

## February 17, 2007 Review

### Summary

From the Schwab nightly summary on Feb 15:

The Dow Jones Industrials closed at another record high as traders looked past several weak economic reports and focused instead on comments from Fed Chairman Ben Bernanke that moderate growth and a slowly diminishing rate of inflation will likely keep interest rates in check.

In other words “investors” ignored reality and placed their hope in projections. This applies very much to the market as a whole and many sectors and individual stocks I follow. Were we coming off bear market lows there might be some argument such a strategy made sense. Given that the Feb 15 VIX once again dipped near single digits and the equity put call dropped near .5 in with the Dow “at an all time high” (if you haven’t heard this repeatedly for weeks, you must religiously avoid mass media), the “buy the hope” is a pretty high risk “strategy”.

We will see . . .

### Credit

#### Commercial Real Estate

- Feb. 12 (Bloomberg) -- Deutsche Bank Private Wealth Management and MFS Investment Management are dumping shares of U.S. real-estate investment trusts just as Blackstone Group LP pays the most ever for a property owner. **Shares of U.S. REITs are the most expensive in more than two decades compared with Treasury notes after the five-year property boom.** Real estate stocks have led the Standard & Poor's 500 Index higher this year on speculation takeovers will increase after Blackstone agreed to buy Sam Zell's Equity Office Properties Trust for \$39 billion in the biggest-ever leveraged buyout. **“Sam Zell is probably the shrewdest operator in this field that there is,” said David Dreman, who oversees \$21 billion at Dreman Value Management LLC in Jersey City, New Jersey. “If he's selling, I don't think I want to be a buyer.”** Institutional investors with \$11.9 trillion in assets have been net sellers of REITs since November, according to the brokerage arm of Boston-based State Street Corp. Shareholders sold as dividend yields on the trusts tumbled below those of government debt. The average yield of U.S. REITs tracked by the National Association of Real Estate Investment Trusts, or NAREIT, fell to 3.78 percent at the end of January. That was 1.03 percentage point less than the 10-year Treasury note, the biggest discount since 1985, according to data compiled by Bloomberg. New York Skyscrapers Real estate investment trusts are companies that develop and own everything from warehouses in California to skyscrapers in New York. President Dwight D. Eisenhower signed tax legislation allowing for their creation in 1960. Currently, 19 countries have REIT legislation in place. Property trusts in the U.S. can avoid paying corporate taxes when they distribute at

least 90 percent of their net income as dividends. Because of their bond-like incomes, some investors consider REITs and bonds to be competing investments. Property trusts, whose yields move inversely to their prices, also offer the potential for capital gains, like stocks. Returns in the almost \$500 billion U.S. REIT market quadrupled since 2000 amid the global property boom. `Rich-Looking' U.S. REITs tracked by the Leuthold Group last month traded at an average of 18.8 times adjusted funds from operations. **That's the highest since at least 1997 and almost 50 percent more than the average for the past decade**, according to the Minneapolis-based research and investment firm, which counts two-thirds of the 100 largest U.S. money managers as clients. `Shocked' Benjamin Pace, who oversees \$17 billion as chief investment officer at Deutsche Bank Private Wealth Management in New York, said he's been ``shocked" by the run-up in REIT shares. **``You can't help but feel that the sector is overvalued here," he said, adding the firm sold some of its REIT holdings in December after having an ``aggressive weighting" in 2006.** The last time REIT dividend yields fell as far below Treasury yields was during the seven years that started in November 1978. Bond yields soared as Federal Reserve Chairman Paul Volcker increased the central bank's target interest rate to 20 percent in 1980 to combat soaring inflation. **``One is hard pressed today to say that the REITs are a good value," said Preston Athey, who runs the \$6.27 billion T. Rowe Price Small-Cap Value Fund in Baltimore. ``I'm becoming increasingly underweight."** He said the fund's REIT holdings were about half his benchmark, the Russell 2000 Value Index. New York-based Blackstone upped the ante twice, raising its offer by 8.3 percent, to beat Vornado Realty Trust, the second-largest property trust by market value and also located in New York. Blackstone, which first bid \$36 billion in November, will pay 33.8 times Equity Office's funds from operations, or adjusted net income investors use to determine earnings, in the takeover. Jeffrey Tyler at American Century Investments said the REIT boom provides more reason to sell, especially because private-equity firms are competing to buy. ``It's not a cheap way to get involved in the real estate market," said Tyler, head of asset-allocation funds at American Century, the Kansas City, Missouri-based money manager with \$104 billion in assets. Tyler sold about 40 percent of his REIT holdings in May. ``All the private-equity money to me is somewhat of a last gasp" for the REIT rally, he said. ``If they want them that badly and if you're involved in that market, you're supposed to say, `By all means, have mine.'" **MFS, Deutsche Bank Dump REIT Shares Amid Record Blackstone LBO**

## Commodities

- “Although you can't trade water futures, investors can indeed invest in a basket of water companies. I've always loved this investment theme because it's easy to understand, given the world's booming long-term demographics, scarcity of water supplies and the urgent need to purify water supplies worldwide. The United Nations estimates that by 2050, more than two billion people in 48 countries will be short of water. Global governments are now struggling to bring water to four billion people who live in areas of profound shortages. **According to the World Water Council in Marseilles, France, approximately \$180 billion dollars per annum needs to be invested in water infrastructure in developing countries such as China and India - roughly double the sum currently committed.** As the Developing World becomes richer, it consumes more

food, especially meat and the grains. To produce one ton of meat takes six tons of corn, and to produce six tons of corn requires 6,000 gallons of water. You get the picture. China, for example, is home to 20% of the world's total population; but only 7% of the globe's fresh water supply is available directly in China. An even more amazing statistic is the fact that only 1% of the world's total water supply is actually drinkable! Imagine the infrastructure required for daily consumption around the world and your eyes start to roll. There's no doubt about it - water is a legitimate, long-term investment theme. **The water industry generates a significant \$450 billion dollars in revenue each year, trailing only electricity and oil.** That's a big number. But in the absence of a water futures market, the next best strategy is to buy a well-managed portfolio of companies that treat, service, distribute and monitor this precious commodity. The real deal here is about the bull market in water utilities. I'm very bullish about this secular trend and strongly believe every investor should have some exposure to this exciting theme. While oil might be replaced as a source of energy one day, it's pretty hard to imagine a world without water.” **Wading In** By Eric Roseman Editor, *Global Mutual Fund Investor* <http://www.agorafinancial.com/RudeAwakening/index.html>

- “I crashed Jim Roger's speech yesterday at Federation Square to ask him what he thought about GE's \$1 billion investment in French water operator Ixex Aquaservices. Ixex treats water for industrial use. GE sees lots of opportunity in water infrastructure globally. Why ask Jim Rogers? Because he's here in Melbourne and he's also a fan of T. Boone Pickens, who himself has lately said that water is the next oil...and that he plans to make \$1 billion by investing in water rights. (He actually said that.) When Rogers finished his remarks, the room was silent. So I hitched up my belt, strode to the microphone and asked, "Jim, you're bullish on commodities. But what about water? The world needs it as much, if not more than oil. Yet no one can really produce water the way you can mine gold. What are your thoughts on water as an investment opportunity?" His answer confirmed what I had suspected. Rogers said water would be one of the huge stories of our time, that whole civilizations have collapsed for lack of water, and that it could happen again. He also said that Singapore--which used to be a hilly swampland--leads the world in water purification and transportation technologies. He even called it the "Silicon Valley of water," in reference to the fabled region in California that's been the hotbed of so much ground-breaking innovation in the information technology sector. Just one more point from Roger's speech: "Water is one of the things that could derail China," he said. It's true. We hadn't thought of it that way before. But aside from what you have in your toilet and shower, the vast majority of water use is industrial and agricultural. Conserving at home makes you feel better. But when you begin to drill down into the story, you realize how much of the food you eat and the products you use on a daily basis (including gasoline) require water as an input. Without it, a lot of economic activity dries up...quickly.” **The "Silicon Valley of Water"** By Dan Denning Editor, *Australian Daily Reckoning* <http://www.agorafinancial.com/RudeAwakening/index.html>

## Currency

- Feb. 17 (Bloomberg) -- The yen had the biggest weekly gain against the dollar since May on speculation Japanese economic growth will prompt the nation's central bank to raise interest rates next week. The yen gained 1.9 percent against the dollar this week and 0.9

percent against the euro after a government report showed Japan's gross domestic product expanded at a 4.8 percent annualized clip last quarter, beating most analysts' forecasts. Investors increased bets the Bank of Japan will lift its 0.25 percent benchmark rate when it meets next week. **Yen Posts Weekly Gain on Speculation BOJ to Lift Interest Rates** [this is important re the carry trade, which is a major source of liquidity] <http://www.bloomberg.com/apps/news?pid=20601087&sid=aONyrSfZ0VPU&refer=home>

## Diversification

## Derivatives

## Housing

- Housing starts slumped 14.3 percent in January 2007 to an annual pace of 1.408 million while building permits declined 2.8 percent from December to a 1.568 million pace. Starts of single-family homes dropped 11.2 percent last month to a 1.108 million rate, the weakest since August 1997, while work on multifamily units contracted by 24.1 percent to an annual rate of 300,000. All four Census regions participated in the month-to-month decline, the largest declines having been posted in the Midwest and West <http://www.nahbmonday.com/houseecon/issues/2007-02-16.html>
- Feb. 15 (Bloomberg) -- Home prices fell in half of U.S. cities in the fourth quarter as a housing slump forced sellers to accept lower prices for their real estate, the National Association of Realtors said. The median price for a single-family home fell in 73 of 149 metropolitan areas studied by the Chicago-based real estate trade group. The national median price for a previously owned house was \$219,300 in the fourth quarter, down 2.7 percent from a year earlier when the median price was \$225,300, the group said in a report today. **Home Prices Fell in Half U.S. Cities in 4th Quarter** <http://www.bloomberg.com/apps/news?pid=20601206&sid=am4MtgGQfjas&refer=realestate>
- Feb. 15 (Bloomberg) -- San Francisco Bay Area home prices dropped to a one-and-a-half-year low last month as the number of houses and condominium units that changed hands fell for the 24th month in a row, DataQuick Information Systems said. The median price paid for a home in Sonoma, Contra Costa, Napa and six other Northern California counties last month dropped to \$640,000, down 2.8 percent from December and 1.5 percent from a year earlier, La Jolla, California-based DataQuick said today in a statement. Last month's median was the lowest since May 2005, when it was \$597,000. The Bay Area's slump in prices and sales mirrors the situation throughout the U.S. Sales of new houses across the U.S. will fall until the fourth quarter as an oversupply of properties saps demand, the National Association of Realtors said last week. **San Francisco Bay Area Home Prices Decline to 18-Month Low** <http://www.bloomberg.com/apps/news?pid=20601206&sid=akV1f5uoddzE&refer=realestate>

## PMI's Winter 2007 Risk Index Reflects Slowing Housing Market

WALNUT CREEK, Calif., Jan. 24 /PRNewswire-FirstCall/ -- Continued deceleration in home price appreciation and decreased affordability caused the risk of home price declines to rise in cities across the country, PMI Mortgage Insurance Co., the U.S. subsidiary of The PMI Group, Inc. (NYSE: PMI) reported today. Economic fundamentals remain strong in most areas, however, with historically low unemployment rates and strong job growth, which helps mitigate the risk of price declines.

"Years of rapid appreciation have made homes less affordable in many areas, and that's not sustainable over the long term, so what we are seeing is not unexpected," said Mark F. Milner, Chief Risk Officer of PMI Mortgage Insurance Co. "Over time, moderating appreciation will bring prices back in line with economic fundamentals, particularly incomes, bringing the market back to a healthy balance."

PMI U.S. Market Risk Index(SM) scores increased for 34 of the nation's 50 largest metropolitan statistical areas (MSAs), resulting in an increase in the average score from 328 to 342, which translates into a 34.2 percent chance that home prices will decline in two years. Nineteen MSAs face a greater than 50 percent chance that home prices will decline, up from 18 last quarter.

**While year-over-year appreciation remained in the double digits in 14 of the 50 largest MSAs, the rate of appreciation slowed in 43.** Three MSAs-Detroit and neighboring Warren, MI, and Cambridge, MA-saw slight year over year price declines.

**The risk of price declines continues to be concentrated in California and along the Eastern Seaboard. Of the 19 MSAs facing a greater than 50 percent chance of a price decline, eight are located in California, eight are in the Northeast, and two are in Florida.**

In addition to the PMI U.S. Market Risk Index showing the risk of price declines, PMI's Fall 2006 Economic and Real Estate Trends(SM) (ERET) examines major regional trends, as well as statistics commonly used to judge the housing market's current health and future prospects.

In most areas, the risk of price declines continues to be balanced by strong economic fundamentals. With the exception of the upper Midwest, unemployment remains low in most of the country and job growth is positive. Of the top 50 MSAs all but four-Detroit and Warren, MI, Cleveland, OH, and Indianapolis, IN-saw employment growth. New Orleans led the nation in employment growth at 8.37 percent over the past year, followed closely by Las Vegas, NV at 5.38 percent.

A complete copy of the Winter 2007 PMI ERET report and an appendix that provides data for all U.S. MSAs is available at <http://phx.corporate-ir.net/phoenix.zhtml?c=63356&p=irol-publications> .

<http://phx.corporate-ir.net/phoenix.zhtml?c=63356&p=irol-newsArticle&ID=953696&highlight=>

### Housing Finance

- Feb. 13 (Bloomberg) -- ResMae Mortgage Corp., a U.S. home lender to people with bad credit, filed for bankruptcy protection and said Switzerland's Credit Suisse Group agreed to buy most of its assets for \$19.1 million. "The subprime mortgage market has recently been crippled," ResMae said in its Chapter 11 filing yesterday. **The company didn't have enough reserves to cope with an "enormous" surge in loan defaults, it said.** Closely held ResMae is at least the 20th mortgage company to be sold or closed as delinquencies rise and **the market for home loans to risky borrowers' contracts at the fastest pace ever**, according to a Bloomberg tally of company announcements. Credit Suisse rivals Merrill Lynch & Co., Morgan Stanley and Barclays Plc are swooping in,

buying home lenders to produce more revenue from packaging the loans into bonds.

### **ResMae Seeks Bankruptcy; Credit Suisse to Buy Assets (Update2)**

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

- Feb. 12 (Bloomberg) -- Countrywide Financial Corp. and New Century Financial Corp. led shares of mortgage companies down for a third day as rising defaults drove the perceived risk of owning bonds backed by "subprime" loans to a record high. Subprime loans that have gone bad are at the highest level in at least six years, according to a Friedman, Billings, Ramsey Group report. The U.S. Mortgage Bankers Association said payments were late on almost 13 percent of subprime loans in the third quarter of 2006, and Bear Stearns Cos. President Warren Spector predicted last week problems will get still worse this year. **Rising Risks The perceived risk of owning subprime mortgage bonds rose to a record for a third day, as measured by an index of credit- default swaps tied to the bonds.** The ABX index of 20 BBB- rated bonds sold in the second half of 2006 fell to 83.35 from 85.22 on Feb. 9, according to Markit Group Ltd. The level is the lowest since the index was created Jan. 18, and stands 14 percent below the end of its first day of trading, according to data compiled by Markit Group Ltd. An increase in the contracts, used to speculate on a company's ability to repay its debt, indicates deterioration in the perception of credit quality. The contracts have risen 57 percent from \$23,000 on Feb. 7, Phoenix data show. **Mortgage Lenders Fall a Third Day as Defaults Rise (Update2)**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=avExIsN5ZgcE&refer=home>

## **Macro Economic**

- Feb. 17 (Bloomberg) -- Treasuries this week advanced the most since December after reports suggested the economy is slowing and Federal Reserve Chairman Ben S. Bernanke said there were signs inflation is moderating. Drops in new housing construction and industrial production combined with an increase in initial jobless claims led traders to raise bets the Fed will reduce the overnight lending rate between banks in the second half of the year. Bonds had slumped before the central bank chairman's testimony on speculation he would emphasize the risks of inflation. "The news is beginning to turn, the economic data is beginning to show signs of cracks," said Theodore Ake, head of U.S. Treasury trading in New York at Mizuho Securities USA Inc., one of the 21 primary dealers required to participate in Treasury auctions. "The next move is going to be an ease." Housing starts in January fell to an annual rate of 1.408 million, the lowest level since August 1997, from a revised 1.643 million the previous month, the Commerce Department reported yesterday. The median estimate of 75 economists surveyed by Bloomberg News was for a yearly pace of 1.6 million. "There was a general sense that housing had stabilized," said Amitabh Arora, head of U.S. interest-rate strategy in New York at Lehman Brothers Inc., another primary dealer. "This will cause some reassessment of that view." **[not by anyone who was pay attention to the underlying number instead of the homebuilders' hype]** The Labor Department on Feb. 15 reported **the number of Americans filing first-time claims for state unemployment benefits rose to 357,000 last week** from a revised 313,000 the prior week. Output at factories,

utilities and mines unexpectedly fell 0.5 percent last month after rising the same amount the previous month, the Federal Reserve said Feb. 15. **Treasuries Rise Most Since December on Signs Economy Is Slowing**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=a\\_9q0tsF6L5M&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=a_9q0tsF6L5M&refer=home)

- Feb. 15 (Bloomberg) -- Industrial production in the U.S. declined in January by the most in more than a year as companies held off on new orders while continuing to pare excess inventories of autos and construction supplies. Production at factories, mines and utilities fell 0.5 percent last month, following a 0.5 percent December increase, the Federal Reserve said today. Capacity utilization, which measures the proportion of plants in use, dropped to 81.2 percent from 81.8 percent a month earlier. Unsold goods backed up on dealer lots and in warehouses in the second half of last year, prompting companies to rein in production and fill orders from existing stockpiles. Federal Reserve Chairman Ben S. Bernanke told Congress yesterday that excess inventories, particularly at auto dealers, may hold back factory output early this year. "Inventories still look like they're a drag overall on the economy coming into 2007," said Brian Bethune, an economist at Global Insight Inc. in Lexington, Massachusetts. "Manufacturers are going through a process of bringing supplies into line with demand, and it could be that inventories will weigh on growth this quarter." **The drop in industrial output was the biggest since a 1.6 percent decline in September 2005 following Hurricane Katrina.** Manufacturing Declines Manufacturing, which accounts for about four-fifths of the industrial production report, fell 0.7 percent last month after rising 0.8 percent the prior month. Excluding autos, production fell 0.7 percent, following a 0.7 percent rise in December. Economists expected industrial production to be unchanged after an originally reported 0.4 percent increase the prior month, according to the median forecast in a Bloomberg News survey of 81 economists. Estimates ranged from a decrease of 0.7 percent to an increase of 0.5 percent. Capacity utilization was forecast to drop to 81.7 percent, according to the Bloomberg News survey. Projections ranged from 81 percent to 82 percent. **U.S. Factory Output Falls as Companies Cut Stockpiles**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ak7G281ddJBs&refer=home>
- Feb. 13 (Bloomberg) -- The U.S. trade deficit widened to a record for a fifth straight year in 2006 as American purchases of Chinese goods and imported oil overwhelmed an increase in exports. The gap between imports and exports expanded 6.5 percent to \$763.6 billion last year, the Commerce Department said today in Washington. The shortfall increased to \$61.2 billion in December from a month earlier, more than economists forecast. China replaced Mexico as America's second-largest trading partner behind Canada during the year, intensifying complaints from lawmakers that the nation is keeping its currency weak to spur exports. The deficit was also swollen by rising crude oil prices, masking record U.S. shipments abroad. "The big picture is exports are growing, but in '06 imports grew faster, particularly consumer goods from China," said Chris Low, chief economist at FTN Financial in New York. "The crude oil rise was entirely from price increases." For the year, imports increased to an unprecedented \$2.2 trillion from \$1.99 trillion in 2005. Exports rose to a record \$1.44 trillion, from \$1.28 trillion in 2005. **U.S. Economy: Trade Gap Reaches Record on China, Oil (Update1)**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aWroRwDi1RJY&refer=home>

- Feb. 12 (Bloomberg) -- U.S. profits increased at the slowest pace in more than four years last quarter because of a record loss at Ford Motor Co. and earnings declines at Occidental Petroleum Corp. and Pulte Homes Inc. Companies posted a 9.7 percent gain in fourth-quarter profit through Feb. 9, with 75 percent of Standard & Poor's 500 Index members having reported, according to data compiled by Bloomberg. Quarterly profits of the S&P 500 have climbed by at least 10 percent since the third quarter of 2002. "We've had a long streak of double-digit growth, and it looks like we're going to break that," said Alec Young, an equity strategist at Standard & Poor's in New York. The biggest slump in home sales in 15 years battered homebuilders including Pulte, while a drop in fuel prices hurt natural gas producers and refiners such as Occidental and Sunoco Inc. Results in those industries, along with the loss at Ford, the world's third-largest automaker, countered surging profits at financial companies like Goldman Sachs Group Inc., the biggest securities firm, and raw materials producers DuPont Co. and Alcoa Inc., the largest producer of aluminum. Homebuilder Woes Shares of homebuilders and mortgage companies fell last week after Toll Brothers Inc., the largest U.S. builder of luxury homes, said orders had plunged and London-based HSBC Holdings Plc said bad home loans increased in the U.S. **"Despite what people might say in terms of the bottoming in the housing market, if we are at the bottom, we're not going to get off this bottom for at least a year or two,"** Ernie Ankrim, chief investment strategist at Russell Investment Group in Tacoma, Washington, said Feb. 8. Ford's fourth-quarter loss of \$5.76 billion, or \$3.50 a share, dragged average earnings down. Excluding Ford, the companies reporting through Feb. 9 would have posted a gain of 11.4 percent. Dearborn, Michigan-based Ford, the second-biggest U.S. automaker, lost a record \$12.7 billion for the year on a plunge in sales of pickup trucks and sport-utility vehicles. Bloomfield Hills, Michigan-based Pulte, the second-largest U.S. homebuilder by market value, lost \$8.4 million, or 3 cents a share, while Dallas-based Centex Corp., the fourth-largest, lost \$228 million, or \$1.90 a share. Both were profitable a year earlier. Appliances, Electronics The housing slump also hurt Whirlpool Corp., the world's largest appliance maker, and Black & Decker Corp., the biggest U.S. maker of power tools. Both reported lower profits. Earnings of Best Buy Co., the nation's largest electronics retailer, rose 8.7 percent, less than it had forecast, while No. 2 Circuit City Stores Inc. posted an unexpected loss of \$16 million, or 9 cents a share. Financial companies have recorded a 35 percent increase, the second-biggest gain. New York-based Goldman Sachs reported a 93 percent jump, while St. Paul Travelers Cos., the second-biggest U.S. commercial insurer, said profit was almost seven times higher than a year earlier. **Ford, Pulte Reduce U.S. Profit Growth to Slowest in Four Years**

[http://www.bloomberg.com/apps/news?pid=20601109&sid=ate8AR\\_Bbrrhc&refer=home](http://www.bloomberg.com/apps/news?pid=20601109&sid=ate8AR_Bbrrhc&refer=home)

## Retail

- Feb. 16 (Bloomberg) -- Home Depot Inc., which ousted Chief Executive Officer Robert Nardelli last month, next week will probably report the biggest earnings decline in six years after the U.S. housing slump reduced demand for paint and hardware. The largest

home-improvement retailer's profit dropped 15 percent to 51 cents a share from 60 cents in the fourth quarter ended Jan. 28, according to the average estimate of 20 analysts surveyed by Bloomberg. Sales likely increased 6.8 percent to \$20.8 billion, based on the average estimate of 14 analysts. Revenue at Atlanta-based Home Depot and rival Lowe's Cos. slumped in the second half of 2006 as U.S. home sales dropped the most in 15 years. Nardelli's replacement, Frank Blake, reduced discounts and added workers to revive sales. "The fourth quarter is going to be a tough one," said Keith Davis, a Washington-based analyst with Farr Miller & Washington LLC, which owns 250,000 Home Depot shares among the \$540 million it manages. "Spending by homeowners has lessened as housing turnover slows and prices have been going down. It's still a very difficult environment for them." **Home Depot Profit Probably Declined Most in 6 Years**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aZ4j74naVnIA&refer=home>

## Retirement

## Risk

## Savings Rate

## Tech

- Microsoft (MSFT \$29) is weaker after its CEO Steve Ballmer said in a conference call with analysts that some fiscal 2008 sales forecasts for the new Vista operating system may be a bit too high. He said that most sales of Vista will come from PC sales, and sales of the new operating system should not be "out of whack" with projections for PC sales. But he balanced his conservative outlook with remarks that operating expenses for fiscal 2008 should be a little below the rise in 2007.

## Wall Street

- Feb. 15 (Bloomberg) -- Bear Stearns Cos. may be ordered today to pay a failed hedge fund as much as \$180 million in a court ruling that will help determine how aggressively Wall Street firms police their most lucrative trading clients. Burton Lifland, the U.S. judge overseeing the bankruptcy of Manhattan Investment Fund Ltd., will decide whether Bear Stearns must return the money it took as the fund slid toward insolvency. Lifland concluded last month that Bear Stearns, one of the biggest brokers to hedge funds, was trying to cover its own potential losses and didn't investigate thoroughly after learning of possible fraud at Manhattan Investment, court filings show. **Bear Stearns May Have to Repay Failed Hedge Fund \$180 Million**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aLEP4iK3BUdg&refer=home>
- Feb. 12 (Bloomberg) -- Merrill Lynch & Co. Chief Executive Officer Stanley O'Neal was willing to lose \$230 million to catch Bear Stearns Cos. and the shakeout is just beginning. That's because Merrill is determined to capture a dominant share of trading in bonds backed by home loans, the fastest-growing debt market since 1995 and this year's most troubled. **O'Neal's enthusiasm for mortgages to potentially delinquent borrowers**

**coincides with the highest default rate in more than six years, a record contraction in demand for so-called subprime loans and descending bond prices.** Merrill already has bankrolled two home lenders that subsequently failed and purchased a third, First Franklin Financial Corp., for \$1.3 billion, just before HSBC Holdings Plc disclosed that its bad-loan provisions increased 20 percent because of the unraveling U.S. subprime market. "You've got to remember" that New York-based Bear Stearns, the perennial leader in mortgage bonds with only a quarter of Merrill's 56,000 headcount, "got into this business at the height of the boom, when you could not lose," Angelo Mozilo, Countrywide Financial Corp.'s CEO, said in a telephone interview from his office in Calabasas, California. "The real test will come for these new players in how they do in this new cycle," Mozilo said. "A couple may do fine and a couple won't do fine. Just because it's Wall Street and they've got into the origination business doesn't mean they automatically win." [chasing last year's winners??????? Say it ain't so Joe] Fees Tripled New York-based Merrill, the third-largest securities firm by market value, isn't the only challenger to No. 1 Bear Stearns. Deutsche Bank AG, Morgan Stanley and Barclays Plc have bought or agreed to buy subprime lenders in the past six months, **betting** [a very apt word choice, IMO betting on hitting the inside straight on the river] that a bigger presence in mortgages will produce more revenue from packaging the loans into bonds. **Fees from securitizing debts including mortgages, auto loans, aircraft leases and credit-card receivables have almost tripled in the past five years to \$5.6 billion,** Bank of America Corp. analyst Michael Hecht estimates. [What will happen when those securitizations no longer sell?] **Merrill is counting on securitization to dispose of risky mortgages** [see prior comment] and avoid the headaches now plaguing HSBC, the world's third-largest bank. The London-based company on Feb. 7 increased the amount set aside for bad loans in 2006 to almost \$10.6 billion, 20 percent more than analysts' estimated, and shook up management in the U.S. Subprime Time The same day, New Century Financial Corp., the Irvine, California-based rival to HSBC in subprime mortgages, said the market has deteriorated so much that it expects to report a quarterly loss for the first time since 2001. "The best time to get in is when things are horrible," said Anthony Sanders, former director of mortgage-bond research at Deutsche Bank, who now is a finance professor at Ohio State University in Columbus. "If you can get in at a discount and clean up the underwriting, that could be a big moneymaker when the housing market comes back." [If you hit the inside straight you "could" beat your opponents trip aces up. But, does that make it a smart "bet"? The more direct corollary to Mr. Sander's statement is "if you buy low and sell high you will make money"] O'Neal, 55, agreed to buy First Franklin from Cleveland-based National City Corp. in September. Since then, home loans to borrowers with erratic credit records or burgeoning debt burdens have defaulted at a faster rate than during the U.S. recession in 2001, according to Arlington, Virginia-based Friedman Billings Ramsey Group Inc. "We still **have way too much capacity,**" said David Olson, president of Wholesale Access Mortgage Research & Consulting in Columbia, Maryland, and the former director of market research at Freddie Mac, the second-biggest financier of U.S. mortgages. "That **means a lot more firms have to go out of business.**" Eroding Standards At the time, home prices across the U.S. were surging as the growth in adjustable-rate, interest-only and so-called jumbo mortgages, and some of the lowest borrowing costs in 40 years, fueled buying. **Lenders provided \$640 billion in subprime mortgages last year, an**

**increase of almost fivefold from 2000, according to Inside B&C Lending, an industry publication.** With more than 8,500 financial institutions competing for mortgages, many began extending them to borrowers who might not have qualified previously. **``Too many firms got involved in making loans probably motivated in part by fees,``** Federal Reserve Bank of St. Louis President William Poole told reporters after a speech last week. **``They thought they could lay off the credit risk by securitizing and selling these off in the market.``** Goldman's Subprime View **``That's the one area across all businesses in all firms that is actually in a bit of trouble now,``** David Viniar, chief financial officer of New York-based Goldman Sachs Group Inc., the world's largest securities firm, said on a Feb. 8 conference call with investors. **``My view is that that market's going to get worse before it gets better.``** HSBC's troubles stem from its \$15.5 billion purchase in 2003 of Household International Inc., then one of the largest U.S. lenders to consumers with poor credit. Beguiled by the high interest rates on subprime loans, **HSBC erred by keeping many mortgages on its books instead of selling them to investors.** [think about this. It basically says the problem was not making bad loans, it was keeping the bad loans instead of selling the bad loans to others – the greater fool theory illustrated] It also bought up the second-lien loans homebuyers use to gain additional leverage. Being a force in mortgage bonds confers an **``intangible value``** on a securities firm by attracting investors to the other products it offers, said Randy Robertson, a managing director at Wachovia Corp.'s securities unit. **Investment banks can generate additional fees by repackaging the bonds into other securities, such as collateralized debt obligations.** Declining Margins The average pretax profit margin from making and selling a subprime mortgage was 0.25 percent in the first half of 2006 and probably dropped in the last six months of the year, said Jim Cameron, an Atlanta-based partner at Stratmor Group, an industry consultant that runs profitability studies with the Mortgage Bankers Association. Three years ago, the margin was 1.5 percent. **``There's no secret sauce in this business,``** Countrywide's Mozilo said. **``It's a matter of how efficient you are in the securitization process as well as how efficient you are in the origination**

**Merrill Loaded for Bear in Mortgage Market That Humiliated HSBC**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aqTiIkTKqgzo&refer=home>

#### Article of the week:

The Cheap Oil Mirage

The Daily Reckoning - Weekend Edition  
February 10-11, 2007  
Baltimore, Maryland  
by James Howard Kunster

MARKET REVIEW: THE CHEAP OIL MIRAGE

The American public is understandably happy to see the bottom fall out of the oil futures market. But temporary circumstances are only sending them another false signal that everything is perfectly okay on the oil scene. And it only reinforces the foolish belief that when prices go up it is solely because corporate finaglers tweak them up on purpose. In fact, these days it's the other way around: often prices go down because corporate finaglers are tweaking the markets, dumping positions, playing shorts rather than acting like real oil users bidding on real contracts for delivery for real purposes like making gasoline. When oil goes up, as it certainly will again, it is primarily because of geology - what's left in the ground - and secondarily because of geopolitics - where it's left in the ground (and what's happening there).

The supernaturally warm (up until now) winter temperatures have also played a part, keeping inventories high while the home furnaces idle. There is surely some demand destruction in the background. Third World nations are increasingly dropping out of the bidding (meaning their generators quit making electricity and their trucks stop running). And a contracting U.S. economy may also play a part. But even these circumstances may not overcome the supply problems in the real oil world. Here's what's going on:

As a baseline, it helps to understand that the four largest super-giant oil fields of the world are now in decline. They have been responsible for producing 14 percent of the world's oil supply. They are now old and tired (thirty years is old in the oil world) and they are in depletion. These are The Cantarell field of Mexico, the Burgan field of Kuwait, the Daqing field of China, and the granddaddy of them all, the Ghawar field of Saudi Arabia.

The Cantarell field is a horror story. Pemex, the Mexican national oil company, tried to conceal the dire developments, because Cantarell alone is practically the whole Mexican oil industry. But it is now self-evident that Cantarell is crashing, with a 40 percent annual decline rate projected ahead, meaning a couple of years and it's out. Mexico is America's second largest source of oil imports (after No. 1 Canada and before No. 3 Saudi Arabia). When Cantarell crashes, the Mexican oil industry will crash and the United States will be out a major source of imported oil. The United States will also be out of imports that were so conveniently close they could be shipped by pipeline rather than tanker ships. For its part, Mexico will be out of a major source of export hard currency revenue and as its economy crashes will probably become even more politically unstable - meaning more Mexican citizens desperately seeking to get out. Guess where.

Burgan is in decline. The Kuwaitis announced it themselves last year. Daqing has been the major source of China's domestic oil, which is otherwise paltry, meaning Daqing's decline will only make China more desperate for imports. Ghawar remains shrouded in mystery, since Saudi Aramco does not welcome outside audits. But at 50 years old it is well past the mean age of peak production for oil fields and that alone probably tells the story. Beyond that, we know that Ghawar is producing with a (best case) 35 percent "water cut" (and perhaps much higher). They have to pump seawater into the field (a standard practice) to keep the oil coming out under pressure. The trouble is that they are getting this substantial water cut after redeploying their equipment for horizontal drilling - an ominous sign. Saudi Arabia declared last year that it would increase production to 12 million barrels a day by 2009. By close of 2006, it appeared to have trouble producing 9

million, with prospects for a 4 percent annual decline rate in the years just ahead.

Elsewhere, Iran is not only past peak, but its domestic demand is so high that it cannot maintain its export levels. Iraq is on track to Palookaville, despite substantial reserves, and even if, by some miracle, its tired old oil infrastructure survives the war, the United States may lose access to future production for geopolitical reasons that should be obvious.

Venezuela is past peak for conventional liquid crude and hurting badly for technical expertise to work its oil fields since Hugo Chavez purged the state oil company's management. Last year, Venezuela had to import Russian oil to avoid defaulting on contracts. Whatever the true condition of Venezuela's industry, Chavez is not disposed favorably toward the United States - he hosted Iran's president Ahmadinejad last week to signal that both of them were on the same page where the United States was concerned.

The situation in U.S. production is grim. We peaked in 1970. East Texas is near total depletion, with a 99 percent water cut (it produces "oil-stained water"). Prudhoe Bay in Alaska now has a 75 percent water cut. We're on track to produce under 5 million barrels a day in 2007 (down from a 1970 high of about 10 million), and heading relentlessly further down year-on-year. We burn through more than 20 million barrels a day.

Recently, however, the U.S. Senate Committee on Energy and Natural Resources, in an extraordinary session, heard testimony that the nation is in grave danger of a permanent oil crisis. Some of these senators affected to be shocked and surprised. What planet have they been living on? What is the nation getting for the hundreds of million of dollars paid to their staffers? Outgoing Republican chair, Senator Pete Domenici (R-NM), said to the witnesses that "what you told us today is absolutely startling with reference to the future."

Perhaps the most valuable message the committee got came from Dr. Flynt Leverett from the New America Foundation, who said: "...there is no economically plausible scenario for a strategically meaningful reduction in the dependence of the United States and its allies on imported hydrocarbons during the next quarter century."

James Howard Kunstler

## **UM EMBA**

This article does a nice job of discussing the multitude of different markets

### **Introduction**

Many people know something about stock markets but perhaps not as much about other financial markets. For example, did you know that bond market value exceeds stock market value? There are also commodities, currencies, real estate, derivatives, and other markets. Because these markets are highly interconnected, it pays to know more about them all.

Effective market participants are aware of the key categories of financial markets and their interrelationships.

### **It's Not Just a Stock Market!**

Many people equate financial markets with the stock market. Fair enough. After all, the meteoric rise of U.S. stock markets in the late 1990s and its demonstrated potential for quick wealth creation has been etched into the minds of many. However, there is a lot more to financial markets than just stocks. Let's take a look at some of the main 'categories' of financial markets.

### *Size of Capital Markets 2005 (\$ trillions)*

	GDP	Stocks	Debt (Public / Private / Total)	Bank Assets
U.S.	12.5	17.0	5.9 / 17.9 / 23.8	9.3
World	44.4	37.1	23.1 / 35.9 / 59.0	55.7

**Stocks (a.k.a. 'equities')**: As noted above, the stock market is the one that most folks are somewhat aware of. And it's certainly a big market. At the end of 2005, aggregate value of stocks was about \$17 trillion. For those trying to figure out whether the stock market is overvalued or undervalued, one valuation 'yardstick' is a measure of stock market value to GDP. By this yardstick, stocks clock in at  $17.0/12.5 = 1.36$ . The long term average (LTA) here is in the 0.7 - 0.8 range, which suggests what about the overall valuation of equity markets (using this yardstick, anyway)? Note that the same 'valuation metric' for world stocks clocks in at  $37.2/40.9 = 0.91$ .

**Debt (a.k.a. 'bonds,' 'fixed income')**: Which market is bigger, stocks or bonds? Most people are surprised to learn that bonds are the larger market. From the chart above, total value of the debt market at the end of 2005 was \$23.8 trillion compared to \$17 trillion for stocks (40% larger). Debt markets are divided into two categories: public and private. In the U.S., public debt constitutes U.S. Treasury bonds of various duration worth nearly \$6 trillion. Private debt is corporate bonds and other institutional 'paper' amounting to nearly \$18 trillion in the U.S.

**Bank Assets**: Cash deposits and other bank holdings. The U.S. has \$9.3 trillion in bank assets, while the world at large holds \$55.7 trillion in bank assets. With U.S. GDP at \$12.5 trillion and the rest of the world GDP at \$44.4 trillion, note that the ratio of bank assets to GDP is lower in the U.S. than in the world at large.

### **Lesser Known But Very Important Markets**

While the above markets tend to absorb lots of attention, you need to be aware of a few other 'outside' markets.

**Commodities**: Oil, copper, nickel, wheat, soybeans, cattle, lumber, silver, gold. These are all examples of commodities. (If you've ever seen the movie *Trading Places*, Duke & Duke was a commodities brokerage, and Eddie Murphy and Dan Akroyd made their millions by trading orange juice futures). For years, commodities have been an ignored group. Recently, however, they've been attracting attention. Why? Higher prices, of course. Some market sages argue that the world has underinvested in commodity-related capacity for years, which now is putting upward pressure on commodity prices as supplies tighten. Two commodities in particular are worth watching. **Crude oil**, likely needs little introduction due to the increasing prices of energy. Savvy market watchers should also keep an eye on **gold** and other precious metals as a proxy for confidence in monetary and financial systems.

**Currencies**: Every day trillions of dollars worth of currencies change hands. The U.S. dollar (USD), often regarded as the 'world's reserve currency,' trades with the most volume. Two other key reserve currencies that many folks watch are the Euro (€) and the Japanese Yen (¥). One important index that tracks the value of the USD against a 'basket' of major foreign currencies is the DXY. Tracking relative value of currencies can be an important factor in understanding market functioning.

*Derivatives:* By far, derivatives constitute the world's largest financial market. A derivative is a contract or agreement (usually with a specific payoff and time limit) whose value is based on the price movement of a cash instrument. Options, futures, and 'structured products' are key categories of derivatives. Derivatives can be difficult to understand. This is what makes them potentially dangerous, since lack of understanding (and human nature) about the leverage and risks involved can lead to derivative mispricing. Since the notional world value of derivatives was estimated at about \$285 trillion (that's right!) at the end of 2005 (IMF, 2005: 96), the potential for a derivatives-led 'problem' in the markets is certainly possible--see [here](#) also.

## Stock Market Indices

Because stock markets have such a large impact on financial markets and (by extension) the economy at large, you should be aware of some key stock market indices.

*Dow Jones Industrial Average (DJIA, DJI):* The granddaddy of them all, the DJIA was first published in 1896 by Charles Dow. It consists of stock prices of 30 of the largest and most widely held corporations in the U.S. Similar to all indices, a key objective behind the DJIA is to provide information on overall market movement in a summary statistic. Some feel that the way the DJIA is calculated is problematic. Nonetheless, it remains arguably the most widely followed stock market index.

*Standard & Poors 500 (SPX):* The SPX is an index based on the stock prices of 500 large U.S. corporations. Unlike the DJIA, the index is weighted according to market capitalization. This feature, coupled with the larger sample size, leads many to believe that the SPX is a more accurate reflection of broad stock market activity--at least among larger corporations.

*NASDAQ Composite (COMP):* NASDAQ stands for National Association of Securities Dealers Automated Quotations. It is the world's largest electronic stock market. Nearly 3200 companies are listed on the NASDAQ. The COMP is a stock market index based on all of the companies listed on the NASDAQ. Many regard the COMP as the 'tech' index, as many smaller companies and those engaged in newer, potentially high growth industries like to list on the NASDAQ. A defining feature of NASDAQ-listed stocks is that they contain four letters (**Intel** = INTC, **Microsoft** = MSFT). Stocks listed on the New York Stock Exchange and the American Stock Exchange contain one to three letter symbols (**Citigroup** = C, **Procter & Gamble** = PG, **Walmart** = WMT). Many traders often follow a 'subset' NASDAQ index called the NASDAQ-100, (NDX) which consists of only the top 100 NASDAQ listed companies by market cap.

*Russell 2000 (RUT):* The RUT represents an index formed from the stock prices of the bottom two thirds of a 3000 stock market index developed by the Russell Investment Group. Since the top 1000 stocks are removed, it provides a look at aggregate price movements of 'smaller' stocks. As such, it is the most popular index of stocks with a small market capitalization (a.k.a. the 'small caps').

*Global stock market indices:* Some global include the **Nikkei** (Japan), **Hang Seng** (Hong Kong), **FTSE** (England), and **DAX** (Germany). <http://www.minyanville.com/articles/index.php?a=12140>