

The Other Side of the Street February 24, 2008

Comments

Still catching up, but wanted to get this out. Bottom line is this February run up is like its forefathers, much adieu about nothing. It sets up a significant opportunity to short grossly overvalued stocks with little upside and lots of downside. The “market” has pretty much “priced in” a rose colored fall. It will not happen. The credit problems are just beginning, not “being resolved.” A great example is RIMM. They recently pre-announced that this Qs subscriber growth would be 20% greater than expected. Yet despite this wonderful news did not increase either top or bottom line. What that tells me is the channel was stuffed and that this is probably the last good quarter for a long while. It is a \$30 stock trading at \$109.

There will be much more in next week’s edition.

Until then, keep in mind it is nearing Spring and there will be lots of hongry bears on the prowl . . .

Stock Notes

- Rumors coming out of **Goldman Sachs** suggest there's more damage to be revealed – something we've been betting on all year. News came out last month that the Wall Street powerhouse was cutting 1,000 employees. But now layoffs are expected to increase to 1,500. **While Goldman considers itself an 'investment bank,' only 16% of its \$46 billion in revenue came from investment banking. Goldman is an investment bank in the same way Enron was a gas pipeline company.** What both firms really did was trade. At Goldman last year, two-thirds of its revenue (\$31 billion) came from trading. And – as we've seen time after time – lots of trading revenue is a sure sign of an impending disaster. Stansberry

Notes

- “Last year US import prices soared 10.9% up from 2.5% in 2006. In January import prices rocketed 13.7% higher YOY, the largest increase on record.” . . . “Earnings estimates for the year assume a big second half recovery.” . . . 30-year fixed rate mortgages skyrocketed to 6.09% from 5.72% just a week earlier . . . same store sales for the month of January were the weakest since 1970. . . . The High Tech Strategist March 2008
- Economists believe nearly 8.8 million Americans are now saddled with homes worth less than their mortgages. Chere Ferraiulo is among them
- So the Fed's interest rate cuts were supposed to make borrowing easier, right? If only that were so. Instead, jumbo mortgage rates are higher now than they were when the Fed began taking monetary action in September and have even shot up since the central bank's aggressive rate cuts late last month. That makes it harder for homeowners to refinance those loans. Companies are also paying to borrow money from banks and for the yields they have to offer to woo investors to buy

their corporate bonds, which means businesses will be more pressed to hire workers or build new facilities. Taut financial conditions have gotten even tighter, despite the Fed. Risk is being repriced throughout the marketplace, adding more stress to the already fragile economy. This presents a problem for the Fed. It clearly needs to cut rates more to stimulate economic growth, but rising inflationary pressures limits how low the central bank can go. U.S. consumer prices jumped by a higher-than-expected 0.4 percent in January and rose 4.3 percent over the past 12 months.

- **Across the Pacific, the Shanghai Composite fell again overnight, this time by 3.5%.** We hear that many “lockup periods” among institutional shareholders -- holding huge amounts of recent IPOs -- will soon expire in China. Coupled with higher-than-usual share offerings from Chinese financial institutions, investors are bailing in fear that a flood of shares will soon hit the market with nary a buyer in sight.
- Last week, the economist **Nouriel Roubini cooked up a 12-step doomsday scenario explaining how failing monetary policies might wreck the global economy.** Martin Wolf, writing in the Financial Times, paraphrased him in this way: “Step one is the worst housing recession in U.S. history. House prices will, he says, fall by 20-30% from their peak, which would wipe out between \$4,000-6,000 billion in household wealth. Ten million households will end up with negative equity, and so with a huge incentive to put the house keys in the post and depart for greener fields. Many more homebuilders will be bankrupted. “Step two would be further losses, beyond the \$250-300 billion now estimated, for subprime mortgages. About 60% of all mortgage origination between 2005-2007 had ‘reckless or toxic features,’ argues professor Roubini. Goldman Sachs estimates mortgage losses at \$400 billion. But if home prices fell by more than 20%, losses would be bigger. That would further impair the banks' ability to offer credit. “Step three would be big losses on unsecured consumer debt: credit cards, auto loans, student loans and so forth. The ‘credit crunch’ would then spread from mortgages to a wide range of consumer credit.” Steps four-12 are a swirling Charybdis of defaults, write-downs and deleveraging of hedged bets on a global scale. In the end, the Fed could be ineffective in dealing with the onslaught of bankruptcies, for some of the following reasons: “U.S. monetary easing is constrained by risks to the dollar and inflation, aggressive easing deals only with illiquidity, not insolvency... overall losses will be too large for sovereign wealth funds to deal with, public intervention is too small to stabilize housing losses, and regulators cannot find a good middle way between transparency over losses and regulatory forbearance.” DR
- After more than two decades of credit expansion the limits have been met. The debt in the economy is no longer sustainable without an expansion of credit and we are now seeing reductions in lending, reductions in spending and reductions in production, all of which are conspiring to slow the velocity of money necessary to sustain economic growth. The Federal Reserve's ability to "engineer" the economy out of deflation is entirely dependent on expanding appetites for credit, an increase in the velocity of money. A general decline in the ability and, more importantly, the *desire* to lend and borrow acts is showing up virtually

everywhere we look: **Sharper Image (SHRP)** and **Lillian Vernon (LVC)** filed for Chapter 11 bankruptcy protection this week, both citing an inability to access sufficient credit to sustain operations. **JC Penney (JCP)** reported a nearly 10% decline in profits due to a combination of slower demand and promotional price cutting. **Delphi** has been unable to secure \$6.1 billion in financing from banks and is being forced to seek help from its parent company, **General Motors (GM)**. **GMAC** is closing a majority of its auto-financing offices in the U.S. and Canada. Since 2006 more than 200 major U.S. lending operations **have shut down**. Meanwhile, the shut-down in Auction Rate Securities markets forcing some companies to re categorize short-term securities as long-term holdings. A survey of 126 U.S. employers, by consulting firm Mercer, shows that 33% of U.S. companies may implement hiring freezes or downsize staffs as a result of the changing economic environment. **Although foreclosures make up a fraction of the total housing market, it would be a mistake to underestimate the socio-economic significance of the repudiation of debt and credit manifest in homeowners voluntarily choosing to walk away from their mortgages. The fact people are walking away from their mortgages is not a moral failure, but a warning sign that this type of credit unwind is extraordinarily deflationary. The fact an increasing number of people are not interested in protecting their ability to access credit, their credit rating, is a harbinger of how bad things have yet to get. That means, socio-economically, that people have already repudiated credit and are no longer interested in accessing it.** Minyanville

- Fidelity Investments, the world's largest mutual fund company, says net new client assets rose 32% in the fourth quarter of 2007 to \$58.5 billion. The number of new client accounts rose 5% to about 18 million. Fidelity's results seem to indicate fund buyers are bullish. That generally happens when markets are topping out, not bottoming.
- Feb. 20 (Bloomberg) -- Alliance & Leicester Plc plunged in London trading to the lowest level since going public in 1997 after the U.K. mortgage lender scrapped its profit target for this year and next because of the seizure in credit markets.
- Feb. 20 (Bloomberg) -- South Africa will introduce a 10 percent tax on electricity and give the state-owned power utility a 60 billion rand (\$7.7 billion) loan to help build power plants to ease shortages that shut gold and platinum mines.
- Feb. 20 (Bloomberg) -- It was only a week ago when Brady Dougan, the chief executive officer of Credit Suisse Group, assured shareholders that everything he and his 20,600 colleagues were trading, from government securities to the most complicated derivatives, "should give people comfort." So it came as a surprise yesterday when Switzerland's second-largest bank said it would write down \$2.85 billion of asset-backed securities because of unspecified "mismarkings" by a group of traders. Zurich-based Credit Suisse fell 6.6 percent in Swiss trading. **"To suddenly turn around less than 10 days later and say 'oops, we found 3 billion' just doesn't give you any confidence at all that there aren't more problems out there to be uncovered,"** said Andy Lynch, who helps oversee about \$10 billion, including Credit Suisse shares, at London-based Schroder

Investment Management. **[one of hundreds of examples of a failure by those in charge to grasp the magnitude of the problem]**

- Feb. 20 (Bloomberg) -- Japanese importers of liquefied natural gas may have to pay an extra \$3.5 billion to suppliers after fuel prices rose more than expected the past four years, said an official involved in the contract talks.
- Feb 20 Mortgage applications in the U.S. dropped by the most in more than four years last week as the highest rates in two months weakened demand for home buying and refinancing. The Mortgage Bankers Association's index of applications to buy a home or refinance a loan fell 23 percent from the previous week. The group's refinancing gauge plunged 28 percent, the most in more than three years, and the purchase index declined 12 percent.

Weblinks

Credit

- Feb. 22 (Bloomberg) -- California, Florida schools and the operator of John F. Kennedy International Airport joined a growing list of municipal borrowers exiting the U.S. auction-rate bond market as record failures push taxpayer costs higher. **Thousands of auctions run by banks to set rates on the debt failed this month as investors shunned the securities and bankers refused to submit bids, sending interest costs as high as 10 percent on some bonds. Auctions covering as much as \$26 billion of bonds a day failed to attract enough buyers since Feb. 13, according to Bank of America Corp.** Rates in the \$133 billion market are determined through a bidding process every seven, 28 or 35 days. Auctions fail when there aren't enough buyers, leaving bondholders who wanted to sell stuck with the securities and taxpayers with higher interest costs. Rising Failures **Yesterday's 641 auctions of publicly offered bonds resulted in 395 failures, or 62 percent, according to data compiled by Bloomberg from four auction agents including Deutsche Bank AG. Just 44 failures were recorded between 1984, when the market was created, and the end of last year,** Moody's Investors Service said in a Feb. 19 report. The average rate for seven-day municipal auction bonds rose to a record 6.59 percent on Feb. 13 from 4.03 percent the previous week, according to indexes compiled by the Securities Industry and Financial Markets Association. **Until this year, banks that collect annual fees of about 0.25 percent to run auctions would step in to stop failures when bidding faltered. Goldman Sachs Group Inc., Citigroup Inc., UBS AG and Merrill Lynch & Co. stopped committing capital** after banks sustained at least \$146 billion in credit losses and writedowns from the subprime mortgage collapse. That's left corporate treasurers and wealthy individuals, some of whom bought the debt as cash equivalents, unable to access their money. Not Deep ``The auction-rate market was not as deep or as wide as people thought it would be," said Christopher ``Kit" Taylor, former executive director of the Municipal Securities Rulemaking Board, in an interview from Washington. Sapping Demand **Investors focused on opportunities in auction-rate bonds**

sapped demand for traditional fixed-rate debt this week. Concern that ailing bond insurers will continue to lose their top credit ratings also weakened municipal bonds, even as Treasuries gained. Since the first of the securities were sold in 1984 for American Express Co., the market has expanded as investors sought the bonds as a higher-yielding alternative to money funds. SEC Fines Along the way, New York-based Lehman Brothers Holdings Inc. was fined \$850,000 in 1995 by the Securities and Exchange Commission for manipulating auctions conducted for American Express. Almost two years ago, 15 securities firms paid the SEC \$13 million to settle claims of bid-rigging in auction-rate bonds. The banks neither admitted nor denied wrongdoing. While the SEC required dealers to disclose that they may use insider knowledge to place bids, they don't have to say how frequently they bid or how much. Dealers also aren't obligated to disclose rates on auction debt when the securities trade. **Florida Schools, California Convert Auction-Rate Debt**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=awCJRyi5ngcQ&refer=home>

- Feb. 20 (Bloomberg) -- Standard Chartered Plc abandoned a plan to refinance its \$7.15 billion Whistlejacket Capital Ltd. structured investment vehicle, the largest SIV run by a bank to collapse. The London-based bank blamed the "continuing deterioration in the market" for its decision, in a statement today. Whistlejacket will become the sixth SIV to default if it doesn't make a payment by Feb. 21 when a three-day grace period ends, according to Standard & Poor's. SIVs with more than \$20 billion of total assets are in default, including funds managed by New York-based Ceres Capital LLC and Cheyne Capital Management (UK) LLP in London. SIVs, funds that use short-term borrowing to buy longer-dated assets, are failing because they're unable to attract investors recoiling from securities that package mortgages and other assets. Banks led by HSBC Holdings Plc and Citigroup Inc. have stepped in to support their SIVs with more than \$140 billion of assets. Whistlejacket appointed receivers after a decline in the value of its holdings triggered rules forcing it to wind down. Deloitte & Touche LLP was working with Standard Chartered this week on the bank's proposal to buy assets from the SIV, according to Neville Kahn, a receiver at Deloitte. Deloitte didn't pay notes due Feb. 15, S&P said. **Standard Chartered Abandons Funding \$7.15 Billion SIV**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aLaaPwmpgc10&refer=home>
- Feb. 20 (Bloomberg) -- **KKR Financial Holdings LLC, Kohlberg Kravis Roberts & Co.'s publicly traded fixed-income fund, delayed repaying some asset-backed commercial paper and started restructuring talks with its creditors.** The fund, which invests in corporate debt and mortgages, agreed with holders of its residential mortgage-backed securities to defer repayment a second time, KKR said in a regulatory filing yesterday. About half the debt will be due by March 3 instead of Feb. 15, with the rest owed on March 25. KKR didn't provide details of how much debt is affected. **The talks come less than six months after the fund received a \$230 million cash infusion from investors**

following losses on residential mortgages in the wake of the U.S. subprime crisis. The fund, led by Chief Executive Officer Saturnino Fanlo, raised a further \$270 million in a rights offering with some of KKR's own partners buying shares in it, which had \$19 billion of assets at the end of December. **“The picture is getting worse and worse,”** said Felix Freund, who helps manage the equivalent of \$14.7 billion of fixed-income securities at Frankfurt-based Union Investment GmbH. KKR's second extension of repayment deadline **“shows there is still a lot of levered investments in the credit market that we can't see,”** he said.

Repricing ‘Driver’ The deferral drove investors to seek the security of government debt, sending 10-year Japanese bonds to the biggest gain in two weeks while perceived corporate risk in Asia and Europe soared. Contracts on Europe's Markit iTraxx Crossover Index of 50 companies with mostly high-yield credit ratings increased 26.5 basis points to 611.5 today, according to Deutsche Bank AG. A basis point is 0.01 percentage point. **“The driver behind the current repricing is KKR Financial Holdings delaying repayment of CP for the second time,”** analysts led by Mark Harmer, head of credit research at ING Groep NV, said in a note to clients today. Cash Injection The terms of investing in both programs were first changed Oct. 15, S&P said, with KKR agreeing to inject cash into the funds and lengthening the maturities to Feb. 15 for half of each program's extendible notes and March 13 for the other half. KKR Financial booked a third-quarter loss of \$261.5 million, hurt by a \$250 million writedown for the notes. The fund had \$1.04 billion of cash available at the end of 2007, according to its earnings report. The company received \$500 million in August from investors including Farallon Capital Management LLC and Morgan Stanley. The fund also raised \$270 million in a rights offering in September, with almost a fifth of the shares on sale bought by Kohlberg Kravis Roberts partners. **KKR Financial Delays Repayments, Starts Negotiations**
http://www.bloomberg.com/apps/news?pid=20601087&sid=aLBZO0_GxUJI&refer=home

- Feb. 19 (Bloomberg) -- Drivers on the Massachusetts Turnpike may face higher tolls after the state couldn't sell auction-rate securities backed by a unit of Ambac Financial Group Inc. The Massachusetts Turnpike Authority, the state agency overseeing Boston's “Big Dig,” is spending an additional \$300,000 a month because of its failed transaction involving \$126.7 million of the Ambac-backed securities, state officials said today. A prolonged delay could upset efforts to cut agency costs and avoid raising tolls later this year, officials said. The turnpike paid Ambac \$6 million seven years ago for a bond insurance policy that it planned to use in the future to refinance up to \$800 million it borrowed for the Big Dig. The authority is now unable to sell \$126.7 million in Ambac-backed bonds after the insurer's credit rating fell because of subprime-related debt it guaranteed, LeBovidge said. Additionally, the market for auction-rate debt has been roiled by bankers' reluctance to stand behind those bonds and buy them for their own accounts, causing auctions to fail. The delay costs the turnpike an additional \$300,000 a month because the \$126.7 million in bonds are tied to an interest-rate swap with UBS AG that began in January. Officials are trying to rework the arrangement with different variable-rate securities to match the terms of the swap

contract. **Massachusetts May Raise Tolls Amid Auction-Rate Woes**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a8KMqwEekyq4&refer=home>

- Feb. 19 (Bloomberg) -- MBIA Inc. brought back former Chief Executive Officer Joseph Brown to run the company and will consider splitting in two after record losses on subprime debt prompted an 83 percent slump in the share price and put its AAA credit ratings in jeopardy. Brown, 59, said in an interview today that the world's largest bond insurer may separate its municipal business from guarantees on subprime-mortgage securities, which caused a net loss of \$2.3 billion last quarter. Gary Dunton, who succeeded Brown as CEO in 2004 and has resisted pressure to restructure the Armonk, New York-based company, will leave, MBIA said. **'Joined the Crowd'** "It looks like MBIA has joined the crowd in at least looking at a split," said Donald Light, an insurance analyst at Celent, a consulting firm in Boston. "They brought in a new CEO whose views are aligned with them, presumably on the issue of exploring the split." Brown said he has already discussed MBIA's plans with Dinallo who provided "helpful guidance." Dinallo, who is taking the lead among the nation's insurance regulators, brought in Warren Buffett to start a new insurer and also asked the billionaire investor to value the guarantors' municipal business. "We are trying to be very responsive to an amazingly fluid situation," Brown said. The company won't break up "if there's nothing in it for us," Brown said. Dinallo is also trying to forge a rescue of the bond insurers by banks or investors such as private-equity firms or sovereign wealth funds who could inject capital. **Capital Raising Under Dunton, 52, MBIA sold about \$2.5 billion in the sale of shares and notes in the past three months. Subject to shareholder approval, Brown will receive an added award of \$5 million and will be eligible for 1,634,000 shares of restricted stock under a performance incentive plan, MBIA said today in a regulatory filing. He will buy 359,000 shares with his own money, according to the filing. Moody's Investors Service, which has AAA ratings on the insurance arms of MBIA and Ambac, has said it plans to complete a review of the ratings by the end of the month. Standard & Poor's is also considering a downgrade of the companies' ratings. Fitch Ratings cut Ambac to AA last month.** **MBIA Former Chief Returns as Credit Rating Cut**

Looms
<http://www.bloomberg.com/apps/news?pid=20601087&sid=an6P2OmsMKGA&refer=home>

- Feb. 19 (Bloomberg) -- Credit Suisse Group said worsening credit markets and pricing errors on bonds will cut first-quarter profit by about \$1 billion, sending the shares down 6.6 percent in Swiss trading. **Switzerland's second-largest bank took \$2.85 billion of writedowns on asset-backed securities after an internal review found "mismarkings" by a group of traders and debt markets deteriorated.** The Zurich-based bank said in a statement today that it's assessing whether 2007 earnings were also affected. The announcement comes two days after Qatar said it was buying shares in Credit Suisse and a week after the company reported net writedowns of 2 billion Swiss francs (\$1.8 billion) for 2007, a fraction of those disclosed by bigger Swiss competitor UBS AG. Chief Executive Officer Brady Dougan said on Feb. 12 that the bank tried to be

“extremely transparent” about its debt holdings and related risks. “I’m speechless,” said Georg Kandera, an analyst at WestLB in Dusseldorf with a “buy” rating on Credit Suisse. “To announce this just a week after reporting earnings is a major blow. This will again put the whole sector under pressure.”

‘Loss of Confidence’ Credit-default swaps on Credit Suisse’s subordinated debt rose to a record, according to Deutsche Bank AG. Credit-default swaps, used to speculate on a company’s ability to repay debt, rise as perceptions of credit quality worsen. Credit Suisse blamed the writedowns on “adverse first quarter 2008 market developments” and pricing errors “by a small number of traders” in the structured credit trading business. The company estimated that it remained profitable so far in the first quarter. **The announcement raises questions about oversight at the bank less than a month after Paris-based Societe Generale SA reported the worst trading loss in banking history** following unauthorized bets by trader Jerome Kerviel. Companies ranging from Paris-based Credit Agricole SA to D. Carnegie & Co. of Stockholm have also been hurt by unauthorized trading. “The big question mark is about the bank’s control systems,” said Stefan Raetzer, who helps manage about \$28 billion at Allianz Global Investors in Frankfurt. “The writedown isn’t as much of a problem here as the loss of confidence.” Dougan told reporters and analysts on a conference call that the bulk of the writedown “was attributable to first-quarter market movements, but the issue is still under review.” **He said he didn’t know there were issues related to the pricing of securities when the company reported earnings last week.** The discrepancies were discovered during the bank’s normal risk management procedures, he said. **“It unfortunately just reinforces the reputation that the large Swiss banks have generated over the last year for financial ineptitude,”** Peter Thorne, a London-based analyst at Helvea Ltd., said in a note to clients. **“Whilst we had received some assurance that the Credit Suisse balance sheet is not as laden with problem securities as UBS, this disclosure just raises the prospect that they may be simply bad at knowing what problems they do have.”** **Credit Suisse Writedowns to Cut Profit by \$1 Billion**

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Commercial Real Estate

Commodities

- Feb. 24 (Bloomberg) -- Organization of Petroleum Exporting Countries President Chakib Khelil said he expects oil demand to decrease in the second quarter and that the group may agree to cut production at its next meeting. “We don’t expect to put more oil in the market,” Khelil told reporters in Algiers today. Inventories are “very high and international demand is expected to decrease in the second quarter. OPEC is going either to keep production or reduce it.” OPEC members, whose ministers meet on March 5, are concerned that inventories and prices will fall during the second quarter, when consumption usually declines amid waning demand for winter heating in the northern

hemisphere. **OPEC President Khelil Expects OPEC to Cut Production**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a6B5Fzo9Ln9c&refer=home>

- **“If you had any major upset,”** warns William Doyle, CEO of Potash -- the world’s largest maker of crop nutrients -- **“where you didn't have a crop in a major growing agricultural region this year, I believe you'd see famine.”** Global grain supplies briefly touched all-time lows late last year, and have barely recovered since. “We keep going to the cupboard without replacing,” Doyle explained to Bloomberg this week, “and so there is enormous pressure on agriculture to have a record crop every year. We need to have a record crop in 2008 just to stay even with this very low inventory situation.” “There’s no room for error,” laments our resource trader Kevin Kerr. “Feels a lot like the energy refining situation in the U.S. One bad weather scenario and suddenly we have a whole different pricing matrix. If we get a drought here like they suffered in Australia last year and it impacts soybeans during the critical pod stage, or if it were to roast 50% of the corn prior to harvest, imagine where that would (will) send prices. “My advice, stock up on those cheap soybeans at 13.50 and \$5 corn.” If you need additional trading advice on the ever hot commodities market DR
- Feb. 19 (Bloomberg) -- Crude oil rose to a record \$100.10 a barrel in New York on speculation OPEC will cut production when it meets next month. The Organization of Petroleum Exporting Countries, due to meet on March 5, may cut output as winter heating demand wanes, oil ministers from Algeria and Iran said in the past week. Oil also rose after the U.S. dollar fell against the euro, enhancing the appeal of commodities as an inflation hedge. Platinum, soybeans, gasoline and heating oil also reached records today. “Prices are primarily up because OPEC will more than likely cut production in two weeks,” said Richard Chimblo, manager of global business development at Calgary-based Genoil Inc. “OPEC is concerned about the outlook for a slowing global economy and demand.” **Crude Oil Rises to a Record \$100.10 on OPEC Production Outlook**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a6lCNH4bqeiA&refer=home>

Currency

Diversification

Derivatives

- Feb. 20 (Bloomberg) -- **The cost of protecting corporate bonds from default soared to a record as investors purchased credit-default swaps to hedge against mounting losses in the \$2 trillion market for collateralized debt obligations.** “Investors are accumulating losses,” said Andrea Cicione, a credit strategist at BNP Paribas SA in London. “It makes sense to reduce risk and cut losses.” **Securities known as constant proportion debt obligations that package indexes of credit-default swaps may be forced to sell about \$44 billion of assets because of a decline in the value of their holdings,** UniCredit SpA analyst Tim Brunne in Munich said today. The value of the so-called CPDOs has fallen to as low as 40 percent of face value, according to Morgan Stanley. Credit-default swaps on the Markit CDX North America Investment-Grade

Index of 125 companies with investment-grade ratings jumped 9 basis points to 163 at 7:44 a.m. in New York, according to Deutsche Bank AG. Credit-default swaps are financial instruments based on bonds and loans that are used to speculate on a company's ability to repay debt. They pay the buyer face value in exchange for the underlying securities or the cash equivalent if a borrower fails to adhere to its debt agreements. A rise indicates deterioration in the perception of credit quality; a decline, the opposite.

Moody's Investors Service downgraded 1.1 billion euros (\$1.62 billion) of CPDOs arranged by ABN Amro Holding NV, Lehman Brothers Holdings Inc. and BNP Paribas SA last week as asset values fell. CPDOs arranged in 2006 by banks including Amsterdam-based ABN Amro may be forced to unwind if the iTraxx Europe index rises to 140, according to UniCredit's Brunne and BNP's Cicione. **“Different CPDOs have different trigger levels, but once one is triggered the negative technical pressure that is created may well cause other triggers to be hit,”** Willem Sels, a credit analyst at Dresdner Kleinwort in London, said in note to investors today. CPDO Unwinds Banks would seek to unwind CPDOs by buying credit-default swap indexes to offset their bets. **“What seems to be clear in both Europe and the U.S. is that the continued unwind of leverage and structured products has continued to lead to underperformance in investment grade,”** Nick Burns, a London-based credit strategist at Deutsche Bank, wrote in a note today. KKR Financial Holdings LLC, the \$18 billion publicly traded credit fund run by Kohlberg Kravis Roberts & Co., delayed repaying some of its asset-backed commercial paper and started restructuring talks with its creditors, according to a regulatory filing yesterday.

Corporate Bond Risk Soars to Record on CDO Loss Speculation
<http://www.bloomberg.com/apps/news?pid=20601087&sid=alkE63ZGqRYc&refer=home>

Housing

- Feb. 20 (Bloomberg) -- **Housing starts in the U.S. remained near their lowest level since 1991 in January, a sign the deepest real-estate recession in a quarter century will continue to weigh on the economy this year.** Work began on 1.012 million homes at an annual rate, up 0.8 percent from December, the Commerce Department said today in Washington. Building permits, an indication of future construction, fell 3 percent to a 1.048 million rate. **“Residential investment is likely to be a drag on growth through the end of the year,”** Ethan Harris, chief economist at Lehman Brothers Holdings Inc. in New York, said before the report. **“As the direct drag from construction diminishes at year-end and into next year, the collateral damage to consumers will likely slow growth.”** Starts were projected to rise to a 1.01 million pace from an originally reported 1.006 million rate in December, according to the median forecast in a Bloomberg survey of 72 economists. Estimates in the Bloomberg survey ranged from 950,000 to 1.1 million. Permits were forecast to drop to a 1.05 million rate, from 1.068 million in December, according to the survey median. Materials, Appliance Demand **The decline in home construction, exacerbated by tighter credit conditions, is slowing demand for construction materials and appliances, and increasing firings at builders, lenders and retailers.** Falling home prices also leave consumers feeling less wealthy, slowing the spending that makes up two-thirds of the economy and threatening to push the economy

into a recession. The U.S. economy will probably grow at a 0.5 percent pace in the first quarter and a 1 percent rate in the second quarter, according to the median forecast in a Bloomberg survey of economists taken the first week of February. The economists surveyed said a recession this year was an even bet. "Growth looks to be weak but still positive during the first half of the year," Bernanke told Congress last week. The Fed "will act in a timely manner as needed to support growth and to provide adequate insurance against downside risks." **U.S. January Housing Starts Rise 0.8% to 1.012 Million** **Pace**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aXxvaAasBfoI&refer=home>

Housing Finance

- Feb. 22 (Bloomberg) -- Joe Lents hasn't made a payment on his \$1.5 million mortgage since 2002. That's when [Washington Mutual Inc.](#) first tried to foreclose on his home in Boca Raton, Florida. The Seattle-based lender failed to prove that it owned Lents's mortgage note and dropped attempts to take his house. Subsequent efforts to [foreclose](#) have stalled because no one has produced the paperwork. Judges in at least five states have stopped foreclosure proceedings because the banks that pool mortgages into securities and the companies that collect monthly payments haven't been able to prove they own the mortgages. The confusion is another headache for U.S. Treasury Secretary [Henry Paulson](#) as he revises rules for packaging mortgages into securities. "I think it's going to become pretty hairy," said [Josh Rosner](#), managing director at the New York-based investment research firm [Graham Fisher & Co.](#) "**Regulators appear to have ignored this, given the size and scope of the problem.**" More than \$2.1 trillion, or 19 percent, of outstanding mortgages have been bundled into securities by private banks, according to [Inside Mortgage Finance](#), a Bethesda, Maryland-based industry newsletter. **Those loans may be sold several times before they land in a security.** Mortgage servicers, who collect monthly payments and distribute them to securities investors, can buy and sell the home loans many times. Housing Boom Each time the mortgages change hands, the sellers are required to sign over the mortgage notes to the buyers. In the rush to originate more loans during the U.S. [mortgage boom](#), from 2003 to 2006, that assignment of ownership wasn't always properly completed, said [Alan White](#), assistant professor at [Valparaiso University School of Law](#) in Valparaiso, Indiana. "**Loans were mass produced and short cuts were taken," White said. "A lot of the paperwork is done in the name of the original lender and a lot of the original lenders aren't around anymore."** More than 100 mortgage companies stopped making loans, closed or were sold last year, according to Bloomberg data. The foreclosure rate, at 1.69 percent of all U.S. homeowners, is the highest since the [Mortgage Bankers Association](#) began tracking it in 1993. [750,000 Homeowners Lost-Note Affidavits](#) When the mortgage servicers and securitizing banks that act as trustees of the securities fail to present proof that they own a mortgage, they sometimes file what's called a lost-note affidavit, said [April Charney](#), a lawyer at [Jacksonville Area Legal Aid](#) in Florida. Nobody knows how widespread the use of [lost-note affidavits](#) are, Charney said. She's had foreclosure proceedings for 300 clients dismissed or postponed in the past year, with about 80 percent of them involving lost-note affidavits, she said. "All these loan documents are

being sent to the inside of a mountain in the middle of America and not being checked very carefully," Saft said. "The lenders can't find the paper. We're dealing with a lot of paper produced in a mortgage closing." Judges are becoming increasingly impatient with plaintiffs who produce no more proof of ownership than a lost-note affidavit or a copy of the note, said Michael Doan, an attorney at [Doan Law Firm LLP](#) in Carlsbad, California. U.S. District Judge [David D. Dowd Jr.](#) in Ohio's northern district chastised Deutsche Bank National Trust Co. and Argent Mortgage Securities Inc. in October for what he called their "cavalier approach" and "take my word for it" attitude toward proving ownership of the mortgage note in a foreclosure case. Federal District Judge [Christopher Boyko](#) dismissed 14 foreclosure cases in Cleveland in November due to the inability of the trustee and the servicer to prove ownership of the mortgages. "**Judges are human beings," said Kenneth M. Lapine, a partner at the Cleveland law firm Roetzel & Andress LPA. "They no doubt feel the little guy needs all the help he can get against the impersonal, out of town, mega-investment banking company."** Warning Plaintiffs U.S. Bankruptcy Judge [Samuel L. Bufford](#) in Los Angeles issued a notice last month warning plaintiffs in foreclosure cases to bring the mortgage notes to court and not submit copies. "This requirement will apply because developments in the secondary market for mortgages and other security interests cause the court to lack confidence that presenting a copy of a promissory note is sufficient to show that movant has a right to enforce the note or that it qualifies as a real party in interest," the notice said. Looking for Loopholes "I can't believe the handling of notes is worse than it was five years ago," said [Guy Cecala](#), publisher of Inside Mortgage Finance. "What we didn't have back then were armies of attorneys out there looking for loopholes. People are challenging foreclosures and courts are paying a lot more attention to foreclosures than they ever did before." [American Home Mortgage Investment Corp.](#), the Melville, New York-based lender that filed for bankruptcy last August, said it was paying \$45,000 a month to store loan paperwork and petitioned U.S. Bankruptcy Judge [Christopher Sontchi](#) in Wilmington, Delaware, for the right to toss it all. Sontchi ruled last week that American Home Mortgage could charge banks from \$3 to \$13 a file to retrieve documents. The home-loan industry has had a central electronic database since 1997 to track mortgages as they are bought and sold. It's run by [Mortgage Electronic Registration System](#), or MERS, a subsidiary of Vienna, Virginia-based MERSCORP Inc., which is owned by mortgage companies. No Tracking Mechanism MERS has 3,246 member companies and about half of outstanding mortgages are registered with the company, including loans purchased by government-sponsored entities Fannie Mae, Freddie Mac and Ginnie Mae, said R.K. Arnold, the company's CEO. **For about half of U.S. mortgages, there is no tracking mechanism.** "Something is wrong if you start from what I think is the reasonable assumption that these banks are not losing all of these notes," Raskin said. "As an officer of the court, I find it troubling that they've been going in and saying we lost the note, and because nobody is challenging it, the foreclosures are pushed through the system." **Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish** <http://www.bloomberg.com/apps/news?pid=20601109&sid=aejJZdqodTCM&refer=home>

Macro Economic

- Feb. 24 (Bloomberg) -- China will stick with a tight monetary policy as controlling inflation remains a top priority, the vice governor of the People's Bank of China said. **The central bank will ``vigorously'' soak up liquidity by raising the level of reserves that banks must keep on hand, Yi Gang said today at an economic forum in Beijing.** The central bank will select an ``optimal'' package of currency, interest- rate and money-supply measures, he said. Last month's 7.1 percent inflation rate was highest in more than 11 years. Snowstorms that started in mid-January in provinces such as Zhejiang, Guangxi and Jiangxi closed factories, paralyzed transportation and disrupted food and power supplies, pushing up prices that had begun to soar last year. ``The central bank will stick with a tightened monetary policy this year despite uncertain factors domestically and externally," Yi said. **``Inflation remains the biggest risk in the economy this year.''** Chinese policymakers are preoccupied with inflation even as they face the prospect that an economic slowdown in the U.S. may curb demand for the country's exports. Overseas sales helped power 11.4 percent economic growth last year in China, the world's fourth-largest economy. **``The inflation situation is serious and upward pressure will be further felt throughout the first quarter,''** Xing Ziqiang, an economist at China International Capital Corp., said today at the conference in Beijing. Xing predicted that the pace of consumer price increases may be higher than 7 percent in the first three months. **More Flexible Yuan** The central bank will make the yuan more flexible and use interest rate tools to curb inflation, it said in its monetary policy report issued on Feb. 22. The bank has kept borrowing costs steady this year after six increases in 2007 pushed the key one-year lending rate to 7.47 percent. Currency Appreciation Liang said the central bank may front-load currency appreciation over the next few months, with the full year's gains totaling 12 percent against the U.S. dollar. Yi also said today that growth in M2, the broadest measure of money supply, will slow to 16 percent this year. It rose 18.9 percent in January to 41.8 trillion yuan (\$5.9 trillion) from a year earlier. Bank lending growth is expected to be lower than last year, Yi said. Outstanding loans in yuan jumped 17 percent to 26.97 trillion yuan at the end of January from a year earlier. ``The impact of a slowdown in the U.S. economy on China's export would be slower growth, rather than shrinking exports, because China's exports are mostly cheap and necessary consumer goods," said Justin Yifu Lin, head of the China Center for Economic Research at Peking University, who was appointed as World Bank's chief economist on Feb. 5. **China to Stay With Tight Monetary Policy, PBOC Says** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aGppznaP1ra4&refer=home>
- Feb. 21 (Bloomberg) -- The U.S. moved closer to a recession as manufacturing in the Philadelphia area shrank the most in seven years, while a measure of the economy's future performance declined for a fourth month. **The Federal Reserve Bank of Philadelphia's general economic index fell more than forecast this month to minus 24, showing the margin by which more firms reported a decrease in activity instead of an increase. That was the lowest figure since February 2001, weeks before the last downturn began.** The Conference Board's index of leading indicators dropped 0.1 percent in January, matching December's decline. Even as data indicate the economy is deteriorating, two members of the panel that dates U.S. economic cycles said it's too early

to say a recession has begun. "Notwithstanding the darkening clouds, we are still far from the point where the committee would act," said Robert Hall, an economist at Stanford University who leads the National Bureau of Economic Research's Business Cycle Dating Committee. Economists had forecast the Philadelphia manufacturing index would rise to minus 10.0, according to the median of 54 estimates in a Bloomberg News survey. Eighty-five companies responded to this month's survey, which was taken from Feb. 6 to Feb. 18, said Philadelphia Fed spokeswoman Marilyn Wimp. **U.S. Economy: Philadelphia Factory Index Declines**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aY.hGKudYRH8&refer=home>

- Feb. 20 (Bloomberg) -- Federal Reserve officials judged that low interest rates "were appropriate for a time," as they enacted the fastest easing of monetary policy in two decades last month. "Several participants noted that the risks of a downturn in the economy were significant," according to minutes of the Fed's Jan. 9 and 21 conference calls and Jan. 29-30 meeting last month. **Many participants were concerned that the drop in equity prices, coupled with the ongoing decline in house prices, implied reductions in household wealth that would likely damp consumer spending.** [the solution to which is greater saving and not more credit fueled spending] The central bank will lower rates further if financial conditions and the availability of credit deteriorate, Chairman Ben S. Bernanke indicated to lawmakers last week. **Since the Fed met, credit-market disruptions have spread to the securities backed by bond insurers, while government figures showed the U.S. lost jobs in January.** Some officials also considered that a reversal of the rate cuts may be needed once the economy stabilizes, the minutes showed. "Some noted that, when prospects for growth had improved, a reversal of a portion of the recent easing actions, possibly even a rapid reversal, might be appropriate," said the minutes, released in Washington today. **Still, policy makers didn't see their rate cut as adding to inflation pressures given the weakness in growth. Members agreed that inflation was likely to moderate in coming quarters.** [see story on these pages re inflation coming in above expected both top line and core] Fed Forecasts The figures represent the median range of projections. Bernanke increased the forecasts from twice-a-year after a review of Fed communications last year. Traders anticipate the Fed will lower the target rate for overnight loans between banks by another half-point by the end of the next meeting, on March 18. **The availability of credit to consumers and businesses appeared to be tightening, likely adding to restraint on economic growth,** the minutes said. The Fed's Jan. 22 rate cut followed a videoconference at about 6 p.m. the previous evening. **Officials gathered after a sell-off in global stock markets from Hong Kong to London threatened to send the Standard & Poor's 500 index of U.S. stocks down as much as 5.3 percent.** [i.e. the Fed intervened to prevent price discovery and prolong the inevitable] Biggest Cut The three-quarter point cut was the biggest single reduction since the Fed began using the rate as its principal tool of monetary policy about 1990. The cut was conducted to "begin aligning the real policy rate with a weakening economic situation," the minutes said. Some officials were concerned that the cut "could be misinterpreted as directed at recent declines in stock prices." **Some credit markets have remained under stress even after the Fed's rate cuts. The cost of protecting corporate bonds from default soared to a record today.** [Why? Because the players in the credit market are smarter and more

sophisticated than the gamblers in the equity markets and less prone to be swayed by the latest headline] Credit-default swaps on the Markit CDX North America Investment-Grade Index of 125 companies with ratings above junk jumped as much as 13 basis points to 167.25. A basis point is 0.01 percentage point. **Since the beginning of 2007 through the end of January, financial institutions have posted \$146 billion in credit losses and asset writedowns.** Inflation Data The faltering economy has yet to damp inflation, government figures indicated today. The Labor Department's measure of consumer prices rose 4.3 percent in January from a year ago, up from a 4.1 percent rate in December. Stripping out food and energy, the core gauge rose 2.5 percent, the most since March. Rising energy and commodity costs, along with food prices, are pushing up inflation. Crude oil rose to a record \$100.10 a barrel yesterday. Sales of existing homes fell 13 percent last year, the biggest slump in 25 years, and prices dropped 1.8 percent, the first decrease since records began in 1968. The U.S. lost jobs for the first time in four years last month, as payrolls fell by 17,000 after an 82,000 gain in December. Confidence among U.S. consumers fell to a 16-year low this month, according to a preliminary index of consumer sentiment by Reuters/University of Michigan released last week. Economists surveyed by Bloomberg News predict economic growth will slow to a 0.5 percent pace in the first quarter from the annualized rate of 0.6 percent in the previous three months. Fed staff revised down their growth estimates for the first half of 2008, the minutes show, indicating that they still didn't foresee a recession. **Fed Saw Need for 'Relatively Low' Interest Rates 'For a Time'**
http://www.bloomberg.com/apps/news?pid=20601087&sid=al0e_Xsy7HW0&refer=home

- Feb. 20 (Bloomberg) -- **Federal Reserve officials cut their forecasts for economic growth this year by about a half percentage point and raised unemployment projections after the housing recession and financial-market turmoil deepened. [markets RALLIED!!!!]** Fed policy makers now expect U.S. gross domestic product to increase by 1.3 percent to 2 percent in 2008, compared with the 1.8 percent to 2.5 percent they predicted in October. The fourth-quarter jobless rate will be between 5.2 percent and 5.3 percent, up from a range of 4.8 percent to 4.9 percent in the last forecast. The estimates, a median range of projections by governors and regional-bank presidents, informed the Federal Open Market Committee's decisions to lower interest rates twice last month in the fastest easing of monetary policy in two decades. The quarterly forecasts were released today as an addendum to minutes of the Fed's Jan. 29-30 meeting in Washington. **Inflation, excluding food and energy, will run at 2 percent to 2.2 percent this year, compared with 1.7 percent to 1.9 percent projected in October. Total consumer prices will rise by 2.1 percent to 2.4 percent; the FOMC projected an increase of 1.8 percent to 2.1 percent three months earlier.** In the "Risks to the Outlook" section of the revamped economic forecasts, the Fed said officials saw growth risks "weighted to the downside." More policy makers than in October viewed inflation risks as "broadly balanced," though "several" saw them as "skewed to the upside." Main Risks The chance of faster-falling home prices and ongoing strains in financial markets were the main risks, officials said. **"Especially worrisome," the Fed said, was the possibility that slower growth would lead to "worsening of financial conditions and a reduced availability of credit, which in turn could further damp economic growth."** The Fed forecasts are in line with those of economists outside the central bank.

Those surveyed by Bloomberg News expect GDP growth of 1.7 percent this year, the median of 59 estimates taken from Jan. 30 to Feb. 7. Forecasts range from 0.4 percent to 3.3 percent, and 15 of 62 economists project the economy will shrink in the first quarter. The central bank again provided historical error ranges for projections, saying the GDP forecasts have a 70 percent chance of ending up 1.2 percentage point above or below the projected paces. The confidence ranges for the unemployment-rate projections run from 0.5 percentage point above or below the forecast in 2008 to 1 percentage point in 2010. That means there's a 70 percent probability that actual growth will be between 0.1 percent and 3.2 percent, based on the bounds of the central-tendency projections. For total inflation, the error range is 1 percentage point above or below the forecast rates. The Fed didn't provide a confidence range for core prices. The forecasts are based on Fed governors and bank presidents' views of the "appropriate" path of interest rates, something that isn't disclosed. **Fed Officials Cut '08 Growth Projections to Range of 1.3%-2.0%**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aYyY3msqPdSM&refer=home>

Retail

- Feb. 25 (Bloomberg) -- Lowe's Cos., the world's second- largest home-improvement retailer, said fourth-quarter profit fell after the worst U.S. housing slump in a quarter century slowed remodeling projects. The retailer forecast full-year earnings and sales that trail analysts' projections, sending the shares lower in trading before the New York Stock Exchange opened. Lowe's said today the next several quarters will be "challenging" as the housing slump slows sales at its more than 1,450 locations. The retailer rates higher among shoppers for customer service than bigger Home Depot Inc., helping it gain customers. **Lowe's Net Falls; Earnings Forecast Trails Estimates**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a5d5ZVtQGLkI&refer=home>

Retirement

Risk

Savings Rate

Tech

Wall Street

- Feb. 22 (Bloomberg) -- [Ambac Financial Group Inc.](#), the bond insurer in rescue talks with banks, may announce an agreement early next week that would save its AAA credit rating and avoid losses on \$566 billion of debt, according to a person familiar with the discussions. Banks may invest about \$3 billion in the company, said the person, who declined to be named because no details have been set. The New York-based company

rose 16 percent in New York Stock Exchange trading today after CNBC Television said Ambac and its banks were preparing to announce a deal. "Everything is being considered," Ambac spokeswoman Vandana Sharma said in a telephone interview. "These are complicated things. We hope to have something shortly." She wouldn't discuss any specific plans. A rescue that enabled Ambac to retain its AAA rating for the municipal and asset-backed securities guaranty units would help banks and municipal debt investors avoid losses on securities it guarantees. Banks stood to lose as much as \$70 billion if the top-rated bond insurers, which include MBIA Inc. and FGIC Corp., lose their credit ratings, Oppenheimer & Co. analysts estimated. "It's been on the table for a while and if it happens it will certainly be a good thing for any bond insurer that gets a capital infusion," said Donald Light, a senior analyst covering insurance at Celent, a consulting firm in Boston. Eight Banks Eight banks including Citigroup Inc. and UBS AG formed a group to consider providing financing, a person familiar with the matter said earlier this month. Royal Bank of Scotland Group Plc, Wachovia Corp., Barclays Plc, Societe Generale SA, BNP Paribas SA and Dresdner Bank AG, were also involved, said the person, who declined to be named because details hadn't been set. Spokespeople for Citigroup, UBS, Wachovia and BNP declined to comment on the rescue plans. Spokespeople for RBS, Barclays, Societe Generale and Dresdner didn't immediately return e-mails or calls seeking comment. Ambac, down 88 percent in the past year, jumped \$1.48 to \$10.71 in New York trading. Ambac is also considering raising money from shareholders, the Financial Times reported. Credit-default swaps tied to Ambac's bond-insurance unit fell 5 basis points to 406 basis points, according to CMA Datavision in London. Credit-default swaps are financial instruments based on bonds and loans that are used to speculate on a company's ability to repay debt. They pay the buyer face value in exchange for the underlying securities or the cash equivalent if a borrower fails to adhere to its debt agreements. A rise indicates deterioration in the perception of credit quality; a decline, the opposite. Downgrades Possible The bond insurers and banks are working against the clock. Moody's Investors Service indicated it will decide whether to downgrade Ambac and Armonk, New York-based by the end of the month. A downgrade of all the insurers would cast doubt over \$2.4 trillion of securities they back. Losses on the subprime- mortgage securities they guaranteed prompted the ratings companies to demand the insurers add more capital or face downgrades. Ambac, which was already downgraded by Fitch, lends its credit rating to \$376.6 billion of municipal and international bonds and \$176.6 billion of structured finance debt, according to its Web site. Dinallo Meeting Ambac isn't having any trouble meeting claims, Sharma said. "To me, a bailout means a company that is struggling to meet its obligations," Sharma said. "We're in no need of a bailout." New York Insurance Superintendent Eric Dinallo last month arranged a meeting with banks to help avoid a downgrade of the bond insurers. Dinallo told a congressional hearing last week the companies may be forced to separate their municipal insurance business from their asset-backed guarantees.

- Feb. 22 (Bloomberg) -- Goldman Sachs Group Inc., Lehman Brothers Holdings Inc. and Bear Stearns Cos. had their profit estimates cut by more than 40 percent in the first quarter by Sanford C. Bernstein & Co. because of lower investment banking revenue. Morgan Stanley may report 12 percent less profit than forecast, according to Brad Hintz, who is at least the fourth analyst in the past two weeks to reduce earnings forecasts for

the biggest brokerages because of credit losses and writedowns triggered by the collapse of subprime mortgages last year. **Fixed income and trading ``will be the center of investor concern this quarter," Hintz wrote in a note to investors today. ``Market conditions remained challenging through February as troubles spread through a variety of areas within the fixed income market."** Investment banking revenue may decline 35 percent on average for the firms, he said. ``The high margin businesses of equity underwriting and M&A had their weakest quarters since 2005." **U.S. Brokers May Earn 40% Less Profit, Bernstein Says** <http://www.bloomberg.com/apps/news?pid=20601087&sid=agES6lvsEsAI&refer=home>

- Feb. 22 (Bloomberg) -- AQR Capital Management LLC's largest hedge fund fell almost 15 percent this year through Feb. 15 as **market swings** tripped up computer models the managers use to make trades, two people with knowledge of the matter said. The assets of AQR's Absolute Return fund dropped to \$2.9 billion last month from \$4 billion in the fourth quarter, said the people, who declined to be identified because the Greenwich, Connecticut-based **firm** doesn't publicly disclose the data. AQR's smaller Asset Allocation fund lost at least 16 percent of value. **Quantitative managers who rely on computers to make trades have struggled as global equity markets declined.** Assets managed by AQR, co-founded in 1998 by former Goldman Sachs Group Inc. managing director **Clifford Asness**, slipped more than 20 percent to \$8.6 billion in the past six months because of investment losses and client redemptions. Quant funds run by AQR, Goldman and JPMorgan Chase & Co.'s Highbridge Capital Management LLC stumbled in July and August when credit markets seized up and managers rushed to raise cash by selling stocks. **AQR Hedge Fund Fell Almost 15% Through Mid-February** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aci29mS9gZ6Y&refer=home>
- Feb. 22 (Bloomberg) -- **D.B. Zwirn & Co., the New York-based investment firm that was hobbled by disclosures of improper accounting, will liquidate the two largest hedge funds after clients asked to withdraw more than \$2 billion.** The firm will shut the domestic and offshore versions of the Special Opportunities Fund after its 2006 financial audit was delayed, leading to ``a large number of investor redemptions," according to a letter sent yesterday to clients. The funds have about \$4 billion in assets, 80 percent of the firm's total. Started by **Daniel Zwirn** in October 2001, the company expects to tell investors in March how it will return their money, according to the letter, a copy of which was obtained by Bloomberg News. It may take as many as four years to wind down the funds, whose holdings include hard-to-sell private-equity investments and derivatives based on the underlying value of debt securities. The hedge-fund manager told investors in early 2007 that an internal investigation found improper financial transfers and accounting of expenses. Its independent auditor, PricewaterhouseCoopers LLP, took until December to sign off on its books, according to a copy of a Dec. 3 audit obtained by Bloomberg. **D.B. Zwirn was ``the unfortunate victim of misconduct by certain former employees,"** according to an e-mailed statement from spokesman **Shawn Pattison**. Accounting issues were ``thoroughly investigated" and current managers of the firm were ``found to be above reproach," the statement said, without naming the former employees. **Trader Dismissed D.B. Zwirn drew attention in 2006 after it fired a trader previously terminated by Citigroup Inc. for inflating profits by \$20 million to**

boost his bonus. The trader, David Becker, pleaded guilty in September 2006 to one count of conspiracy to falsify bank records and to commit wire fraud while he oversaw commodities trading at the New York-based bank, which ended his employment in March 2004. Zwirn Shuts Hedge Funds After Clients Pull \$2 Billion
<http://www.bloomberg.com/apps/news?pid=20601087&sid=am4jS98c6wwQ&refer=home>

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

Capital & Crisis Hotline -- A World of Increasing Scarcity
February 22, 2008

UPDATES: SJW, BIP

Dear Capital & Crisis Investor,

Interesting to note what's coming out of corporate executives' mouths these days. I like to follow conference calls, because they can give you some insight into what management is thinking. Sometimes, management just talks about what it's seeing. This sort of bottoms-up viewpoint is very valuable, I believe.

In the world of financial writers, there are too many people who just stitch together stories based on their trolling around on the Internet or who create fanciful scenarios based on 40,000-foot views. Predictably, those insights are like warmed leftovers or are just plain unhelpful.

I make a point to get out and talk to people, go to conferences, travel and keep close to the ground about what is actually happening in the world. I often stumble on good insights this way. Sometimes, they even lead me to a really good investment idea. But the main point is to find people and ideas that add to my understanding of the world in some way.

In that spirit, we had a couple of interesting conference calls this week. First, we had the CEO of Potash, a fertilizer maker, talk about the risk of famine. He said that if we had any "any major upset where you didn't have a crop in a major growing agricultural region this year, I believe you'd see famine."

Grain consumption is at record levels, as I've written to you before. We'll need record harvests to stop draining the world's declining inventories. And as that margin grows thinner, we risk having actual shortages. So far, we've seen large price spikes for many grains. But what we could see beyond spikes in price are actual shortages.

Yesterday, the CEO of Nestle gave a similar bleak outlook on finding scarce food-related commodities. Peter Brabeck said that the food industry would have to fight the biofuel industry over access to arable land. “We will not find sufficient water to produce all the crops... there will be a fierce fight for arable land.”

Another telling move is what’s happening to import duties. Normally, import duties on food protect homegrown producers from outside competition and make the local consumers foot the bill. But governments around the world are suddenly slashing tariffs and import duties on wheat, rice and cooking oil.

Why? The answer is simply that there is an acute need for a lot more of those basic foodstuffs. In fact, some countries, such as China, are actually increasing their export duties to keep domestic production at home.

China traditionally is a corn exporter, for example. But that margin is slimming as the Chinese consume more of their own crop. India faces cooking oil shortages. Other traditional global breadbaskets such as Russia and Argentina are consuming more of their produce at home. Brazil, South Korea, Nigeria -- among others -- all cut import duties to attract more food.

Meanwhile, food prices rise. The United Nations estimates that food prices rose 40% last year.

As investors, there are a lot of ways you can participate in the strong agricultural cycle. I have more ideas in Mayer’s Special Situations, because many of the companies are smaller, less liquid and riskier. In that portfolio, I have a crop protection company, a grain handler, an ag equipment play and a farmland play. Also related are a number of water plays, including a filtration company, a Japanese water company and, most recently, a company involved in sewage and water pipe repair. I can’t give those names here, out of respect for the paying readers of MSS, but you can [learn more here](#) .

In a way, energy is also a backdoor play on the idea. Natural gas is a backdoor way into the strong ag cycle, because natural gas is a key ingredient in producing fertilizer. It is also the primary fuel of ethanol distilleries. I’m also looking at adding another natural gas producer, since we lost CNX Gas to a buyout.

In any event, I think these resource constraints are going to be with us for a while. I’ll keep an eye on the developing story and unfolding investment opportunities in future letters. More to come.

***** China Builds More of Everything**

The main driver of all of this is what’s happening in China and India and other emerging markets. In these pages, we’ve followed the boom in infrastructure in China, India, Russia and other places.

Interesting to note, The Economist ran a story last week on China’s race to build roads, railways and airports. Beijing just unveiled a brand-new airport terminal. It’s the largest in the world. The

terminal is 1.8 miles long. The floor space is 17% bigger than all the terminals at Heathrow, London, combined. What's really amazing is not just the size, but the speed in which it was conceived and built. It was four years from scratch to reality, with about 50,000 workers completing the project. The speed at which the Chinese build always amazes. It would take at least a decade to get something like that done in the U.S.

In my last letter, I wrote about the boom in road-building, especially in China and India. China now has the second longest highway network in the world, behind only the U.S. But it will add to that significantly over the next decade. Then there is the railway expansion. The Economist calls it "the biggest expansion of railway capacity undertaken by any country since the 19th century." Then there is air travel: From only 7 million air travelers as recently as 1985, China topped 185 million last year. Then there is sea container capacity: Over the next decade, China plans to expand this by 85%.

And on and on it goes. That's a lot of metal and concrete to consume. That's a lot of fuel. All of that infrastructure supports a growing appetite -- in the many senses of that word -- of over a billion people. That's just China. Add India to the mix. Add Russia.

So you see, it's not hard to imagine where the scarcity comes from. We need to produce a lot more of the basics, and we need to use what we have more efficiently. Those are powerful trends in the world today.

For investors then, the playbook seems obvious. Own what's scarce. Own what helps alleviate that scarcity.

We have many companies with unique and valuable assets already. Most recently, we added **CVR Energy (CVI:nyse)**. In this one stock, you get two incredibly valuable assets. You get an oil refinery and a fertilizer plant. Most importantly, the latter uses coal gasification -- instead of natural gas -- giving it a huge edge over competitors.

I want to find more situations just like that. Preferably, I'd like to find more situations with direct ties to what's happening in China and India. (On the latter, don't forget to check out my special report on India, available online.)

Until then, here are a couple of updates on existing positions...

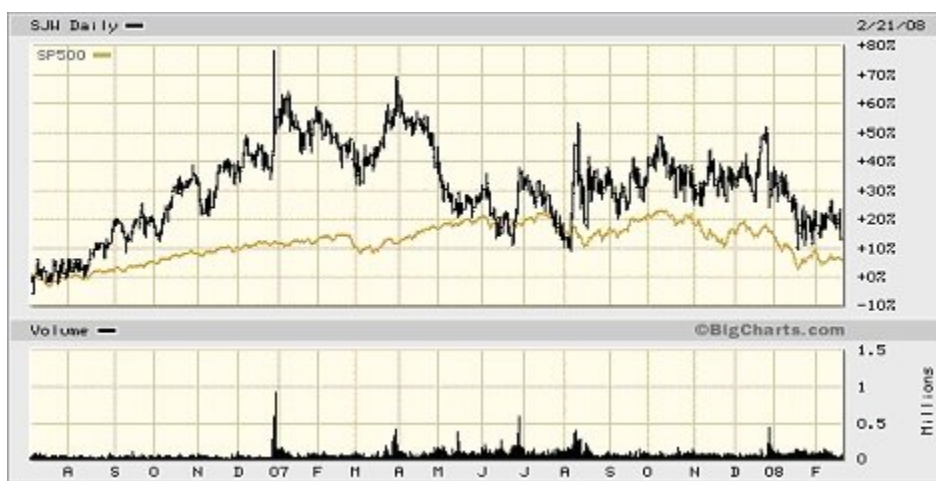
***** SJW Corp.**

SJW Corp. (SJW:nyse) reported fourth-quarter earnings a little light with expectations. Overall results for 2007 were OK, but below those of recent years. Earnings per share for 2007 totaled \$1.04, a level not seen since 2004. For 2008, the company ought to earn somewhere in the neighborhood of \$1.35 per share. Based on the current share price of \$28 per share, the forward price-earnings ratio comes in at about 20. The average for water utilities is about 24. SJW's own five-year average is about 23. So it would seem SJW trades at a bit of a discount based on earnings. A price target based on industry averages puts SJW at \$32-33 per share by the end of 2008.

There are some good things happening beneath the surface, but it is slow work. SJW's land company generated some good cash flow. Its portfolio of real estate investments now totals \$85 million. Part of the wealth creation taking place at SJW involves turning old land holdings into cash that is reinvested tax free in new income-producing properties. All of SJW's real estate is fully leased and doing well.

A water utility is not the most exciting business in the world, but it's a steady producer. We got a 7% increase in our dividend, to 65 cents. SJW has been able to grow that dividend meaningfully over time.

Including dividends, we're up about 17%. Annualized, that comes to about 11% per year, well below the average annual return of water utilities over the prior decade before we owned one. The annual return from 1995-2005 -- and even from 2000-2005 -- was about 18%. Of course, the market's been tougher over the 19 months we've owned it. Our return on SJW has trounced the S&P 500, for example, over that time frame. Here's the chart, in case you are curious:



As I say, these things are never exciting to own, but they work. I never wrote up SJW as something that would double overnight. Here's what I wrote in my issue recommending SJW: "This is a long-term holding, not likely to double overnight. But if it gets close to the 18% annual gain water utilities have enjoyed over the past 10 years or more, you'll surely have a market-beating winner."

And so it has been a market-beating winner. I'm not beating my chest on SJW. It's kind of a boring holding for a newsletter. Newsletter writers are bred to be home run hitters. SJW is no home run. It's just interesting to me how often the boring investments that seem to just plod along win out over the longer term.

I'm inclined to let SJW run some more. I'm sort of bored with it, but my rational brain says let it sit. Let the power of compounding work. This is a stock for the more conservative part of your portfolio. It also makes a decent IRA holding. I recommend holding onto your shares of SJW Corp.

***** Brookfield Infrastructure Partners**

Brookfield Infrastructure (BIP:nyse) also reported earnings in its first quarter as a publicly traded company. The results were in line with expectations. Strong results in transmission lines offset some weakness in timber.

Overall, I still like Brookfield Infrastructure. The dividend yield is now 5.65%, based on the \$18.77 it trades for as I write. I have a buy on BIP and put the NAV at \$25 per share. Long term, the company ought to continue to add to its portfolio of infrastructure assets and boost its payout.

I wrote to you before about creating a subportfolio of income-producing stocks for C&C dubbed the “Paycheck Portfolio.” BIP is the first entry in that portfolio. I’m working on adding a few others. I’ll let you know when that becomes available.

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Best of the Dog