

February 24, 2007 Review

Summary

Sometime last week I had the sound on Bloomberg TV. As a result of what I am sure was a scheduling error, they had on someone who was not an overt cheerleader. This money manager actually thought it best to avoid US equities, thought the dollar was in for a substantial drop and was investing in foreign utility stocks for the yield. The Bloomberg anchor after hearing this said “well aren’t you concerned that if the dollar drops like you think the yield will get eaten up by the currency conversion?” The manager for a brief moment looked like he might say “aren’t you concerned that you have no idea about what you are talking about?” Instead he said, “Well actually a drop in the dollar would enhance the yield in dollar terms”

Why that story now?

Because this morning the “media” had on any number of “traders” saying it was great the DOW would open down 100 because it would allow intuitional “investors” to get in. This is the type garbage that is cable financial reporting.

What is relevant to all of you is that the events we have been discussing for months are unfolding. In particular, the volatility is exploding, spreads are widening and the market is having a major stress test. We will see shortly how all those short the outliers will cover.

This is the real deal folks. Ignore the televisions reporters and look at your risk in the event of a sustained drop in US equities.

Sorry about the lack of a review this week. It was a U Mich weekend and today’s market move takes precedence over last week's stories.

Credit

Commercial Real Estate

Commodities

Currency

Diversification

Derivatives

Housing

Housing Finance

- The FBI’s *Financial Crimes Report to the Public* states that “the increased reliance by both financial institutions and non-financial institution lenders on third-party brokers has created opportunities for organized [mortgage] fraud groups...” The report identified

mortgage fraud as “persuasive and growing” and noted that combating this type of fraud is a priority. The report found that “**a recent analysis of mortgage industry fraud surveys identified 26 different states as having significant mortgage fraud problems.**” Association of Certified Fraud Examiners

Macro Economic

Retail

- Feb 20 - Fellow Dow component **Home Depot** (HD \$41) recorded a 28% decline in net income to \$925 million and posted EPS, excluding items of \$0.50, \$0.01 shy of the Reuters estimate. And the world's leading home improvement retailer said net sales grew 4% to \$20.3 billion, below the consensus estimate of \$20.8 billion. Home Depot said its retail segment reported a 2.0% drop in net sales to \$17.4 billion, which was offset by higher sales at its HD Supply segment amid an acquisition. The company blamed its poor results on the challenging housing market.

Retirement

Risk

Savings Rate

Tech

Wall Street

- Investor concerns about initial public offerings of private-equity-backed companies heightened after their postflotation share price performance last year trailed new listings of non-buyout-backed businesses by nearly a third. The underperformance could have serious consequences for the mutual fund industry, suffering from a decline in long-term stock market returns, as flotations of private-equity-backed companies form an increasing proportion of the businesses coming to market. Warner Chilcott, the drug-maker floated in September by backers Bain Capital, Thomas H Lee, Credit Suisse and JPMorgan, after less than two years of ownership, is among the most high-profile disappointments of 2006. Its shares declined 2.33 per cent while the S&P 500 index rose by 8.99 per cent. Sealy, floated by Kohlberg, Kravis, Roberts after two years of ownership, and Magellan Midstream, which listed three years after Carlyle bought it, both underperformed the S&P 500 by more than 12 percentage points since listing last year. Investor scepticism is increasing after new research showed that shares from 2006 flotations of companies with private-equity backing rose 20 per cent on average in a buoyant stock market, according to Thomson Financial. That puts them 45 per cent below the average rise notched up by non-buyout-backed counterparts.

http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article1403682.ece

Article of the week:

UM EMBA

I thought this an interesting “marketing in real life” story

- Feb. 20 (Bloomberg) -- Foster's Group Ltd., the world's second-largest winemaker, posted first-half earnings that missed analyst estimates after a new sales strategy in Australia backfired. The shares had their biggest decline in two years. Profit excluding the sale of breweries in Vietnam and India rose 11 percent to A\$363 million (\$285 million) in the six months ended Dec. 31, compared with a A\$402 million median estimate of four analysts Bloomberg News surveyed by telephone and e-mail. Chief Executive Officer Trevor O'Hoy abandoned specialist wine, beer and spirits marketing teams in favor of a single network selling its full range to customers, causing profit growth in Australia to slow to 2.5 percent in the half. The Melbourne-based company sold 11 percent less wine in Australia, prompting Foster's to spend more to improve customer service and revive sales growth to restaurants. “That rejigging and transformation has caused their problems,” said Angus Gluskie, who helps manage about \$307 million at White Funds Management in Sydney, including Foster's shares. “They need to rework their sales strategy aimed at high- end customers, that is restaurants and high-end bottle shops, and offer a special wine sales team in those areas.” Foster's Profit Misses Analyst Estimates; Shares Fall (Update3)
<http://www.bloomberg.com/apps/news?pid=20601087&sid=anIDH5yw1V8s&refer=home>

Treasuries Lose ‘Masters of Universe’ as Volatility Dwindles

By Elizabeth Stanton

Feb. 20 (Bloomberg) -- The market that once told every other market what to do, also known as U.S. government securities, is so dull these days that the world's biggest banks are losing interest and bowing out.

“Low volatility makes it very hard to generate any income,” said E. Craig Coats, who was co-head of fixed-income at Salomon Brothers in the 1980s, when it was the world's biggest bond trader.

That's why the firms that underwrite U.S. government debt may fall to the fewest in 36 years as profits from trading Treasuries decline along with price swings in the bonds. “You have to generate your income by doing massive amounts of volume,” said Coats, who was among the elite at Salomon, a firm whose influence was caricatured in Tom Wolfe's “Bonfire of the Vanities.”

CIBC World Markets Corp. gave up its so-called primary dealer franchise this month, reducing the number of firms that can buy and sell government securities directly with the Federal Reserve Bank of New York to 21. There haven't been fewer since 1971. The group is down from a high of 46 in 1988.

The average daily change in yields on Treasuries has fallen to 2.5 basis points this year, from 4.9 basis points in 2001, and is the lowest since Merrill Lynch & Co. began compiling data a decade ago. A typical 10-year note trade provides about \$1 in revenue for every \$40 it produced in the mid-1980s, said the head trader at a primary dealer who asked not to be identified because his firm doesn't disclose details of trading.

Merrill Lynch's MOVE Index, which measures expectations for Treasury market volatility, fell on Feb. 5 to the lowest since the firm began tracking the data in 1988. The index, based on prices of over-the-counter options on notes and bonds, closed at 54.9 that day and finished last week at 60.7.

Decline in Revenue

Opportunities to profit from trading the \$4.35 trillion of outstanding U.S. government debt are disappearing. Revenue from 10-year notes has dwindled to about \$30 per \$1 million trade before processing and hedging fees, which average \$10 to \$15, said the head trader at the primary dealer. The same trade earned about \$150 in 1999 and \$1,200 in the mid-1980s.

The benchmark 10-year note's yield hasn't moved more than 20 basis points in a week since April 2005. The yield on the 4 5/8 percent Treasury note due in February 2017, last week declined 9 basis points, or 0.09 percentage point, to 4.69 percent. From 2001 to 2006, weekly moves of at least 20 basis points occurred 31 times.

The number of primary dealers probably will fall in the next two years, said Jason Evans, head of U.S. government bond trading in New York at primary dealer Deutsche Bank AG. The decline won't reduce the ability of investors to buy and sell large amounts of securities, he said.

'Changing Economics'

"The changing economics of the business is putting a lot of pressure, especially on the smaller or lower-tier players, to really question what is the value proposition of maintaining a dealership," said Evans, who previously headed Treasury debt trading at primary dealer Goldman Sachs Group Inc.

Representatives at Bear Stearns Cos., BNP Paribas, Cantor Fitzgerald LP, Credit Suisse, Daiwa Securities Group Inc., Deutsche Bank, Goldman and JPMorgan Chase & Co. said they were committed to their primary dealer business. The rest either declined to comment or didn't respond to calls.

Many firms use their primary dealership to gain more lucrative business trading and selling credit derivatives or other types of fixed income, Evans said.

U.S. government debt trading by primary dealers fell last year for the first time since at least 2001, according to data compiled by the New York Fed. Transactions averaged \$525.2 billion a day, down 5 percent from a record set in 2005. The daily average rose at least 11 percent a year from 2000 through 2005.

Shrinking Group

“The primary dealer community will continue to shrink based on opportunities for profit in the marketplace,” said Patrick Haskell, former head of interest-rate sales and trading at primary dealer HSBC Bank USA. Haskell quit in December when the firm cut about 20 jobs from the group.

Twelve of 30 firms in the Bond Market Association's 2000 directory of primary dealers have dropped out. They include ABN Amro Holding NV, which withdrew in September, and Donaldson, Lufkin & Jenrette Securities Corp., acquired by Credit Suisse Group in 2000.

The New York Fed declined to comment, spokeswoman Linda Ricci said. The market “is deep and liquid,” said Jennifer Zuccarelli, a Treasury Department spokeswoman.

Stable Growth

Price volatility has fallen as global economic growth became more stable and the Fed and other central banks made monetary policy more predictable, said Marie Schofield, a senior portfolio strategist at Columbia Management in Boston. The investment-management arm of Bank of America Corp. oversees \$87 billion of bonds.

The Fed now publishes minutes of policy makers' meetings three weeks after they occur, compared with six weeks before 2005.

“We're seeing lower volatility in terms of economic cycles and lower volatility in terms of market cycles,” Schofield said. “Things that caused volatility in the past were excesses.”

Inflation has slowed, leading investors to accept lower and more stable yields than previously. The annual inflation rate has averaged 2.8 percent since the start of 2000, down from 3 percent in the 1990s and 5.6 percent in the 1980s. Lower inflation has enabled the Fed to keep its benchmark overnight rate lower. It has averaged 3.24 percent this decade, compared with 5.12 percent in the 1990s and 9.86 percent in the 1980s.

Economic Flexibility

The economy has also benefited from increased flexibility in the labor market as companies use temporary workers and overtime to meet production deadlines, according to a New York Fed staff report published in April 2006.

A January research report by Credit Suisse said the “persistent trade imbalances with countries that recycle a substantial portion of their surplus dollars” back into the U.S. without hedging against volatility also has contributed to lower price swings.

John Roberts, a managing director in New York at primary dealer Barclays Capital Inc. and head of the government securities division of the Securities Industry and Financial Markets

Association, said the number of primary dealers is ``stable to growing" in part because the business is key to winning business from central banks.

For example, Countrywide Financial Corp. became a primary dealer in 2004 and Cantor Fitzgerald joined the ranks in 2006.

Dealt Out

Almost all of the 17 firms that were primary dealers when the Fed formalized rules in 1960 have changed their names, been acquired by other securities companies or gone out of business. For example, First Boston is now part of Zurich-based Credit Suisse Group; Salomon Brothers is now owned by Citigroup Inc. in New York; and PaineWebber Inc. is owned by UBS AG, also in Zurich.

In the 1980s, as Japan increased purchases of U.S. debt, six Japanese securities firms became primary dealers: Fuji Securities Inc., Sanwa Securities Co., Daiwa, Nomura Securities International Inc., Nikko Securities Co. and Yamaichi International Inc. Only Nomura and Daiwa remain. Fuji is now part of Mizuho Financial Group Inc.

CIBC cut the jobs of all nine people involved in trading Treasuries and other securities based on U.S. interest-rates when it withdrew this month.

Chris Anderson, a spokesman for CIBC, and Patrick Phalon, a spokesman for ABN Amro, declined to comment.

<http://www.bloomberg.com/apps/news?pid=20601109&sid=axP8wj0pdIPI&refer=home>