/9/2002	22%	17%	20%	41%
10/9/2007	11/20/2008	30%	-7%	11%	67%
Average		22%	17%	17%	45%

Percentage of S&P 500 bear market decline by quartiles². Source: Birinyi Associates.

As always, if you have questions or need help, please contact your Schwab consultant. If you're not yet a Schwab client but would like to learn more, a Schwab consultant can help. Call **800-435-4000** to get started.

Don't Fight The Fed

I Disagree ... and why

[Article of the week:](#)

Best of the Dog