

Feb 4 -Jan 28, 2007 Review

Summary

- **US Public debt - 02/01/2007 \$8,694,902,769,091.18 [this is up nearly 40% in less than 4.5 years (9/30/02 \$6,228,235,965,597.16)]**
<http://www.publicdebt.treas.gov/opd/opdpenny.htm>

How does the foregoing matter? It is hard number evidence that the current “growth” has little to do with “growth” and everything to do with irresponsible easy money. Assuming that the government can borrow at 5% (which will occur only so long as foreign entities support these artificial rates), the additional annual interest on the increase alone is 123 billion dollars.

On to the weeks (2) news, . . . For the first time ever, I missed a weekly report and have combined the missing with the current. Interestingly, it provides some perspective of how quickly things can change – for example the oil stories. There exists the same overall “base decisions on today’s weather” attitude in the markets as a whole that were evident in the “drive oil below \$50 because it was unseasonably warm in early January” that suddenly turned to “back up to \$60, it’s unseasonably cold in late January”. What that means for the market as a whole is it continues to trade as if there will NEVER be another downturn. As we have discussed many times, those who fail to measure risk in a benign market will get crushed in a volatile one.

The clock ticks on . . .

For what it’s worth -from everything I have read, from sources I consider to be very trustworthy, the fundamentals in (PC/cell phone/related semis) tech are in serious decline and will implode sooner rather than later.

From the “I really have not been making it up” department, there are a number of very learned folks who have articulated the risk issues, on which I have been ranting, much better than me. Please look at the Risk and Derivatives sections, if interested.

Commercial Real Estate

Commodities

- Jan 30 - Oil Gusher: Crude Oil futures soared over \$3 per barrel as cold weather forecasts combined with upcoming OPEC production cuts have traders covering short positions. [wow, cold weather and price support from OPEC. Where do these things come from?]
- Jan 25 Again the essential math: There's only \$1.8 trillion in gold above ground. **Over the last 10 years, at today's prices, we estimate that about \$300 billion of new gold was added to the world supply. Meanwhile, the price of all other assets rose by an estimated \$70 trillion** (this is just a guess; generally the price of assets doubled during the past 10 years). In other words, 10 years ago, there was one ounce of gold - at \$300, more or less - for \$31,000 worth of other stuff. Today, there is one ounce of gold for every \$50,000 worth of other stuff. As much as \$140,000 worth of stuff has been added for every ounce of gold...grosso modo...that came out of the ground in the last 10 years.
DR 1/25

- Jan. 24 (Bloomberg) -- Crude oil was little changed near \$55 a barrel in New York after rising the most in 16 months yesterday on plans by the U.S. to double the nation's emergency supplies. Oil jumped 4.7 percent yesterday after Energy Secretary Samuel Bodman said the government will start buying 100,000 barrels a day this spring as part of a plan to increase the capacity of the strategic reserve to 1.5 billion barrels during the next 20 years. Purchases that adversely affect the market will be avoided, Bodman said. ``It's still going to take barrels out of the market," said Chris Mennis, owner of oil broker New Wave Energy LLC in Aptos, California. ``We've got real winter weather now, so maybe we've got a couple of reasons" for the market to turn higher, he said. Crude oil for March delivery was at \$54.92 a barrel, down 12 cents in after-hours electronic trading on the New York Mercantile Exchange at 8:43 a.m. in Singapore. The contract rose \$2.46 to \$55.04 yesterday, the highest close since Jan. 9 and the biggest one-day gain since Sept. 19, 2005. Prices jumped \$1.35 a barrel in 15 minutes after Bodman's announcement. Reserves Cover The U.S. government holds 691 million barrels, roughly equivalent to 55 days of imports, Bodman said. The expanded reserve, stored in salt caverns along the U.S. Gulf Coast, will cater for rising energy demand and will hold the equivalent of about 97 days of U.S. oil imports, he said. U.S. crude oil imports averaged 10.1 million barrels a day in 2006, up 0.7 percent from a year earlier, according to the department. They have gained 23 percent the past five years. ``Taking 100,000 barrels a day will take some oil off the market," Robert Ebel, chairman of the energy program at the Center for Strategic and International Studies in Washington, said yesterday. ``But keep in mind the world produces about 85 million barrels day." New York oil futures have fallen 30 percent from last July's \$78.40 record. The just-expired February contract reached a 19- month low of \$49.90 on Jan. 18 as mild weather in the U.S. Northeast cut heating demand and helped increase the nation's fuel stockpiles for five straight weeks. **Oil Trades Near \$55 After Rising on U.S. Plan to Boost Reserves**
http://www.bloomberg.com/apps/news?pid=20601087&sid=a6idCFHQF_zA&refer=home

Currency

Diversification

- The FSA, which highlighted nine priorities in its 126-page report, said firms should **consider the increased correlation of asset classes which could worsen the impact of any shock** -- commodities and equities, for example, with many top indices now heavy with energy groups and miners. "The combination of low volatility, high correlation and a historically low level of risk premia brings with it an inherently high likelihood of a major shock, especially if an event were to occur that triggered a significant deterioration in market sentiment," the FSA said in the report. See Risk below for full story

Derivatives

- The Financial Times takes up an important little piece of the discussion: **“It is widely acknowledged, for example, that mathematical models of risk, which are used to stress-test derivatives, give too much weight to the low volatility of recent times. In other words, they use the recent past as a guide to predicting the future. In financial markets this is the one sense**

in which history is bunk, since financial shocks have a habit of coming from unexpected quarters.” The average man - even the average economist - is cowed by the complexity of it. What exactly is the effect of a souped-up, high-tech, optimized financial world, he wonders? Do hyper-sophisticated financial instruments dreamed up by MIT Ph.Ds. in mathematics and to speculators, banks and hedge funds all over the world really disperse risk...making the foundations of the world financial system more solid? Or do they merely increase the risks overall? No one really knows. And the longer this new Titanic Credit Expansion sails along with no major mishap, the more people settle down into their comfortable deck chairs or order more drinks at the bar. Why worry about it? Why take out insurance or check out the lifeboats? Nothing has gone wrong, so far, they say to themselves. Nothing ever will. But the reason nothing has gone wrong so far is merely because the tide of liquidity is still in flood mode. “Academics such as Harry Kat of the Cass Business School at the City University in London have produced evidence that **many hedge funds are, in fact, pursuing trading strategies that can be relied on to produce positive returns most of the time as compensation for a very rare negative return.** They are encouraged to do this by a fee structure that does not require the fund managers to pay back their earlier profit share to investors if an extreme event strikes and wipes out the fund. **“At the same time, big financial institutions have no incentive to incorporate the potential costs and risks to the system of their own collapse in their market pricing. They prefer others to incur the costs of providing the ‘public good’ of financial stability, while under-insuring against the risk of failure and under-investing in systems to enhance financial stability.”** In other words, when the inevitable end comes...neither the hedge funds nor the big financial institutions will be able to absorb the losses. DR 1/31 <http://www.dailyreckoning.com>

- Jan 30 - The head of the European Central Bank elaborates. "There is now such creativity of new and very sophisticated financial instruments...that **we don't know fully where the risks are located,**" said Jean Claude Trichet. "We are trying to understand what is going on - but it is a big, big challenge." Mr. Trichet was speaking to the illustrious group gathered in Davos, Switzerland. The Financial Times describes the debate in which he played a role: "**Many investment bankers and some regulators and economists argued at last week's World Economic Forum in Davos that the growth of the \$450,000 billion...derivatives sector had helped reduce market volatility and made the system more resilient to shocks by spreading credit risk. But other officials fear these instruments may be raising leverage and risk-taking to dangerous levels and keeping the cost of borrowing artificially low, potentially increasing the chance of financial crises.**" DR 1/31 <http://www.dailyreckoning.com>
- Jan 30 - MUMBAI: Economists at Davos are worried about derivatives. The splurge for demand for derivative instruments across the globe was one of the most interesting points in a meeting between Montek Singh Ahluwalia and other economists like Zhu Min of the Bank of China and Jean Claude Trichet from the European Central Bank. All of them agreed that capital markets **are becoming more significant in global economics than ever before and the demand for complex instruments is ever increasing, especially for credit derivatives.** They are worried about the risks that these instruments can bring to global capital flows. **Mr Ahluwalia said investors have generally experienced the**

growth of these derivatives in good times and people don't have much experience of these instruments in declining markets. Derivatives growth has economists in a tizzy <http://economictimes.indiatimes.com/articleshow/msid-1525791,prtpage-1.cms>

- The flip side of the surge in the global hedge fund industry since the turn of the millennium is the dramatic expansion of the world's derivatives markets. By the middle of 2006, according to the International Swaps and Derivatives Association, the value of outstanding value of interest rate, equity and credit derivatives had grown to more than USD280trn, half as much again as two years earlier, and there is no sign of the pace slackening. The parallel expansion of hedge funds and derivatives is no coincidence. **The growth of hedge fund investment over the past decade has been accompanied by a massive diversification of strategies away from the traditional approaches of long/short equity and global macro in which derivatives have played a crucial role. Once obscure instruments such as credit default swaps have become everyday features of the alternative investment management industry.** Derivatives exchanges have moved to centre-stage along with the instruments traded there. Institutions such as the Chicago commodities exchanges, not so long ago viewed by the outside world as somewhat arcane appendages to the US agricultural industry, are now acknowledged not only as important trade centres for trade dealers but as the playground for hedge funds seeking out inefficiencies and opportunities in an ever more bewildering range of markets. And valuable assets in their own right, too. The past couple of years have seen derivatives exchanges become coveted and increasingly highly valued assets amid the growing free-for-all that has followed demutualisation of many of Europe's leading stock exchanges - and in which hedge funds themselves have played no small part. An early indication was the acquisition of the London International Financial Futures Exchange (Liffe) by Euronext (itself created from a merger of the Paris, Brussels and Amsterdam stock exchanges), snapped up under the nose of the London Stock Exchange. **Merger deals move derivatives exchanges to centre-stage** http://www.hedgeweek.com/articles/detail.jsp?content_id=47621&livehome=true

Earnings

- Feb 2 - YRC Worldwide (YRCW \$46) posted a larger-than-expected 31% drop in 4Q adjusted EPS to \$0.94 per share, below the Street's estimate of \$1.00, which the trucking company blamed on weaker economic conditions. Though YRC said it believes slower growth going forward will impact results in 2007, the company offered full-year profit guidance above the Street's view, and shares are higher.
- Jan 30 - Package shipper **United Parcel Service (UPS, \$72.70, -0.95)** hit its Q4 earnings target, but the stock fell -1% today on a weak outlook for the coming year. According to the company, a "slowing" U.S. economy means that its full-year 2007 earnings per share will rise by between 6-10%, or within a range of \$4.10-4.25. Analysts have been projecting 2007 earnings of \$4.26 per share. UPS reported Q4 net income of \$1.1 billion, or \$1.04 a share, compared with \$1.1 billion, or 95 cents a share, in 2005. The company said it expects business to pick up in the latter part of the year following a slow start.

Housing

- Disparity in home prices is a given worldwide, but in some areas the rich are richer and live in homes dramatically more expensive than the houses the general public lives in. BusinessWeek has quantified inequity of home prices, comparing housing cost data for more than 100 metro areas to determine the gap between the most expensive homes and those that are priced at the median. Here are the top 10 most disparate markets. <http://www.realtor.org/RMODaily.nsf/pages/News2007013002?OpenDocument>
- Norman Angell's book, published at the beginning of the 20th century, argued persuasively that new innovations in politics and markets of the period made war unthinkable. People stopped thinking about it. They stopped worrying. They stopped taking precautions. Never had people been more optimistic and more complacent than they were - right up until WWI began in August of 1914. Then, all the innovations that so delighted Angell - industrialization, technological improvements, nationalization - became the exact same innovations that made it the bloodiest and most expensive war in history. **Coincidentally, that was also when U.S. property prices reached their last epic high. In real terms, they went down in WWI and kept going down for 70 years or more. Only in the last 10 years have they gone back up - returning to their 1914 high only in 2005.** DR 1/30

Housing Finance

- If you were to ask most Wall Street analysts about the condition of the nation's housing market, they would probably say that it is "bottoming out" or "stabilizing." **But if you were to pose the identical question to most CEOs of major homebuilding companies, they would probably say, "We have not yet seen tangible evidence of a market recovery," just like Lennar's CEO, Stuart Miller said on a recent conference call.** We'd like to believe Wall Street's upbeat outlook – really, we would – but we find the first-hand accounts from the homebuilders themselves to be much more persuasive. Furthermore, the rapidly imploding subprime mortgage industry persuades us that homebuilding CEOs will not be heralding a recovery any time soon. "Subprime" refers to borrowers with relatively poor credit – i.e., borrowers who cannot qualify for a traditional "prime" or "conforming" mortgage. Not so long ago, subprime borrowers represented a small sliver of the overall mortgage market. But during the recently ended housing boom, these borrowers came to represent a whopping 23% of the total share of new loans. What's bad for subprime borrowers, therefore, is bad for the entire housing market. And what's beginning to happen to subprime borrowers – and their lenders – is quite bad indeed. **These borrowers are defaulting in large numbers, while their lenders are going bankrupt in large numbers.** During previous housing booms, a buyer who could not qualify for a conventional loan could not buy a house, plain and simple. But during the boom that just ended, a relaxed, new set of lending standards emerged. Borrowers who could not qualify for a traditional loan could still obtain a non-traditional loan – i.e., a sub-prime loan. **"Thanks to relaxed lending standards in recent years," the Dallas Morning News relates, "borrowers with bad credit – such as a bankruptcy or a delinquent loan on their record – found it relatively easy to get home mortgages."** Unfortunately, the mortgages they got usually contained toxic features like "adjustable" interest rates that, inconveniently, would adjust higher whenever short-term interest rates moved higher – in the process raising mortgage payments to unaffordable levels. Since

rates have been moving higher, therefore, at the very same time that home prices have been moving lower, many subprime borrowers are finding themselves with no way out...except to default. Nationwide, foreclosure filings jumped 51 percent last year. In California, the epicenter of the housing bubble-cum-bust, default notices jumped 145% in the last three months of 2006. It was the largest number of default notices in any three-month period since 1998. Therefore, as James Grant explains in a recent issue of *Grant's Interest Rate Observer*, **"It's a fact of macro as well as micro significance that roughly 25% of the U.S. home-buying population can be classified as 'subprime.'"** It is significant, says Grant, because this large contingent of marginal buyers played a major role in the powering the housing boom. If, as it now appears, these marginal buyers are disappearing, the housing market will miss them dearly. "It was the marginal lender who financed the marginal borrower," says Grant. **"And it was the marginal borrower who stepped up to pay the extra dollar for the incremental house.** Such was the way off the boom. Now, the marginal, or subprime, lender is withdrawing and so, too, is the marginal borrower." The marginal buyer is not withdrawing, as much as he is collapsing under the weight of unbearable mortgage payments. "We project that one out of five (actually 19%) subprime mortgages originated during the past two years will end in foreclosure," a December report from the Center for Responsible Lending (CRL) predicts. "This rate is nearly double the projected rate of subprime loans made in 2002, and it exceeds the worst foreclosure experience in the modern mortgage market, which occurred during the 'Oil Patch' disaster off the 1980s." Meanwhile, subprime lenders are disappearing rapidly. In early December, Ownit Mortgage Solutions Inc., a California-based lender, went out of business. "It's a lousy market right now," one of the company's loan officers complained, "and it's heading down, not up." Ownit was the nation's 11th largest subprime lender. Since early December, several more subprime lenders have ceased operations. The [Mortgage Lender Implode-O-Meter](#) is reporting *"Twelve lenders have now gone caput since December 2006"*. This number has been increasing at a rate of 1-2 a week since December. In early January, for example, subprime lender, Secured Funding, announced, "Based upon market conditions and limited product availability, we are ceasing wholesale operations. We have stopped accepting new applications." One week later, Bay Capital announced that it would be shutting its doors. One week after that, FundingAmerican announced, "Due to current market conditions in the mortgage industry, Funding America has decided to discontinue accepting any new business." Some subprime lenders continue to operate, of course. But the surviving lenders are issuing fewer mortgages than they used to issue. "It's tightening up a lot," says Eddie Carmona, a mortgage broker who deals with subprime borrowers. "Almost every single subprime lender has done dramatic changes. It's all recent." The new and improved subprime lending environment requires borrowers to have higher credit scores, make larger down payments, and possess larger reserves of savings. But even though the lenders have closed their proverbial barn doors, the subprime horses are still running wild. And many of these wild horses will straggle back to the stable as delinquents. "[S]erious delinquencies have increased almost 50% year-over-year," Fitch Ratings points out. <http://www.agorafinancial.com>

Macro Economic

- Feb 2 Unemployment hits a 4-month high of 4.6%, according to the Labor Department this morning, signaling a sluggish start for the New Year. New jobs were expected to

come in around 150,000, but skittish employers created only 111,000 new jobs for January's payroll. Revisions of prior data from December 2006 stole the show again, with a confusing 405,000 new jobs created for the year.

- Feb 2 New orders for manufactured goods in December 2006 rose 2.4%, to \$405.2 billion. Shipments increased 1.4%, to \$395.9 billion. Unfilled orders rose 2.1%, to \$693.8 billion. And inventories were \$482.1 billion, up 0.1%. The inventories-to-shipments ratio was 1.22, down from 1.23 in November. <http://www.economicindicators.gov>
- Feb 1 - Personal income in December 2006 was \$11,147.5 billion, up 0.5% from November. Nominal disposable personal income (DPI) rose 0.5%, while real DPI increased 0.2%. Nominal personal consumption expenditures (PCE) rose 0.7%, while real PCE increased 0.3%. The personal savings rate as a percentage of DPI was -1.2% in December. **[In dollars personal income rose 60.6B, disposable income 50.8B while personal consumption rose 67.1B. your average first grader knows 67 is higher than 60 or 50. The "revised" Nov numbers are even worse – 32.4B, 25.4B versus 51.1B. Let the boom times roll on]** <http://www.economicindicators.gov>.

Retail

- Feb 2 - GENERAL MOTORS CORP. and FORD MOTOR CO. lost more than a sixth of their combined U.S. sales in January, and TOYOTA MOTOR CORP. extended its 20-month winning streak and claimed the No. 2 spot in the U.S. market. Ford's sales plunged 19% and GM lost 16%, as both automakers cut their reliance on low-margin sales to car rental agencies and closed a combined 28 factories. But Toyota's contrasting 10% gain in January sales underscored its momentum with a lineup of fuel-efficient cars and the pressure on the struggling U.S. auto industry to offer more aggressive discounts in the face of lackluster consumer demand. Analysts said they expected industrywide sales to have dropped by 5% or more, reflecting less aggressive discounting, a weaker U.S. housing market and higher interest rates. "We've hit a point where the consumer is strained and I think we're in a position where the industry is going to downshift and stay there," said Global Insight analyst George Magliano.

Retirement

- ***Women's Retirement Reality***
Almost half of women (48%) have considered the financial implications of retiring alone, compared with 36% of men, according to the sixth annual Allstate "Retirement Reality Check" survey. Women are slightly more likely than men to say they are planning for retirement separately from their spouse or partner (37% of women versus 32% of men). About half of the women surveyed said they invest money separately from their spouse or partner, and 42% of women said they maintain a separate savings account, compared with 28% of male respondents. However, the survey highlighted two potential barriers between women and a financially comfortable retirement. Almost half of the women respondents said the husband or partner takes the lead in planning for retirement. Second, couples appear to believe that just "a simple conversation" keeps their plan on track.
What Women Don't Learn about Finances
Many women did not learn about personal financial issues from their parents—and most regret that fact today. A column on the Women's Personal Finance.net Web site discusses

some of the 46 things the writer didn't learn from her mother. It begins with basics, such as the importance of spending less than you earn and putting aside savings on a regular basis. It also offers tips on home purchases, credit and debt, education, health, insurance, investing, retirement and taxes, as well as other topics. CPAs can point women clients to the article or review it themselves for a reminder of some of the areas in which they can help these clients. http://www.womenspersonalfinance.net/2006/09/46_things_i_wis.html

Five Mistakes of Married Women

What five mistakes do married women make? According to a *SmartMoney* article, they include letting a spouse take care of all the finances—something that can be a big mistake in case of a divorce or if the spouse simply makes bad choices. Other errors include not establishing a financial identity—including a credit record—of their own; failing to maintain their professional skills and training even if they leave the workforce; neglecting retirement savings; and asking for the family home in a divorce and ending up cash poor.

http://www.wachovia.com/personal/page/0,,505_513,00.html ***Resources for Women in Divorce***

The Prudential site offers a number of tools for women going through a divorce that may be of value to CPA clients. They include a financial analyzer that assesses net worth and analyzes cash flow; a financial goals worksheet; and a discussion of investment basics.

<http://www.prudential.com/productsAndServices/0,1474,intPageID%253D9014%2526blnPrinterFriendly%253D0,00.html>

AICPA PFP monthly newsletter

Risk

- Feb 1 “I speak to alotta fund managers and while many are making money, most are feeling frustrated by the tape. That's leading to alotta "reward chasing" behavior which typically comes at the expense of risk management.” Todd Harrison
<http://www.minyanville.com/articles/index.php?a=12073>
- Feb 1 – [it's all good, not a cloud in sight in Fantasyland . . . oops I meant Wall Street . . . “ignore the debt behind the curtain”] For the first time since 1996, the **SP500** finished higher for the 8th consecutive month. Even more impressive is the strength of the close. For the first time since 1995, the index finished above the prior month's high for the 6th time in a row. And for the first time since March 2004, the **SP500** has six higher highs and higher lows on the monthly chart. Given the steady rise, it's no surprise there's been little drawdown from the prior month's close. In fact, the index has not seen a monthly drawdown of more than 5% from the prior month's close (low to prior month close) since July 2004 (**the longest stretch since at least 1950**). And of course the **Dow** is the strongest of all. Not only has there been minimal drawdown on the monthly chart, the **daily chart has not seen a 2.5% correction since the fall of 2006 (longest streak since the 1950s)** <http://www.minyanville.com/articles/index.php?a=12073>
- Jan 31 - LONDON (Reuters) - The impact of a shock to financial markets would be more severe now than two or three years ago, the Financial Services Authority said, warning firms they need to do more to prepare for growing risks. In its annual Financial Risk Outlook, published on Wednesday, the Financial Services Authority said its outlook for the global economy, set for a fifth straight year of growth, remained benign, but there was

a heightened risk that could change. **The FSA pointed to increased geopolitical risks, including the Middle East and North Korea, complex financial markets and a combination of increasingly correlated asset classes, low volatility and cheap risk, with bond yields very low.** "Although some of this sounds very gloomy, we do continue to believe the outlook is benign," Sarah Carlson, the FSA's manager of global risk, said. "This document is really a clarion call to industry to think hard about the sort of risks they are facing." **In the past months, the FSA has repeatedly told banks and financial institutions they are not doing enough to use the current economic climate to prepare for potential shocks.** A recent review of so-called "stress-testing" practices at 10 large firms in the banking, building society and investment banking sectors found that only a small number of firms matched up fully to the FSA's criteria. **"We haven't lived through a significant downturn in the market for some time," Carlson said. "Firms should be thinking about challenging the models they are using. The stresses may have changed." The FSA said firms should be looking, for example, at what would happen if the current glut of liquidity on financial markets dried up, if markets began to put a higher price on risk, widening credit spreads.** They should also consider the impact of a major event like an influenza pandemic. TOO TIGHTLY-KNIT? The FSA, which highlighted nine priorities in its 126-page report, said firms should consider the increased correlation of asset classes which could worsen the impact of any shock -- commodities and equities, for example, with many top indices now heavy with energy groups and miners. "The combination of low volatility, high correlation and a historically low level of risk premia brings with it an inherently high likelihood of a major shock, especially if an event were to occur that triggered a significant deterioration in market sentiment," the FSA said in the report. The FSA put terrorism at the top of its list last year and repeated the warning for 2007, saying London and other financial centres faced the "key operational threat" of a direct attack. The UK insurance industry has so far withstood such shocks, but the FSA warned potential losses from terrorism could be larger than the private sector was prepared to finance. **The regulator also reiterated its warnings on alternative financial instruments -- private equity, complex derivatives, structured products and distressed debt. It said firms should consider the risks of innovative, and therefore often illiquid, instruments as well as conflicts of interest.** For consumers, the FSA said the main risks related to rising debt levels. Britons hold over a trillion pounds of personal debts and the regulator said they could often be unprepared for tougher economic times and overconfident about the future. **FSA says financial markets face increased risks [I must have missed the extensive CNBC coverage of this story]**

http://today.reuters.co.uk/news/articleinvesting.aspx?type=fundsNews&storyid=2007-01-31T144131Z_01_NOA144383_RTRUKOC_0_FSA-RISKS.xml&src=rss

- Jan 30 Not since the time of Long Term Capital Management in 1998 where it lost \$4.6 billion in less than 4 months has leverage been at the all time high that it is at now. Hedge funds are riding high on the abled use of leverage (also known as debt) and the arising concern regarding their debt financing is due to their lack of controls over risks that they take. As of present, the hedge funds manage US\$1.3 trillion (that's approx the current total amount of China's foreign reserves), and after including all the borrowings, the hedge funds total up to about US\$2.6 trillion. **With the leverage further increased by placement of funds in derivatives,** hedge funds has made it to the top issues that

requires discussion in the Group-of-Eight nations (G8) together with fellow issue of the explosion in global derivatives trading. The Business Times states that Deloitte's survey found that only 60% of its hedge fund respondents monitor balance sheet leverage, and only 50% of them monitor off balance sheet leverage (the extent of derivatives position). That highlights many a red flag that risk management policies are inadequate or insufficient enough for the dealing with a possibility of a possible risk crisis (i.e. counterparty risk and credit defaults). **Those who remembered the Long Term Capital Management (LTCM) debacle in 1998 will shiver at the thought that such a major crisis may repeat.** The then fear that LTCM's forced liquidation of its company would lead to drastic fall in prices and hence creating a vicious cycle where other companies would have to liquidate as well was so huge that even the Federal Reserve had to step in to mediate the potential losses. This entire debacle was the result of the credit risks and default risks undertaken by LTCM; the Russian defaulting of their government bonds made what was supposed to be a huge gain in LTCM's positions (had the spreads of the bonds actually converged) turn out to be the biggest loss by a hedge fund in the market. It's slightly worrying, all this debt that is carrying the financial markets around. Leverage is good, but where it starts to hit highs never before seen, it is justifiable for us to get more than just a little tingle of worry. **Hedge Funds leaning on too much leverage [LTCM lost in total less than Amaranth did last Spetember. The current exposure in an LTCM type melt-down in credit derivatives markets is exponentially higher and would require massive intervention by all major central banks. Will that happen? I don't know, but I am confident that the chance it happens is higher than none, which is where it is being priced by those shorting the volatility]**
<http://rosewithoutthorns.wordpress.com/2007/01/30/hedge-funds-leaning-too-much-on-leverage/>

- Jan 29 - A flood of cheap money is putting pressure on the world's financial system, threatening to burst its banks and wash away five straight years of strong economic growth. Leading financial officials discussing risks to the global economy at the World Economic Forum here say **central bankers have limits to what they can achieve by raising interest rates to reduce the danger that under-priced risk and imbalances in financial markets** will upset the rosy growth picture. "Over liquidity is killing us," said Zhu Min, group executive vice president of the Bank of China, the country's second largest bank. Policymakers have trained their sights on better monitoring of the \$1.7 trillion asset hedge fund industry and the complex new financial instruments they use that are fuelling a credit problem. "Monetary policy can play only a very small role in correcting these problems," said Wu Xiaoling, deputy governor of the People's Bank of China. **Very low bond yields, known as tight credit spreads, show investors are underpricing risk** and it is "not necessarily sustainable" for global financial markets, warned European Central Bank President Jean-Claude Trichet. "Clearly this phenomenon is not probably induced by ... good work produced by central banks," Trichet said, referring to over two years of interest rate rises by major central banks. **"Capital ... is chasing all over the world. You have to be prepared for a possible global re-appreciation of risks."** Persistently low bond yields have surprised policymakers, who had expected that over two years of major central banks pushing up financing costs would cool off bouyant financial markets and help restore a more balanced pattern of global growth with less market risk. But that hasn't happened, top International Monetary

Fund official John Lipsky said. "This has prompted a reassessment, not of global imbalances, but of the time scale for the adjustment," he said. **Cheap money threatens to wash away global growth** <http://www.theage.com.au/news/business/cheap-money-threatens-to-wash-away-global-growth/2007/01/29/1169919244710.html#>

- Jan 28 - Tired of being on the outside looking in at the scads of money being made by corporate takeover artists and hedge funds? It's easy enough to be part of those booms. By buying into mutual funds that own either high-yield bonds or high-yield bank loans, you can invest with the new movers and shakers in finance, who are ravenous for cash to bankroll their escapades. But to jump in today is to ignore the advice of Wall Street veterans who say the risks are too worrisome, and **the potential investment returns too low**, to justify joining the big-money crowd. The problem with those warnings is that they were out there a year ago too — and you would have been better off paying no attention to them. **[just as in late 1999 early 2000 a trader would have missed out on the climax run when the traders handed off the mispriced assets to the little guys]** **It's just no use trashing junk bonds** <http://www.latimes.com/business/la-fi-petruno28jan28,1,5477471.column?track=rss&ctrack=1&cset=true>
- Jan. 22 (Bloomberg) -- Lawrence Summers has a message for investors heading to the Swiss mountain resort of Davos this week to toast a year of booming returns and record bonuses. **“It's worth remembering that markets were very upbeat in the early summer of 1914,”** the former U.S. Treasury secretary observes. While Summers isn't predicting the onset of another world war, he and European Central Bank President Jean-Claude Trichet are among those who are warning the more than 2,200 movers and shakers at the 37th annual meeting of the World Economic Forum that they've **become too complacent about risks ranging from trade imbalances to terrorism**. A glut of cheap money and the strongest global economic growth in three decades have encouraged banks, private-equity firms and hedge funds to bet that the good times will keep rolling. **“It's too good to be true,”** says Vittorio Corbo, head of Chile's central bank, who will speak at a seminar in Davos about the dangers of derivatives. **“Tomorrow the mood could change. We have to be prepared.”** Last Year's Warnings In fact, they heard them last year at Davos, when Summers, the former president of Harvard University, billionaire George Soros and Bundesbank President Axel Weber cited the potential consequences of trade imbalances, budget deficits and the then- surging price of oil. **Since then, the rewards have just gotten better for investors. Prices of London's most expensive homes surged 29 percent last year, bonuses at the five largest U.S. investment firms rose 30 percent to \$36 billion and the Dow Jones Industrial Average climbed to a record.** An Appetite for Risk With banks tapping what Trichet calls an **“ample”** pool of liquidity, **investor appetite for risk has never been greater.** Several measures show perception of risk is near historic lows. The gap between the yield demanded by investors to hold emerging-market and U.S. government bonds narrowed to a record on Jan. 17, according to JPMorgan Chase & Co., while the amount of debt used to finance European buyouts rose to 8.7 times earnings in the third quarter, the most ever. **Hedge funds in the U.S. are the most leveraged since 1998,** the year that Long-Term Capital Management collapsed, according to Bridgewater Associates Inc., a Westport, Connecticut-based fund manager. Regulators from the U.S. Securities and Exchange Commission, the Federal Reserve Bank of New York and the U.K.'s Financial Services Authority, concerned that credit standards for hedge funds are too lax, are jointly probing

whether lenders set strict enough limits on loans. Little Concern Meanwhile, one gauge of stock-market volatility -- the Chicago Board Options Exchange's VIX index -- shows that concern about a slump in equity prices is at a 13-year low. **Summers, Trichet Warn Davos Party-Goers They Underestimate Risk**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=akRtIITTEx2Q&refer=home>

Savings Rate

- Personal saving -- DPI less personal outlays -- was a negative \$116.6 billion in December, compared with a negative \$99.2 billion in November. Personal saving as a percentage of disposable personal income was a negative 1.2 percent in December, compared with a negative 1.0 percent in November. Negative personal saving reflects personal outlays that exceed disposable personal income. Saving from current income may be near zero or negative when outlays are financed by borrowing (including borrowing financed through credit cards or home equity loans), by selling investments or other assets, or by using savings from previous periods. For more information, see the FAQs on "Personal Saving" on BEA's Web site. For a comparison of personal saving in BEA's national income and product accounts with personal saving in the Federal Reserve Board's flow of funds accounts and data on changes in net worth (which help finance consumption), go to <http://www.bea.gov/bea/dn/nipaweb/Nipa-Frb.asp>. Also See macro economic section for complete article

Tech

Wall Street

- Hedge funds have become big players in the private investments in public equities market, with PIPEs investments totaling \$28 billion last year alone, and that may present a problem for the industry and regulators. It certainly has captured the attention of *Forbes* magazine, which in a Feb. 12 article titled "Sewer Pipes" suggests that "**Hedge funds are posting nice returns from deals that may involve ex-cons, stock scammers...even the mob.**" According to *Forbes*, hedge funds are attracted to the deals, which allow them to invest in public companies in dire need of cash, for various profitable reasons. The hedge funds, says *Forbes*, do quite nicely for themselves, what with deals that give them 2% of assets, 20% of the profits and an average 3.5% as a closing fee for each deal. *Forbes* notes that in return for their investment hedge funds receive shares of a company's stock at a deep discount, as a compensation for the fact that the shares can't be traded until they're registered with the **Securities and Exchange Commission**. As a result, *Forbes* reports, "hedge funds can value those PIPE warrants and options pretty much any way want and calculate their net asset value accordingly." The higher the NAV, the more attractive the investment. The somewhat shady side of PIPEs – *Forbes* cites one hedge fund sued by an investor who was promised he could double his assets with penny stocks, and ended up losing most of it, and another run by a manager convicted of wire fraud – has prompted the **Securities and Exchange Commission** to turn the spotlight on them. "Improper trading practices in connection with PIPEs is a concern," **David Markowitz** of the SEC's office in New York, told *Forbes*. "It's an area that SEC enforcement is looking

at." **Hedge Funds Smoking In PIPES, Signal Potential Problems**

<http://www.dailyii.com/article.asp?ArticleID=1227864&LS=EMS118251>

- As if to prove how hot branch banking is, Merrill Lynch & Co. is jumping into the fray with the \$1.8 billion purchase of a San Francisco private bank, First Republic. Merrill is paying up big-time, too. The cash and stock deal is a whopping 46% premium to First Republic's closing share price Friday and more than triple First Republic's book value --a 1990s-era price tag that gets Merrill a bank that caters to wealthy individuals in fast-growing communities like Las Vegas and Santa Barbara, Calif., as well as Greenwich, Conn., and New York City. It's also getting some \$16.4 billion of assets under management, a curiosity considering Merrill just sold off its asset-management division to BlackRock in exchange for a minority stake. Merrill Lynch wants to offer its slate of brokerage and banking products to First Republic's wealthy clientele, **a type of cross-selling that has grown increasingly important to brokerages and banks in the quest for retail customers.** Despite the trend toward online brokerage in the last decade or so, branches have continued to be important places to capture this market, analysts said. And despite eye-popping results in investment banking and capital markets, retail continues to be an area of focus for the big brokerages. At least in the short-term, **some 68% of financial services executives expect retail products to be the most important drivers of performance**, according to a new survey by Mercer Oliver Wyman. **[retail products its sales people sell to its clients – the brokers prefer the terms “client”, “investment” and “financial services executives” but it is in fact retail sales by sales people, just like used cars, and largely with the same interest in “customer wellbeing”]** **Merrill Jumps Into Private Banking**
http://www.forbes.com/2007/01/29/merrill-first-republic-takeover-biz-cx_lm_0129merrill_print.html
- Standard & Poor's latest mutual fund persistence scorecard, which measures the consistency of top mutual funds, showed that in 2006 **“very few” funds consistently managed to repeat top-half or top-quartile performance.** For the five years ended Dec. 31, just 13.2% of large-cap, 9.9% of mid-cap and 10% of small-cap funds maintained a top-half ranking over five consecutive 12-month periods, S&P, a unit of New York-based The McGraw-Hill Companies Inc., said. **Just 3% of large-cap, 2.5% of mid-cap and no small-cap funds maintained a top-quartile ranking over the same period**, S&P said. “Standard & Poor's research suggests that screening for top-quartile funds, as the sole basis for an investment decision, is inappropriate,” Srikant Dash, index strategist at Standard & Poor's, said in a statement. Few funds repeat a top-quartile performance, he said. “Standard & Poor's research shows that a healthy percentage, and in most cases a majority, of top-quartile funds in the future will most likely come from the ranks of prior period second and third quartiles,” Mr. Dash said. S&P: Top funds failed to repeat **[yet another example of why you should not chase last year's winners]**
<http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070129/REG/70129024/-1/INDaily01&template=printart>
- NEW YORK — Financial advisers are not only inspiring intense loyalty among their clients, but they also might be able to find a mother lode of new customers among younger baby boomers, according to a new research report. However, more than one-third of the 4,000 investors who were born between 1956 and 1964 with investible assets of more than \$100,000 surveyed in Cogent Research LLC's Investor Brandscape 2007

study said they didn't work with an investment adviser. And 57% of the respondents' total investible assets were managed without the assistance of a financial adviser, the survey showed. **Those findings imply "a lack of trust" in advisers**, which is especially troubling because the investors surveyed were affluent, said Chris Brown, managing director in the wealth management practice for Cambridge, Mass.-based Cogent. He is the author of the study, which is scheduled for release next month. "Advisers may play a smaller role than they think in clients' investment decisions," Mr. Brown concluded. **For survey respondents who said they worked with an adviser, 41% said they used financial planners, 20% said they used stockbrokers, and 17% said they used certified public accountants. Clients loyal, but investors wary, survey says**
<http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070129/FREE/70129003/1009/INIssueAlert01&template=printart>

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Article of the week: [the Street says "just trust us we'll watch out for you"]

Deals on 'dark pools' set to surge

The volume of shares traded on private systems owned by investment banks, rather than on public exchanges, is set to surge, both in Europe and the US, a new report suggests.

Indeed, deals that occur on private inter-bank platforms - known as "dark pools of liquidity" - probably account for about 10 per cent of all shares trading in the US, a sharp increase from previous years, research by the Tabb consultancy suggests.

According to Tabb, "dark pools" and crossing networks captured nearly 10 per cent of the total US equity market last year, with an average of 420m shares traded per day, a number that will increase to 512m shares a day by the end of this year. In Europe, such systems accounted for 2 per cent of all equity trading and in Asia, less than 1 per cent, but both are growing steadily, according to the research.

In the US, several banks have launched their own branded internal systems, adding to the momentum. These include Morgan Stanley's Pool, Goldman Sachs' Sigma X, Credit Suisse's CrossFinder and UBS's Price Improvement Network.

There is also the Block Interest Discovery System, or Bids, an alternative liquidity source for block trading backed by Citigroup, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley and UBS.

These systems also face competition from established names such as Investment Technology Group (ITG), Liquidnet, Nyfix Millennium and Pipeline Trading.

This trend toward dark pools and crossing networks is providing a lucrative source of revenues for investment banks and it is likely to accelerate, particularly as the introduction of the Market in Financial Instruments Directive this year in Europe is likely to expand the use of private networks there.

In response to the Mifid, seven investment banks are preparing to create a pan-European rival share execution network, known as Project Turquoise, which could challenge traditional platforms, such as the London Stock Exchange.

However, as such trading networks expand, regulatory concerns could arise because once a system accounts for a large portion of total equity market volume, most regulators require prices to be quoted to the public.

The UK financial regulator is concerned that if the market fragments, it will become more difficult to gather consistent and comprehensive data about trading behaviour on stock exchanges. "It's clearly easier to monitor one market than several, but we will respond to the challenges as they arise," an FSA spokesman told the FT.

http://news.yahoo.com/s/ft/20070130/bs_ft/fto013020071556012770&printer=1;_ylt=Age0CLcAqzax7gm21ETr1yD3ULEF;_ylu=X3oDMTA3MXN1bHE0BHNIYwN0bWE-

UM MBA

- Cases in the news –

Reprinted from NewsMax.com

Monday, Jan. 29, 2007 10:22 a.m. EST

McDonald's Tops Starbucks in Coffee Taste Test

When Consumer Reports magazine compared coffee from mega-chain Starbucks with java from three fast-food restaurants, the surprising winner was – McDonald's.

The magazine had trained tasters sample a medium cup of black coffee from McDonald's, Burger King, Dunkin' Donuts and Starbucks, and found the best cup of joe under the golden arches.

McDonald's coffee "beat the rest," according to Consumer Reports. It was "decent and moderately strong. Although it lacked the subtle top notes needed to make it rise and shine, it had no flaws."

As for Starbucks, its coffee "was strong, but burnt and bitter enough to make your eyes water instead of open."

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- Jan. 24 (Bloomberg) -- United Microelectronics Corp., Taiwan's second-biggest chipmaker, plans to cancel 30 percent of its stock and return as much as NT\$57.4 billion

(\$1.7 billion) to shareholders in a move that may fend off possible takeovers. The board of the Hsinchu-based chip foundry yesterday approved a plan to cancel about 5.7 billion shares and return about NT\$3 per stock held to investors, according to a filing to the Securities and Exchange Commission. Shares of United Microelectronics rose by their 7 percent limit in Taipei today. ``The company will be less attractive to private equity funds because the stock cancellation will cut its cash position hugely, but also boost the share price, making a buyout more costly," said Phil Chen, who manages \$154 million at Grand Cathay Securities Investment Trust Co. in Taipei. ``It's positive news for the company." Chen said he doesn't own the stock. Shares of United Microelectronics, the world's second- largest supplier of made-to-order chips, rose 9.7 percent in the past year, lagging behind a 22 percent gain in the benchmark Taiex index as customers scaled back orders for semiconductors. The company will probably report lower profits in the fourth quarter next month, according to analyst estimates. **United Micro to Cancel Shares, Return \$1.7 Billion (Update2) [a real world example of a massive change in equity on a balance sheet]**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aQT1Sn9uNWec&refer=home>