

December 3, 2006 Review

Summary

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

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

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

Credit

- Where will the money come from (to pay off credit)? Most CFOs (2/3) expect no employee raises or bonuses in 2006 as reported in the Journal of Accountancy Sept 2006 p. 18

Commercial Real Estate

Commodities

- Dec. 2 (Bloomberg) -- Saudi Arabian Oil Minister Ali Al- Naimi said crude inventories are too high, indicating the Organization of Petroleum Exporting Countries, which supplies two out of every five barrels, should cut output. OPEC meets in Nigeria on Dec. 14 to decide whether to cut production for a second time in as many months. The group decided in October to reduce output by 1.2 million barrels a day starting Nov. 1, to check a decline in oil prices from a record \$78.40 a barrel in July, to \$63.43 yesterday. **"I agree that we have to take 100 million barrels out of the market,"** Naimi told reporters in Cairo today, where there is a meeting of Arab oil ministers, without specifying how that should be done. OPEC President Edmund Daukoru this week said the group should cut output by at least 500,000 barrels a day. Saudi Says Oil Stocks Too High, Indicating Supply Cut
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aKmxPHSA9M34&refer=home>
- What's ahead for the dollar? Can't all prices be figured as a product of supply and demand? The feds stopped reporting the growth in M3, the principal measure of the U.S. money supply, earlier this year. But Adrian Van Eck, who keeps track of these things, estimates that the world's supply of dollars has increased by \$3 trillion over the last three years. Let's compare the figure to the world's supply of gold. Gold stocks grow at about 1.7% annually. If the base of 155,000 tonnes above ground - the figure provided by the World Gold Council - is correct, that means we only have to do a little math to know where we are headed. Let's see...there are 28.35 grams to the ounce...and 1,000 grams to a

kilogram...and 1,000 kilograms to a metric tonne. If we're doing the figures right, we end up with an above-ground supply of more than 5 billion ounces...which, multiplied by 1.7% over three years...gives us an addition to the world's gold supply of about 25 million ounces over the last three years. **In other words, for every ounce of gold added to the world supply over the last three years, the United States has added \$120,000.** But wait, we are talking about the world's total supply of new gold. So, in addition to the new supply of dollars, we have to include the increases in the rest of the world's money supplies. We won't even try. Instead, we will guess that, altogether, the foreigners added about the same amount of new currency - about \$3 trillion worth. Which gives us a total of about \$240,000 for every ounce of gold added to the world supply. Daily Reckoning 12/1

- Nov. 27 (Bloomberg) -- Oil stocks are signaling that crude prices may rebound to a record in 2007. **Benchmark U.S. crude oil is likely to average \$70 a barrel next year,** according to Dallas hedge fund manager Boone Pickens. Economist Ed Morse at Lehman Brothers Inc., the fourth-largest U.S. securities firm, predicts \$72. Either would top the average price for New York oil futures so far this year, \$66.73 a barrel, and set a record. **Oil Shares Signal a Rebound; Pickens Predicts Record 2007 Price By Matthew Leising**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aoUFR2LTJGpc&refer=home>

Currency

- The dollar plunged with startling ferocity late last week, driven by heavy selling. This was very bearish action that signals panic, and the probable onset of a severe downtrend. A break below the crucial support at 80 on the dollar index is expected to mark the transition from a clandestine unloading of dollar assets to an all-out stampede to "get what you can for them" before it's too late. The conditions leading to an inevitable dollar panic sell-off did not come about overnight. **They are the result of years of abuse, principally by the Federal Reserve of the US, which has created a veritable blizzard of dollars, and the universal acceptance of this "funny money" has, up until now, allowed the United States to freeload economically on the rest of the world, living way beyond its means.** The exponential growth in dollars has been and is created electronically at the touch of a button, so that paying for anything is never a problem, whatever you want you simply print the extra money to pay for. **Because foreigners have so far played along with this game, they are now widely, and to some extent understandably, regarded as stupid.** However, it is a dangerous mistake to underestimate the mental capacities of other peoples. The Chinese, in particular, have an ancient and deep culture, and when it comes to strategic considerations, can outthink - and outflank - virtually anyone. So what's going on? - why have they accepted a mountain of paper and IOUs over many years in exchange for real hard work and a vast quantity of real tangible products? **The Chinese, and others, have done this to carry them over a bringing period during which they have built up their economies and infrastructure. Their goal - which they are fast moving towards - is to arrive at the point where there is sufficient domestic and regional demand that they no longer need to rely on orders from countries like the United States.** At this point - which we

may arrive at sooner rather than later - things will become very dangerous for the US dollar, and the situation is actually far worse than many now believe, because the Chinese and others are preparing to WRITE OFF THEIR DOLLAR ASSETS AS A BAD LOSS - **they will try to get what they can for them, of course**, but otherwise will be ready to fall back on domestic and regional demand and tough it out, thus severing the umbilical with the United States, which will be left stranded, with no takers for its funny money, a gutted manufacturing base, astronomic debts and fiscal chaos, and a huge military it can no longer afford to service. **Death Knell of the US Dollar 11/27 Clive Maund**
<http://www.321gold.com/editorials/maund/maund112706.html>

Diversification

Derivatives

- Last week, another bit of news reached us: the derivatives market, in which hedge funds tend to speculate, has reached a face value of \$480 trillion...30 times the size of the U.S. economy...and 12 times the size of the entire world economy. Trading in derivatives has become not merely a huge boom or even a large bubble - but the mother of a whole tribe of bubbles...dripping little big bubbles throughout the entire financial sector. 12/1 Daily Reckoning

Housing

- Dec. 1 (Bloomberg) -- Construction spending in the U.S. fell by the most in five years in October, led by a plunge in home building, a government report showed. Spending fell 1 percent, more than forecast, following a 0.8 percent drop in September that was larger than originally reported, the Commerce Department said today in Washington. Spending on private residential construction fell 1.9 percent, **the seventh straight drop**. Builders such as Toll Brothers Inc. are cutting back on projects as demand for new homes wanes and are offering incentives to reduce inventories. ``The big part is the residential sector, **where we see continued freefall on the construction side**," said Richard DeKaser, chief economist at National City Corp. in Cleveland, Ohio. ``This has some ways to go still."
U.S. Construction Spending Dropped 1% in October
http://www.bloomberg.com/apps/news?pid=20601068&sid=a5mYocc_of4A&refer=economy
- Nov. 29 (Bloomberg) -- The U.S. economy may head into 2007 in weaker-than-expected shape after reports showed October new-home sales fell for the first time in three months and stockpiles at companies jumped last quarter. House purchases declined 3.2 percent to an annual pace of 1.004 million from a 1.037 million rate in September that was slower than previously reported, the Commerce Department said in Washington.
<http://www.bloomberg.com/apps/news?pid=20601068&sid=a7smWvXsK5oE&refer=economy>

Housing Finance

- Dec. 1 (Bloomberg) -- **The mortgage bond market is beginning to buckle under the weight of the worst U.S. housing slump in six years.** Yields on so-called sub-prime mortgage securities rated BBB have risen to 6.52 percent on average from 6.28 percent on Sept. 5, data compiled by Bank of America Corp. show. The yield premium, or spread above the one-month London interbank offered rate, a lending benchmark, rose to a seven-month high of 1.2 percentage points. **About 3.3 percent of the \$160 billion in sub-prime loans made this year through July have payments that are more than two months late, the highest ever for mortgages in their first year, according to New York-based Fitch Ratings.** Housing starts tumbled in October to an annual rate of 1.486 million, the lowest in more than six years. The economy grew at the slowest pace since 2005 during the third quarter. "The higher delinquencies do set off an alarm for many people and make us more conservative," said Alex Wei, a senior vice president at Delaware Investments in Philadelphia. **Mortgage Bonds Hurt by Delinquencies, Housing Slump By Darrell Hassler**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aJpnPI7qhPck&refer=home> [This is an indication that the sub prime rot is beginning to work its way through the system. One of the major issues with structured finance is its reliance on historical data for the ratings on the various tranches of debt. As these historical numbers prove to be "overly optimistic" as applied in the current environment, many bad things will occur. Among them: The inability to pump out new deals, which will impact the investment brokers new mortgage pipeline (the deals they made last summer to buy the suppliers of this stuff). The decline in value of the existing structured products, which will at some point (very quickly) bring into play all the exotic credit derivatives that were created to "insure" against a decline in principal. Once these exotics begin to increase in volatility, the even more exotic credit derivative volatility plays will explode against those who shorted the vol. Given that it is very likely that those short the vol include numerous hedge funds who have highly leveraged themselves to compete for the crumbs and the leverage is supplied by the investment banks, we have an extremely flammable LTCM times a very large number situation currently unfolding]
- Fitch Ratings-New York-01 December 2006: Fitch has taken rating actions on the following Ameriquest Mortgage Securities Inc. home equity issues: AMSI, series 2002-C --Class M2 downgraded to 'CC/DR4' from 'B'. AMSI, series 2003-6 --Class M5 rated 'BBB' is placed on Rating Watch Negative; --Class M6 rated 'BBB-' is placed on Rating Watch Negative. **In AMSI series 2002-C, class M2 is downgraded due to monthly losses which have generally exceeded excess spread and caused deterioration in the overcollateralization (OC) amount.** As of the November 2006 distribution, the OC amount of \$2,122,961.06 is below the target amount of \$6,500,000. As of the cut-off date, the collateral for series 2002-C had a weighted average original loan-to-value (OLTV) of 78.10%, and consists primarily of loans for the purpose of refinance. The balance of collateral in states which have averaged annual home price appreciation below the national average has increased from 36% of current balance at origination to 62% of current balance in November. **In AMSI series 2003-6, classes M5 and M6 (approximately \$36.49 million outstanding in aggregate) are placed on Rating Watch Negative due to monthly losses exceeding the available excess spread in recent months, which has caused deterioration in the overcollateralization (OC)**

amount. As of the November 2006 distribution, the OC amount of \$6,978,833 is below the target amount of \$8,902,438. As of the cut-off date, the collateral for series 2003-6 had a weighted average original loan-to-value (OLTV) of 79.32%, and all of the loans from the trust were for the purpose of refinance. The balance of collateral in states which have averaged annual home price appreciation below the national average has increased from 35% of current balance at origination to 57% of current balance in November. The underlying collateral consists of fully amortizing 15 to 30 year fixed and adjustable rate mortgages secured by first liens extended to subprime borrowers. As of the November distribution date, the transactions listed above are seasoned from 48 (2002-C) to 42 (2003-6) months. The pool factors (current principal balance as a percentage of original) range approximately from 9% (2002-C) to 17% (2003-6). The Ameriquest Securities (AMSI) loans, the retail sector for the Ameriquest Mortgage Securities Inc., were either originated or acquired by Ameriquest Mortgage Company. Ameriquest Mortgage Company serves as the servicer for the loans and is rated 'RPS2+' by Fitch. [for those who subscribe to Grant's Interest Rate Observer, this is the issue he raises with respect to the Moody's "review for possible downgrade" of the Fremont offerings]
http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?print=1&pr_id=327514

Macro Economic

- **November ended with a volley of unfriendly data for the U.S. economy**, and it looks as if December is starting out the same way. Weakness in U.S. economic reports released on Dec. 1 concerning the Institute for Supply Management's factory sentiment index, and construction spending—**following the weak releases on durable goods orders, the Chicago purchasing managers' sentiment index, and initial jobless claims earlier in the week—have taken a big chunk out of the near-term U.S. GDP outlook.** But the reports probably won't move the Federal Reserve from its current policy path. The culprit in all this seems to be the housing sector. The reports suggest that we are finally seeing some "pass through" of housing weakness to other sectors of the economy, and the factory sector in particular. This partly reverses what has been, up until now, a surprising containment of weakness in the single-family segment of the residential construction market. [proper wording would be failure to acknowledge weakness in] **The Economy's Gloomy December Start 12/1**
http://www.businessweek.com/investor/content/dec2006/pi20061201_134976.htm?chan=top+news_top+news+index_businessweek+exclusives
- Dec. 1 (Bloomberg) -- Manufacturing in the U.S. unexpectedly shrank last month for the first time in more than three years, exacerbating a housing-led economic slowdown. The Institute for Supply Management's factory index fell to 49.5, from 51.2 in the prior month. A reading below 50 signals contraction in an industry that accounts for 12 percent of gross domestic product. Construction spending dropped by the most in five years in October, sliding 1 percent, the Commerce Department said in Washington today. **U.S. Economy: Manufacturing Unexpectedly Contracts (Update3) By Courtney Schlisserman**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ajS2nPBOTDno&refer=home>

- At \$800 billion, the world has never seen anything like it. Normally, it would mean an increase in U.S. net debt, with which would come an obligation to pay interest. This year's deficit equals 7% of GDP. Ten years at this rate would put the accumulated debt at 70% of GDP. At 5% interest, this would mean that the United States was paying out 3.5% of its GDP in interest to foreigners - an amount equal to all its GDP growth, and then some...forever. **[I'm not sure this analysis makes sense, but included it for context.]** Not good. But don't worry; the system will blow up long before that happens. Team Deutsche Bank figures there must be a reason it hasn't blown up already; their analysts come to the conclusion that the system is not unstable at all. Maybe it will never blow up! What the researchers think they see is a "new global imperial cycle." It is based, they say, on low-cost Asian labor, superior management and skills of U.S. companies, different rates of return from United States vs. foreign investments, high profits in the financial sector, high leverage, and the profit that the United States makes from issuing its own currency to the rest of the world. All of these factors, they say, give the United States an advantage that doesn't show up in the world's flow of funds statistics. It is a kind of 'dark matter,' they seem to be saying. But it is so dark we cannot see it at all. **Every one of the factors listed above could be taken as a negative as much as a positive. Low cost Asian labor allows American companies to cut labor costs...and increases their profits. But what happens to the displaced American laborers? How will they afford to buy the imported products, unless by going into debt (and thereby creating more profits in the financial sector)? When they finally realize what is happening to them, shouldn't we expect them to cut back a little? Maybe that is why auto sales are falling. House sales are falling, too. According to the Financial Times, sellers in Las Vegas are so desperate they throw in a free swimming pool and a vacation in Florida when you buy a new house. Cancellation on new house contracts are said to be running as high as 42 percent. And here comes Wal-Mart with the news that its same store sales have just suffered their first decline ever. And at some point won't all that leverage turn out to be not so great after all? Leverage is great when prices are rising. But when prices fall, it magnifies your losses. And then, mightn't foreigners decide to cut back too? Mightn't they get a little weary of so much liquidity provided by the U.S. dollar and decide to hold a little more of their wealth in other brands? Isn't that why the dollar is falling - even while U.S. interest rates are above those of Europe and Japan? Yes...the system is stable. But it is only stable as long as it is stable. All it takes is something to destabilize it - and then the whole thing begins to wobble, and could fall apart. We can't look into the future any better than Deutsche Bank. Looking at the past, we see what they see; the dollar system has been a great success. The easy money it has provided the world has set off a global boom unlike anything in history. But also looking at history, we've never read of a Keynesian boom that didn't end...or a paper-money system that didn't eventually collapse.** 11/29 Commentary from the Daily Reckoning <http://www1.youreletters.com/t/447036/1469639/787079/0/>
- There's a two-ton elephant in the room, and Federal Reserve officials are trying to convince people it's a figment of the market's collective imagination.** The yield curve has inverted to a point where it's putting pretty solid odds on a recession in the next year, but the campaign by officials — which began in early 2005 with Alan Greenspan's "conundrum" speech — to tell people that the yield curve is different this time has been renewed with vigor of late. The difference between the 10-year note and the three-month

Treasury bill has averaged about 0.48 percentage point in November, which, according to an oft-cited study by the New York Fed, puts the **odds on a recession in the next 12 months at about 40%**. Of course, Fed officials are arguing this doesn't matter. **[I believe history will show that the recession began in Q3 or Q4 2006]** Pay No Attention to that Yield Curve Behind the Curtain! 11/29

<http://blogs.wsj.com/marketbeat/2006/11/29/pay-no-attention-to-that-yield-curve-behind-the-curtain/> see also **Bonds Scream Recession**

http://www.thestreet.com/_kirk/markets/marketfeatures/10325315.html

- Nov. 29 (Bloomberg) -- The U.S. economy may head into 2007 in weaker-than-expected shape after reports showed October new-home sales fell for the first time in three months and stockpiles at companies jumped last quarter. House purchases declined 3.2 percent to an annual pace of 1.004 million from a 1.037 million rate in September that was slower than previously reported, the Commerce Department said in Washington. Rising inventories were responsible for an upward revision in economic growth to 2.2 percent last quarter, the department also reported.
<http://www.bloomberg.com/apps/news?pid=20601068&sid=a7smWvXsK5oE&refer=economy>
- Nov. 28 (Bloomberg) -- Orders for U.S.-made durable goods declined last month by the most since July 2000, suggesting a slowing economy is making companies more cautious about spending. Orders for Durable Goods in U.S. Declined 8.3% in October By Joe Richter
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aiTiTd19hOME&refer=home>

Retail

- Dec. 1 (Bloomberg) -- Ford Motor Co.'s U.S. sales fell 9.6 percent last month, unexpectedly putting its total behind both Toyota Motor Corp. and DaimlerChrysler AG. Toyota gained 16 percent, pushing U.S. automakers' market share to a record low. Ford, traditionally No. 2 in U.S. sales, was fourth in November. The decline prompted Ford to again cut its production forecast. DaimlerChrysler recorded a 4.7 percent increase and General Motors Corp. said U.S. sales rose 5.8 percent. "The world is changing," said David Cole, chairman of the Center for Automotive Research in Ann Arbor, Michigan. "Is it big news that Ford dropped to fourth last month? Yes." Ford has reported monthly sales gains only three times this year, and analysts had expected an increase last month due to weak sales a year earlier. November's results probably ensured Ford's 11th consecutive annual decline in U.S. market share. **Ford's U.S. Sales Unexpectedly Fall; Toyota Gains By Bill Koenig and Alan Ohnsman**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a.a0YE7a.N1k&refer=home>
- Ford was forced to pawn the family jewels yesterday **for the first time in its 104-year** history as the troubled carmaker sought to borrow \$18 billion (£9.3 billion), using its factories, cash in the bank and other assets as security. Mounting pressures from dwindling sales and profits, increased competition from Asia, a weakening dollar and an ever-deteriorating credit rating have combined to force Ford into using its prized assets to borrow money. 11/28 **Struggling Ford puts up assets as it seeks to borrow \$18bn**

JAMES DORAN, NEW YORK <http://business.timesonline.co.uk/article/0,,9067-2475012,00.html>

- Nov. 25 (Bloomberg) -- Wal-Mart Stores Inc., the world's largest retailer, said November sales at U.S. stores open at least a year fell 0.1 percent, **the worst performance in more than a decade** as the holiday selling season got under way. Wal-Mart marked down toys, electronics, appliances and groceries while cutting prices on generic drugs in 38 U.S. states. Chief Executive Officer H. Lee Scott told analysts **in October he expected sales to improve** as holiday merchandise went on sale and gasoline prices fell. Wal-Mart had forecast unchanged same-store sales for November. Wal-Mart's sales are slumping as retailers enter a quarter that accounts for almost one-third of annual profits. Wal-Mart's attempt to spur holiday demand with lower prices may be risky, said money manager Walter Todd. **“That could really be disastrous for them, because if the sales don't come through, they're really going to get creamed,”** said Todd, who helps manage \$850 million at Greenwood Capital in Greenwood, South Carolina. The retailer began its holiday promotions Oct. 18 by cutting prices on 100 toys. The company will give final sales figures Nov. 30, when most U.S. retailers report November results. **Wal-Mart Same-Store Sales Fall First Time in 10 Years (Update2)**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aNBbsjHQOZc8&refer=home>

Risk

- Dec. 1 (Bloomberg) -- Bank of America Corp. Chief Financial Officer Alvaro de Molina resigned from the nation's second- biggest bank after 17 years, saying he'll look for another job partly because the regulatory constraints of the Sarbanes-Oxley Act made his duties “a little less fun.” De Molina, 49, will be replaced by Joe Price, a risk-management executive with the company's corporate and investment bank, Charlotte, North Carolina-based Bank of America said in a statement today. Price, 45, **will be the third CFO at the bank in 16 months.** **“I like taking risks** and you don't want a CFO who's a risk taker” in this regulatory environment, de Molina said in an interview. **“Between Sarbanes-Oxley and other regulatory stuff, it makes it a little less fun.** That's one aspect of my decision.” Henry Higdon, an executive recruiter in New York, said de Molina could “join some sort of a hedge fund investing globally in financial services institutions.” **By Will Edwards Bank of America Finance Chief De Molina Resigns [a CFO who quits because it's no fun not to take risks – I couldn't make up stuff this strange. Fortunately there is always investing other people's money for “fun” risk taking]**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aLTk5T2hQU6Y&refer=home>
- Reality is a delicate fabric. “You can't handle the truth” was a famous Jack Nicholson courtroom one-liner, suggesting that even in the face of hard facts, people resort to self-deception in order to protect treasured illusions. How else to explain a recent poll by CNN that 54% of the respondents believed that OJ did not murder his wife and Ron Goldman? **Risk assets ranging from private equity all the way down to two-year Treasury Notes have been repriced in recent months/years under the assumption that future economic and financial asset price volatility will be fractions of historical**

levels. Globalization, the “great moderation,” central bank transparency, and financial innovation leading to the hedging and therefore the smoothing of risk are all cited as explanations for why current and future risk spreads should remain compressed. It is not hard to accept these apparent realities; in fact, I’m somewhat of a believer myself. But I write today not to expound on the cyclical economic outlook nor to unnecessarily repeat observations of prior *Investment Outlooks* conceding that risk spreads are compressed and potential alpha generation likely “anemic.” Most of us would agree with that reality – subject as with OJ to inevitable illusions to the contrary. **What I would like to speak to now is the current pricing (overpricing) of certain risk assets.** Because the bond market is more mathematically oriented than riskier asset markets, it stands to reason that a quest for certainty and reality in financial markets would begin there. Fed Funds at 1%, JGBs at .35%, and ?. Where is the present day counterpart where one could claim that prices could go no higher or risk spreads compress no further? a rather obvious 25 or 35 basis points to 0 analogy could quickly be advanced here, a finer, more precise analysis emanates from the quantitative dissection of a new derivative credit product retailed to institutional buyers under the sticker known as a CPDO or “constant proportion debt obligation.” Without too much explanation, these multibillion-dollar instruments lever investment grade indices up to 15 times the amount invested and offer or have offered a spread of 200 basis points over LIBOR with a AAA rating. Hard to pass up I suppose, recognizing that AAA securities are by definition blue chip with rare, only infinitesimally small annual default rates. But this AAA rating is subject to numerous (more numerous than usual) subjective assumptions on the part of the rating services and in turn vulnerable to quicker downgrades than your normal AAA GE credit rating (there GE, I’ve paid you back.) My purpose in bringing up the CPDO, however is not to denigrate the rating sources or to praise GE, but to state that under PIMCO quantitative modeling, current investment grade CDX spreads, shown in Chart 1, can only narrow by 3 or 4 more basis points before these CPDO instruments can no longer earn a AAA rating or offer such an attractive 200 basis point spread. **More importantly, increasing multiples of leverage beyond 15x near current yields spreads cannot maintain either a AAA rating and/or the 200 basis points in yield spread that have made this derivative so attractive and in turn helped to reinforce a declining trend in all credit spreads over the past few months. The increasing use of leverage, in other words, at least as applied to this particular area, appears to have run out of its magical ability to increase returns.** Investment grade corporate spreads therefore are not likely to narrow further **Investment Outlook December 2006 Bill Gross**

<http://www.pimco.com/LeftNav/Featured+Market+Commentary/IO/2006/IO+December+2006.htm>

Retirement

- An estimated \$12-18 trillion will shift to a new generation in the next two decades as boomers move from asset accumulation to retirement as reported in the Journal of Accountancy Oct 2006 p. 19
- 41% of small business owners are not on track to save for a comfortable retirement as reported in the Journal of Accountancy Sept 2006 p. 13
- 37% of adults 66-70 were still working with financial need being the top reason for working as reported in the Journal of Accountancy Sept 2006 p. 15

- A McKinsey asked 1000 adults 45 or older, with assets worth 250K to 2MM, “what is your overall impression of the ability of the following institutions to address your household needs for retirement-related products and advice?” The responses for the top three investment companies – 55% negative 5% neutral; top five brokerage firms - 56% negative 16% neutral; top five life insurers – 67% negative 9% neutral; top five banks – 74% negative 8% neutral. [I think those polled were overly optimistic ☺] as reported in the Journal of Accountancy June 2006 p. 15
- **How aging will reduce global wealth:** The world's population is aging, and as it gets even grayer, bank balances will stop growing and living standards, which have improved steadily since the industrial revolution, could stagnate. The reason is that the populations of Japan, the United States, and Western Europe, where the vast majority of the world's wealth is created and held, are aging rapidly (Exhibit 1). During the next two decades, the median age in Italy will rise to 51, from 42, and in Japan to 50, from 43. **Since people save less after they retire and younger generations in their prime earning years are less frugal than their elders were, savings rates are set to fall dramatically.** Web exclusive, March 2005 http://www.mckinseyquarterly.com/article_page.aspx?ar=1588
- In much of the world, retiring is riskier than it's been since the modern welfare state began to emerge, in the late 19th century. Over the past two decades, the level of retirement-related risk has increased as employers shifted from defined-benefit to defined-contribution retirement plans, life expectancies increased, and health care costs rose. Now, looming public-pension crises mean that many people must plan for retirement without knowing how much support the state will provide. [I disagree with the idea that any large institution is the answer, however, this article does discuss interesting issues] Since innovative, risk-mitigating products are highly replicable, strong advisory services and distribution capabilities will become increasingly important competitive differentiators. **Most advisers today, whether independent or affiliated with a provider of financial products, have greater experience selling the latest hit mutual fund than asking clients how much income they will need in retirement.** Successful advisers will change that approach—becoming more sophisticated and specialized while keeping things simple. Too many of the financial-planning models that advisers use to develop strategies for clients are still rooted in an accumulation-oriented framework. These advisers will need better tools for discussing the issues most important to retirees: tax-efficient income management, longevity risks, and catastrophic health risks. **A few emerging leaders are starting to embrace a more income-oriented planning model that also helps clients plan for risks such as health care costs, inflation, longevity, and market downturns.** We expect such tools to be just the first in a series of planning advances. Despite better planning tools, the magnitude and complexity of present and future retirement risks make many people—even affluent ones—extremely anxious (Exhibit 3). Increasingly, they want their financial advisers to understand their industry, company benefits package, and specific financial situation. As a result, a number of the next-generation advisers we interviewed specialize: one serves airline pilots, for example, while another serves clients at just a single oil company. **Taking the risk out of retirement June 2005**
http://www.mckinseyquarterly.com/article_page.aspx?ar=1607&L2=10&L3=52

Savings Rate

Tech

Wall Street

- 84% of financial forecasts were less than 95% accurate. Global Planning Survey by Cartesis (www.cartesis.com) as reported in the Journal of Accountancy Sept 2006 p. 13
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Article of the week:

LITTLE BIG BUBBLES

by Bill Bonner

On November 27th, a story appeared in the Financial Times telling readers that rich investors were having to resort to 'underhanded' means and special favors in order to get into the best hedge funds.

Somewhere in the dark mush of our own brain came a flicker of light...and the ringing of a bell. We recalled how hard it was to get in on the Initial Public Offers of the late '90s. All a fellow had to do was to put together a plausible dot.com story and take it to the financial wizards of Wall Street or the City. A few months later, actual shares of this hypothetical business would hit the streets. And since managers found it convenient for the shares to rise quickly following their release, they were normally priced at a level where they were bound to go up, even though they were already selling for far more than they were worth. This meant that getting in on the early stages of the IPO was almost guaranteed money-in-the-bank. And it is why Barbara Streisand, to cite a famous example, would send tickets to her shows to IPO managers, hoping for more than a round of applause.

Of course, the dot.coms blew up in January 2000...and investment bankers stopped getting the free tickets. Now, they're going to hedge fund managers.

But the average fund has not been doing well; so far in 2006 you could have done better by accident than by hedge fund. The typical fund is up only about 7%. The FTSE has risen 9% and the Dow is up 15%. This seems only to have made investors desperate to get into the tiny group of funds that are doing well.

Well-established and top performing funds are often 'closed.' They already have plenty of money. And smart managers know that they cannot accept more without degrading their returns. When too much money chases a limited number of good investment ideas, investments regress to the mean. Still, "people are quite flabbergasted, especially very wealthy people, when you send their money back," said the FT source.

Last week, another bit of news reached us: the derivatives market, in which hedge funds tend to speculate, has reached a face value of \$480 trillion...30 times the size of the U.S. economy...and 12 times the size of the entire world economy. Trading in derivatives has become not merely a huge boom or even a large bubble - but the mother of a whole tribe of bubbles...dripping little big bubbles throughout the entire financial sector.

And now our friend Simon Nixon reports that the hedge fund industry is transforming the "social geography of Britain. Fortunes have been created on

a scale and in a timeframe that we have not witnessed for 100 years, if ever before. According to the Daily Telegraph, the average age of buyers of old rectories - those quaint country houses favored by the new-moneyed classes - in Britain has fallen by ten years to people in their early 30s."

Societies go through major trends and minor ones; small fads and big ones; cute little peccadilloes and major public spectacles. Before the Renaissance, societies were besotted with religion - a passion that burned itself out in the crusades, the wars of religion, and the inquisition. Then, they took up politics - and became so wrapped up in 'isms' that, by the 20th century, they were killing each other at the fastest pace in history. More than 100 million people died in the 20th century - victims of bolshevism, national socialism, communism, nationalism or some other excess of political enthusiasm.

And now it is finance that has the world's attention. China says it is a 'communist' country. But it seems not to care. Nor does anyone else care what the Chinese call themselves. The only thing anyone seems to care about is that China is open for business. They could throw vestal virgins into Vesuvius or tear the beating hearts out of their enemies so long as their economy grew at 10% per year. The Chinese are the envy of the entire world. Politics has yielded to money.

The fashion for politics peaked out in the United States during the Kennedy Administration. Kennedy's inaugural remarks - 'ask not what your country can do for you...ask what you can do for your country' - marked the all-time high. That was before the war in Vietnam came a cropper, and before the war on poverty and the war on drugs were launched. People believed in those wars and were sorely disappointed when victories weren't forthcoming. Now of course, we have a war on terror...but few people talk about it at all...and no thinking-person mentions it without an ironic smirk. In fact, the war on terror is hardly a political war at all - but a campaign designed to protect the flanks of the great financial empire. If it were discovered that it diminished consumer spending or raised mortgage rates, for example, it would be stopped tomorrow.

Now, it is money that counts. And mommas now want their babies to grow up to be hedge fund managers. They know where the money is. There's no money in religion - unless you're a TV evangelist...and those slots are hard to get. Besides, they are more business than religion, anyway. A good politician, meanwhile, even if he is slick, can only skim off a certain amount without getting caught with his pants down. The Clintons, for example, were only able to pull off a shady land deal...and operate a penny-ante cattle-trading account - besides the book contracts, of course. It might have been serious money, but it took a whole career of sordid dissembling to pull it off. The Bushes have done better, but it has taken them a couple of generations and a few CIA contracts. And in any case, it is nothing compared to the kind of loot a hedge fund manager takes in while he is still young enough to enjoy it.

In this late, degenerate imperial age, no one gets richer faster than hedge fund managers. Last year, Edward Lampert, of ESL Investments (a hedge fund business), set the pace with \$1.02 billion in compensation. Compared to him, James Simons of Renaissance Technologies Corp. must have felt like a charity case, with only a bit more than \$600 million in take-home. But he still did better than Bruce Kovner, at Caxton Associates, who earned \$550 million.

The New York Times provides a list: Steven Cohen of SAC Capital Advisors, \$450 million; David Tepper of Appaloosa Management, \$420 million; George Soros of Soros Fund Management, \$305 million (Soros was number one in 2003, with \$750 million); Paul Tudor Jones II of Tudor Investment Corp., \$300 million; Kenneth Griffin of Citadel Investment Group, \$240 million; Raymond Dalio of Bridgewater Associates, \$225 million; and Israel Englander of Millennium Partners, \$205 million. Poor Richard Fuld; the man earned only a paltry \$35,257,099 for his work running Lehman Brothers. And E. Stanley O'Neal, at Merrill Lynch got even less: a miserly \$32,134,673.

We do not report those figures out of jealousy, but simply puzzlement and amusement. **Every penny had to come from somewhere. And every penny had to come from clients' money.** Investors in leading hedge funds must be among the richest, smartest people in the world. Still, with no gun to their heads, they turned over billions of dollars' worth of earnings to slick hedge fund promoters.

What do you need to do to get that kind of work? Well, it helps to be good with complicated math. Then, you can join other hedge fund managers who trade derivative contracts that the clients cannot understand, such as the recently launched CPDO, the Constant Proportion Debt Obligation. According to Grant's Interest Rate Observer, the CPDO may be an innovation, but it is hardly a new idea. It is remarkably similar to the CPPI, or Constant Proportion Portfolio Insurance, which made its debut 20 years earlier.

The CPDO is meant to protect investors against the risk of investment-grade credit defaults. CPPI was meant to protect investors from a stock market crash, using a complex formula that clients also couldn't quite understand. Then in 1987, only about a year after the CPPI was introduced, the stock market crashed and investors finally figured out how they worked. Sifting through the debris, analysts determined that CPPI had not protected investors; instead its fancy programmed trading features actually magnified the losses.

We don't know how the CPDO will hold up under pressure, but we can barely wait to find out. Whenever the higher math and the greater greed come together, there are bound to be thrills.

The twitty quants at big investment firms invent the complex derivative contracts...give them a jolt of juice...and then the abominations spring to life. **The next thing you know, the hedge fund whizzes are building big houses in Greenwich, Connecticut - and there are billions of dollars...no trillions...in CPDO and other contracts, in the hands of buyers who don't quite understand the elaborate equations behind the contract...and (here we are just guessing) who will be surprised when they find out.**

If you are good with figures, you can at least partially protect your own investments. But it usually means taking a position on the opposite side of the great weight of investment capital. You can also find ways to make more money than your slower-moving peers, again, by doing things a bit differently. **But neither financial wizardry...nor any complex instrument...can protect a whole market.** The whole market can't protect itself from itself. The more people climb onto an investment platform - whether it is derivatives, dot.coms, dollars or dirigibles - the more it creaks and cracks, and the more damage it does when it finally gives way.

But buyers of CME (the Chicago Mercantile Exchange) don't seem to notice. Google, the newest, hottest technology stock of late 2006, trades at a forward P/E of 36...CME trades at an astounding 51. CME is where futures and derivatives trade. The stock came out three years ago at \$39. Since then it's gone up 14 times, to more than \$550. In New York, meanwhile, the NYSE gets half its daily volume from hedge fund trading. Its stock too, has been on a roll, now trading at 10 times sales, 119 times trailing earnings, and 46 times forward earnings.

If you want to profit from hedge funds, the best way is to become a hedge fund manager. Or, if you want really want to get into hedge funds, but wish to retain your dignity, you could consider investing in a hedge fund company. At least two hedge fund companies have sold shares to the public on the London market.

But hedge funds are supposed to be able to produce superior returns for both investors and managers. If they could do so, why would they wish to trade their shares for cash? What will they do with the money; invest it in someone else's hedge fund? **But with returns falling...and customers beginning to ask questions...more hedge fund impresarios are likely to want to get out while the getting is good.** As the funds become less profitable, in other words, more will probably be sold to strangers who don't know any better.

And then, someday - perhaps someday soon - a peak in the credit cycle will come. The mother of all bubbles will finally pop and then the 'little big bubbles' in the financial industry will pop. The Dow will come down - the dollar too. Junk bonds will sink. Builders in Greenwich will notice that their phones aren't ringing as often. NYX and CME will crash. And 5,000 hedge fund managers will be on the streets...looking for the next big thing. When will it happen? How? We don't know. **But our guess is that when the history of this bubble cycle is finally written, derivatives will get a special 'tipping point' place...like the Hindenburg in the history of the Zeppelin business...or the Little Big Horn in the life of George Armstrong Custer.**

Bill Bonner
The Daily Reckoning

Editor's Note: Bill Bonner is the founder and editor of The Daily Reckoning. He is also the author, with Addison Wiggin, of The Wall Street Journal best seller Financial Reckoning Day: Surviving the Soft Depression of the 21st Century (John Wiley & Sons).

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