

## The Other Side of the Street December 23, 2007

### Comments

Happy whatever holiday you celebrate!

There certainly was a celebration on Wall Street Friday. A celebration of illegal stock manipulation that is. It has been a long while since I have seen such overt manipulation of stock in the days before and of a triple witch. The pinning that took place amazing. For instance, GS after a lackluster week jumped 7 plus and magically closed right on top of the 210 strike. In fact fully 3/4s of the stocks I follow hit a strike or within a nickel of a strike (strikes are option strikes and hitting a strike wipes out the value of both the put and the call at that strike). One of the best was BIDU, which traded above 380 until 20 minutes to close, dropped to 377 and then jumped back to 380 at the buzzer. Also of interest, RIMM comes out in line basically, affirms guidance and then trades as high as 20% above the Wednesday close in the Friday pre-market. All in all it was a very fitting cap to what will prove to be the end of an era. 2008 will be a whole new ball game.

Speaking of whole new ball games, recall Super SIV? If not, perhaps this direct quote from the 10/14/07 OSS commentary might refresh your recollection:

In a great example as to the lengths to which the Street and your government are willing to go to continue to perpetrate the largest securities fraud in recent memory, Citi, BOA and JPM are setting up a fund of about \$80 billion to help revive the asset-backed commercial paper market. Whatever the stated purpose, the underlying reason relates to an avoidance of the market place putting a value on the garbage AAA rated CDOs and other derivatives. If the market is allowed to place a price on these illiquid instruments, it will be substantially lower than the current "model", which is a fictitious number created to inflate the values of these instruments.

It won't work. It will spawn billions in litigation. It is a sign that desperation has clearly taken over.

As an aside, if the credit markets are doing so well because of the Fed cut – as unequivocally stated by the government on numerous occasions, why is this chicanery needed to "avoid selling [\$320 billion in CDOs] at fire-sale prices, further roiling the credit markets,"? Answer – one can't solve a credit problem with interest rate cuts.

Well, it appears your not very humble correspondent "pinned" that story. Bloomberg ran a story in its Friday back pages set forth below in the credit section, the headline: **Banks Decide Not to Go Ahead With Super-SIV Fund, WSJ Reports**

It is after noon in Jellystone Park . . .

## Notes

### Web links

### Credit

- Dec. 21 (Bloomberg) -- Bank of America Corp., Citigroup Inc. and J.P. Morgan Chase & Co. have decided not to go ahead with a fund to bail out investments threatened by subprime loan defaults, the Wall Street Journal reported, citing unidentified people familiar with the situation. The fund would have bought assets from so-called structured investment vehicles, or SIVs, which have been hurt by the credit crunch as investors refused to buy short-term commercial paper issued for securities such as those backed by subprime mortgages, the newspaper said. The banks and BlackRock Inc., which had been chosen to oversee and operate the fund, are likely to issue a statement on Dec. 24 saying they don't intend to go ahead with the fund, although it could be reactivated in the future if conditions get worse, the newspaper said. **Banks Decide Not to Go Ahead With Super-SIV Fund, WSJ Reports**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aJSL50Pd\\_28c&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aJSL50Pd_28c&refer=home)
- Dec. 21 (Bloomberg) -- The Federal Reserve will conduct emergency auctions of loans as "long as necessary" every two weeks as part of a global attempt by central bankers to restore faith in the money markets. The Fed and European Central Bank loaned \$30 billion in 35-day funds today at an interest rate of 4.67 percent, 2 basis points more than at the initial auctions four days ago. The rates are less than the 4.75 percent banks are charged to borrow directly at the Fed's discount window, suggesting the central bank is making progress in alleviating a credit crunch. "I would view these auctions as a success and this general approach by all the central banks as the appropriate approach," [recall all the touts who claimed the Sept rate cut was a success within days of the cut. How did that work out for them?] said Jeffrey Caughron, chief market analyst in Oklahoma City at Baker Group, which advises community banks on investing assets totaling \$20 billion. "Lending will become healthy again." [as noted below, the fact that central bankers are conducting auctions and flooding the market with half a trillion in loans is in fact NOT a good sign, nor is it an indication that "lending is becoming healthy". It is instead a sign as to how desperate things have become] Four special auctions had been scheduled, with the final two slated for Jan. 14 and Jan. 18. The central banks, along with those in Canada, Switzerland and the U.K., announced plans on Dec. 12 to move in concert to alleviate the credit squeeze threatening global growth, in the biggest act of international economic cooperation since the Sept. 11 terrorist attacks. Policy makers have cut the Fed's target rate for overnight loans between banks by 100 basis points to 4.25 percent since September, and the discount rate by 150 basis points. The U.S. central bank has also let \$35.2 billion in short-term securities mature so the proceeds could be used to

provide liquidity in the banking system. Yields Climb ``The fact that the Fed said they will continue every two weeks with these auctions will help yields on Treasuries to move higher, spreads to come in, and stocks" to rise, said Richard Gilhooly, an interest-rate strategist in New York at BNP Paribas Securities Corp., one of the 20 primary dealers that trade directly with the central bank. Benchmark 10-year note yields rose 11 basis points to 4.16 percent, the biggest increase in a week. Yields on three-month bills, seen as a haven from turmoil by investors, increased 4 basis points to 2.97 percent. The Dow Jones Industrial Average gained 1.5 percent to 13,451.06, while the Standard & Poor's 500 Index increased 1.7 percent to 1,484.49. **The difference between three-month Treasury bills and the three-month London Interbank Offered Rate, known as the TED spread, narrowed 8 basis points to 1.88 percentage point. That's down from a four-month high of 2.21 percentage points Dec. 11. [and still multiples higher than what it was in July]** Expectations for the Fed to reduce its overnight rate by another quarter percentage point on Jan. 30 fell to 76 percent from 92 percent yesterday, according to futures on the Chicago Board of Trade. Odds of a decrease to 3.75 percent in March declined to 40 percent from 53 percent. Fewer Bids Financial institutions submitted \$57.66 billion in bids to the Fed at their \$20 billion auction of 35-day funds, resulting in a bid-to-cover ratio of 2.88, lower than the prior auction. There were 73 bidders, compared with 93 banks and securities firms earlier, the central bank said in a statement today. ``The rate wasn't so high that it should cause concern about any dire need for liquidity," said Michael Pond, an interest-rate strategist in New York at Barclays Capital Inc., another primary dealer. ``People were looking for funds and liquidity on a competitive basis." All the funds were made available at the stop-out rate, or the lowest rate that the Fed accepted at the auction. Bids at the stop-out rate were prorated at 73.40 percent, compared with 1.96 percent at the \$20 billion auction of 28-day funds. `Being Nimble' The minimum accepted bid rate set by the Fed for today's auction was 4.15 percent, a rate based on a measure, known as the overnight indexed swap rate, of the average overnight fed funds rate over the term of the credit being auctioned. Overnight indexed swaps are derivatives in which one person agrees to pay a fixed rate in exchange for receiving the average of a floating central bank rate over the life of the swap. For such swaps based in U.S. dollars, the floating rate is the daily effective federal funds rate. `It's a sign the Fed is being nimble in terms of managing reserves and these temporary liquidity problems," said Kenneth Kim, an economist at Stone & McCarthy Research Associates in Skillman, New Jersey. ``I don't think they will have to do much more but it's a good sign." **[or it may be a sign that the private sector has no interest in making these loans at these rates and is happy to let the government pick up the garbage] Fed to Offer Special Auctions as `Long as Necessary'**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=asIOHfWCxC3M&refer=home>

- **"WHAT WAS I SCARED OF?"** That was one of my favorite Dr. Seuss stories to read to my children, about being frightened when meeting up with "the pale green pants with no one inside them." It turned out the apparition was just as scared of the stranger, and for equally no good reason. Once they got to know each other, neither was scared and they became good friends. If only things were as simple as in the world of Dr. Seuss. In the grown-up world of financial markets, what's not known is far more frightening than what is. And that's why money markets are nearly paralyzed with fear. According to

Bridgewater Associates' chief Ray Dalio and his associate, Fred Post, the widely known problems are manageable while those beneath the surface are big and pose the potential problems. Rational or not, those "unknown unknowns," to use former Defense Secretary Donald Rumsfeld's tortured terminology, are keeping banks from lending to each other over the new year. On Dec. 31, banks and other financial institutions don't want to have any dealings with other parties that might prove an embarrassment to show up when their year-end accounts have to be revealed to the world. Banks are so reluctant to part with their money that central banks around the globe are finding it necessary to step into the breach. In an operation so stunning in size that defies description, the European Central Bank provided \$500 billion dollars' worth of two-week loans to tide banks over the new year. A half trillion dollars. Former President Reagan used to describe how high a stack of one billion dollar bills would extend, and I confess I don't remember exactly how far that would be. But even he would be lost for words for a half trillion dollars. It is a number that only people at Goldman Sachs can possibly comprehend. And think that they deserve. Forget about helicopters dumping dollar bills from the sky. This operation would take a B-52. The carpet-bombing of the markets with liquidity is the result of the fear of lending to a loser. As a result, banks are lending to anybody. Steven Abrahams of Bear Stearns neatly explains the problem of the reluctance to lend in a report titled "Capital Punishment:" "Since the beginning of July, banks and brokers and insurers have announced \$80.8 billion in losses from exposure to U.S. mortgage credit. If that were the last word, then financial life could go on. "But more losses look likely to come out -- the value of outstanding subprime securities have dropped by an estimated \$176 billion since July, not to mention second-lien loans and other mortgages -- and therein lies the problem. "No one knows where the losses are, and the consequent concern about counterparties has pushed up financing rates and thinned out liquidity across markets." That's what the central banks are up against, at least through year-end. The ECB's surge of lending apparently worked, to some extent. It alleviated the worst of the year-end tightness but, ominously, did little to relieve the constriction beyond Dec. 31. According to Tom Gallagher of International Strategy & Investment Group, the ECB's provision of unlimited loans for two weeks at 4.21% brought one-month Euro money rates down a sharp 50 basis points, or a half percentage point. Still, the ECB's lending rate was still well above its 4% overnight target rate. More importantly, one-month rates indicated for one month out in January failed to respond at all to the ECB's massive injection, Gallagher points out. This reaction calls into question how much of the money-market tightness, caused by banks' reluctance to lend, is merely a year-end phenomenon, and how much is something else, he says. The Federal Reserve also is seeking to alleviate these funding strains with its new Term Auction Facility of the initial auction of \$20 billion of loans will be released Wednesday morning. That amount is dwarfed by the ECB's provision of liquidity, which also was vastly less than the injection in August. Indeed, the Fed seems like a piker by comparison, and may have to step up its provision of cash over the short term. At this time, ISI's Ed Hyman observes, there is plenty of cash waiting to be invested in these troubled credit. From Abu Dhabi's investment in Citigroup to Singapore's investment in UBS, capital is available to large, troubled financial firms. That long-term capital comes at a stiff cost, however. Through the end of the year, meanwhile, the markets can count on the major central banks to step into the breach and, apparently, supply what ever amount of cash is needed. The question is what

happens on Jan. 2 and the calendar no longer can be blamed for the money market's travails. Then, we may find out what we should be scared of. **What's To Be Scared Of? We Don't Know, and That's the Problem.**

<http://online.barrons.com/article/SB119801460577337697.html?mod=djemBF>

- Dec. 19 (Bloomberg) -- Wall Street's three-year love affair with debt sold by U.S. states and cities is over. Municipal bonds, whose returns trounced Treasuries and corporate debt from 2004 to 2006, are headed for their worst year since 1999, according to Merrill Lynch & Co. indexes. They may remain laggards after securities firms reduced their holdings during the third quarter by the largest amount in at least 12 years, data compiled by the Federal Reserve show. Citigroup Inc., Goldman Sachs Group Inc. and the rest of the securities industry reduced holdings of municipal bonds in their trading accounts by more than 16 percent, to \$45 billion as of Sept. 30 from a record \$53.9 billion at the end of June, according to the most recent Fed data released Dec. 6. The sales raised yields on municipal debt relative to Treasuries and increased financing costs for state and local governments planning bond sales by as much as \$320 million through 2017. "There's no money flowing into the market right now from hedge funds, banks or anywhere else," said Thomas Metzold, manager of the \$6 billion Eaton Vance National municipal fund in Boston. "**The banks have other needs for their capital.**" As investors retreated from corporate and asset-backed bonds to the safety of Treasuries, some also sold munis as losses on mortgages made to people with poor credit began to spread in August. Municipal yields rose to the highest compared with Treasuries since 2003, data compiled by Bloomberg show. Yields on 10-year municipal bonds averaged about 93 percent of what the U.S. government pays, compared with 83 percent on average in the two years before August. Investors typically accept lower rates on state and local debt because interest is exempt from taxes. Structured Investments Municipal debt has suffered as structured investment programs that sell short-term debt backed by long-term tax-exempt bonds have pulled back, CreditSights Inc. said in a report. "Their structured nature -- like anything else structured in recent months -- has forced investors to re-examine their true quality," Christian Stracke wrote in the report. Such "tender-option bond" programs make up almost 8 percent of the \$2.6 trillion municipal market after being "almost non-existent at the beginning of the decade," Stracke added. "Reduced demand from some traders may keep municipal yields higher than they ought to be for an extended time," said James Kochan, fixed-income strategist at Wells Fargo & Co.'s Funds Management Group, which oversees \$3.2 billion of municipal bonds. "Eventually, buyers will emerge and we will see this was a major opportunity." Greater Risk That's the opposite of what happened a year ago, when firms such as New York-based Citigroup, the biggest U.S. bank, along with hedge funds piled into munis, Fed data show. "**The market became more reliant on trading accounts and arbitragers, and now it faces a greater risk of capital being pulled from those kind of buyers,**" Kochan said. The higher yields relative to Treasuries means local government borrowers pay 34 basis points, or 0.34 percentage point, more in interest than if municipal bond yields had stayed at 83 percent of Treasuries as in the two years ended in July. **Muni Bonds Swoon With Worst Total Returns Since 1999**

[http://www.bloomberg.com/apps/news?pid=20601109&sid=a\\_KGBW0Ew71A&refer=home](http://www.bloomberg.com/apps/news?pid=20601109&sid=a_KGBW0Ew71A&refer=home)

- Dec. 19 (Bloomberg) -- Sallie Mae posted a record drop in New York trading as Chief Executive Officer Albert Lord failed to convince investors the company will rebound after an aborted buyout and credit-market distress cut its stock price in half. Lord, who returned as CEO of the largest U.S. education lender on Dec. 14, said today on a conference call that SLM may cut its dividend or sell shares to raise cash and earn a higher credit rating. SLM Corp., as the Reston, Virginia-based company is formally known, last week lowered its fourth-quarter and 2008 earnings forecasts, citing an increase in borrowing costs. Sallie Mae's stock has tumbled since July 10, the day before it said a group led by J.C. Flowers & Co. might back out of an agreement to buy the company because of legislation that cut federal loan subsidies to student lenders. It sued the group over the failed \$25.3 billion deal and rejected a reduced offer. "Investors were disappointed they didn't get more details," said Sameer Gokhale, an analyst with Keefe, Bruyette & Woods in New York. Sallie Mae fell \$5.98, or 21 percent, to \$22.89 at 4:02 p.m. in New York Stock Exchange Composite trading. The decline, the biggest since the company went public in 1983, left the stock at its lowest price in more than six years.

**The Flowers group, which includes Bank of America Corp. and JPMorgan Chase & Co., offered \$60 a share in April in what would have been the largest leveraged buyout of a financial-services company.** [the next time you think that big players know what they are doing, keep this in mind. The private equity crowd was going to pay nearly triple the current price nine months ago] Sallie Mae traded as high as \$58 in July before the buyers grew skittish when borrowing costs became more expensive and Congress passed legislation, signed by President George W. Bush, that cut subsidies to student lenders. "This is not a great time to be financing," Lord, 62, said on the call, his first public comments since being named chief executive officer. First Marblehead Corp., the third-largest U.S. arranger of securities backed by student loans and a specialist in private loans, said Dec. 7 that it would halt sales until at least next year "due to uneconomic terms in the current capital markets." Lord returned as CEO two days after the company said fourth-quarter earnings, excluding some costs, would be 52 cents to 57 cents a share. That compared with an average analyst estimate of 71 cents. The company, which has \$160 billion of loans, also cut its 2008 earnings forecast. **As analysts continued to press for details about the company's financial needs, Lord said he couldn't provide a "bottom line answer."** "There's No Questions" "There's no questions," Lord said, adding an expletive while telling an aide, "Let's get out of here." SLM's debt has been downgraded two levels by Standards & Poor's, to BBB+ from A before the April acquisition agreement. Standard & Poor's rates the senior unsecured debt at Baa1, three levels above speculative grade. The company will consider issuing shares to raise capital, Lord told investors. **Lord sold more than 1.2 million of his own shares on Dec. 14, the company reported last week.** Credit-default swaps tied to Sallie Mae's bonds, which are used to speculate on the company's ability to repay its debt or hedge against the risk it won't, rose 5 basis points to 290 basis points, according to broker Phoenix Partners Group in New York. A basis point on a contract protecting \$10 million in bonds for five years is equivalent to \$1,000 a year. Lord was CEO from 1997 through 2005. In May of this year, after the Flowers deal was announced, C.E. Andrews, who had been Sallie Mae's chief financial officer, was promoted to chief executive officer. Lord was named executive chairman last month and given day-to-day responsibility for running the company. **Sallie Mae Posts Record Drop as Lord Lacks Details**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aUufsOuR3rml&refer=home>

- Dec. 19 (Bloomberg) -- The ratings outlook for MBIA Inc. and Ambac Financial Group Inc., the world's largest bond insurers, was lowered to negative by Standard & Poor's, raising the specter of more writedowns for the companies' investment-bank clients. S&P also cut its A rating on ACA Financial Guaranty Corp. to CCC, suggesting potential default. Toronto-based Canadian Imperial Bank of Commerce said today it may have \$2 billion of writedowns on U.S. subprime mortgage securities it insured through ACA. "The hits keep coming," said Gregory Peters, head of credit strategy at Morgan Stanley in New York. "It's been our view that these guys are in a much more difficult predicament than investors or the companies themselves believed." Industrywide downgrades would lead to losses of \$200 billion on securities as some banks would have to sell their bonds in a depressed market because of investment guidelines, according to data compiled by Bloomberg. MBIA's guaranty business stands behind about \$652 billion of municipal and structured finance bonds, while Ambac's insures \$546 billion of debt. Both are rated AAA. S&P also reduced its outlook to negative from stable for XL Capital Assurance Inc. and placed Financial Guaranty Insurance Co.'s AAA rating under review for a possible downgrade. The actions were "prompted by worsening expectations" for insured nonprime residential mortgage bonds and collateralized debt obligations of asset-backed securities, New York-based S&P said. "Everyone Got Greedy" The changes by S&P follow negative actions on Armonk, New York-based MBIA's guaranty business and CIFG Guaranty by Moody's Investors Service last week. Bond insurers are paying a price for expanding beyond their traditional business of backing municipal bonds to guaranteeing debt linked to riskier subprime mortgages and home-equity loans, as well as CDOs. **"Everyone got greedy and thought they were smart enough to write structured product insurance like it was the same as insuring municipal bonds,"** said Rob Haines, an analyst with CreditSights Inc. in New York. S&P ran a stress test to determine the losses bond insurers would take on securities backed by subprime mortgages, including CDOs. Losses were projected at \$3.1 billion for MBIA, \$1.8 billion for Ambac, and \$2.2 billion for FGIC. MBIA's higher loss potential was attributed to the company's guarantees on securities backed by home equity loans, S&P said. CIBC, Merrill The ratings cut on ACA Financial, a unit of ACA Capital Holdings Inc., may lead to writedowns at Merrill Lynch & Co. and Canadian Imperial Bank of Commerce. Toronto-based CIBC said today it will likely take a large writedown because New York-based ACA insures about \$3.5 billion of its U.S. subprime investments. Merrill Lynch may have used contracts with ACA Capital to pass off the market risk of \$5 billion in CDOs, Roger Freeman, an analyst covering the brokerage industry for Lehman Brothers Holdings Inc., wrote in a Nov. 5 report. If ACA Capital defaults on its swap contracts, Merrill Lynch could recognize unrealized losses on those securities of about \$3 billion, Freeman wrote. ACA Capital is required to post \$1.7 billion in collateral if its rating falls at least two steps to below A-, management said on a Nov. 8 conference call. The rating was cut 12 levels today to CCC from A. The company said Nov. 19 it wouldn't be able to post that much or make termination payments on the contracts. ACA Capital Bailout Bear Stearns Cos. and Merrill Lynch are among several major banks in talks to bail out ACA, the New York Times reported today, citing two people familiar with the situation. "Effectively by bailing out the monolines, they're

bailing out themselves, because the hedges they thought they had with them aren't really hedges," said Toby Nangle, who helps oversee \$37 billion as head of global aggregate business at Baring Asset Management in London. ACA Capital rose 34 cents to 65 cents in over-the-counter trading on that news. The shares, suspended by the New York Stock Exchange this week for breaching capitalization requirements, had plunged 98 percent this year. ACA Capital as of June 30 had sold protection to 31 counterparties through credit-default swaps on \$61 billion of highly rated securities, including CDOs backed by subprime mortgage securities, according to filings. CDOs are created by packaging debt or derivatives into new bonds with varying ratings. Losses Grow The collapse of the U.S. subprime mortgage market has led to about \$76 billion of losses at securities firms and banks this year. Subprime loans are made to people with poor credit. Ambac, the second-biggest bond insurer, guarantees \$546 billion of securities. MBIA stands behind about \$652 billion of municipal and structured finance bonds, while FGIC Corp., parent of Financial Guaranty Insurance Co., insured \$314 billion. "We are confident the performance of our insured portfolio and the measures being taken to expand Ambac's capital position will be sufficient to return our outlook to stable," Ambac Chief Executive Officer Robert J. Genader said in a statement today. For more than 20 years, the safety of bond insurance has eased the way for elementary schools, Wall Street banks and thousands of municipalities to sell debt with unquestioned credit quality. The bond insurers promise to make interest and principal payments as they come due on securities if the issuer falters. "If these companies are going to survive, they've got to go back and focus on the core muni business," Haines said. Moody's, Fitch and S&P, criticized throughout the credit slump for giving excessively high ratings to asset-backed debt, took a second look at the bond insurers in the past few weeks after sweeping downgrades of CDOs. The companies had issued reports as recently as October that said the insurers were unlikely to face capital constraints because of the subprime mortgage crisis.

**Ambac, MBIA Outlook Lowered by S&P, ACA Cut to CCC**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=ayn8jGXirVvg&refer=home>

- Dec. 19 (Bloomberg) -- Japan's Topix index advanced for the first time in six days, led by Mitsubishi UFJ Financial Group Inc., [on speculation the country's top three banks will refuse a request by U.S. counterparts for a credit-line contribution to a subprime-asset bailout fund](#). Sumitomo Mitsui Financial Group Inc. has been asked to provide as much as \$5 billion to the fund, and its two largest competitors Mitsubishi UFJ and Mizuho Financial Group Inc. also received requests. Shareholders of Sumitomo Mitsui, Japan's third-largest publicly traded bank, won't accept the bank contributing to the fund, the Mainichi newspaper reported today. **"With the bailout fund the U.S. banks are creating there's no way of choosing where your money goes and you don't have a high guaranteed return,"** said Fujio Ando, who helps oversee about \$1 billion in Asian equities as managing director at Chibagin Asset Management Co. in Tokyo. **"There's no way shareholders can consent to that kind of investment, so if the reports are true it's a positive development."** [\[this is very well stated as to why the Super SIV is simply a scam to bailout the bad actors.\]](#) The Topix gained 5.11, or 0.4 percent, to 1,474.88 as of 10:56 a.m. in Tokyo. The Nikkei 225 Stock Average was little changed at 15,206.22. The broader Topix advanced for the first time since Dec. 11. Mitsubishi UFJ and Mizuho also gained after Credit Suisse Group raised its rating on both banks to "outperform"

from ``neutral." **Japan's Topix Rise on Report Banks May Reject Fund Contribution**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aBIHjDW7ULk8&refer=home>

## Commercial Real Estate

## Commodities

## Currency

## Diversification

## Derivatives

- Dec. 19, 2007 **SAN FRANCISCO (MarketWatch) -- The latest version of the closely watched ABX index is being postponed, in yet another sign of turmoil in mortgage markets.** The next series of the ABX, a synthetic index of mortgage-backed securities, was due to be rolled out on Jan. 19. But that's been put off for three months because there have been so few residential mortgage-backed securities issued during the second half of 2007, according to Markit, which helps run the index. Under current index rules, only five deals qualified for inclusion in the planned ABX.HE 08-1 index, Markit explained. "The dealer community considered amending the index rules to include deals which failed to qualify initially but decided against this approach at this time," the firm added. "Markit and the dealer community remain fully committed to the index and will update the market as and when appropriate."
- Markit's decision shows how badly the secondary mortgage market has been hit by the subprime-fueled credit crisis this year. As delinquencies and foreclosures on subprime mortgages soared this year, investors became wary of buying securities backed by these types of home loans. That's led to a slump in securitizations, leaving many mortgage originators in a difficult position. Mortgage-backed securities have to have an average weighted FICO, or credit, score of no more than 660 to be included in the ABX index. There are other criteria, such as the requirement that 90% of the underlying loans have to be first lien mortgages. ABX rules may be changed if mortgage securitizations don't pick up in the next few months. If enough new securities are sold, the new series will be rolled out with the current rules later, Ben Logan, a managing director at Markit, explained in an interview. **ABX index postponed for lack of subprime deals**  
<http://www.marketwatch.com/news/story/closely-watched-abx-subprime-index/story.aspx?guid=%7b61D60EAD-92B4-4AE8-8B84-280ECA0902FD%7d&print=true&dist=printTop>

## Housing

## Housing Finance

- Dec. 21 (Bloomberg) -- **Washington Mutual Inc., the largest U.S. savings and loan, dropped to an 11-year low in New York trading after regulators began investigating how the company set values for mortgages sold to investors.** The SEC is examining

loans that New York prosecutors claim were based on inflated home appraisals, a person with direct knowledge of the probe said today. The agency may also review how the bank accounted for the debts in its financial statements, said the person, who declined to be identified because the investigation isn't public. The Office of Thrift Supervision is also participating in the review, Washington Mutual said. SEC spokesman John Nester and OTS spokesman Bill Ruberry declined to comment. The Wall Street Journal reported the probe earlier today. New York State Attorney General Andrew Cuomo last month sued First American Corp., the largest U.S. title insurer, claiming its eAppraiseIT LLC unit inflated home values under pressure from Washington Mutual. False appraisals can mislead investors about the risk of defaults in mortgage-backed securities by overstating the ability of troubled borrowers to sell their property or refinance to settle the debt. `No Systematic Effort' First American produced 262,000 valuations over 18 months for Washington Mutual, earning \$50 million, Cuomo said in his complaint. **E-mails between executives at the appraisal company and Washington Mutual show eAppraiseIT `willingly violated' state and federal regulations that call for independent appraisals,** Cuomo said at the time. `After spending a month and a half investigating these allegations, we can say with confidence that there has been no systematic effort by WaMu to inflate home appraisals," Washington Mutual said in its statement today. `We take these allegations very seriously," it added. Washington Mutual on Dec. 11 wrote down the value of its home-lending unit by \$1.6 billion and cut 2,600 jobs. The lender also reduced its dividend by 73 percent to 15 cents a share. Moody's Investor Service said that the bank's profitability won't `begin to recover" until 2010. **Washington Mutual Declines as SEC Probes Mortgage Appraisals**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=abngHpGFrEb4&refer=home>

## Macro Economic

- Dec. 19 (Bloomberg) -- Federal Reserve Bank of Richmond President Jeffrey Lacker said economic growth will be `very weak" into next year as the housing market is set to keep contracting. `I expect growth to be very weak for several more months," Lacker said in remarks at the Charlotte Chamber of Commerce's Annual Economic Outlook conference in North Carolina. `Most cogent risks to the outlook are on the downside." Fed officials are trying to cushion the economy from the worst housing recession in 16 years. The Federal Open Market Committee has cut its benchmark interest rate 1 percentage point in the past three months, the biggest reduction in that period of time since the last recession in 2001. `Home construction and sales are unlikely to bottom out before the middle of the year, and I expect housing to continue to be a drag on growth well into 2008," he said. Rising incomes, buttressed by job growth, `will support further gains in consumer spending," he said. The Richmond Fed president, 52, next votes on interest rates in 2009. He alone dissented in favor of raising rates in the last four Fed meetings of 2006. Policy makers lowered the benchmark to 4.25 percent this month. `Uncomfortable' Inflation Lacker said he is `uncomfortable" with the inflation outlook and `disappointed" that the improvement seen earlier this year `was not more lasting." He told reporters after the speech that a `drift up in inflation expectations" is contributing to his concern. The central bank's preferred inflation gauge, the personal consumption expenditures price

index, minus food and energy, has risen at an annual rate of less than 2 percent since June. Still, the Fed in its Dec. 11 statement said that higher energy and commodity prices "may put upward pressure on inflation." The Richmond Fed chief noted that the headline PCE index rose at a 3.3 percent annual rate in September and October, and said prices in November "will be even worse." **"Because the job of a central banker is to protect the purchasing power of currency, it is overall inflation that we need to keep down, not just core inflation,"** Lacker said. "If energy prices fail to decline, monetary-policy decisions will be that much more difficult in 2008." A wave of foreclosures threatens to deepen the housing recession next year as the charges on subprime adjustable-rate mortgages reset higher. Subprime Fallout Subprime mortgages are usually made to people with poor or incomplete credit histories. Subprime delinquency rates reached 16.3 percent in the third quarter, from 14.8 percent the previous three months. The Bush administration this month negotiated an agreement with mortgage lenders to freeze some subprime home loans for five years, in an effort to forestall foreclosures. The Fed's Board of Governors unanimously voted in favor of stricter regulations on high-cost mortgage lending yesterday. The proposal will ban most prepayment penalties and no- documentation loans, force high-cost lenders to escrow tax and insurance payments for at least a year, and make lenders accountable for the loan's affordability. The proposal, which received a mixed reaction in Congress and among consumer groups, will be subject to a three-month comment period before it is finalized.

- Dec. 19 (Bloomberg) -- Singapore's property companies may lag behind Asian real estate developers for a second straight year in 2008 as government limits on speculation cool the housing market. CapitaLand Ltd., Southeast Asia's largest developer, is suffering its biggest quarterly decline in more than six years after the government raised development taxes by as much as 58 percent. The Singapore Property Equities Index dropped 19 percent so far this quarter, the most since a 35 percent plunge in the third quarter of 2001. International buyers, who accounted for more than 40 percent of real estate purchases in 2006, bought 38 percent fewer properties last quarter as capital-market gridlock caused by rising U.S. subprime mortgage defaults curbed borrowing worldwide. The supply of new homes for sale next year may almost double by value compared with 2006, weighing on prices, according to CLSA Ltd. "We can find better propositions elsewhere in the region, where there's more growth and value to be found," said Leslie Phang, who helps manage \$1 billion at Commonwealth Private Bank in the city. He doesn't own local builders and prefers Hong Kong developer Sun Hung Kai Properties Ltd. The decline in Singapore's property gauge compares with a 10 percent drop in the Bloomberg Asia Pacific Real Estate Index, which tracks 164 companies. The Bloomberg World Real Estate Index has slipped 8.9 percent this quarter. Singapore's property index climbed 1.3 percent today, the biggest rise since Nov. 29. 'Policy Risk' The government scrapped a program on Oct. 26 that allowed buyers of planned apartments to pay 10 percent of the asking price and defer the remainder until completion. Builders face higher fees on new developments after the government raised charges by 58 percent for apartment projects and by 42 percent for commercial properties, starting Sept. 1. "There are still a lot of policy risks in this segment," said Daphne Roth, vice president of equity research at ABN Amro Private Banking in Singapore. "The government doesn't want home prices to go up too much, too quickly and the policy changes introduced so far have already impacted the market." CapitaLand has slumped 25 percent in Singapore stock exchange trading

during the fourth quarter, set for its biggest quarterly drop since a 47 percent plunge in the three months ended September 2001. It has lost 29 percent after reaching a record high on April 26, even though third-quarter profit more than doubled from a year earlier. "People's expectations for the property market here have definitely dampened, which justifies some of those declines," he said. "If you look at economic and income growth and new offices starting up, the fundamentals haven't changed that much, so the pullback looks a bit excessive." Forecasts Cut CIMB-GK Research Pte, based in Singapore, cut its price forecasts in a Dec. 10 note. Properties costing at least S\$1,200 (\$831) a square foot may climb 8 percent in 2008, compared with an earlier forecast of 15 percent. Overall home prices will rise 15 percent from a previous estimate of a 25 percent increase, said Donald Chua, a Singapore-based analyst. The brokerage, a unit of CIMB Bank Bhd., Malaysia's largest investment bank, also cut its rating on the industry to "underweight" from "overweight," citing slowing growth. The firm lowered its recommendation on CapitaLand to "neutral" from "outperform." "There's just too much negative news out there right now, with the government regulations and concerns over subprime," said Nicole Sze, Singapore-based investment analyst at Bank Julius Baer, which manages \$350 billion. "We're unlikely to see the same kind of broad-based rally that we've had." **Singapore Property Stocks Slow as Tax Rise Curbs Boom**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=a\\_H.eXuYPBjk&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=a_H.eXuYPBjk&refer=home)

- Dec. 19 (Bloomberg) -- Japan's government slashed its economic growth forecast after stricter rules for obtaining building permits caused housing starts to plummet to a four-decade low. The world's second-biggest economy will probably grow 1.3 percent in the year ending March 31, slower than a previous forecast of 2.1 percent, the Cabinet Office said in Tokyo today. The government predicts a 2 percent expansion the following year. Slower growth may cause tax revenue to decline, making it more difficult for the government to eliminate the deficit and curb the world's largest public debt. The Finance Ministry will release its budget proposal for next fiscal year overnight. "The more the economy loses steam, the more difficulty the government will have in stoking economic growth through policy measures," said Takahira Ogawa, director of sovereign ratings at Standard and Poor's in Singapore. **Japan Cuts Growth Forecast to 1.3% on Housing Slump**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ax02CbEDWjE4&refer=home>

## Retail

- Dec. 23 (Bloomberg) -- **U.S. Internet sales rose at the slowest pace ever during the holiday season as customers reined in spending and retailers slashed prices on items from DVD players to sweaters.** Online spending through Dec. 21 increased 19 percent to \$26.3 billion, from \$22 billion during the same period a year earlier, Reston, Virginia-based ComScore Inc. said today in a statement. The research firm has forecast a 20 percent gain for the holidays. "At this point of the season, the heaviest online spending days are now well behind us," said ComScore Chairman Gian Fulgoni in the statement. Wal-Mart Stores Inc., Best Buy Co. and Circuit City Inc. offered discounts of 50 percent or more and promoted savings for in-store pickup of products purchased online to attract

shoppers during what may be the worst holiday shopping season since 2002. The peak period for Internet purchases has passed, said Patti Freeman Evans, a Jupiter Research analyst. "Everybody goes online, researches their purchases, then goes offline to buy," Evans said in a Dec. 21 interview on Bloomberg Television. "This year will be the year of the discount," Crawford told Bloomberg Television on Dec. 21. "You will see great bargains this weekend." AlixPartners is a consulting firm based in Southfield, Michigan.

**U.S. Online Holiday Sales Rise at Slowest Pace Ever**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ajdTcxc15ji8&refer=home>

## Retirement

## Risk

## Savings Rate

## Tech

## Wall Street

- Dec. 21 (Bloomberg) -- United Rentals Inc., the largest U.S. construction-equipment rental company, lost a bid to force a \$4 billion takeover by Cerberus Capital Management LP when a judge ruled the agreement allowed the buyer to pull its offer. Delaware Chancery Court Judge William B. Chandler III ruled today that United Rentals officials should have known that Cerberus executives believed they had a right to pull out of the deal at any time as long as they paid a \$100 million fee. "URI knew or should have known what Cerberus' understanding of the merger agreement was," Chandler said in his 67-page ruling, after a two-day trial that ended Dec. 19. United Rentals fell \$3.69, or 17 percent, to \$17.91 in New York Stock Exchange composite trading at 4:02 p.m.. It was a one-year low for the stock. United alleged Cerberus's RAM Holdings buyout entities agreed in July to pay \$34.50 per share for United Rentals' stock, and reneged on the deal in November amid weakened U.S. credit markets. The stock has been trading in the low-\$20 range. **[Keep in mind that it is these "experts" who were willing to pay double the current price for this stock that the pension funds are running after to manage money. Also keep in mind that the management knew the price was so ridiculous that it SUED the buyer to make them pay]** Mark Semer, a United Rentals spokesman, declined to immediately comment on the judge's ruling. Cerberus spokesman Peter Duda didn't immediately return a call for comment. United Rentals, based in Greenwich, Connecticut, filed suit claiming the contract gave it the right to seek a court order to complete the buyout. Cerberus claimed the contract let it walk away from the deal for a \$100 million termination fee. The case is United Rentals Inc. v. RAM Holdings Inc., CA3360, Delaware Chancery Court (Wilmington). **United Rentals Can't Force \$4 Billion Cerberus Buyout**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=arG1wOTuMpBo&refer=home>
- Dec. 19 (Bloomberg) -- **Morgan Stanley increased its bonus pool 18 percent to almost \$10 billion following the firm's first-ever quarterly loss, saying employees in divisions that reported record results in 2007 deserved the awards.** **[what word best**

**describes this? How about disgraceful]** Total compensation, including salaries, benefits and bonuses, climbed to \$16.55 billion in 2007 from \$13.99 billion last year, the New York-based firm said today in a statement. Year-end bonuses, estimated at about 60 percent of the total, will jump to \$9.93 billion from \$8.39 billion. Chief Executive Officer John Mack, who received a \$40 million payout in 2006, said he won't accept a bonus after the company wrote down \$9.4 billion in debt securities during the quarter. Morgan Stanley, the second-biggest U.S. securities firm, boosted the percentage of revenue set aside for compensation to 59 percent from 47 percent last year to reward employees in units handling equities, investment banking and wealth management, where revenue climbed. **“We felt it was inappropriate, as our board of directors did as well, for employees who delivered sterling results and a very strong performance to suffer,” [better for our shareholders to suffer]** Chief Financial Officer Colm Kelleher said in an interview today. **“If you were to normalize our business and take out this \$9.4 billion charge, you would see that we had a record year across the whole enterprise.” [if you could take out our bad deals and only count our good ones, we would be great!!!!]** Morgan Stanley employed 48,256 people on Nov. 30, up 12 percent from 43,124 a year earlier. Average pay per employee climbed to \$343,004 from \$324,320 a year earlier, with the bonus portion increasing to an estimated \$205,802 from \$194,592. Goldman's Payout Morgan Stanley is the third Wall Street firm to report higher compensation this year. Goldman Sachs Group Inc., the biggest and most-profitable company in the industry, yesterday reported that the figure climbed 23 percent, with average pay rising to \$661,490. Lehman Brothers Holdings Inc., the fourth- biggest firm, said its compensation pool increased 9.5 percent from a year earlier, with average pay dropping 0.5 percent to \$332,470. Morgan Stanley rose \$2.01, or 4.2 percent, to \$50.08 at 4:03 p.m. in New York Stock Exchange composite trading. The stock has declined 26 percent this year, compared with a 16 percent drop in the 12-member Amex Securities Broker/Dealer Index. **Morgan Stanley Bonus Pool Rises as CEO Forgoes Pay**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=amn7duYECJQA&refer=home>

- Dec. 18 (Bloomberg) -- Bear Stearns Cos. hedge fund manager Ralph Cioffi left the firm amid an investigation by U.S. prosecutors into whether he improperly pulled his money from two funds before they collapsed in July. Cioffi, 51, ceased to be an employee last week, Bear Stearns spokeswoman Elizabeth Ventura said in an interview today. She declined to say why he left or to comment on the federal probe. He had stayed on as an adviser to the New York- based securities firm after being relieved of his duties as a fund manager in June, when his funds' subprime mortgage investments began to unravel. Cioffi declined to comment on his departure. He left Bear Stearns, the second-biggest U.S. underwriter of bonds backed by mortgages, because his role in unwinding the funds was completed, a person close to the firm said. The U.S. Attorney in Brooklyn and the U.S. Securities and Exchange Commission are investigating Cioffi's withdrawal of some of his own money from the funds, three people with knowledge of the matter said. The probe is part of a broader regulatory review of the funds' implosion, according to the people, who declined to be identified because the examination isn't public. Investors in the two funds, which filed for bankruptcy in July, lost \$1.6 billion of capital. The Wall Street Journal reported the probe of Cioffi earlier today. **Cioffi pulled \$2 million of his own money**, one third of the amount he'd invested in one of his funds, before March so

he could commit it to another fund he set up, one of the people said. The withdrawal occurred before the funds ran into trouble, the person said. CDO Writedowns The two Bear Stearns funds failed when prices for so-called collateralized debt obligations linked to subprime mortgages plummeted, hit by surging late payments among U.S. borrowers with poor credit histories or heavy debts. Bear Stearns said last month it would write down the value of its CDO holdings, including some seized from one of Cioffi's funds, by \$1.2 billion in the fourth quarter. Cioffi's first fund, the High Grade Structured Credit Strategies Fund, generated a 46.8 percent return between October 2003 and March 2007. The second fund, started in August 2006, earned investors about 7.5 percent in its first seven months before losing 5.4 percent in March. A native of Burlington, Vermont, Cioffi joined Bear Stearns in 1985, selling so-called structured products such as bonds backed by mortgages or other loans. Before transferring to asset management in 2003, Cioffi was the head of structured credit products. **Bear Stearns Hedge Fund Manager Cioffi Departs Amid U.S. Probes**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=aRoyIm13e\\_G8&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aRoyIm13e_G8&refer=home)

- Dec. 19 (Bloomberg) -- **Morgan Stanley wrote down its subprime-infected mortgage holdings by a greater-than-expected \$9.4 billion and received a \$5 billion cash infusion from state- controlled China Investment Corp.** [wrote off nearly twice the “new infusion” AND rallied on the news – it doesn’t get much better than that] The second-largest U.S. securities firm rose 4.2 percent in New York Stock Exchange composite trading. The “significant capital raise” and writedowns may suggest to investors that Morgan Stanley has put the worst of its subprime losses behind it, Jeffery Harte, an analyst at Sandler O’Neill & Partners LP, wrote in a note today. **Chief Executive Officer John Mack called the fourth-quarter loss of \$3.56 billion, the first in the New York-based firm's history, “embarrassing.”** He’ll forgo his bonus for the year, the company said today in a statement. Mack’s strategy of expanding in mortgages and making bigger trading bets backfired as losses from securities linked to home loans more than doubled in November. He ousted Co-President Zoe Cruz, who had overseen the fixed-income unit responsible for the mortgage trades, last month and promoted James Gorman and Walid Chammah, who previously ran wealth management and the New York- based firm's European operations. “They quantified damages, quantified remaining exposure and assigned accountability,” said Douglas Ciocca, who helps manage \$1.6 billion, including Morgan Stanley shares, at Renaissance Financial Corp. in Leawood, Kansas. There’s “a bit of a relief rally given that the stock was heavily shorted and down 28 percent since Nov. 1.” “Depressed Valuations’ China Investment, the nation's sovereign wealth fund, will acquire as much as 9.9 percent of Morgan Stanley, making it the company's second-largest shareholder after Boston-based State Street Corp., according to data compiled by Bloomberg. The fund, advised by New York-based investment bank Lazard Ltd., is buying securities that convert into Morgan Stanley shares and pay annual interest of 9 percent. China Investment won't get a seat on the board or play a role in management, Morgan Stanley said in the statement. The fund is “not really looking for voting rights or control but trying to take advantage of surging asset values in China and depressed valuations here in the U.S.,” said Winston Wenyan Ma, author of “Investing in China: New Opportunities in a Transforming Stock Market,” published last year by Risk Books. “They like minority stakes, so as not to raise the ire of politicians in

Washington." Morgan Stanley said its fixed income sales and trading group recorded a net loss of \$7.9 billion in the fourth quarter, after the writedowns, which included \$7.8 billion for subprime- related losses. The remainder stemmed from a decline in the value of loans, commercial mortgage-backed securities, and so- called Alt-A mortgage securities. **“Our assumptions included what at the time was deemed to be a worst-case scenario,” said Colm Kelleher, the firm’s chief financial officer, in a phone interview today. “History has proven that that worst-case scenario was not the worst case.”** Kelleher said conditions in the credit markets “clearly got worse” after September. Credit Drag “The credit environment remains challenged, it will take several quarters to return to more normal markets,” he said. “Credit is going to be a drag on the fixed-income business going forward for the next few quarters.” Equity sales and trading revenue climbed 72 percent to \$2.5 billion and investment banking revenue rose 4 percent to almost \$1.6 billion. Revenue at the global wealth management unit, still overseen by Gorman, increased 23 percent to \$1.8 billion and pretax profit advanced 124 percent to \$378 million. Asset management, run by Owen Thomas, reported a 9.7 percent gain in pretax profit, to \$294 million. The company ranks second after Goldman among the world’s biggest advisers on mergers and acquisitions announced in 2007, data compiled by Bloomberg show. The firm advised on \$42.2 billion of takeovers completed during the fiscal fourth quarter, more than double a year earlier. Kelleher said the firm’s pipeline of merger assignments was unchanged from the previous two quarters. ‘Increasing Caution’ “We are seeing increasing caution” in conversations with the firm’s investment-banking clients, he said. In equity underwriting, Morgan Stanley managed \$14.1 billion of offerings during the quarter, up from \$13.6 billion a year earlier, Bloomberg data show. Morgan Stanley said in October that it was eliminating 900 jobs, mostly in the mortgage units. The firm said Nov. 7 that investments in subprime mortgages and related securities lost \$3.7 billion of value in September and October. “There was a huge risk-management failure here,” said Steve Roukis, who helps oversee \$1.8 billion at Matrix Asset Advisors Inc. in New York, including Morgan Stanley shares. “You’re going to see a broad undertaking by the Street to have more diversification and more hedging of all positions.” **Morgan Stanley Posts Loss, Sells Stake to China**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a61Th6lcsbsU&refer=home>

- Dec. 18 (Bloomberg) -- Goldman Sachs Group Inc., the world's largest securities firm, reported record earnings in the worst quarter for Wall Street in six years. Fourth-quarter net income climbed 2 percent to \$3.22 billion, or \$7.01 a share, from \$3.15 billion, or \$6.59, a year earlier, the New York-based firm said in a statement. Goldman fell 3.4 percent in New York Stock Exchange composite trading after Chief Financial Officer David Viniar **said he was “cautious about the near-term outlook.” [the self avowed greatest traders on Wall Street are “cautious”. Better keep them away from CNBC]** Goldman's earnings were buoyed by \$1.3 billion of gains from the sale of power plant investments and loans to finance leveraged buyouts. **[also known as non-recurring]** Chief Executive Officer Lloyd Blankfein sidestepped mortgage losses that unseated CEOs at Merrill Lynch & Co., Citigroup Inc. and UBS AG. “You would never have thought there was a subprime problem, not from their numbers anyway,” said Rose Grant, who helps manage about \$2 billion, including Goldman shares, at Boston-based Eastern Investment Advisors. Goldman fell \$7.12 to \$201.51 at 4:01 p.m. in NYSE trading, after

the firm said revenue in the three months ended Nov. 30 declined from the prior quarter, led by a 32 percent drop in fixed-income trading. ["The weakest thing environmentally in the fourth quarter was the credit markets in November," Viniar said in a conference call with analysts. "It's too early to tell in December" how the markets are developing. \[it was too early on December 18 to make the call on credit but by Dec 20, it was all good if you look at the Bloomberg lead in the credit section above\]](#) Core Items? Compared with the third quarter, "negatives included weaker fixed-income trading, lower equity trading and debt underwriting," Deutsche Bank AG analyst Mike Mayo wrote in a note to investors today. "There will likely be debate about which items are 'core' or not." Fourth-quarter revenue in Goldman's fixed income, currency and commodities division, the firm's largest, climbed 6 percent to \$3.3 billion from a year earlier. The results included a gain of about \$800 million from Cogentrix Energy LLC, the Goldman subsidiary that sold 80 percent of its stake in 14 power plants during the quarter. Goldman also booked a \$500 million gain as loans to finance leveraged buyouts increased in value during the quarter, partially offsetting a \$1.48 billion writedown on loans and loan commitments in the previous period. Firmwide revenue rose to \$10.7 billion, up 14 percent from the fourth quarter of 2006, Goldman said. Return on equity, a measure of how effectively the company reinvests earnings, was 34.6 percent in the fourth quarter, down from 41.5 percent a year earlier. Mortgage Impact Goldman is the second of Wall Street's five largest firms to post fourth-quarter earnings. Lehman Brothers Holdings Inc., the fourth-biggest by market value, reported last week that profit dropped 12 percent and said losses from the collapse of the subprime mortgage market will probably extend into next year. Viniar declined to disclose the size of any writedowns or gains on mortgage-related securities, saying only that the total impact on the firm was "modest." Goldman had less than \$400 million in collateralized debt obligations at the end of the fourth quarter and less than \$1.5 billion in subprime mortgage-related assets, Viniar said. The firm's so-called Level 3 assets, which are hardest to value, fell to 6 percent of total assets in the period from 7 percent in the third quarter, he said. Rivals Fall Analysts predict Morgan Stanley and Bear Stearns Cos., the second- and fifth-biggest firms, will report their first-ever quarterly losses later this week because of wrong-way bets on mortgage-related securities. Merrill Lynch & Co., the third-largest, will post its financial results next month. Goldman was expected to earn \$3.14 billion in the quarter, according to the average estimate of nine analysts surveyed by Bloomberg. Total profit for the five companies will decline 61 percent in the fourth quarter, analysts predict. The drop would be steeper than the previous quarter's 53 percent and the worst since the fourth quarter of 2001, when earnings shrank 88 percent. "Just looking at the world's capital markets and looking at the lack of liquidity that we saw in November, it has to make us cautious," Viniar said today in a telephone interview. Goldman shares gained 1 percent this year, while shares of its major rivals fell. The firm's full-year profit climbed 22 percent to a record \$11.6 billion and revenue increased 22 percent to \$46 billion. 'Head and Shoulders' "Goldman's results stand head-and-shoulders above its competitors, many of whom have struggled with the difficulties in the mortgage market this past year," said Octavio Marenzi, CEO of Boston-based research firm Celent. "Goldman took that weakness and turned it to its own advantage." Viniar said the firm's so-called unfunded commitments to provide leveraged loans on takeovers fell to \$27 billion at the end of the fourth quarter from \$42 billion at the end of the previous period. Goldman sold or

canceled \$16 billion of the loan commitments during the fourth quarter, funded \$9 billion of the commitments and made \$10 billion of new commitments, Viniar said on a conference call with journalists today. Equity trading revenue climbed 22 percent to \$2.59 billion. The S&P 500 Index ended November just marginally higher than it started, while the U.K.'s FTSE 100 gained and Japan's Nikkei 225 fell 5.1 percent. Average daily trading volume on the New York Stock Exchange fell 8.7 percent during the period from a year earlier, and rose 10.5 percent on the Nasdaq. Global Alpha Investment-banking revenue rose 47 percent to \$1.97 billion. Financial advisory revenue, derived mainly from counseling clients on mergers and acquisitions, climbed 98 percent to \$1.24 billion. Goldman, the No. 1 adviser in worldwide announced mergers and acquisitions for the seventh consecutive year, arranged \$417.9 billion of takeovers completed during the fourth quarter, more than double a year earlier, according to data compiled by Bloomberg. The company's backlog of pending merger assignments fell during the fourth quarter, Viniar said. The firm, which ranks second this year behind Zurich-based UBS in managing global equity offerings, arranged \$18 billion of equity sales during the quarter, up from \$16.7 billion a year earlier, Bloomberg data show. Revenue from asset management increased 25 percent to \$1.17 billion. The firm is starting three new hedge funds, expanding its so-called alternative investment offerings. Investors pulled about \$3 billion from Goldman's so-called quantitative hedge funds during the quarter, Viniar said. About half of the withdrawals were from the Global Alpha fund, he said. ``Redemptions in the first quarter from what we can see will be even greater than that, and again about half of that is going to be Global Alpha," Viniar said. **Goldman Gains in Worst Wall Street Quarter Since '01**

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

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

Article of the week:

Dec. 18 (Bloomberg) -- It was the first day of November and Coleman Stipanovich's world was coming undone. Florida school districts and towns had begun pulling their cash out of the \$26 billion money market fund he supervised, after they learned it held subprime-tainted debt.

Stipanovich, who earned \$180,214 in 2006 as executive director of the State Board of Administration, was in New York in confidential meetings with Lehman Brothers Holdings Inc., the largest U.S. underwriter of mortgage-backed bonds. Lehman was proposing ways to help the state manage the risk of its debt investments, according to a letter the bank sent to Stipanovich after the meeting.

What Stipanovich, 58, hadn't told his boss, Florida Chief Financial Officer Alex Sink, was that Lehman Brothers was the same firm that had sold the state fund \$842 million of mortgage-backed debt in July and August. Those securities defaulted within four months, and totaled more

failing debt than any other bank sold the state, Florida records show. ``At the time, I never knew it was Lehman Brothers that actually sold us these investments," Sink says.

Sink also was unaware that former Florida Governor Jeb Bush, who incorporated Jeb Bush & Associates in February 2007, a month after completing his second term, had been hired as a consultant to Lehman Brothers in June. Bush is the brother of President George W. Bush.

`Do Something Quickly'

In November, school districts and local agencies that kept their cash in the state pool rushed to withdraw \$12 billion, or 46 percent, of the money in the fund. On Nov. 29, the state froze the fund to stop all withdrawals. ``If we don't do something quickly, we're not going to have an investment pool," Stipanovich told the board that day.

Until November, the Florida pool was the largest public money market fund in the U.S. It held cash for about 1,000 school districts, towns and local agencies in Florida.

Stipanovich resigned on Dec. 4. He declined to comment.

Florida CFO Sink is riled up about more than Stipanovich. She says JPMorgan Chase & Co. and Lehman Brothers were offloading tainted debt on Florida and other states at a time when those assets were plummeting in value.

The subprime meltdown made front-page news in June, when Bear Stearns Cos. disclosed that two of its hedge funds were collapsing because they were stuffed with subprime collateral. During the next two months, Wall Street firms were quietly peddling mortgage-backed securities to the states.

And the states, eager for higher returns, were buying them.

`It Looks Questionable'

``Lehman and the other big players in the market decided they didn't like this stuff in their own accounts," Sink says. ``Where did they drop it and who did they dump it to? It looks questionable to me."

Joseph Mason, a former U.S. Treasury official and now a finance professor at Drexel University in Philadelphia, says Wall Street had few takers for its subprime-tainted debt. ``When they couldn't sell it to more-sophisticated investors, they found less-sophisticated investors like local government investment pools," he says.

At the same time, Lehman Brothers served its shareholders well in 2007, says Bruce Foerster, president of Miami-based corporate financial adviser South Beach Capital Markets. On Dec. 13, the bank reported it had limited a fourth-quarter writedown of \$2.2 billion tied to residential mortgages with \$2 billion it made on hedges.

The board of Lehman, whose shares are down 21.2 percent this year, gave Chief Executive Officer Richard Fuld a \$35 million stock award for record income in 2007.. ``What's not to like about a record year?" Foerster says.

### `We Are Disappointed'

Lehman Brothers spokeswoman Kerrie Cohen says the bank had only good intentions in its sales to Florida. ``The firm's number one priority is to deliver first-rate products to our clients," she says. ``We are disappointed when any security that is purchased by a client underperforms expectations."

JPMorgan Chase spokesman Joseph Evangelisti declined to comment for this story.

Florida first revealed that close to \$1 billion of its money market fund investments had been downgraded by credit rating companies on Nov. 1, after a month of inquiries by Bloomberg News, which published a story on the pool on Nov. 14.

States and counties run pools similar to money market funds to hold cash for school districts and local agencies. Most states require fund managers to make only short-term investments in debt such as U.S. Treasuries, certificates of deposit and corporate commercial paper, or short-term loans.

### Strayed From Guidelines

Florida and other states have strayed from those guidelines in recent years, buying commercial paper from collateralized debt obligations, or CDOs, and structured investment vehicles, or SIVs. These investments are bundles of securitized loans, often loaded with subprime debt, which is why they offer higher returns than Treasuries.

They also hold greater risk of default. Banks and other firms create these ``structured finance" packages and put them into a company, usually registered offshore.

Harvey Pitt, chairman of the U.S. Securities and Exchange Commission from 2001 to 2003, says state fund managers should have been savvier. ``All of this could, and should, have been avoided by careful due diligence, constant reassessment of risk and paying close attention to market trends," he says.

Pool investors like the Jefferson County School District in Florida, which kept more than \$4 million of cash in the state fund, were left scrambling to pay their teachers.

### `Stolen' From Taxpayers

Hal Wilson, the school board's chief financial officer, stopped checks to vendors to ensure the district's 220 employees would be able to cash their paychecks. ``It has been stolen from our local taxpayers because we entrusted their money with the state and our elected officials assured us it was safe," Wilson says.

On Nov. 30, state officials hired New York-based investment management firm BlackRock Inc. to study the fund's holdings and recommend a plan. On Dec. 4, BlackRock reported that about \$2 billion of the pool's holdings were in default or had significant credit risk.

It recommended that the state put 86 percent of its remaining \$14 billion of assets that had no risk of loss or default in what it called Fund A. The remaining 14 percent of distressed assets would go into Fund B and stay frozen indefinitely.

Two days later, the state allowed limited withdrawals from Fund A. Local districts withdrew \$1.8 billion from the pool in the first three days after the state lifted the freeze.

### Lehman Brothers Role

Sink, 59, who sits on a three-member board overseeing the Florida pool, says she didn't learn until Nov. 28 that New York-based Lehman Brothers had sold Florida most of its now default-rated commercial paper.

Governor Charlie Crist and Attorney General Bill McCollum, who are also on the board, declined to comment.

On Dec. 12, CFO Sink asked the audit committee of the State Board of Administration to determine who sold the pool the assets now in Fund B, whether any rules were broken and if managers made adequate disclosure once the fund's holdings had been downgraded.

Sink is upset that when Stipanovich went to New York on Nov. 1 to meet with Lehman Brothers, she had believed the bank was an independent adviser to the state.

"If there's anything that raises my hackles, it's when the executive director said he was relying on Lehman Brothers' advice, when I had suggested that we might need an independent adviser to help us figure out how to deal with these issues," Sink says.

### 'Significant' Risk

The state's flirtation with the mortgage meltdown began in February 2007 when the fund bought \$400 million of one-year Countrywide Bank certificates of deposit from the nation's then largest mortgage lender, Countrywide Financial Corp. The CDs yielded 5.35 percent at the time. BlackRock later quarantined the Countrywide CDs into Fund B because of their "significant" credit risk.

Two years ago, Florida's pool held safer debt investments. On Sept. 30, 2005, 25 percent of the pool was invested in U.S. Treasuries and debt issued by U.S. agencies, the safest and most liquid debt sold. The rest was in short-term corporate commercial paper. Interest rates were low, and fund managers for about 100 such pools in the U.S. wanted higher yields.

Florida was more aggressive than most states. In October, the Florida pool had the highest return of any public fund in the U.S., with a return of 5.63 percent. Chasing higher yields not only

meant potentially higher returns for taxpayers; it could also mean bonuses for Stipanovich and his colleagues.

#### 'An Outstanding Individual'

The state gave Stipanovich and pool manager Michael Lombardi financial incentives of up to 8 percent of their annual salaries if they could increase returns for the state's pension fund.

Lombardi bought many of the same tainted debt investments that had helped raise the pension fund returns for the state's money market pool, state records show. Pension funds across the U.S. offer managers bonuses.

Stipanovich, who ran the State Board of Administration which manages \$184 billion, was hired in 2000. Two of his three personal references came from then-Governor Bush's top aides.

"An outstanding individual capable of significant contributions to the board," Sally Bradshaw, Bush's chief of staff, wrote about Stipanovich.

After serving as an infantryman in the U.S. Army during the Vietnam War in 1969 and 1970, Stipanovich, a Michigan State graduate, became a stockbroker and then a branch manager at Paine Webber & Co.'s Tampa office in 1986.

#### 'Difficult Situations'

In August 1992, he settled a complaint filed against him by Florida's Division of Securities and Investor Protection. The agency found that, as a Paine Webber branch office manager, he failed to supervise a broker who sold unsuitable, money-losing investments to two retired cigar-factory workers.

One was a 73-year-old man, who was living in subsidized housing with his blind sister-in-law, who was 74. Paine Webber paid \$5,000 in investigative costs to the state and \$12,624 to the victims.

Stipanovich left Paine Webber five months later to open his own investment company, CoLee Inc. It was dissolved in 2000 after Florida hired him. The following year, he attended a two-day Harvard University seminar called, "Dealing With Difficult People and Difficult Situations."

The state promoted Stipanovich to executive director in 2002. In that role, he oversaw management of Florida's pension fund and investment pool. He drew few headlines until 2007. As the subprime crisis unfolded around the world, Stipanovich and Lombardi increased their holdings of high-risk debt.

They steadily reduced holdings of government securities, in favor of higher-yielding -- and riskier -- commercial paper, records show.

#### Less Treasuries in Fund

In February 2007, London-based HSBC Holdings Plc, Europe's largest bank by market value, reported it had losses of \$1.8 billion more than expected on its U.S. subprime lending. In the same month, Lombardi bought the \$400 million in Countrywide CDs.

By March, the fund's holdings of government bonds had shriveled to less than 2 percent of its holdings. "As you may have noticed, there are less U.S. Treasury and agency securities than before," Lombardi wrote in a quarterly newsletter to investors. "By focusing on maturities three months and in, we can comfortably accept more credit risk."

In the same month, bad loans soared at New Century Financial Corp., then the second-largest U.S. subprime lender. Its shares plummeted 93 percent that month as it ran out of cash. On March 15, Lombardi had bought another \$400 million in Countrywide CDs.

Calabasas, California-based Countrywide shares plunged 75 percent in 2007 through Dec. 12, when shares traded at \$10.53. On Aug. 16, Moody's Investors Service had dropped Countrywide's rating three steps to Baa3, one level above junk, from A3.

#### 'Leaking at The Seams'

Lombardi, 50, is a chartered financial analyst with a Masters of Business Administration degree from Fordham University in New York. He managed a \$250 million short-term fund for the Port Authority of New York and New Jersey from 1988 to 1997 in the World Trade Center before going to Florida. He declined to comment.

"Media headlines scream rising delinquencies and falling housing prices," Lombardi wrote in the pool's June newsletter. "The housing market contagion is leaking at the seams."

On June 14, Bear Stearns announced it would liquidate two of its hedge funds, holding more than \$4 billion in assets, because their subprime holdings were collapsing. The news roiled global financial markets. Eleven days later, Lombardi took on even more risk for the pool, buying another \$150 million of one-year Countrywide CDs, which were then yielding 5.33 percent.

At about the same time, Bush and his new company won a consulting contract from Lehman Brothers, according to Lehman spokesman Randall Whitestone, who declined to say how much Bush is being paid.

#### Jeb Bush

On July 2, Lehman Brothers sold Lombardi \$250 million of one-month commercial paper from a structured finance company called KKR Atlantic Funding Trust yielding 5.37 percent, state records show. KKR Atlantic was rated A-1+ by Standard & Poor's and Prime-1 by Moody's.

It matured, and on Aug. 2, Lehman Brothers sold Lombardi \$200 million of one-month KKR Atlantic paper yielding 5.53 percent. It was downgraded to default by Fitch Ratings on Oct. 8, and Not Prime, or junk, by Moody's on Oct. 29.

From July 3 to July 9, Lehman Brothers sold the pool \$153 million of commercial paper from another structured finance company called Ottimo Funding yielding 5.36-5.38 percent.

Lehman Brothers spokeswoman Cohen says there's no link between Bush and Lehman's sale of debt to Florida. "Bush is a member of the Lehman Brothers private equity advisory board and his company has been retained by the firm for consulting and advisory services," she says. The former governor declined to comment.

#### 'A Clear Conflict'

Craig Holman, of Washington-based nonprofit public interest group Public Citizen, disputes Lehman Brothers' view. "That defies credibility," says Holman, who lobbies for ethics in government. "It's a clear conflict of interest. Bush is a consultant to the company selling bad investments to the same agency on which he served as a trustee until January."

On July 10, Moody's cut ratings on \$5.2 billion of bonds backed by subprime mortgages. Standard & Poor's said that day it might slash ratings on \$7 billion of subprime-backed debt.

From July 26 to Aug. 2, Lehman Brothers sold the pool \$489 million of one-month KKR Pacific Funding Trust paper, state records show. With each new purchase, KKR Pacific offered a higher interest rate. On July 26, KKR Pacific paid 5.38 percent; on July 27, 5.39 percent; on Aug. 1, 5.46 percent; and on Aug. 2, 5.65 percent.

#### 'A Broader Dislocation'

On July 27, JPMorgan Chase sold the pool \$175 million in commercial paper from an SIV called Axon Financial Funding maturing on April 25, 2008, and \$31 million of Ottimo, yielding 5.4 percent, state records show. Axon was rated Prime-1 by Moody's, A-1+ by S&P and F1+ by Fitch. The yield was 5.34 percent.

Also that month, Lombardi bought \$1.8 billion of commercial paper issued by CDOs, including \$734 million managed by Bear Stearns.

On Aug. 15, less than three weeks after the pool's purchases, Fitch slashed KKR Atlantic and KKR Pacific to B, or junk, from F1+, citing a decline in value of the underlying residential mortgage-backed securities.

"Unfortunately the performance of Ottimo, KKR Atlantic and KKR Pacific, which are supported entirely by AAA securities, are reflective of a broader dislocation in the mortgage- and asset-backed commercial paper markets," says Lehman's Cohen.

#### Oversight Committee

On Aug. 8, Lombardi bought \$100 million of Countrywide six-month CDs with a yield of 5.45 percent. The pool held \$830 million of Countrywide debt on Aug. 15, when a Merrill Lynch & Co. analyst raised the possibility of bankruptcy for the company.

A day later, Countrywide borrowed the entire \$11.5 billion available in its bank credit lines. On the same day, Moody's downgraded Countrywide to one step above junk.

After the downgrade, Countrywide's debt no longer met the pool's minimum credit quality requirements. The pool's operating procedures require a swift meeting of its investment oversight committee when any holding drops below acceptable risk levels.

Countrywide's downgrade, and the decision to continue holding the debt, wasn't communicated to the pool trustees. Sink says it should have been. "Absolutely," she says. "That's why the executive director isn't the executive director anymore."

### Justification Memo

The committee was composed of Lombardi's boss Robert Smith, senior investment officer for fixed income; Lisa Collins, the compliance officer; and Lombardi. On Aug. 22, the committee met and approved a "justification" memo to keep the debt.

"Our recommendation is to continue to hold the paper until maturity," the document says. "Naturally, we will continue to monitor the credit markets to take advantage of any sale opportunities."

That meeting was the first in a series of decisions the state made to hold a total of more than \$1.7 billion in debt that had either been downgraded below state standards or had defaulted, records show.

On Aug. 21, Sink's office asked Stipanovich if the pool's CDOs faced subprime risk. "None of these CDOs are backed by subprime mortgage loans," Stipanovich wrote in an e-mail reply the next day.

State records show the pool owned \$234 million of paper issued by Buckingham CDO III on that date, holding 40 percent subprime collateral. "I think we were asking a lot of the right questions," Sink says. "We just weren't getting the right answers back."

### No Votes, No Records

From August to October, the committee decided to keep five debt holdings that had been downgraded or had defaulted. In late October, the board's investment oversight committee allowed the pool to keep a total of \$532 million in downgraded commercial paper from KKR Atlantic and KKR Pacific.

The debt of both had been lowered to D for default by Fitch, after they had been downgraded to B, or junk, from F1+ two months earlier.

The committee meetings to hold the spiraling debt had no agendas, took no votes and kept no records of the sessions, says Linda Lettera, general counsel of the state board. It went through the

same process each time one of the pool's holdings was downgraded below its minimum standards.

“That's just not the way you do business,” Sink says. “The way business is conducted over there is going to be very different going forward.”

On Sept. 12, Lombardi wrote a memo to compliance officer Collins, saying, “All asset-backed commercial paper has been tainted with the sub-prime mortgage troubles.”

Stipanovich, in an update to the pool's trustees on Oct. 15, said the pool has no direct exposure to subprime mortgages and buys only asset-backed commercial paper from 150-200 approved programs. He described negotiations with KKR Atlantic, KKR Pacific and Ottimo Funding to extend the time of commercial paper that couldn't be repaid.

#### Downgrade Disclosed

On Nov. 1, the pool's third-quarter newsletter revealed the first sign of potential losses to the pool's participants. It said that 3.4 percent of its holdings, including Axon, KKR Atlantic and KKR Pacific, were downgraded below the pool's acceptable risk levels.

It also disclosed ownership of \$440 million of Harrier Finance Funding, a second SIV. “No one can consistently predict the future course of the financial markets and residential mortgage default rates, but credit markets are showing some signs of gradually recovering,” the newsletter said. It omitted mention of the \$650 million of downgraded Countrywide CDs.

#### Stan O'Neal Ousted

Banks had written down more than \$20 billion in subprime holdings by Nov. 1. In October, Merrill Lynch had reported a loss of \$2.24 billion, the largest in its 93-year history. On Oct. 30, Merrill ousted Stan O'Neal as its chief executive officer.

The day after O'Neal was fired, Stipanovich was in New York, for the confidential meeting with Lehman Brothers. In a presentation at the Nov. 1 meeting, Lehman Brothers included a graphic titled “Potential Opportunities to Explore.”

It suggested that Florida could buy more structured finance commercial paper from Lehman Brothers for the state pension fund. “Florida is very well funded relative to its peer group,” the graphic said.

Back in Florida four days later, the State Board of Administration determined that 7.2 percent or \$3.6 billion of its then \$50 billion of short-term investments, which includes the investment pool, were on credit watch for possible downgrades.

‘Build Our Relationship’

In the first two weeks of November, local districts had withdrawn \$2 billion from the pool, records show.

On Nov. 12, Lehman executive Marty Klein sent Stipanovich an e-mail. "On behalf of my colleagues at Lehman Brothers, I would like to thank you for your time at our recent lunch," Klein wrote. "We'd like very much to continue to build our relationship with the Florida State Board of Administration. Given our broad capabilities, we think we can be helpful on several fronts."

On Nov. 14, the state board held a public meeting to discuss all of its investments, including the pool for local districts and the pension fund. "The SBA's bond and money market investments have maintained high overall credit ratings," Stipanovich said. "The only disappointment that we've been dealing with is the credit downgrades."

He said the downgrades included 4.7 percent or \$2.28 billion of the board's total \$50 billion of short-term debt holdings.

'I Feel Very Good'

"Most importantly, I want to emphasize that no client has ever lost money in the SBA's short-term fixed-income investment program, and we remain confident that our portfolios in this program will meet their objectives," Stipanovich said. "I feel very good about our situation."

Governor Crist offered reassuring words for Stipanovich. "It's always easier to be a Monday morning quarterback," he said. "We all know that. But I just want to thank you for your diligence and for your staff's work. We have confidence in you. Sometimes these things do get blown out and sensationalized."

In the next two weeks, the credit downgrades and defaults of pool debt holdings overtook the positive spin Stepanovich had given the governor and the pool's trustees. Local agencies withdrew \$10 billion more from the pool, until the state froze the fund on Nov. 29.

That's when Stipanovich officially turned in his resignation. State officials selected BlackRock to manage the pool the next day.

For those running the Florida pool, the best hope is that the audit committee can sort out what went wrong and restore the fund's credibility and financial stability. If the committee doesn't, the state might have no choice other than shutting the pool down. **Florida Got Lehman Help Before Run on School's Funds**

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