

## The Other Side of the Street February 3, 2008

### Comments

**“Alan Greenspan freely admitted that by orchestrating a rescue of Long Term, the Fed had encouraged future risk takers and perhaps increased the odds of a future disaster. ‘To be sure, some moral hazard, however slight might have been created by the Federal Reserve’s involvement,’ the Fed chief declared.” - *When Genius Failed – The Rise and Fall of Long Term Capital Management* p. 229-30**

If the foregoing seems familiar, I first quoted it in the lead to the August 19, 2007 Comments. While it will be some time until Mr. Bernacke can be quoted concerning any moral hazard created by cutting 125 BPS in nine days to prop up the stock market in January 2008, I will go ahead and predict the hazard he brings down will not be as attenuated as that initiated by Greenspan in 1998.

I will run you by a couple of other comments from issues past to juxtapose against the current enthusiasm emanating out of the Street. Review them and judge for yourself whether there is some reason to believe we are in anything other than a bear trap (i.e. a short term rally in a bear market that traps unsuspecting investors into “dip buying” just before another ugly leg down).

**What 10%? I read yesterday that the SP500 had “rallied” 10% since the Fed cut 75 BPS. This quite frankly puzzled me until I realized they were using the absolute intraday low the day after that cut, which virtually no one could have bought at. I thought it might be more useful to look at the numbers immediately pre-cut in January, September 2007 before the first Fed Funds cut and August 2007 before the first discount rate cut. Judge for yourselves what 225 BPS in cuts has done to bolster stocks and remember just 300 BPS left to zero:**

NOW – Dow 12,743; SP500 1,395; NAZ 2,413

THEN – Jan 18, 2008 Dow 12,099; SP500 1,312; NAZ 2,340

THEN – Sept 17, 2007 Dow 13,403; SP500 1,476; NAZ 2,581

THEN – Aug 15, 2007 Dow 12,874; SP500 1,406; NAZ 2,451

**The supposed explanation for the Thursday January 31 rally (which just happened to coincide exactly with the day the hedge funds and others needed to mark up inventory for month-end statements); Stocks finished solidly higher as financials led the Dow Jones Industrials to over a 350 point swing after MBIA offered soothing commentary on the health of the bond insurer market:**

- NOW – January 31, 2008 MBIA statement - **“MBIA’s capital raising efforts will exceed the requirements necessary to keep its top credit ranking.”** This statement attributed as the catalyst for 350 point Dow run up on Thursday. Later

that same day . . . “Standard & Poor's placed MBIA on a negative credit watch late Thursday.” Oddly there was no reaction to the news straight from the horse’s mouth as the used car salesman’s “just trust me” was good enough.

- **THEN** - November 2007 statement from FGIC – **“FGIC respects the importance of all our triple-A ratings and intends to take actions necessary to preserve those ratings.”** FGIC downgraded to AA last week . . . August 2007 statement from ACA Holdings – **“ACA Holdings today announced that Standard & Poor's has published its report entitled "U.S. Bond Insurers Withstand Subprime Stress," concluding that, in spite of the well-documented deterioration in the world of subprime mortgages, this sector is not an apparent threat to the rating stability of the bond insurers.”** (emphasis added). ACA Holdings downgraded last week

**This time the Fed will really really save us:**

- **NOW** - **“The bull case is that rates are coming down and that the worst is behind us,”** said Mike Morcos, who helps manage about \$1.4 billion at Old Second Wealth Management in Aurora, Illinois. **“The Fed easing is going to lead us on the road to recovery.”** Or maybe the Fed has 300 BPS left before even the dimmest bulbs understand that interest rate cuts will not solve the current problems.
- **THEN** - **“The fundamentals in my opinion are quite strong,”** said Lincoln Anderson, who helps manage \$150 billion as chief investment officer of LPL Financial in Boston. **“The second-half earnings outlook is pretty doggone good. I look at this period as more of a buying opportunity.** Lincoln is not referring to the second half of 2008, although you will be reading quotes identical to this soon. He was in fact referring to the second half of 2007 as previously set forth in the July 29, 2007 comments.

**Leaders and best????? (i.e. this is the reason we should believe that all is well and we are off on a new bull run????):**

- **NOW** - Pulte Homes Inc. pushed homebuilders to a four-month high after forecasting a narrower loss than analysts estimated. The builder of Del Webb-brand homes for retirees also reported fourth-quarter revenue that topped estimates. Pulte jumped 21 percent to \$15.84. The stock has rallied 60 percent this year, the second-best gain in the S&P 500, after retreating 68 percent in 2007. The “bottom” has been in in housing for at least eighteen months now even as the Realtor economist missed 12 out of 12 estimates for growth in 2007 (you can guess if he was high or low)
- **THEN** - **"We continue to implement initiatives in support of our core business strategies: market share expansion through diversification, operational excellence, people development and financial discipline,"** said Richard J. Dugas, Jr., President and CEO of Pulte Homes. **"By focusing on**

**these key business drivers, Pulte Homes delivered solid Q1 operating and financial results, while ending the quarter with a strong balance sheet and well positioned land pipeline. Based on our Q1 results and expectations that a soft landing is unfolding for the U.S. housing industry, - Pulte Homes announces record First Quarter Results April 26, 2006 (the last time revenue topped estimates - the stock traded at 40)**

### Stock Notes

- More on MBIA: MBIA, the world's largest bond insurer, reported its second consecutive quarterly loss Thursday after writing down \$3.5 billion worth of CDOs, those nasty, complex credit derivatives we mentioned Tuesday. **The company lost \$2.3 billion for the quarter, or \$18.61 a share.** Shares dropped more than 5% today to \$13.20. In the press release dated today and released minutes after midnight, CEO Gary Dunton said the company's capital-raising efforts will offset any credit impairments. **Hedge-fund manager Bill Ackman disagrees with Dunton. Ackman sent a letter to regulators yesterday estimating the two bond insurers will lose north of \$12 billion each.** Ackman's Pershing Square hedge fund is short MBIA and Ambac. **Who would you trust in this situation? On the one hand, you have a CEO who has done his best to conceal everything that's wrong with his company and helped to run a potentially wonderful business straight into the ground. On the other hand, you have a hedge-fund manager who read 140,000 pages on MBIA and has spent six years getting at the truth, uncovering everything that's wrong with the bond-insurance business.** MBIA had Ackman investigated by Eliot Spitzer and the SEC. Ackman's photocopying bill for subpoenaed documents was more than \$100,000. The SEC only recently sent Ackman a letter exonerating him, which he had to ask for multiple times. **On today's earnings conference call, MBIA only allowed questions to be submitted in advance through e-mail. This was MBIA's way of "taking the microphone away" from people who had "abused the privilege and ranted" in the past, said Greg Diamond, head of investor relations.** Diamond labeled these people adversaries of the company, its employees, and its business relationships. He didn't mention any names, but we all know Diamond was talking about Bill Ackman.
- Call it **Sony** shokku: the sequel. The Japanese consumer electronics and entertainment conglomerate, whose star was firmly in the ascendant, on Thursday indicated it would fail to meet its targets for full-year operating margins.

### Notes

- Let's return to Robert Shiller. His research shows that house prices in America, in real terms, are remarkably stable. For 100 years – from 1890 to 1990 – they went nowhere. **In real terms, they barely changed in the entire century. Then, suddenly after 1997, house prices shot up by 71% in real terms. What this tells us is that housing prices are not likely to remain up so high for too long. Historically, they kept up with inflation, nothing more. America is still a big**

- place; there is no obvious reason why all of a sudden housing should occupy a bigger percentage of the nation's assets and earnings. Most likely, the gains of the last 10 years will be given back.** But the process is long, slow and hard.
- In a recession or a crisis, the right approach for individuals is to save. So too for the national economy. A looming recession will prompt a pullback in consumer spending as a rational response to the perception of economic troubles. This action does not cause the economy to fall into recession any more than more spending can save it from recession. The downturn is a fact that cannot be avoided. **We don't blame umbrellas for floods, and, in the same way, we shouldn't blame tightfisted consumers for recessions.**
  - Now, turning to the rebate package just passed by the House of Representatives, we haven't looked at the details...just the amount. At \$146 billion it is almost exactly the same amount as Frederic Mishkin figures the U.S. economy lost last year in consumer spending because of the bear market in housing. Fed governor Mishkin says that families cut back spending by seven cents for every dollar their houses go down in price (with a lag, we presume). **Last year, that comes out to about \$150 billion of reduced spending. Assuming consumers spend their rebate checks, the economy comes out even.** But the drop in consumer spending caused by housing is just a small part of the deflation hitting the U.S. economy. Stocks are down 15% from their peak...and finance and housing industry leaders are reporting huge losses that could reach into the trillions before it is over. What's more, the collapse in consumers' purchasing power comes not just from a fall in their house prices, but also from the fact that they aren't rising. **At the peak of the bubble, homeowners were taking out as much as \$250 billion per quarter in refinancing, home-equity lines, and other housing related credit.** Now, that source is drying up. DR
  - Centro's plan was to fund the acquisition by selling its boatloads of commercial mortgage-backed securities (CMBSs)... but, umn... nobody wants to buy them. "The asset-backed commercial paper market is dead. Centro is just another in the growing list of casualties," says Mish. Over \$225 billion in CMBSs were issued between 2002-2007, multiples higher than at any other time in history. And just like with the consumer mortgage-backed security market this summer, buyers of CMBSs have stopped buying, but sellers have yet to re-evaluate their true worth. "This is exactly the same environment that preceded the housing plunge. Transactions dried up, inventories rose and sellers waited patiently to get their price. They never did. The winners recognized conditions had changed and bailed for whatever they could get."
  - Items excluded from US government inflation data include eggs – up 36% in 2007; bread up 12.6%; milk up 29% and chicken up 10.3%
  - **Ratings agency Standard & Poor's said it has begun cutting ratings of as much as \$534 billion in additional mortgage backed securities and CDOs. According to S&P officials, the downgrades could cost the world's holders of such securities more than \$265 billion in losses.** Such losses would have a "ripple impact" on broader financial markets, a release from the agency said. That would be shocking.
  - The downgrades have led to a series of problems for municipalities who rely on the insurance. If an insurer's rating falls, bonds backed by the insurer fall as well. The lower the rating, the higher the cost. "Clearly the cost for insurance is going up," said Richard Tortora, president of Capital Markets Advisors, which provides bond

advisory services for municipalities in the Northeast. There was about \$2.6 trillion in municipal bonds outstanding as of Sept. 30, the latest figures reported by the Securities Industry and Financial Markets Association. More than half of municipal bonds carry insurance, Tortora said. Any increased price on that insurance is "passed on to the taxpayer," Tortora said. Exactly how much larger of a burden taxpayers will shoulder depends on the underlying credit rating of the municipality. **"The prices for lesser-grade borrowers has widened rather significantly,"** said Tim Long, a managing director and investment banker focused on public finance with Robert W. Baird & Co. While cheaper bond insurance helps municipalities, rising insurance costs are unlikely to stop them from issuing a bond, Long said. The municipalities also have been helped by the rate cuts, Tortora said. The Fed moves have helped to offset the higher insurance prices, so municipalities have been able to avoid higher costs from the insurance uncertainties. But if the Fed is unable to keep up, the cost to governments will rise. [not mentioned is the plummeting revenues caused by a decline in the property tax base.]

- **In the last seven years of the Bush administration, the federal debt increased by two-thirds while U.S. household debt doubled.** Despite all this extra spending, median real incomes have continued to go down. **Practically all new jobs have been created either by government, or in housing, health care, bars or restaurants.** Jobs in manufacturing are now at levels not seen since just after WWII. **"This is the profile of a third world economy,"** says former Under Secretary of the Treasury **Paul Craig Roberts.** How does an economy like this keep going? It depends on the kindness of strangers and the stupidity of friends. Who but a fool or a friend would buy a U.S. 30-year treasury bond at a 4.28% yield? This number is only a few basis points from the number for annual increases in consumer prices. **Which means, if all goes well, investors can expect to make a return of zero on their investment over the next 30 years.** And if all this talk of Zimbabwe economics and banana republic finances turns out to be true, they can expect to suffer another round of losses – measured in the trillions. And why shouldn't it be true? The American Empire is a bit like General Motors, says Martin Hutchinson. It has heavy fixed costs, an aging workforce, worn-out equipment, mammoth debts, and it is losing market share. At home, the mobs call for bread. And every candidate for office – save the forgotten man, Dr. Ron Paul – offers more of it. "We cannot afford another year without decent wages because our leaders could not come together and get it done," said Barack Obama in South Carolina. DR
- **The dollar has lost 30% of its purchasing power during the last 7 years. Against gold, oil and other blue commodities – and other major currencies – it is down much more.**
- Who ever heard of a stock market without corrections? Don't prices go up as well as down? And isn't it normal from economies to take a breather every once in a while? Why the panic at a slight market pullback and first signs of a coming slump? **What is most astonishing about the situation is that there is so little astonishing about it. Bear markets and recessions – like the poor – will always be with us. It's not the end of the world when they come...because they go, too.** Why then the feds' desperate attempts to avoid them? As we pointed out yesterday, the stock market was barely down 15% from its all-time high and already the Bernanke Fed was taking

- emergency measures. And hardly has a slowdown begun, and both the House and the Senate have rushed through proposals to send out checks. What kind of economics is this? What theory tells you that you should send out \$1,000 checks as soon as GDP growth rates fall to 2%? And if \$1,000 checks are supposed to make things better, why not send out \$2,000 checks...and make them wonderful again? DR
- Later, after the dotcoms blew up, another hallucination developed. One that sophisticated financial engineering, combined with enlightened macroeconomic management, had made market crashes and recessions obsolete. The geniuses went to work with computers, proving that those fancy derivative contracts (which they were selling) were completely foolproof. They were supposed to run into problems only once in a blue moon. "You're talking about sigma 25 events," they said, as if they had a clue. Scarcely three years later, the moon was blue. DR
  - It is not even 20 years later, and both Russia and China are already formidable competitors. China's reserves of foreign currency, for example, are nearly 20 times those of the USA. China is said to have about 70% of its \$1.53 trillion pile in U.S. dollars. And now, if the Red Giant decides to dump dollars, America's economy will be hit by a major crisis...and possibly paralyzed. DR
  - David Fuller is right. What we are really watching is the decline of the United States of America...its currency...its capital base...and its competitiveness in the world economy. The feds can try to play out more lines of credit to strapped families, but what they are really doing is giving them more rope with which to hang themselves. The real problem is that American wages have not kept pace with inflation...which means, the average American is not as rich as he used to be. **He can only pretend to be rich...by exchanging more of his leisure time for dollars...and by borrowing. Both of those "coping mechanisms," as Robert Reich called them, are now exhausted.** Now, he's going to swing. DR
  - Deterioration of the commercial real-estate market will lead to rising losses and bank failures in the near future. Sound like typical bear rumblings? Maybe. Except in this case the "bear" making the rumblings is John Dugan, the comptroller of the currency. "We're entering a stage of the commercial real-estate credit cycle where problems have started to surface and losses have started to increase," Mr Dugan said in a speech in Florida, according to the *Financial Times*. Specifically, Dugan said what began as a residential real estate problem has spread to commercial real estate. Wait, just who is this so-called comptroller of the currency anyway? No worries. The Office of the Comptroller of the Currency (OCC) is merely responsible for ensuring the safety and soundness of the national banking system. Minyanville
  - Springfield, Massachusetts, brought a complaint against Merrill Lynch, which sold the city collateralized debt obligations that dropped in value. Merrill Lynch is paying \$13.9 million to settle the dispute.
  - Yesterday, Richard Russell noted that the cover of the latest issue of *BusinessWeek* has recession all over it. **The magazine-cover indicator says if an idea is popular enough to make the cover of a national magazine, it's either over already or it's not going to happen.** This sounds a little flimsy, but it's not to be taken lightly, especially when it comes to the big, overarching trends... The magazine-cover

indicator flashed a buy signal on oil in March 1999, when the cover of *The Economist* said the world was "Drowning in Oil." It flashed a big buy in stocks in the late 1970s when *BusinessWeek* pronounced "The Death of Equities." [This type of "analysis" is quite popular. The Business Week story repeated often, just as is the "Sports Illustrated jinx". However, a detailed study showed that there was not in fact any SI jinx. Instead, the times that disaster befell someone on the cover merely stood out while the vast majority where nothing happened did not. Putting more on point, how many bad news stories appeared during the Great Depression that did not herald the bottom?]

- Feb. 1 (Bloomberg) -- Microsoft Corp.'s \$44.6 billion unsolicited bid to buy Yahoo! Inc. signals a revival of mergers and acquisitions as corporate buyers exploit falling stock prices and fill a void left by private-equity firms. [note how quickly one event is extrapolated into another "all clear" – the reality is that very few companies can peel off pocket money to pay cash for a 44B purchase]
- **jobs fell by 17,000 in January** -- a number far below the 70,000-plus jobs analysts' expected to see. Unemployment fell slightly, down to 4.9%, which makes perfect sense... only the U.S. government can report an unexpected loss of jobs and lower unemployment in the same breath. Assuming the BLS doesn't "revise" the number back to positive growth next month, this will go down as the first monthly payroll decline since August 2003. **the jobs number is far worse than it seems.** The number of long-term unemployed -- those seeking a job for more than six months -- now stands at over 1.3 million -- up 22% from this time last year. The number of people who've given up looking for work is nearly double the same reading for 2000, the last time we feared a looming recession.
- Construction spending in December 2007 was \$1,140.2 billion at a seasonally adjusted annual rate, down 1.1% from November 2007 and down 2.3% from December 2006. For the full year 2007, the value of construction spending was \$1,161.3 billion, down 2.6% from 2006.
- The FBI on Tuesday said it is investigating 14 companies for possible accounting fraud, insider trading or other violations in connection with home loans made to risky borrowers. Agency officials did not identify the companies under investigation but said the wide-ranging probe, which began in spring 2007, involves companies across the financial services industry, from mortgage lenders to investment banks that bundle home loans into securities sold to investors. The Federal Bureau of Investigation is working in conjunction with the Securities and Exchange Commission on the corporate-fraud probe, said Neil Power, chief of the FBI's economic crimes unit in Washington. As the nation's housing crisis worsens, there has been a dramatic spike in the number of mortgage fraud cases under investigation. An agency spokesman said 1,210 such cases are open, up from roughly 800 a year ago. The announcement comes weeks after authorities in New York and Connecticut said they are investigating whether Wall Street banks hid crucial information about high-risk loans bundled into securities sold to investors. Power said the FBI is looking into the practices of so-called subprime lenders, as well as potential accounting fraud committed by financial firms that hold these loans on their books or securitize them and sell them to other investors.

- "Car sales were remarkably slow in January, probably in part because of dramatic stock market fluctuations that flustered consumers at a time when the housing market and other economic uncertainties were also making headlines," said Jesse Toprak, executive director for industry analysis at the auto information site Edmunds.com.
- A survey from the Confederation of British Industry indicated that UK retail sales lost further momentum in January as the balance of retailers reporting rising sales dropped to a 14-month low.
- Global growth has slowed "markedly" amid the turmoil in financial markets, and risks remain to the downside, the IMF said. In updating its World Economic Outlook, the fund said the world economy should slow to a 4.1% growth rate in 2008, down from a 4.4% rate forecast in October. Growth is estimated to be 4.9% in 2007. The U.S. economy is the main drag on the world economy, expected to decelerate to 1.5% growth in 2008 from an estimated 2.2% rate last year. "Financial market strains originating through the U.S. subprime sector -- and the associated financial losses -- have deepened and spread," said IMF chief economist Simon Johnson. WSJ
- "While considerably improved from the previous quarter, Countrywide's results for the fourth quarter of 2007 were adversely impacted by further credit deterioration across the industry and continued liquidity in the secondary mortgage markets," CEO and co-founder Angelo Mozilo said in a company statement. CFC 1/29/08
- Jan. 30 (Bloomberg) -- Woolworths Ltd., Australia's biggest retailer, posted second-quarter revenue that missed analyst estimates as rising fuel prices and interest rates curbed growth in supermarket and clothing sales.
- "On the political front, some noted the surprising focus on the manufacturing data given the change in the US economy, manufacturing had decreased to 15 pct of the workforce. The US now has more choreographers (16k) than metal casters. More people make a living shuffling cards (88k) rather than running lathes (66k) and there are three times the number of security guards than machinists (386k)."
- The intensifying credit crunch is so severe that lower interest rates alone will not be enough "to get out of the turmoil we are in", the managing director of the International Monetary Fund warned at the weekend. In a dramatic *volte face* for an international body that only in the autumn called for "continued fiscal consolidation" in the US, Dominique Strauss-Kahn, the new IMF head, gave a green light for the proposed US fiscal stimulus package and called for other countries to follow suit. "I don't think we would get rid of the crisis with just monetary tools," he said at the World Economic Forum in Davos, Switzerland, adding "a new fiscal policy is probably today an accurate way to answer the crisis". Mr Strauss-Kahn's words rip apart a long-standing global consensus that fiscal retrenchment in the US and Japan is needed to help reduce huge trade imbalances. It comes as the IMF is due to release new economic forecasts this week which, he said, would show a "serious slowdown and it needs a serious response".
- Fidelity Investments of Boston laid off more than 200 workers this week from its information technology and personal investments divisions.

## Weblinks

### Credit

- [this is yet another red herring. First it is doubtful this will ever happen. Second, even if they do not go under, it does not mean things are wonderful, it means a huge negative was avoided.] Feb. 1 (Bloomberg) -- New York Insurance Superintendent Eric Dinallo is trying to organize a bank-led rescue of Ambac Financial Group Inc. to prevent downgrades of the bond insurer that may roil credit markets, according to two people briefed on the plan. Eight banks including Citigroup Inc. and UBS AG have formed a group to provide financing, said one of the people, who declined to be identified because the details haven't been completed. Separate groups have begun working on similar plans to provide capital to MBIA Inc., the largest bond insurer, and Financial Guaranty Insurance Co., two people said. "While we cannot discuss specifics, there are a number of developments relating to the bond insurers," Dinallo said in a statement today. "We are continuing to communicate with all parties to help them reach firm deals as soon as possible." Ambac spokesman Peter Poillon didn't return calls seeking comment. **Fitch Ratings stripped Ambac, the second-largest bond insurer, of its AAA rating last month, casting doubt on the company's guarantees on about \$556 billion of municipal and structured finance debt.** Standard & Poor's and Moody's Investors Service Inc. are reviewing their top ratings on the New York-based company. Reductions would lead to asset writedowns for banks that depend on the insurers for coverage of securities. Reinsurance Plan One of Dinallo's proposals to rescue the company would have banks and securities firms act as reinsurers of bonds and securities that Ambac guarantees, one of the people said. Ambac would pay an upfront fee in return for a promise that the banks would reimburse it if insurance-related losses exceeded an agreed-upon limit, the person said. Another option would be for banks to provide the bond insurer with capital to help it pay claims. The banks discussing a possible Ambac rescue also include Royal Bank of Scotland Group Plc, Wachovia Corp., Barclays Plc, Societe Generale SA, BNP Paribas SA and Dresdner Bank AG, one of the people said. "Wachovia recognizes the importance of the monoline insurance industry to the financial services sector," said spokeswoman Christy Phillips-Brown. "We would be supportive of efforts to add stability to the system." Company by Company The banks discussing MBIA and FGIC weren't named by the people familiar with the discussions. Dinallo and the financial institutions that stand to lose money in the event of a downgrade have been moving to a company-by-company approach to reviving the industry. "The likelihood of getting an industry solution is not very high," said Merrill Lynch & Co. Chief Executive Officer John Thain during a conference call earlier this week. "It's quite likely that we get recapitalization or restructuring type of solutions for the individual companies." Ambac scrapped a plan last month to sell \$1 billion of shares or convertible notes after the bond insurer's stock plunged 70 percent in two days. The plan provoked a boardroom dispute and led to the departure of CEO Robert Genader. MBIA Inc., the largest bond insurer, this week received \$500 million from private-equity firm Warburg Pincus LLC., which has also agreed to backstop another equity raising of at least \$500 million. The insurer also sold \$1 billion of surplus notes. "Pressure is On" "MBIA has

already had \$2 billion in capital infusions," said Jeffrey Kleintop, the chief market strategist who helps manage \$163 billion for LPL Financial Services in Boston, in an interview on Bloomberg Television today. "Ambac has not seen any. The pressure is on to make sure they get what they need before S&P has to take some action." MBIA CEO Gary Dunton said yesterday the world's largest bond insurer has more than enough capital to keep its AAA grade and dismissed speculation the Armonk, New York-based company may go bankrupt. MBIA rose 86 cents, or 5.6 percent, to \$16.36. Financial Guaranty, a unit of New York-based FGIC Corp., lost its AAA credit rating at Fitch Ratings Jan. 30 after missing a deadline to raise capital. Willard Hill, a spokesman for MBIA, and Brian Moore, a spokesman for FGIC, didn't immediately return calls left after regular business hours today. \$15 Billion In a meeting with banks and securities firms last week, Dinallo proposed several possibilities for saving insurers, including a line of credit that may be as much as \$15 billion, said one of the people familiar with the negotiations. Spokeswomen Christina Pretto of Citigroup, Rohini Pragasam of UBS, Carolyn McAdam of Royal Bank of Scotland and Christelle Maldague of BNP Paribas declined to comment, as did spokesmen Alistair Smith of Barclays and Martin Halusa of Dresdner. The U.S. doesn't have a federal agency that regulates the insurance industry and instead leaves the task to the states. Dinallo is working on the plan for the bond insurers in consultation with New York Governor Eliot Spitzer and officials from the New York Federal Reserve Bank. "We wouldn't want to do anything without feeling we'd be moving in alignment with what the feds believed was the right thing to do," Spitzer said in an interview last week. Federal Regulators **Federal regulators may object to letting banks prop up Ambac because the maneuver may artificially delay writedowns of debt holdings, said Joshua Rosner, managing director at New York-based research firm Graham Fisher & Co.** "Those losses might ultimately happen anyway," Rosner said in an interview last week. Ambac is projected to lose \$11.6 billion on guarantees of mortgage-linked debt and other securities, according to William Ackman, managing partner at hedge fund Pershing Square Capital Management LP. **Dinallo's Rescue Plan Focuses on Ambac, People Say**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aAwQfj8ezp7g&refer=home>

- Jan. 31 (Bloomberg) -- It was the \$109,000 photocopying bill that hedge fund manager William Ackman says made him realize how much he'd read and underlined before betting against bond insurer MBIA Inc. in 2002. His law firm charged him for copying 725,000 pages of financial statements and other documents, 140,000 of them about MBIA, to comply with a subpoena. Following New York and U.S. probes of his trading and reports, Ackman persisted in challenging MBIA's AAA credit rating for more than five years, based on his own research. Ackman may soon be proved right. MBIA, the largest provider of insurance against defaults in the global credit market, today reported a fourth-quarter net loss of \$2.3 billion because of the declining value of mortgage-related securities it guaranteed. The independent research firm CreditSights Inc. this week said MBIA's credit rating may be downgraded. Ackman had warned that MBIA was magnifying its risks by backing instruments such as those based on loans to the least creditworthy homebuyers. "It's in the nature of a shareholder activist to be persistent," says Ackman, now 41. "I've been persistent because it's an important issue. People are obsessive about stupid things. They are persistent about important things." In the MBIA documents, Ackman says he saw that the insurer was guaranteeing untested asset-backed

securities. He also found a reinsurance transaction that allowed the company to downplay a loss. MBIA agreed in January 2007 to pay \$75 million to settle U.S. regulators' inquiries into that deal. Speaking Publicly "He has spoken out publicly about it, approached regulators, talked to the media," says David Einhorn, 39, head of New York-based Greenlight Capital LLC, who also has wagered against MBIA. **"He's not more right today than he was five years ago that MBIA was never AAA."** Yesterday, in a letter to the Securities and Exchange Commission and to New York Insurance Superintendent Eric Dinallo, Ackman said MBIA and Ambac may each lose \$11.6 billion on guarantees of mortgage-linked debt and other securities. He posted a list of the securities the two companies guaranteed on the Internet, along with a model supplied by an unnamed investment bank, so investors could do their own forecasts of what the insurers might lose. "No one wanted to believe that a AAA-rated company was doing what it was doing," says Roger Siefert, a forensic accountant Ackman hired in 2003. **"We were treated like the little boy saying 'the emperor has no clothes.'"** Chuck Chaplin, MBIA's chief financial officer, says in an interview that Ackman's criticism reflects misperceptions of the bond insurer's business. He disputes Ackman's estimates of MBIA's losses and says the trader is benefiting more from lucky timing than smart analysis. "He was at the right place at the right time," Chaplin says. "The past six months turned out to be a good time to be short business sectors with mortgage-market exposure, and as it turned out, the bond insurers ended up being one of them." "Mr. Ackman is a slick salesman who doesn't know much about insurance," Whitman said. Whitman's firm owned more than 10 percent of MBIA's stock, he said in the interview. Advertising Commissions Straight out of business school, Ackman started his first hedge fund, Gotham Partners, with fellow student David Berkowitz. In the mid-1990s, Gotham tried to buy Rockefeller Center. During the talks, Ackman, then 28, says he got a call from Donald Trump. Ackman took an interest in MBIA after asking a credit-market trader which companies didn't deserve AAA ratings, he says. In a report entitled, "Is MBIA Triple-A?" he argued that the company had insufficient reserves to cover potential losses and was guaranteeing increasingly risky debts. Spitzer Investigation Late in 2002, Ackman published his MBIA findings on Gotham's Web site. Ron MacDonald, the head of reinsurance at MBIA until 1999, read the report early in 2003 and e-mailed Ackman praising it, MacDonald says. Ackman learned in January 2003 from a Wall Street Journal reporter that Spitzer was investigating whether Gotham had engaged in manipulative trading on MBIA and other companies and that the newspaper would publish an article the next day. The SEC later started its own probe. "This is going to be a good thing," Ackman says he told friends that evening. "I'm going to meet Eliot Spitzer." He says he saw it as an opportunity to turn the tables and present his concerns about MBIA. Turning the Tables Ackman and Siefert, the forensic accountant, drew investigators' attention to the reinsurance deal that led to the \$75 million settlement a year ago. The transaction covered MBIA for losses related to the 1998 bankruptcy of a Pennsylvania hospital group.

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a5tQL4.YXs8I&refer=home>

- January 30 2008 FT Further uncertainty over the fate of the embattled bond insurers has rocked the normally sedate world of municipal bond investing in recent weeks. **Municipal bond yields have spiked sharply higher versus US Treasuries, a sign that**

**long-term investors are selling munis because of a perceived increase in risk – about half of the \$2,600bn municipal bond market is guaranteed by bond insurers such as MBIA and Ambac.** But it is also a sign of forced selling from a little-known but important group of short-term municipal bond investment vehicles that have run into acute stress in recent weeks, based on suspicions about the quality of bond insurers’ guarantees on the paper that they issue. “For a long time, investors were working on the assumption that the insurers would always be AAA-rated and now they are looking at the world through a different lens,” said Ben Thompson, portfolio manager at Samson Capital Advisors. “It’s a pretty bad scenario for munis and everything hinges on the fate of the bond insurers.” **The vehicles, known as tender option bonds, have been popular with money market funds – which are required to invest in short-term and highly-rated paper and to maintain the value of every dollar invested.** TOB programmes issue securities backed by long-term municipal bond assets. The securities typically have long-term maturities, but the buyers of such notes have the right to tender them back to the issuer for repayment, usually on a weekly basis. The market for TOBs, and related programmes such as variable rate demand obligations, is worth \$400bn. Now that the bond insurers, also known as monolines, face losing their crucial AAA ratings because of subprime mortgage losses, money market investors are selling TOB paper to protect themselves from the risk of downgrades. “Over the last few months, tax-free money market funds have liquidated anything they had concerns about,” said Mr Thompson. “Some have sold everything with exposure to the bond insurers and others have combed through the underlying ratings to decide what to sell.” He said problems with the bond insurers had taken a large part of the municipal bond market and made it ineligible for money market funds choosing to invest only on the underlying ratings. More than 50 per cent of the overall municipal bond market is rated A or below, the level at which it becomes ineligible for money market buyers. **This has pushed the cost of funding for TOB programmes sharply higher and forced some to begin selling long-term assets from their portfolios.** Dan Solender, head of municipal bond management at Lord Abbett said: “There’s been some selling of bonds out of TOB structures in the last week in particular, because rating concerns over the insurers have raised the cost of their short-term funding.” Traditionally, muni bonds yield much less than US Treasuries because of their tax-advantaged status – from the beginning of 2001 to July 2007, two-year muni yields averaged just 78 per cent of US Treasury yields. Recent selling pressure in the market has pushed that ratio up to more than 90 per cent. This has also proved problematic for sponsors of the related VRDO programmes, which are typically run by municipal issuers themselves. **As money market investors sell out of their exposures to such programmes, municipal issuers have had to find the cash elsewhere – and pay dearly for it.** Christian Stracke, analyst at CreditSights said: “Because muni money market funds are so sensitive to the credit ratings of their assets, a downgrade of a monoline, which had provided a TOB credit enhancement, could force the money market funds to exercise their puts.” Fears of further downgrades are not the only driver of concern about such vehicles, however, warns Mr Stracke. As another requirement for the programme’s AAA rating, the TOBs secure a bank liquidity backstop line of credit. The problem is that, given bank balance sheet constraints as a result of problems in the mortgage market, such lines of credit look less secure. “In the context of banks having to take well over \$100bn in [structured investment vehicle] assets on to their balance sheets,

the banks' ability to take on any additional assets, regardless of their underlying credit quality, is far from certain," said Mr Stracke. The uncertainty has raised the cost of financing for municipalities such as hospitals and school districts, helping to push new issuance in the municipal bond market down more than 20 per cent year-on-year, marking the first meaningful decline in the market since 2003. **Municipal bonds hit by monoline uncertainty** <http://www.ft.com/cms/s/0/c7f65d06-cf85-11dc-854a-0000779fd2ac.html>

- Jan. 31 (Bloomberg) -- **Losses from securities linked to subprime mortgages may exceed \$265 billion as regional U.S. banks, credit unions and overseas financial institutions write down the value of their holdings, according to Standard & Poor's.** S&P cut or put on review yesterday the ratings on \$534 billion of bonds and collateralized debt obligations tied to home loans made to people with poor credit, the most by the New York-based firm in response to rising mortgage delinquencies. While banks and securities firms such as Citigroup Inc. and Merrill Lynch & Co. accounted for most of the \$90 billion in writedowns to date, S&P said the next round will be borne mainly by smaller financial institutions in Europe, Asia, and the U.S. The ratings actions yesterday may create a "ripple impact" that further reduces prices of the securities, S&P said. **"There's a lack of confidence in the markets and this exacerbates that,"** said Anthony Davis, a banking analyst at Stifel Nicolaus & Co. in Florham Park, New Jersey. **"This will have a chilling effect on the markets."** Almost half the subprime bonds rated by S&P in 2006 and early 2007 were cut or placed on review, potentially forcing credit unions and government-sponsored enterprises such as Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks to write down their holdings, the firm said. The securities represent \$270.1 billion of subprime mortgage bonds and \$263.9 billion of CDOs. About 35 percent of all CDOs comprised of asset-backed securities were put under review, S&P said. Widespread 'Implications' **"It is difficult to predict the magnitude of any such effect, but we believe it will have implications for trading revenues, general business activity, and liquidity for the banks,"** S&P said in a statement yesterday. Some of the largest banks have already taken "significant" losses related to subprime mortgages and CDOs, and aren't likely to report more writedowns, S&P said. CDOs package assets into new securities with varying degrees of risk, from AAA to unrated classes. **Accounting rules have allowed smaller banks to avoid writing down their holdings until the credit ratings fell if they intended to keep them until maturity. S&P said it will review the ratings of smaller banks that are "thinly capitalized."** **It didn't name any of the institutions.** The largest U.S. regional banks with the **lowest Tier 1 capital ratios as of June 30 were Seattle-based Washington Mutual Inc.; Wachovia Corp. in Charlotte, North Carolina; National City Corp. of Cleveland; Atlanta-based SunTrust Banks Inc.; and Regions Financial Corp. in Birmingham, Alabama.** Tier 1 capital measures a company's ability to cover losses. Spokespeople for the banks either declined to comment or couldn't be reached for comment. Credit Unions The nation's biggest credit unions by assets include Navy Federal Credit Union in Vienna, Virginia; State Employees Credit Union in Raleigh, North Carolina; and Pentagon Federal Credit Union in Alexandria, Virginia, according to

American Banker. Spokespeople for the credit unions didn't immediately return calls for comment. **Even before the S&P downgrades, analysts at Credit Suisse Group predicted that Washington-based Fannie Mae and Mclean, Virginia-based Freddie Mac, the two largest providers of mortgage financing, would write down their subprime holdings by \$16 billion because they could no longer argue the declines would be reversed.** ``We expect that the U.S. housing market, especially the subprime sector, will continue to decline before it improves, and we expect housing prices will continue to come under stress," S&P said in the report. Foreclosures Increase S&P's move came a day after RealtyTrac Inc. said the number of U.S. homeowners entering foreclosure climbed 75 percent in 2007 from a year earlier as mortgages became more difficult to refinance and falling property values made it tougher to sell. More than 1 percent of U.S. households were in some stage of foreclosure during the year, up from 0.58 percent in 2006, according to RealtyTrac, an Irvine, California-based seller of real estate data. Home prices in 20 U.S. metropolitan areas fell 7.7 percent in November, the 11th consecutive decline, according to the S&P/Case-Shiller home-price index released this week. The Federal Reserve yesterday cut its target interest rate for overnight loans between banks by half a percentage point to 3 percent, the lowest since June 2005. Lower borrowing costs may help borrowers of subprime loans by reducing the scheduled rate increases on their mortgages, according to reports by analysts at banks including Wachovia and JPMorgan Chase & Co. in New York. **Subprime, CDO Bank Losses May Exceed \$265 Billion, S&P Says**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aS\\_DNKFmqEx4&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aS_DNKFmqEx4&refer=home)

- Jan. 31 (Bloomberg) -- **MBIA Inc., the world's largest bond insurer, posted its biggest-ever quarterly loss and is considering new ways to raise capital after a slump in the value of subprime-mortgage securities.** The fourth-quarter net loss was \$2.3 billion, or \$18.61 a share, raising concern the Armonk, New York-based company will lose its top credit ratings. The loss came a day after FGIC Corp.'s insurance unit became the third company to be stripped of its AAA grade. MBIA is seeking to convince Moody's Investors Service to retain the highest ranking for its insurance unit as Chief Executive Officer Gary Dunton tries to shore up capital through stock and bond sales. Without the Aaa stamp, MBIA's business would be crippled and throw ratings on \$652 billion of securities into doubt. The threat of losses prompted the New York State Insurance Department to call a meeting of banks last week to discuss a rescue. ``In the absence of a credible bailout plan, I think investors and issuers need to assume that MBIA, along with all of the other companies, will face continuing, worsening downgrade pressure all year," said Matt Fabian, a managing director at Concord, Massachusetts-based consulting firm Municipal Market Advisors. Excluding writedowns and some other items, the operating loss was \$407.8 million, or \$3.30 a share, MBIA said today in a statement. The average analyst estimate from a Bloomberg survey was for a loss of \$2.98. **``We are disappointed in our operating results,"** Dunton, 52, said in the statement. Bond insurers guarantee \$2.4 trillion of debt combined and are sitting on losses of as much as \$41 billion, according to JPMorgan Chase & Co. analysts. Their downgrades could force banks to write down \$70 billion, Oppenheimer & Co. analyst Meredith Whitney said yesterday in a report. Hedge Fund Pressure Hedge fund manager

William Ackman has also stepped up pressure on the companies. Ackman, a managing partner of Pershing Square Capital Management LP, released a letter to regulators yesterday estimating MBIA's CDO losses would reach \$11.6 billion. MBIA posted \$3.4 billion of losses from marking down the value of residential and commercial mortgages as well as CDOs that it guarantees, according to the statement. MBIA also wrote off its \$85.7 million investment in Channel Reinsurance Ltd., which reinsures securities guaranteed by MBIA. Moody's said Jan. 23 it may cut Channel Re's Aaa rating. Adjusted direct premiums, a measure of new business written that doesn't adhere to generally accepted accounting principles, fell 38 percent to \$262.4 million during the fourth quarter, MBIA said. **``Today's announcement is hardly good news," Cicione said. ``MBIA said it's pursuing plans to raise capital, which will be supportive for its ratings but it may not be enough.** ``MBIA can raise more capital, but will probably need to sell the attractive parts of its business to do so," said Toby Nangle, who helps oversee \$37 billion as head of global aggregate business at Baring Asset Management in London. ``They're a long way from being out of the woods. A downgrade is still a real possibility." **MBIA Posts Biggest Loss, Considers New Capital Plans**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aCvAZBIR\\_obI&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aCvAZBIR_obI&refer=home)

- Jan. 30 (Bloomberg) -- Standard & Poor's said it cut or may reduce ratings on \$534 billion of subprime-mortgage securities and collateralized debt obligations, the most sweeping action in response to rising since home-loan defaults. **The downgrades may extend bank losses to more than \$265 billion and have a ``ripple impact" on the broader financial markets, S&P said in a statement today.** The securities represent \$270.1 billion, or 47 percent, of subprime mortgage bonds rated between January 2006 and June 2007. The New York-based ratings company also said it may cut 572 CDOs valued at \$263.9 billion. The reductions may increase losses at European, Asian and U.S. regional banks, credit unions and government-sponsored enterprises such as Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks, S&P said. Many of those institutions haven't written down their subprime holdings to reflect a drop in market values and these downgrades may force them to recognize losses, S&P said. **``It is difficult to predict the magnitude of any such effect, but we believe it will have implications for trading revenues, general business activity, and liquidity for the banks,"** S&P said. The ratings company will start reviewing its rankings for some banks, especially those that ``are thinly capitalized," it said. S&P downgraded \$50.1 billion of subprime-mortgage securities, none rated higher than A+. More than 69 percent of the AAA rated subprime securities from 2006 and 46 percent from the first half of 2007 were placed on review. Didn't See It ``This one, I didn't see coming," said Mark Adelson a consultant at Adelson & Jacob Consulting LLC in New York, and a former asset-backed bond analyst at Nomura Securities. Some of the largest global banks have already taken ``significant" losses and they aren't likely to have more writedowns, S&P said. CDOs repackage assets into new securities with varying degrees of risk, from AAA grade to unrated classes. Subprime loans are made to people with poor credit. **Under accounting rules, many smaller banks haven't been required to write down their holdings until the credit ratings fell, enabling them to avoid the losses at bigger competitors including Citigroup Inc., Merrill Lynch & Co. and UBS AG.** The world's largest banks have

reported losses exceeding \$133 billion related to mortgages, CDOs and high-yield, high-risk loans, according to data compiled by Bloomberg. "If you're holding a AAA piece and it's now downgraded to AA, you might have to write it down, even if you're holding it for an investment," Gary Gordon, a bank stock analyst at Portales Partners LLC in New York, said. **"The longer it goes on and the higher the credit rating of the instrument downgraded, the wider the pain."** Foreclosures S&P's move comes a day after RealtyTrac Inc. said the number of U.S. homeowners entering foreclosure climbed 75 percent in 2007 from a year earlier as mortgages became more difficult to refinance and falling property values made it tougher to sell. More than 1 percent of U.S. households were in some stage of foreclosure during the year, up from 0.58 percent in 2006, according to RealtyTrac, an Irvine, California-based seller of real estate data. Home prices in 20 U.S. metropolitan areas fell 7.7 percent in November, the 11th consecutive month of declines, according to the S&P/Case-Shiller home-price index released this week. **S&P Lowers or May Cut \$534 Billion of Subprime Debt**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=am2Nk1VM5YsA&refer=home>

- Jan. 29 (Bloomberg) -- **The market for high-yield, high-risk bonds shows that a U.S. recession is a foregone conclusion.** Junk bonds are off to their worst start since 1990, falling 1.8 percent and triggering \$17 billion in losses this month, according to index data compiled by New York-based Merrill Lynch & Co. Yields relative to Treasuries are rising at the fastest pace in at least 11 years as prices drop. **The pain may only get worse. Speculative-grade borrowers made up the majority of U.S. corporate debtors for the first time last year, according to Standard & Poor's. The default rate will soar to more than 8 percent this year, the highest since Enron Corp.'s collapse rippled through the market in 2002, estimates Zurich-based UBS AG. Yields show retailers, homebuilders and mortgage companies are among companies at the greatest risk as banks rein in lending.** "You're somewhere between half and 60 percent of the way from the top of the market to the bottom of the market" if the economy contracts, said Michael Parks, a managing director at Los Angeles-based TCW Group Inc., which manages \$148 billion in assets. "Who wants to put a lot of capital to work there?" Junk bonds, debt rated below the investment grade threshold of Baa3 at Moody's Investors Service and BBB- at S&P, fell an average of 9 cents on the dollar between March and November 2001, when the National Bureau of Economic Research Inc. in Cambridge, Massachusetts, said the last recession occurred. **\$50 Billion Losses** This month they've dropped an average 2 cents on the dollar. An additional 7 cents would create losses of about \$50 billion, based on the \$709 billion of debt in Merrill's high-yield index. In a recession, the extra yield investors demand to own junk bonds instead of Treasuries would widen to an average of more than 10 percentage points from about 7 percentage points, said Parks, who wouldn't disclose what he was buying or selling. The spread was a record low of 2.41 percentage points in June. **"The market is saying 'We're on the verge of a recession and we may see an incredibly rapid escalation in the default rate,'"** said Martin Fridson, chief executive officer of high-yield research firm FridsonVision LLC in New York. **"The floodgates could really open."** A recession as deep as the one in 1990, which lasted eight months, may push the rate to 16 percent, said Fridson, who previously led a research group at Merrill that won first place for high-yield strategy in Institutional Investor's survey nine years in a row. Enron

Aftermath The December 2001 failure of Houston-based energy trader Enron was the biggest bankruptcy to date. It sparked an 11.2 percent annualized default rate the following month, according to New York-based Moody's. Spreads reached 11.2 percentage points in October 2002, the highest since at least 1996. The economy will contract in the first three quarters of this year as a drop in home prices, stock market declines and rising unemployment contribute to "the worst consumer recession since 1980," David Rosenberg, Merrill's chief North America economist, said in a Jan. 22 report. In a Bloomberg survey published Jan. 9, he called for the economy to expand in every quarter. **The subprime crisis is "just the tip of the iceberg,"** said Wilbur Ross, the billionaire chairman of New York-based WL Ross & Co. who made his fortune buying distressed steel and textile businesses. "Afraid of Everything" **"For quite a few years, nobody in the credit markets was afraid of anything," Ross said in an interview with Bloomberg Television last week. "Now we're going into a period where they'll be afraid of everything."** The appetite of investors such as hedge funds enabled even the lowest-rated companies to raise debt financing and avert default last year. Since then, the widening of spreads has enticed buyers such as Matthew Eagan, a money manager at Boston-based Loomis Sayles & Co., who said investors previously weren't being compensated for the risk **Junk Bond Market Widening Spreads Signal Worst Bust Since Enron**

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

- Jan. 29 (Bloomberg) -- New York Insurance Superintendent Eric Dinallo's attempt to bail out bond insurers is "coming too late in the game" to stave off ratings downgrades, CreditSights Inc. analysts said in a report. Dinallo wants to bolster bond insurers' capital with a \$15 billion guarantee fund supported by contributions from banks and securities firms, according to the New York-based bond-research firm. Setting up the fund and gaining the backing of the banks is likely to be overtaken by events, CreditSights said today. **"Given the number of competing interests and levels of commitment of participants involved, we think it is unlikely that an agreement sponsored by Dinallo could be hammered out within the appropriate timeframe,"** Rob Haines, Craig Guttenplan and Joe Di Carlo wrote. "In the offchance that any deal could be solidified, the rating agencies are likely to have already taken action." Bond insurers including MBIA Inc. and Ambac Financial Group Inc., the two largest, have guaranteed about \$2.4 trillion of securities issued by U.S. cities and states and bonds backed by mortgages, credit cards and other assets. The industry has been seeking capital since November when Fitch Ratings and Moody's Investors Service began reviewing the effect of rising defaults on subprime mortgage securities guaranteed by the insurers. **Bond Insurer Bailout Plan May Be 'Too Late,' CreditSights Says**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aJ44bYhiJPTA&refer=home>

## Commercial Real Estate

- Jan. 31 (Bloomberg) -- New York real estate developer Harry Macklowe will sell the General Motors Building on Fifth Avenue in Manhattan next month to help pay debts he owes to Deutsche Bank AG, said two people with knowledge of the plans. Bids for the 50-story GM building are due Feb. 15, said one of the people, who declined to be

identified because he isn't authorized to discuss the deal. Macklowe, 70, bought seven Manhattan skyscrapers from billionaire Sam Zell's Equity Office Properties Trust for \$7.2 billion a year ago, spending \$50 million of his own money and borrowing the rest. The developer reached an agreement to turn the properties over to lenders because he was unable to refinance as real estate values declined over the past year, the Wall Street Journal reported today. "People who said Sam Zell called the top of the market were 1,000 percent right," said David Tobin, a principal at Mission Capital Advisors LLC in New York, which advised on \$5 billion of property sales last year. Equity Office Sale The developer pledged his stake in the GM Building as collateral for a \$1.2 billion bridge loan by Fortress Investment Group LLC that helped finance the acquisition of the seven office buildings, the Journal reported. Macklowe bought the GM Building in 2003 for a then-record \$1.4 billion. Macklowe bought the seven office buildings on Feb. 9, 2007, the same day that Blackstone Group LP bought Equity Office for \$39 billion including debt, in the biggest leveraged buyout up to that time. Macklowe borrowed \$5.8 billion from Deutsche Bank to buy the properties and hasn't been able to refinance the debt, which comes due Feb. 9. A trip by Macklowe to the Middle East to drum up equity partners proved fruitless, the people said. Earlier this month, Macklowe hired CB Richard Ellis, the world's largest commercial real estate broker, to find a buyer or investor for the GM building. Deutsche Bank extended the loan while stipulating that it would control the properties while they are marketed and sold, the Journal reported.

### **Macklowe to Sell GM Building Next Month to Pay Debt, People Say**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=allKfDkp\\_TM0&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=allKfDkp_TM0&refer=home)

## **Commodities**

### **Currency**

- FT February 1 - The dollar fell to within striking distance of a record low against the euro on Friday after data showed a surprise fall in US employment in January. The dollar fell 0.4 per cent to \$1.4930 against the euro, within half a cent of the record low of \$1.4968 it hit against the single currency last November, lost 0.2 per cent to Y106.05 against the yen and eased 0.1 per cent to \$1.9900 against the pound. However, analysts said one reason why the dollar had failed to fall more sharply following the 125 basis-point cut seen in US interest rates over the past two weeks was a considerable portion of the market took the view that the bad news from the US was already priced in. **Dollar falls after jobs data** [http://www.ft.com/cms/s/0/b3e60a2a-d0aa-11dc-953a-0000779fd2ac.html?nclick\\_check=1](http://www.ft.com/cms/s/0/b3e60a2a-d0aa-11dc-953a-0000779fd2ac.html?nclick_check=1)
- Jan. 30 (Bloomberg) -- The yuan climbed to the highest since the end of a link to the U.S. currency in 2005 on speculation China's worst snowstorms in five decades will exacerbate inflation, paving the way for faster currency gains. The yuan rose for a sixth day as the heaviest snow fall since 1954 has killed 24 people, destroyed 4.2 million hectares of farmland and strained supplies of food and coal. China is willing to use the exchange rate to help slow inflation, which is double the central bank's annual target. "Transport problems will cause shortages in many areas and energy demand for heating

will be surging," said Sean Callow, a currency strategist at Westpac Banking Corp in Singapore. ``Allowing faster yuan appreciation is a better way to fight commodity price inflation." The currency's gains have accelerated this year, racking up a 1.5 percent advance so far after rising about 7 percent in 2007. Japan's former top currency official Eisuke Sakakibara forecast yesterday that the yuan may rise more than 10 percent this year. **China's Yuan Rises on Speculation Snowstorm Will Push Up Prices**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aVna3xz7abDQ&refer=home>

- Jan. 30 (Bloomberg) -- The yen gained against all 16 of the most-active currencies on speculation credit-market losses will prompt investors to sell higher-yielding assets. The currency rose the most versus Australia's dollar, a favorite of so-called carry trades, after Yomiuri newspaper reported Mizuho Financial Group Inc.'s losses linked to subprime debt may swell to 250 billion yen (\$2.3 billion) in the year ended March 31. The dollar fell on speculation the Federal Reserve will cut interest rates today by a half-percentage point. ``The subprime problems don't seem to be fully resolved yet," said Masanobu Ishikawa, general manager of foreign exchange at Tokyo Forex & Ueda Harlow Ltd., Japan's largest currency broker. ``Investors are still very averse to taking on risk. It's a factor for buying the yen." The yen climbed to 106.86 against the dollar at 10:10 a.m. in Tokyo from 107.11 late in New York yesterday. It also advanced to 157.77 per euro from 158.27. Japan's currency may rise to 157.50 against the euro and 106.70 versus the dollar today, Ishikawa forecast. In a carry trade, investors get funds in a country with low borrowing costs and invest in one with higher interest rates, earning the spread between the borrowing and lending rate. The risk is that currency market moves erase those profits. **Yen Rises on Concern Credit-Market Losses to Slow Global Growth**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aTxiIhwoWn3I&refer=home>

## Derivatives

- Jan. 31 (Bloomberg) -- The risk of companies defaulting soared after the bond insurer MBIA Inc. posted a record loss and Standard & Poor's cut or put on review ratings on \$534 billion of bonds and collateralized debt obligations. Credit-default swaps on Europe's benchmark Markit iTraxx Crossover Index jumped 29 basis points to 479 today, the highest in a week, according to JPMorgan Chase & Co. prices at 11:25 a.m. in London. In Asia, the Markit iTraxx Japan index rose 6 basis points to 70, Morgan Stanley prices show. MBIA, the biggest bond insurer, reported a fourth-quarter net loss of \$2.3 billion, fueling concern it will be stripped off its top credit rankings, crippling its business and throwing ratings on \$652 billion of securities into doubt. S&P said its review of debt securities linked to home loans may cause bank losses to exceed \$265 billion and have a ``ripple impact" on the financial markets. ``**The market has accounted for only half those losses," said Mehernosh Engineer, credit strategist at BNP Paribas in London.** ``**The question is, where are the rest of the losses?**" Credit-default swaps on Mitsubishi UFJ Financial Group Inc. and Mizuho Financial Group Inc., the two biggest Japanese banks, rose after they reported a combined \$3 billion of third-quarter losses from subprime-related investments. Mitsubishi UFJ increased 7 basis points to 45 and Mizuho jumped 9 to 99. `Credit Crunch' ``**Does it stop here or will it increase?**" said

**Engineer at BNP Paribas. "If it increases, we'll start going into a credit crunch again because it will start sucking up capital on to financials' balance sheets."**

Contracts on the Markit iTraxx Europe index of 125 companies with investment-grade ratings rose 6 basis points to 79.75, JPMorgan prices show. The Markit CDX North America Investment Grade Index rose 5 basis points to 107.5 at the close of trading in New York yesterday, according to Deutsche Bank AG. **Corporate Bond Risk Soars on MBIA Loss, S&P's Subprime Review**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aB6R9yXyyPJo&refer=home>

- Jan. 28 (Bloomberg) -- The risk-taking model that emboldened Wall Street to trade with impunity is broken and everyone from Merrill Lynch & Co. Chief Executive Officer John Thain to Morgan Stanley Chief Financial Officer Colm Kelleher is coming to the realization that no algorithm or triple-A rating can substitute for old-fashioned due diligence. **Value at risk, the measure banks use to calculate the maximum their trades can lose each day, failed to detect the scope of the U.S. subprime mortgage market's collapse as it triggered more than \$130 billion of losses since June for the biggest securities firms led by Citigroup Inc., Merrill, Morgan Stanley and UBS AG.** The past six months have exposed the flaws of a financial measure based on historical prices that securities firms use **idiosyncratically and that doesn't anticipate every potential disaster, such as the mistaken credit ratings on defaulted subprime debt.** "Finance is an area that's dominated by rare events," said Nassim Taleb, a research professor at London Business School and former options trader. **"The tools we have in quantitative finance do not work in what I call the 'Black Swan' domain."** Taleb's book "The Black Swan," published last year by Random House, describes how people underestimate the impact of infrequent occurrences. Just as it was assumed that all swans were white until the first black species was spotted in Australia during the 17th century, **historical analysis is an inadequate way to judge risk,** he said. Merrill vs. Goldman Executives at Merrill, Morgan Stanley and UBS took steps in the past six weeks to overhaul their risk-management groups after internal models failed to foresee the first annual decline in house prices since the Great Depression that eroded five years of trading gains. Goldman Sachs Group Inc., the firm with the highest nominal VaR, was the sole investment bank to report record earnings in the fourth quarter, while New York-based Merrill, which had the second-lowest nominal VaR of the five biggest U.S. securities firms, posted a \$9.8 billion loss for the last three months of 2007, the biggest in its 94-year history. Rogue Trader Societe Generale said the trader was Jerome Kerviel, 31, who joined the bank's trading division in 2006 after working six years in the company's back office. He had "intimate and perverse" knowledge of the bank's controls, which enabled him to avoid detection, Co-Chief Executive Officer Philippe Citerne told reporters on Jan. 24. Citerne didn't identify the trader. "That's a whole other side of risk management," said Benjamin Wallace, who helps oversee \$850 million at Grimes & Co. in Westborough, Massachusetts, which owns shares of Morgan Stanley and Merrill. **"That's not the modeling, that's making sure that people are overseen properly."** Hiring risk managers and giving them more power won't alter the mistake that led to last year's slump and that was Wall Street's dependence on statistics to quantify risks, Taleb said. **"We have had dismal failures in quantitative finance in measuring these risks,**

**yet people hire quants and hire risk managers simply to back up their desire to take these risks," he said. "There are some probabilities that you cannot compute."**

Bigger Bets Banks and securities firms increased the size of their trades during the past decade on interest rates, stocks, commodities and credit. Trading revenue for the five largest securities firms -- Goldman, Morgan Stanley, Merrill, Lehman Brothers Holdings Inc. and Bear Stearns Cos. -- climbed to a combined \$71.1 billion by 2006 from \$29.1 billion in 2002. The higher profits added to the firms' capital, enabling even bigger trading bets. "You can scale your value at risk relative to your book value," said Wallace. "It was a self-reinforcing part of the cycle." Goldman's average daily VaR more than tripled to \$151 million in the fourth quarter from \$46 million five years earlier, according to company reports. Goldman's VaR was almost twice as high as Merrill's in the third quarter. Merrill said third-quarter daily average VaR was \$76 million, compared with Goldman's \$139 million, Morgan Stanley's \$87 million, Lehman's \$96 million and Bear Stearns's \$32 million. Different Methodologies All the New York-based firms base their calculations at a confidence level of 95 percent, meaning they don't expect one-day drops to exceed the reported amount more than 5 percent of the time. The amounts differ in part because every firm uses their own methodology and data. For instance, Lehman uses four years of historical data to calculate VaR, with a higher weighting given to more recent time periods, while Morgan Stanley provides VaR calculations using both four years and one year of market data. "If you compare what peoples' values at risk are versus what their losses were in the third quarter or fourth quarter, the numbers are astounding," said David Einhorn, president and co-founder of hedge fund Greenlight Capital LLC in New York. "There are a lot of things that probably the value-at-risk model said would have trivial losses 95 percent of the time or 99 percent of the time but are now having a huge loss." Mortgage Defaults Merrill's highest one-day value at risk in the third quarter was \$92 million, indicating that the firm's maximum expected cost during the 63-trading day period would be \$5.8 billion. In fact, the firm wrote down \$8.4 billion from the value of collateralized debt obligations, subprime mortgages and leveraged finance commitments, 45 percent more than the worst-case scenario. All of the risk-measurement tools failed to prepare Merrill for the unforeseen declines on triple-A rated securities backed by subprime mortgages, according to the company's third-quarter filing with the U.S. Securities and Exchange Commission. The firm's writedowns related to the highest-rated portions of CDOs backed by pools of home loans, which plunged in value as defaults on the underlying mortgages soared. **"VaR, stress tests and other risk measures significantly underestimated the magnitude of actual loss from the unprecedented credit market environment,"** Merrill's filing said. "In the past, these AAA ABS CDO securities had never experienced a significant loss in value." Meriwether's Fund Securities firms developed statistical models during the early 1990s to better quantify risks as the trading of bonds, stocks, currencies and derivatives increased. J.P. Morgan & Co., now part of JPMorgan Chase & Co., helped popularize the use of value at risk as the primary measurement tool in 1994 when it published its so-called RiskMetrics system. Four years later, two events helped demonstrate the drawbacks in using statistical analysis based on historical market movements to measure risk. Russia's bond default sent fixed-income markets into a tailspin and Long-Term Capital Management LP, the Greenwich, Connecticut-based hedge fund run by former Salomon Brothers trader John W. Meriwether, had to be bailed out after \$4 billion of trading declines. "Market Stress'

Russia's default risk was underestimated because value-at-risk computations used by investment banks depended on market events of the preceding two to three years, when nothing similar had occurred, according to Wilson Ervin, who's now chief risk officer at Zurich-based Credit Suisse Group, Switzerland's second-biggest bank after UBS. Long-Term Capital Management, which amplified its risk by relying on borrowed money for most of its trading bets, blew up in part because it didn't anticipate that investor panic after the Russian default would cut the value of any risky debt, whether it was issued by a country, sold by a company, or backed by mortgages. The riskiest Russian and Brazilian bonds owned by the fund plunged far more than the safer Russian and Brazilian bonds that it had bet against as a hedge, according to "When Genius Failed," the book written by Roger Lowenstein. **"In a market stress event, some individual sectors that previously appeared unrelated do move together, and as a result, the organization could take losses on both of them or even on positions that were previously deemed to be a hedge,"** said Ed Hida, the partner who runs the risk strategy and analytics services group at Deloitte & Touche LLP in New York. Worst-Case Scenario The other risk tool commonly used by securities firms, known as stress testing or scenario analysis, also failed to prepare the industry for the plummeting value of AAA-rated securities that had previously been deemed the most creditworthy, he said. "Stress tests are only as good or as predictive as the scenarios used and in many cases the scenarios that played out were much more severe than people anticipated," Hida said. "One lesson learned is that these stress tests should be broader, should consider more scenarios." Kelleher, who became Morgan Stanley's CFO in October, explained the flaw in the firm's stress testing in a Dec. 19 interview, the day the company reported its first unprofitable quarter. "Our assumptions included what at the time was deemed to be a worst-case scenario," he said. "History has proven that the worst-case scenario was not the worst case." Investment banks will continue to take unsafe risks as long as traders are rewarded for making profits, leaving shareholders, bondholders and sometimes taxpayers to shoulder the consequences, Taleb said. **Wall Street traders "make an annual bonus and get an annual review based on risks that don't show up on an annual basis," Taleb said. "You have all the incentive in the world to take these risks."** **Death of VaR Evoked as Risk-Taking Vim Meets Taleb's Black Swan**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=axo1oswvqx4s&refer=home>

## Housing

- Jan. 28 (Bloomberg) -- Purchases of new homes in the U.S. **unexpectedly fell to a 12-year low in December, [that bad news in housing can be described as "unexpected" shows just how clueless some remain. It really is ok to look around the neighborhood and see the foreclosures instead of extrapolating what "should happen" based on computer programs. The times they are a changin' ] ending the worst sales year since records began in 1963 and signaling little prospect for a recovery.** Sales decreased 4.7 percent to an annual pace of **604,000**, the Commerce Department said today in Washington. The median price dropped 10 percent from

December 2006, the most in 37 years. "Today's numbers are a new blow," said Chris Rupkey, a senior financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York, who forecast a decline to 613,000. **"The broader economy is very, very close to falling over the edge. The Fed really needs to think aggressively."** [what prey tell beyond cutting 75 BPS in between meetings and another 50 a week later would be considered to be aggressive?] The Standard & Poor's Supercomposite Homebuilding Index, which includes KB Home, Pulte Homes Inc. and D.R. Horton Inc., was little changed at 337.8 at 11:03 a.m. in New York. The S&P 500 was also little changed. **Economists had forecast new home sales would be unchanged from an originally reported 647,000 rate the prior month**, according to the median estimate in a Bloomberg survey of 62 economists. Forecasts ranged from 595,000 to 680,000. Prices Retreat The median price of a new home fell to \$219,200 in December from \$244,700 a year earlier, today's report showed. For all of 2007, the median price rose 0.2 percent to \$246,900. For the year, sales dropped 26 percent, the most since records began in 1963. "We are in deep recession lows now in terms of new home sales and housing starts," said Lincoln Anderson, chief economist at LPL Financial Services in Boston. **"We're seeing a bottoming, but it's a lot lower bottom than I expected."** [I could not even think of a response to this. I guess evidence of a bottom is that it is only 600K to zero now] Even as builders reduced inventories, the drop failed to keep pace with the decline in sales, pushing up the month's supply. The number of homes for sale fell to a seasonally adjusted 495,000 in December, the fewest since October 2005. **At the current sales pace, it would take 9.6 months to sell all those houses, the most in over two decades.** Purchases dropped in three of four regions, led by a 6.5 percent decline in the South. The Northeast was the only region that registered a gain. **New-home purchases are considered a timelier indicator because they are based on contract signings, while existing home sales are calculated when a contract closes, usually a month or two later.** Purchases of new houses will fall another 15 percent this year, according to a forecast by the Mortgage Bankers Association. Sales of existing homes will drop 13 percent, the group said on Jan. 14. Housing-related firms continue to struggle with the fallout from the subprime mortgage crisis. Wachovia Corp., the fourth-largest U.S. bank, last week said profit plunged 98 percent to its lowest since 2001 after writedowns for bad loans and mortgage-backed securities. "These are extremely difficult times for all homebuilders," Steven J. Hilton, chief executive officer of Meritage Homes Corp., said in a Jan. 17 statement. The homebuilder, whose biggest markets are Texas, Arizona and California, said fourth-quarter revenue from homes sold fell 25 percent as orders declined. **U.S. Economy: New-Home Sales Drop to Lowest Level in 12 Years**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aH3heOi\\_252I&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aH3heOi_252I&refer=home)

## Housing Finance

- Feb. 1 (Bloomberg) -- President George W. Bush's proposal to help 1 million subprime borrowers avoid foreclosure with tax- exempt bonds has an obstacle: **states don't want the risk any more than private lenders do.** The state housing agencies that are already offering mortgage refinancing options are turning away so many applicants that they've had no need to raise funds. **Since New York said it would commit \$100 million in July, three of the 500 loans envisioned have been made. Massachusetts extended four**

**loans under a \$250 million program started in August, and Ohio made just 36 of the thousands anticipated by Governor Ted Strickland.** The reluctance to lend threatens to undermine a pivotal part of the president's plan for alleviating the worst housing slump in 26 years. **More than 50 percent of subprime borrowers are being rejected by state programs because their homes have lost too much value or they've accumulated excessive debt,** estimates Geoffrey Cooper, emerging markets director at a unit of MGIC Investment Co., the country's biggest mortgage insurer. **“These things are basically public relations gimmicks,”** said Bruce Marks, chief executive officer of Neighborhood Assistance Corp. of America. The Boston-based nonprofit organization negotiated an agreement with Countrywide Financial Corp., the biggest U.S. home lender, in October to modify rates and terms on \$16 billion of subprime mortgages to prevent foreclosures.

State of Union Bush proposed the municipal bonds Dec. 6 as part of a larger plan to provide relief to homeowners, and pushed for them again in his State of the Union address on Jan. 28. Housing agencies would get the temporary authority to refinance subprime loans with proceeds from lower-cost tax-exempt bonds, he said. Right now, the government allows the sale of such debt only when borrowers are buying a new home; if states need money for refinancing, they sell taxable bonds that require them, and ultimately the homeowners, to pay higher interest rates. Each year the government sets a limit on tax-exempt bonds for the 50 state housing programs, and \$10 billion was authorized in 2007, according to the National Council of State Housing Agencies in Washington. They weren't allowed to use the funds for refinancing, and avoided even new borrowers whose credit scores put them in the riskiest subprime category, said Wendy Dolber, a housing analyst at Standard & Poor's in New York. **Didn't Compete Unlike private companies, the agencies are required by law to document the income of borrowers, she said. They also don't offer the adjustable-interest mortgages that subprime lenders promoted before dozens collapsed last year. The loans were particularly attractive to the riskiest borrowers because they had low introductory rates that reset at higher levels later.** “They couldn't compete with true subprime lenders, and they didn't,” said Dolber. Of the 24 state agencies S&P rates, all are investment grade, with 18 ranked AA- or higher. None were downgraded as mortgage foreclosures in the U.S. rose 75 percent last year. “Often the borrower just has too much debt and the home does not have the value to support the refinancing,” MGIC's Cooper said at a conference in Washington on Jan. 17.

Stimulus Bill The Senate Finance Committee approved a \$157 billion economic stimulus bill on Jan. 30 that would lift the restriction on refinancing mortgages with tax-exempt bonds and authorize states to raise an extra \$10 billion over the next three years. The amendment, not included in parallel legislation passed by the House of Representatives, doesn't mandate that the funds be used for subprime loans. **Mortgage originations fell 14 percent in 2007 and will probably decline 34 percent to \$1.55 trillion this year,** according to forecasts by the Washington-based Mortgage Bankers Association. “This is more than a subprime problem,” Thompson said. “It has spilled over into the affordable-mortgage product.” When Ohio rolled out its program in April, Strickland said he anticipated selling more than \$100 million in taxable bonds because the state was “facing a crisis.” The Democrat told residents to apply to refinance their subprime loans with 30- year fixed-rate mortgages. The prospects changed once officials saw how many applicants were ineligible because they'd missed a mortgage payment in the last year, said Dawn

Larzelere, the legislative affairs director at the Ohio Housing Finance Agency in Columbus. "I don't think our lending standards are too high," said Larzelere. **"I think people have gotten in too far over their head."** **Bush Subprime Plan Undermined, States Shun Borrowers**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a14wLYqTFa10&refer=home>

- Jan. 29 (Bloomberg) -- Countrywide Financial Corp., the mortgage lender that Bank of America Corp. plans to buy, lost \$422 million in the fourth quarter, failing on its promise to return to profitability. The net loss equaled 79 cents a share, compared with a gain of \$621.6 million, or \$1.01 a share, in the year-earlier period, the Calabasas, California-based company said in a statement today. The average estimate of 13 analysts compiled by Bloomberg predicted a loss of 28 cents. Chief Executive Officer Angelo Mozilo agreed Jan. 11 to sell the company he co-founded in 1969 for about \$4 billion in stock to Bank of America, the nation's second-biggest bank. He vowed in October to restore profit before year-end after Countrywide, the biggest U.S. mortgage lender, posted a \$1.2 billion third-quarter loss, the first in 25 years. Investors have speculated Bank of America may try to lower its bid. **Countrywide Financial Posts Loss on Overdue Mortgages**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=axc3PMj.Dzko&refer=home>

## Macro Economic

- Feb. 1 (Bloomberg) -- President George W. Bush said today's jobs report is a "troubling" sign that the U.S. economy is weaker and "decisive action" must be taken to help people stay in their homes. The U.S. unexpectedly lost jobs for the first time in more than four years, increasing the odds the economy will fall into a recession. Payrolls fell by 17,000 in January after an 82,000 gain in December that was larger than initially reported, the Labor Department said. "There are certainly some troubling signs, serious signs that the economy is weakened and we've got to do something about it," Bush said after a tour of Hallmark Cards Inc. in Kansas City. **Bush Says 'Serious Signs' U.S. Economy Is Weakening**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ax4qT3UnRDBU&refer=home>
- Feb. 1 (Bloomberg) -- The U.S. unexpectedly lost jobs for the first time in more than four years, increasing the odds the economy will fall into a recession and making it likely the Federal Reserve will cut interest rates another half point next month. Payrolls fell by 17,000 in January after an 82,000 gain in December that was larger than initially reported, the Labor Department said today in Washington. None of the 80 economists surveyed by Bloomberg News predicted the decline. **"It is highly unusual for payrolls to fall except in a recession,"** Christopher Low, chief economist at FTN Financial in New York, said in an interview. "The Fed will have to keep cutting rates and we can expect a cut at the next meeting in March." Manufacturers, state governments and construction companies lost jobs, while the healthcare and education industries added fewer workers than the month before. The jobless rate declined to 4.9 percent in January from 5 percent, the highest in two years. "Red Flags" "Employment fell across a broad assortment of industries," said Mark Vitner, senior economist at Wachovia Corp. in Charlotte, North Carolina. **"It raises a number of red flags for the economy. There is**

**no question economic growth has slowed to a crawl and the risks of recession are significant.** That is why the Fed has cut interest rates so aggressively." **The drop in payrolls in January was the first since August 2003.** The median forecast was for a payrolls gain of 70,000, compared with an initially reported gain of 18,000 in December. Forecasts of an increase ranged from 5,000 to 160,000. Data Revisions Revisions for November and December brought total job gains for the two months to 142,000, versus a previously reported 133,000. Service industries, which include banks, insurance companies, restaurants and retailers, added 34,000 workers last month after an increase of 143,000 jobs in December. Retail payrolls rose 11,200 after a decline of 12,000 in December. Factory payrolls dropped by 28,000 after falling 20,000 a month earlier. Economists had forecast a drop of 20,000 in manufacturing employment. Builders trimmed payrolls by 27,000 in January. Government payrolls shrank by 18,000 during January, the first decline in six months, after rising 28,000 in December. Today's report showed the first drop in the average work week since July. Average weekly hours worked by production workers slipped to 33.7 from 33.8. That helped bring average weekly earnings down 42 cents to \$598.18. Earnings Slow Hourly wages rose less than forecast, increasing 4 cents, or 0.2 percent, on average to \$17.75 in January. Wages were up 3.7 percent from a year earlier, the same as in December. Economists had expected a 0.3 percent increase for the month and 3.9 percent for the 12-month period. Seasonal Adjustments With today's report, the Labor Department revised the payroll numbers after reviewing more complete tax data not available earlier from state unemployment insurance programs and making adjustments to its estimates of seasonal hiring patterns. **The revision subtracted 376,000 jobs from the previous estimate for the year ended December 2007, bringing total job growth for the period to 1.137 million.** Growth in the fourth quarter slowed to a 0.6 percent pace, compared with a 4.9 percent rate in the previous three months, the government said this week. Consumer spending weakened to a 2 percent pace in the last three months of 2007 from a 2.8 percent rate in the third quarter. Today's Labor Department figures ran counter to a private report Jan. 30 that suggested hiring rebounded last month. Companies hired 130,000 additional workers in January, according to data compiled by ADP Employer Services. The figures include only private employment and don't take into account hiring by government agencies. According to the Labor Department report, private employers added 1,000 jobs in January. **U.S. Economy: Payrolls Decline for First Time in Four Years**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a.B2A7g9fifU&refer=home>

- Jan. 31 (Bloomberg) -- Consumer spending in the U.S. increased in December at the slowest pace in six months, signaling the economy is likely to keep weakening. The 0.2 percent rise in spending followed a 1 percent gain in November that was smaller than previously estimated, the Commerce Department said today in Washington. Economists had forecast a 0.1 percent rise in spending, according to the median estimate in a Bloomberg News survey. The report also showed incomes and the Federal Reserve's preferred measure of inflation climbed. Consumers, who helped the economy weather the housing slump in 2007, are being pummeled by falling home and stock prices, rising fuel costs and less access to credit. The Fed has cut borrowing costs and the government is discussing sending rebate checks to about 111 million Americans to revive spending. "Consumer spending is not going to fall off the table though it is slowing," Brian

Bethune, director of financial economics at Global Insight Inc. in Lexington, Massachusetts, said before the report. **Initial applications for unemployment insurance climbed more than forecast last week to the highest in 27 months, the Labor Department said in a separate report today. Claims jumped 69,000 to 375,000, in a week when figures were distorted by adjusting for the Jan. 21 holiday,** a Labor spokesman said. Incomes Rise Incomes rose 0.5 percent after a 0.4 percent gain the prior month, today's report showed. Incomes were projected to rise 0.4 percent, the same as in November, according to the survey median. Economists forecast spending would rise 0.1 percent, after an originally reported 1.1 percent increase in November, according to the median of 73 estimates in a Bloomberg News survey. Estimates ranged from a drop of 0.5 percent to a gain of 1 percent. The inflation measure tracked by the Fed rose to 0.2 percent for a third month. It increased 2.2 percent from December 2006, the same as in November. Fed officials in October forecast the index would rise 1.6 percent to 1.9 percent in 2010, offering a measure of their longer-term inflation objective. Adjusted for inflation, spending stalled in December, after a 0.4 percent gain the prior month, the report showed. For all of 2007, consumer spending rose 5.5 percent, the smallest gain in four years. Annual Gain **For all of 2007, consumer spending rose 2.9 percent, the least in four years. [the credit spigot is closed – can't spend what you can't borrow any more]** Consumers may be starting to succumb to mounting headwinds. Retailers' holiday sales rose 2.2 percent, the smallest gain in five years, according to the International Council of Shopping Centers. American Express Co., the third-largest U.S. credit- card network, this week said fourth-quarter profit fell 9.9 percent after setting aside more for customer defaults. The economy may ``continue to be very challenging," Jim Ziemer, chief executive officer of Harley-Davidson Inc., the biggest U.S. motorcycle maker, said in an interview last week. The Milwaukee-based company's fourth-quarter profit and sales both tumbled. Businesses offering bargains may fare better. Royal Caribbean Cruises Ltd., the world's second-largest cruise-ship operator, this week said fourth-quarter profit rose 52 percent as travelers looking for low-priced vacations booked more trips. Conditions in the labor market will determine whether spending ultimately falters, economists said. Payrolls rose by 65,000 in January, after increasing by just 18,000 the prior month, according the median estimate of economists surveyed before a government report tomorrow. The economy created 111,000 a month on average in 2007. The jobless rate in December rose to a two-year high of 5 percent, figures from the Labor department showed. **U.S. Personal Spending Rises Slowest Pace Since June**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=ar0wC3rB9qeI&refer=home>

- Jan. 31 (Bloomberg) -- The number of Americans filing first- time claims for unemployment benefits rose more than forecast last week to a 27-month high, evidence of a weakening job market. Initial jobless claims increased by 69,000 to 375,000 in the week ended Jan. 26, the Labor Department said today in Washington. The increase in claims was the biggest since just after Hurricane Katrina in September 2005. A separate report from Labor showed employment costs rose 0.8 percent in the fourth quarter of 2007, the same as in the prior three months. **Last week's figures were distorted by difficulties adjusting for the Martin Luther King holiday, when state unemployment offices were closed, a Labor Department spokesman said. [There is ALWAYS an excuse for poor data. My question: did the MLK holiday come as a surprise to**

**“Economists [who] had forecast claims would rise to 319,000 from the previously reported 301,000 for the week ended Jan. 19, according to the median of 37 estimates in a Bloomberg News survey. Forecasts ranged from 300,000 to 350,000.”]**

Total benefit rolls have been moving steadily higher since September, signaling a slowing job market and raising the odds the economy may be on the verge of a recession, economists say. “The move in claims in the last few weeks seems more about problems adjusting these numbers at this time of year,” Jonathan Basile, an economist at Credit Suisse in New York, said before the report. “There is a general expectation that the layoff picture will get worse before it gets better.” **Economists had forecast claims would rise to 319,000 from the previously reported 301,000 for the week ended Jan. 19, according to the median of 37 estimates in a Bloomberg News survey. Forecasts ranged from 300,000 to 350,000.** Total Benefit Rolls The number of people staying on benefit rolls rose to 2.716 million in the week ended Jan. 19, from 2.669 million in the prior week, according to today's report. Those numbers are reported with a one-week lag. The four-week moving average, a less volatile measure than initial claims, rose to 325,750 from 315,500 the prior week. Claims tend to move in tandem with the jobless rate. The unemployment rate among people eligible for benefits, which tends to track the U.S. jobless rate, remained at 2.0 percent. **U.S. Initial Jobless Claims Rose 69,000 to 375,000 Last Week**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=akktuOwTacx0&refer=home>

- Jan. 31 (Bloomberg) -- Confidence among European executives and consumers in the economic outlook slumped more than forecast as inflation accelerated and concern mounted that the U.S. economy may slide into recession. An index of sentiment in the euro area dropped to 101.7 this month, the lowest since January 2006, from a revised 103.4 in December, the European Commission in Brussels said today. The inflation rate rose to 3.2 percent, the highest since December 1993, a separate report showed. Slowing economic growth and soaring prices have created a dilemma for the European Central Bank, which aims to keep inflation just below 2 percent. While ECB officials say the U.S. slowdown will affect euro-area growth, accelerating inflation has restrained them from cutting interest rates and put them in what the International Monetary Fund calls a “difficult” position. “The problems in the U.S. will have an impact on the rest of the world, including the euro area,” said Luigi Speranza, an economist at BNP Paribas in London. “We've been a bit skeptical about this decoupling idea,” he said, referring to the theory that the rest of the world could pick up the economic slack as U.S. growth slowed. Economists had forecast that confidence would fall to 104.1 from an initial December reading of 104.7, according to the median of 27 economists surveyed by Bloomberg News. Inflation was forecast to remain at 3.1 percent, a separate survey showed.

**European Confidence Declines, Inflation Accelerates**

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

- Jan. 30 (Bloomberg) -- Japan's factory output rose less than economists estimated in December and companies said they plan to pare production this month as U.S. economic growth slows. Industrial production rose 1.4 percent from a month earlier, when it dropped 1.6 percent from a record, the Trade Ministry said today in Tokyo. The median estimate of 45 economists surveyed by Bloomberg News was for a 2 percent increase. A four-month slump in shipments to the U.S. is taking its toll on an economy that got most

of its growth from overseas shipments in the third quarter. Companies said they plan to cut production this month and in February, today's report showed, the most pessimistic they've been in almost three years. **``Today's number were weak, and the forecasts were also much weaker than we had anticipated," said Yoshimasa Maruyama, senior economist at BNP Paribas Securities Japan Ltd. in Tokyo. ``Production is slowing globally and Japan is no exception.** Slumps in output have coincided with three recessions since 1991. The economy contracted in the fourth quarter of 2004 when an inventory glut in electronics parts forced manufacturers to scale back production.

Aren't Strong Enough **Record shipments to Asia haven't been strong enough to counter waning demand from the U.S., Japan's largest market.** Exports rose at the slowest pace since 2005 in the three months ended Dec. 31, Bloomberg data show. **``The jury's still out**" on how badly emerging markets will be hit by the U.S. slowdown, said Jan Lambregts, head of Asia research at Rabobank International in Hong Kong. **``If you expect a very negative scenario for the U.S., you're obviously going to have a negative outlook on Japan."** Goldman Sachs Group Inc. said this week that Japan's economy may have already fallen into a recession as domestic demand wanes. Production has **``peaked out,"** Goldman's chief Japan economist Tetsufumi Yamakawa said. He added that a slowdown in export growth, the engine that drove the economy's third-quarter expansion, is becoming **``more pronounced."** Reports this month signaled the economy is losing steam, with jobs available to applicants falling to a two-year low and consumer confidence sliding to the lowest level since 2003. Production rose 1.3 percent last quarter, the ministry said. **Japan Factory Output Rises Less-Than-Estimated 1.4%**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aUkklsygJ0yo&refer=home>

- Jan. 29 (Bloomberg) -- **The Federal Reserve may push interest rates below the pace of inflation** this year to avert the first simultaneous decline in U.S. household wealth and income since 1974. The threat of cascading stock and home values and a weakening labor market will spur the Fed to cut its benchmark rate by half a percentage point tomorrow, traders and economists forecast. That would bring the rate to 3 percent, approaching one measure of price increases monitored by the Fed. **``The Fed is going to have to keep slashing rates, probably below inflation,"** said Robert Shiller, the Yale University economist who co-founded an index of house prices. **``We are starting to see a change in consumer psychology."** So-called negative real interest rates represent an emergency strategy by Chairman Ben S. Bernanke and are fraught with risks. The central bank would be skewing incentives toward spending, away from saving, typically leading to asset booms and busts that have to be dealt with later. Negative real rates are **``a substantial danger zone to be in,"** said Marvin Goodfriend, a former senior policy adviser at the Richmond Fed bank. **``The Fed's mistakes have been erring too much on the side of ease, creating circumstances where you had either excessive inflation, or a situation where there is an excessive boom that goes on too long."** **Losing That Prop' The last time household real estate, stocks and real incomes all declined in a quarter was during the 1974 recession, according to calculations by Macroeconomic Advisers LLC.** **``Wealth had been rising because of strong home prices" and stock gains,** said Chris Varvares, president of Macroeconomic Advisers in St. Louis. **``Now, we are losing that prop to consumption, so it all comes down to growth in real income."** Varvares predicted that housing and investment portfolios will add nothing to consumption this year, while incomes, after inflation, may gradually rise **``so long as oil behaves."** The

firm expects the economy to grow at a 1 percent to 2 percent annual pace in the first half. Feldstein, a member of the group that dates U.S. economic cycles, said any recession this year "could be much more painful because of the fragility of the financial sector." The Fed incorporates wealth effects, or the impact of changes in household assets on spending, in its economic model. Americans cut spending by about 5 cents for every \$1 of decline in their home values or stock portfolios, economists estimate. **"We are likely to see another wave of problems in the consumer-credit side," John Thain, chief executive officer of Merrill Lynch & Co., said at the World Economic Forum in Davos, Switzerland, last week. "This is going to be exacerbated by the rise in unemployment and we have issues with higher energy prices." Fed May Cut Rate Below Inflation, Risking Bubbles**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=azUvb2XylX2U&refer=home>

- Jan. 29 (Bloomberg) -- Japan's decade-long fight against deflation may be over, only to be replaced by inflation that is sapping economic growth. Central bank Governor Toshihiko Fukui has been predicting the economy's longest expansion in more than 60 years will spur profits and feed into wages and consumer spending, leading to steady price gains. Instead, prices are being driven by increasing oil and raw-materials costs, which is hurting profits and wages and eroding household spending power. **"After waiting so long, the Bank of Japan may well end up with the wrong sort of inflation,"** said Ben Eldred, a senior economist at Daiwa Securities SMBC Co. in London, a unit of Daiwa Securities Group Inc., Japan's second-biggest brokerage. **"Rising energy and food prices are bad news for firms and consumers and will provide a further headwind at a time when Japan already has to contend with a sharp slowdown in the U.S.,"** he said. Consumer prices, excluding fresh food, rose 0.8 percent in December, the fastest pace in more than nine years and double November's 0.4 percent, the government said last week. Prices had been falling as recently as September. Cost-driven inflation coupled with slower economic growth may make it more difficult for the central bank to implement its policy of gradually raising interest rates. Fukui said on Jan. 11 that higher oil and commodity costs, while putting pressure on consumer prices, are squeezing profits and weighing on growth. **Bursting Bubbles** Since July 2006, when he ended a policy of keeping borrowing costs near zero, Fukui has argued that rates need to rise to reflect an economy that recovered from three recessions following the bursting of the stock- and property-market bubbles in the early 1990s. The bank last increased its benchmark overnight lending rate, to 0.5 percent, in February 2007; that's still the lowest among major economies. "A cut would become a realistic option if the jobless rate starts rising and wages keep falling," said Hiroaki Muto, a senior economist at Sumitomo Mitsui Asset Management Co. in Tokyo. "Policy makers would have to be more worried about the economy rather than inflation." With consumer confidence at a four-year low, companies are finding it hard to pass on higher costs. **Taxi Fares** After Tokyo taxis raised fares last month for the first time in a decade, average daily sales fell 2.8 percent, the Tokyo Taxi Association said. Q.P. Corp., which lifted mayonnaise prices in June for the first time in 17 years, found that revenue remained flat because the quantity sold slid 2 percent. **"There isn't a single bit of good news about the consumer environment," Junji Ueda, president of FamilyMart Co., Japan's third-largest convenience-store operator, said in an interview today. "High fuel**

**prices, increases in product costs, low wages, pension and social security issues, and the state of Japan's politics are all raising concerns among consumers."** Falling Profit Rising costs are taking a toll on corporate profit, which fell for the first time in five years in the third quarter of 2007, according to a Ministry of Finance report last month. Bankruptcies rose to a four-year high in 2007 as 14,091 businesses closed their doors. Cheese Cake Factory garnered headlines this month after the Tokyo-based restaurant chain shuttered 30 outlets, partly because of soaring dairy prices. The company has no connection to the Calabasas Hills, California-based Cheesecake Factory Inc. Some 86 percent of consumers expect prices to rise this year, a Bank of Japan survey showed Jan. 16. That's the highest proportion since the bank began asking the question a decade ago. Most respondents said they plan to spend less. "Living on my husband's pension, higher prices are a big concern," said Yuriko Takenaka, a 72-year-old housewife in Wakayama, western Japan, who has managed the household budget every day since their marriage in 1961. "I make it a strict rule to only buy necessities and avoid any lavish spending." **Japan's Long-Awaited Inflation Saps Spending, Growth**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=axKEU4.DSDs8&refer=home>

- The most painful time to tighten your belt is just after gorging. US state and local government expenditure – 12 per cent of gross domestic product – expanded by almost 8 per cent in the third quarter of 2007. Now governors across the country are proposing big budget cuts. New York City last week said it would cut spending on a range of services from schools to sanitation to offset slowing tax revenues – partly because of Wall Street's woes. It is not merely the prospect of a recession that is forcing a rethink on spending, but the nature of the potential slowdown. State and local taxes, excluding transfers, split roughly 60/40 in favour of the state. On average, state coffers are filled by taxes on sales, personal income and corporate profits. Local taxation, meanwhile, is overwhelmingly based on property – 72 per cent of total revenues, according to Moody's. **US public finances** <http://www.ft.com/cms/s/1/0b457000-cd7f-11dc-9e4e-000077b07658.html>

## Retail

- Feb. 1 (Bloomberg) -- Ford Motor Co., Chrysler LLC and most Asian automakers said U.S. sales fell in January, setting the industry on a course for its third straight year of decline. Ford reported a 3.9 percent drop in light vehicles. Toyota Motor Corp., the Japanese automaker that passed Ford to become second in the U.S. last year, slid along with Honda Motor Co. and Nissan Motor Co. No. 1 General Motors Corp. posted a surprise gain and scaled back planned production cuts. The falloffs by five of the top six automakers in the U.S. spurred a 4.3 percent decline for the industry, reinforcing forecasts saying sales would tumble this year to their lowest level since 1998. Reductions in interest rates may not be enough to entice consumers spooked by skidding home values, high gasoline prices and vanishing jobs. "The first half of the year is going to be pretty ugly," said Mirko Mikelic, who helps manage \$22 billion at Fifth Third Asset Management in Grand Rapids, Michigan, including GM and Ford debt. "The consumers

are really leveraged, and it takes time to work that out." **Ford, Toyota Say January U.S. Sales Fell; GM Gains**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=ajIJmoD4X7tE&refer=home>

- Jan. 31 (Bloomberg) -- Home Depot Inc., the world's largest home-improvement retailer, cut 10 percent of the workforce at its Atlanta headquarters, or 500 employees, to focus on stores during the worst housing slump in 26 years. "We're operating in a tough business environment, and we expect that to continue into 2008," Home Depot spokesman Ron DeFeo said today in an interview. "We're committed to investing in our stores." The job cuts are the largest at its headquarters, and employees were informed today, he said.

**Home Depot Cuts 10% of Jobs at Atlanta Headquarters**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aJ9lfqyKKNLE&refer=home>

- Jan. 28 (Bloomberg) -- McDonald's Corp., the world's largest restaurant company, said fourth-quarter profit rose 2.6 percent on a tax benefit and rising revenue in Europe and China that countered the slowest U.S. same-store sales growth in almost five years. McDonald's fell as much as 5.6 percent in U.S. trading. Net income climbed to \$1.27 billion, or \$1.06 a share, from \$1.24 billion, or \$1, a year earlier when the spinoff of Chipotle Mexican Grill Inc. boosted earnings, the Oak Brook, Illinois-based company said today in a statement. Sales of U.S. restaurants open at least 13 months were unchanged in December, trailing a median estimate among four analysts surveyed by Bloomberg News of a 2.8 percent gain. Consumers contending with the worst housing slump in 26 years and higher fuel prices have cut back on spending. "It's extremely hard for McDonald's to put up quarter after quarter of consistently stronger sales," said Janna Sampson, who helps manage 200,000 McDonald's shares among \$1.1 billion in assets at Oakbrook Investments LLC in Lisle, Illinois. "**In a slumping economy, it's not surprising to see a downtick in the rate of growth.**" Revenue climbed 5.7 percent to \$5.75 billion for the three months that ended Dec. 31. McDonald's increased coffee sales and advertised its \$1 double cheeseburger, blunting introductions of discount burgers by Burger King Holdings Corp. and Wendy's International Inc. "Severe winter weather" and "**softer consumer spending**" led to unchanged same-store sales in **December**, McDonald's said. **McDonald's Net Rises on Tax Gain; December Sales Flat**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aGr\\_hgOQ.8XM&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aGr_hgOQ.8XM&refer=home)

## Retirement

## Risk

## Savings Rate

## Tech

- Feb. 1 (Bloomberg) -- Hynix Semiconductor Inc., the world's second-largest memory chipmaker, posted its first quarterly loss in four years after an oversupply of memory chips drove prices to record lows. The fourth-quarter net loss was 467 billion won (\$493 million), compared with a record profit of 1 trillion won a year earlier, Ichon, South Korea-based

Hynix said today. Sales fell 35 percent to 1.73 trillion won. Profit and revenue missed analysts' estimates. Hynix joined Samsung Electronics Co. and chipmakers in Japan and Taiwan in reporting lower earnings for the latest quarter after they increased production and overestimated demand from computer makers. Morgan Stanley and Credit Suisse Group predict Hynix will be unprofitable in the first half as the glut of memory chips persists this quarter. **Severe Price Decline** **Fourth-quarter losses resulted from severe declines in prices of memory chips used in computers and consumer electronics, Hynix said in a statement.** Prices of computer chips known as dynamic random access memory dropped 36 percent during the three months ended Dec. 31, according to Dramexchange Technology Inc., Asia's biggest spot market for semiconductors. Prices of NAND flash memory chips that save data in portable electronics such as Apple Inc.'s iPods. slumped 48 percent in the same period. Hynix is the world's second-largest maker of DRAM chips and the third-biggest maker of NAND flash chips. Samsung, Asia's largest semiconductor maker, said last month fourth-quarter profit from chips fell about 74 percent, while Toshiba Corp., the world's second-largest maker of NAND flash memory, this week reported profit from semiconductors tumbled 29 percent to the lowest in 10 quarters. Hynix cut this year's spending budget by 10 percent to 3.6 trillion won today. In October, Hynix said it was budgeting about 4 trillion won for capital spending this year, about 16 percent lower than the investment in 2007. **Hynix Posts First Loss in Four Years on Lower Prices**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=apaoz7.2364Y&refer=home>

## Wall Street

- Feb. 1 (Bloomberg) -- James Barker saw no way out. In September 2003, the superintendent of the Erie City School District in Pennsylvania watched helplessly as his buildings began to crumble. David DiCarlo, an Erie-based JPMorgan Chase banker, told Barker and the school board on Sept. 4, 2003, that all they had to do was sign papers he said would benefit them if interest rates increased in the future, and the bank would give the district \$750,000, a transcript of the board meeting shows. "You have severe building needs; you have serious academic needs," Barker, 58, says. "It's very hard to ignore the fact that the bank says it will give you cash." So Barker and the board members agreed to the deal. **What New York-based JPMorgan Chase didn't tell them, the transcript shows, was that the bank would get more in fees than the school district would get in cash: \$1 million. The complex deal, which placed taxpayer money at risk, was linked to four variables involving interest rates. Three years later, as interest rate benchmarks went the wrong way for the school district, the Erie board paid \$2.9 million to JPMorgan to get out of the deal, which officials now say they didn't understand.** \$12 Billion in Deals **During the past four years in Pennsylvania alone, banks have pitched at least 500 deals totaling \$12 billion like the one JPMorgan Chase sold** to Erie, according to records on file with the state Department of Community and Economic Development. Most of the transactions -- which occurred outside the state's largest cities of Philadelphia and Pittsburgh -- have been made without public bidding, which means that banks and advisers privately arranged the deals with small school districts, the records show. JPMorgan's Chief Executive Officer Jamie Dimon declined to say if he thought the bank's fee disclosure was proper and whether the bank acted in a fair, responsible and moral manner in Erie. Banker DiCarlo declined to comment. JPMorgan spokesman Brian Marchiony says the deal gave the school district immediate debt savings

and protected it against unpredictable interest rate risk in the future. He declined to answer specific questions. Overpaying Fees **The Pennsylvania transactions involve interest-rate swaps, which are derivatives. Derivatives are financial contracts whose value is based on other securities or indexes; interest-rate swaps are tied to future changes in lending rates.** The Pennsylvania deals show that school districts routinely lose when making derivative deals. They pay fees to banks that are as much as five times higher than typical rates and overpay advisers by as much as 10-fold. That means banks often underpay schools on upfront amounts, as JPMorgan Chase did in Erie, public records show. And school officials aren't always well served by their supposedly independent advisers, whose fees are paid by the banks selling the deals -- only if the sale is made. **“It's a serious issue, not only in Pennsylvania but across the country,” says Cox, 55, who has headed the SEC since 2005. “That is what we have seen repeatedly. More often than not, the municipalities aren't configured to have financial sophisticates in charge of these offerings -- and the result is that the firms are the only ones who know what's going on.”** Just five years ago, municipal derivative deals weren't sanctioned in Pennsylvania, the sixth-most-populous U.S. state. Then, in September 2003, the state Legislature adopted a law allowing schools and towns to use interest-rate swaps to lower borrowing costs and raise cash. **“Profits Are Greater” “Business moves from transparent and competitive markets to markets where there is less transparency and the profits are greater,” he says. “If you don't know how much you're paying, you're going to be paying too much.”** The **Pennsylvania swap law was passed after lobbying by financial advisory firms that stood to profit from such deals.** SEC Disclosure Rules While the SEC doesn't regulate derivatives, it has authority to oversee how banks conduct transactions. SEC Chairman Cox says all financial firms should tell clients what their fees are before signing any deals. **“Brokers and advisers should disclose their compensation and conflicts of interest to their customers, and to the extent that they are regulated by the SEC, they must,”** he says More than two dozen Pennsylvania school districts bought swaps that bet on the spread between two interest rates. Many bet wrong. Since 2006, at least 27 school districts gambled that the spread would widen between either the five- or 10-year London interbank offered rate on the one hand and weekly municipal bond yields or the one-month Libor on the other. The opposite happened: Spreads narrowed as long-term interest rates fell. The schools had to pay banks, or they could pay a steep exit fee, as Erie did with its swaption to cancel the deal. Historical Fluke **School district officials say their advisers have told them the contracting of the spreads was a historical fluke.** In the Exeter Township School District, 55 miles (88.5 kilometers) northwest of Philadelphia, Financial S&lutions LLC told the schools their swap deals shouldn't have lost them money. **“They tell me that's never happened before,”** says Ernest Werstler, who was business manager of the district until November, when he retired. **“It's happening to us now.”** Financial S&lutions didn't respond to requests for comment. Deane Yang, head of research at financial advisory firm Andrew Kalotay Associates Inc. in New York, says local officials are putting too much stock in financial advisers who are paid by banks--and in many cases are referred to schools by banks. **“It's like trying to decide whether a used-car dealer is offering you a good price or not,”** says Yang, who doesn't work with school districts. **“There's a car appraiser down the street who tells you he will provide an independent evaluation. But he's paid only if there's a sale.”** **“Pound Someone's Brains”** School board members usually have a poor understanding of derivatives, says Peter Egan, a financial adviser and former public finance banker at a unit of Cherry Hill, New Jersey-based Commerce Bancorp Inc. **“A**

derivative is a very powerful tool," says Egan, who's now managing director of Bordentown, New Jersey-based Phoenix Advisors LLC, which advises local governments on bond sales. "It's like a hammer. You could use it to hammer in a nail with perfect precision. But you could also use it to pound someone's brains out." **In many cases, the banks repeatedly sell more derivatives to replace old ones. In Bethlehem, Pennsylvania, JPMorgan and Morgan Stanley sold the school district eight swaps on just two bond issues,** records show. Outside Advice "It sure looks a lot like churning," Yang says. Churning is a term used to describe how stockbrokers or insurance agents sometimes continually sell and resell the same or similar products to clients in order to make more in fees. "Doing more than one swap against a single bond issuance definitely benefited the swap adviser and bank, but probably not the school district." In Pennsylvania, it's the financial advisers who are supposed to keep school district officials from getting fooled. That's why the 2003 law allowing for swaps requires districts to use independent advisers. \$2 Million Asset **DiCarlo, who was a state representative from Erie from 1973 to 1980, didn't tell the board that the contract was worth \$2 million in global derivative markets. Based on interest rates that day and terms of the deal, Bloomberg data show that was the value of the contract. JPMorgan's gross markup on the swaption was 0.82 percentage point of the rate compared with a 0.16 percentage point charge Goldman Sachs Group Inc. collected from the Philadelphia School District on a comparable swaption the city had bid competitively in March 2004.** In a written response to questions, IMAGE disputed the amount of fees paid to JPMorgan. "The numbers your analysis produces for the districts are clearly way off the mark," it wrote. IMAGE said it didn't know the bank's fees, estimating they were \$365,000-\$495,000. IMAGE said it doesn't know who recommended the firm to Erie as an adviser. "Regardless, there are no conflicts," IMAGE wrote. IMAGE said its fees were normal for the industry. Paying to Cancel **JPMorgan actually gave Erie \$785,000 -- \$35,000 more than DiCarlo had promised. The bank paid IMAGE \$60,000, gave bond insurer Financial Security Assurance Inc., known as FSA, \$57,585, paid lawyers and other middlemen \$106,000 and kept \$1 million as its revenue, according to public records and Bloomberg data. By June 2006, the swaption had left Erie's district with a \$2.9 million liability because expectations of future short-term interest rates had risen, narrowing the difference between future costs to borrow for one year and for 30 years. In July 2006, the district paid JPMorgan \$2.9 million to terminate the swaption.** The district got the cash from the proceeds of two new derivative deals it did with Pittsburgh-based PNC Financial Services Group Inc.'s PNC Capital Markets unit. The transactions paid Erie schools \$732,000 up front. One deal was an interest-rate swap that so far has lost \$32,000 for the district, according to local records. "What's Going On?" "It's obscene," says Peter Shapiro, managing director of South Orange, New Jersey-based adviser Swap Financial Group, who doesn't advise Pennsylvania school districts. "What is going on in Pennsylvania? Beyond Angry' **Swap deals in Pennsylvania work out well for banks, advisers and lawyers who are paid for putting them together.** Schools, parents and students see it differently. "We're always at the mercy of the experts that advise us," he says, adding that schools have to find a better way to raise money. One option would be to return to old-fashioned, publicly bid bond sales. He says he doesn't begrudge the banks or advisers their right to get paid. "We expect people to make a profit," Barker says. "But they don't have to put their interests over the kids'." **Hidden Swap Fees by JPMorgan, Morgan**

## Stanley Hit School Boards

<http://www.bloomberg.com/apps/news?pid=20601109&sid=ay5LDbjby6c&refer=home>

- Feb. 2 (Bloomberg) -- **U.S. stocks rose the most in five years after the Federal Reserve's second interest rate cut in nine days boosted banks, homebuilders and retailers. [Look not only at the headline, but also at what went up. Basically the most heavily shorted stocks in the worst industries. This is not how bull markets behave but is a text book bear market rally.]** Washington Mutual Inc., the largest savings and loan, Lennar Corp., the third-biggest homebuilder, and Wal-Mart Stores Inc., the largest discount chain, helped lead gains. All 10 sectors and 461 stocks in the S&P 500 advanced after the half-point reduction in the Fed's target for overnight loans between banks bolstered speculation that a recession may be averted. **``The Fed finally stepped up,"** said Jeffrey Kleintop, who helps oversee about \$163 billion as chief market strategist at LPL Financial Group in Boston. **``They gave us what the economy really needed and what investors needed to get their confidence back."** The S&P 500 climbed 4.9 percent for the week, trimming its yearly loss to 5 percent. The benchmark for U.S. equities has risen for two consecutive weeks after falling 9.8 percent through Jan. 18, its worst-ever start for a year. The Dow Jones Industrial Average added 4.4 percent and the Nasdaq Composite Index increased 3.8 percent, boosted by Microsoft Corp.'s bid for Yahoo! Inc., owner of the most-visited U.S. Web site. The drop in interest rates to 3 percent overshadowed the first decrease in jobs since 2003, the biggest yearly drop in new-home sales on record and fourth-quarter economic growth that was half the rate economists forecast. Fed policy makers have cut the Fed funds rate by 1.25 percentage points to 3 percent since Jan. 22, the fastest reduction since 1990. Citigroup Rises Citigroup Inc., the biggest U.S. bank, added 11 percent to \$29.69. Bank of America Corp., the second-biggest U.S. bank, gained 14 percent to \$45.03. JPMorgan Chase & Co., the third-largest U.S. bank, increased 11 percent to \$48.25. **Pulte Homes Inc. pushed homebuilders to a four-month high after forecasting a narrower loss than analysts estimated. The builder of Del Webb-brand homes for retirees also reported fourth-quarter revenue that topped estimates. Pulte jumped 21 percent to \$15.84. The stock has rallied 60** Ambac Rises Ambac Financial Group Inc. gained 14 percent to \$13.20 on reports that eight banks are working with regulators to rescue the second-largest bond insurer. Investor concern that Ambac and its larger rival, MBIA Inc., may lose their AAA credit ratings contributed to larger-than-average price swings in the U.S. stock market. MBIA added 15 percent to \$16.36. **Washington Mutual soared 35 percent to \$21.82. The company, which reported its first quarterly loss since 1997 this month after a \$1.6 billion writedown in its home-loan unit, said it expects income to increase as the Federal Reserve cuts interest rates.** The S&P 500 has advanced 3 percent on average during the first six months of similar Fed easing cycles and posted a 14 percent average gain during the entire cycle, Bespoke Investment Group LLC wrote in a research note. The S&P 500 has dropped about 3.5 percent since Aug. 17, when the Federal Open Market Committee unexpectedly cut the so-called discount rate by 0.5 percentage point to 5.75 percent. **``The bull case is that rates are coming down and that the worst is behind us,"** said Mike Morcos, who helps manage about \$1.4 billion at Old Second Wealth Management in Aurora, Illinois. **``The Fed easing is going to lead us on the road to recovery."** The Russell 2000 Index, whose members have a median market value of \$557 million, gained 6.1 percent to 730.50 this week. The benchmark for small U.S. stocks has outperformed the S&P 500 for the last three weeks, the longest streak since March. **U.S. Stocks Post Biggest Weekly Gain in Five Years**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=av5wklvmy9hU&refer=home>

- Jan. 31 (Bloomberg) -- Nomura Holdings Inc., Japan's largest securities firm, said third-quarter profit dropped 71 percent on lower income from investment banking and costs for shutting its U.S. residential mortgage unit. **Nomura Profit Falls as Banking Fees Slump, Costs Rise**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=arSZs\\_IXtyN0&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=arSZs_IXtyN0&refer=home)

## Don't Fight The Fed

- Bloomberg headline Feb 1 – **U.S. Unexpectedly Loses Jobs, Signaling Fed May Lower Rate Again in March** - just 300 more BPS of “good news” left before bad economic news = Fed will save us is retired.
- Jan. 28 (Bloomberg) -- **U.S. stocks rose, extending the market's first weekly gain this year, as odds increased that the Federal Reserve will cut its benchmark lending rate by half a percentage point this week to prop up the economy.** [this may be our last don't fight the Fed opportunity, since with a 50 BPS on Wednesday, there should be massive selling and a recognition that going to zero would not matter. However, I guess that is what I have believed for more than two years, so we will keep our eyes open for more pronouncements from the true believers – this was written early in the week – how wrong I was in anticipating a sane reaction.] The Standard & Poor's 500 Index rebounded from earlier losses sparked by slower sales growth at McDonald's Corp. and a drop in purchases of new homes. Stocks fell across Europe and Asia, with China's benchmark index tumbling 6.8 percent. Bank of America Corp., JPMorgan Chase & Co. and Wells Fargo & Co. led financial shares to their fourth gain in five days on expectations that lower borrowing costs will boost profits. **“We actually expect the market to rally somewhat based on Fed easing actions,”** said Dean Gulis, who helps manage about \$3 billion at Loomis Sayles & Co. in Bloomfield Hills, Michigan. **“The Fed will do what's necessary to get us through the current credit issues.”** [this was the same firm that pronounced the market a great buying opportunity in September 2007] **U.S. Stocks Gain on Rate-Cut Speculation; Corning Shares Rise**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=a6Hu3NqI\\_KxM&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=a6Hu3NqI_KxM&refer=home)

## I Disagree . . . and why

Article of the week:

UM EMBA

**Best of the Dog**