

The Other Side of the Street January 20, 2008

Comments

While yet another holiday was celebrated in the US, Asia and Europe dropped between 4-7% today (Monday). It seems that there is a growing understanding that the US government is powerless at this point no matter how much they promise.

Hard to know where we will start tomorrow morning in the US, Dow futures at noon CT on Monday were off 520 (this after being up last night even as Asia imploded). A huge blow off gap down will trigger panic, at some point the “know it all traders” will buy the panic. It is this “rally” that will be of interest to me. Should it fail and we go out on the lows, you can pretty much expect some type of panicked Fed emergency rate cut (if not sooner). This will be met by a knee jerk rally that will be sold very hard and perhaps finally end the “Don’t Fight the Fed” nonsense.

The other unknowable piece is how badly out of position hedge funds and other players will find themselves before the bell rings. Prices can be manipulated when the volume is low enough and the big boys all play the game. A great for instance was AMZN last week trading a little above and below 80 the last three days in the game of pin the strike price on option expiration day. This game has left many players with a ton more AMZN long than they would like in a huge volume sell off. It would not surprise me to see AMZN off ten or more tomorrow on 20 million plus volume. I throw out that as an example that 100PE stocks are not trading on fundamentals they are trading on gamesmanship. This is particularly true of those in the quant formula long short game. AMZN and other high betas were darlings of this on the long side. If significant positions remain from this type trade, computers will be putting out black smoke on the open.

In addition to the margin/leverage issue, there is the psychological issue. Last night I was watching some tivoed “Fast Money” episodes (a CNBC post market close show). The traders were talking bravely about bottoms and short term buying opportunities. From experience, it is much easier to talk about such things on a down 50 day than a down 500 on the open day. I would guess there will be many more hedge fund managers with queasy stomachs looking to take longs off the table at a price higher than the open than managers looking to start the next rally. Should an early bounce off the gap down fail and new lows come in mid-day, it will lead to vastly accelerated selling into the close.

As a final note, we are going to open at a 52 week low tomorrow barring some bizarre intervening event. The traditional definition of a bear market is 20% down from the highs, those numbers based on the “Don’t Fight the Fed” October rally are Dow 11,400 (H14,279); NAZ 2,280 (H2,861); and SP500 1,260 (H1,576). Looking back further, the 2006 lows were around Dow 10,600, NAZ 2000, and SP500 1,220 in the summer. The reason such numbers matter is the huge number of “investors” trapped with losses just wishing and hoping to get back to even. This is one reason why rallies will get sold for a very long time.

Be careful, there are hungry bears on the loose . . .

Stock Notes

- **Washington Mutual maintained this week's trend of depressing financial earnings reports -- the bank announced a nearly \$2 billion loss yesterday.** Such losses included a \$1.6 billion write-down of dead and dying home loans. The bank also stated that it has set aside another \$1.5 billion to cover losses likely to occur in the current quarter
- **The U.S. stock market rallied yesterday, sending the Dow and Nasdaq up about 1.5% and the S&P 500 up just over 1%.** Nearly the entire day's gains were fueled by an early-morning earnings announcement from IBM. Big Blue beat fourth-quarter earnings estimates by a handsome margin. "If you take out the currency component," Chuck Butler from EverBank points out, "IBM's sales increased 4%, not the 10% for revenues expected. Even big old (boring) IBM can make some money in the currency markets!"
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Notes

- Now... behind the scenes: **"Basically, the bond insurers like Ambac have a huge, but hard-to-quantify liability,"** explains Amoss. "This liability is the promise to start covering losses on bonds/mortgages when they default. "Under normal circumstances, this liability is more than offset by a huge, but hard-to-quantify balance sheet asset -- cash inflows from the premiums they earn. But these are not normal times. The accounting works fine in normal times, but it does not work well during a credit crisis. "Mortgage defaults will force the mortgage insurers to pay out much more than they earn in premiums -- perhaps to the point at which they lose the ability to meet payments on their debt. Bond defaults -- especially in structured credit like collateralized debt obligations (CDOs) -- will force the bond insurers like MBIA and Ambac to pay out much more than they earn in premiums. "I'm not sure how it will play out... But I'm guessing that the new Berkshire Hathaway bond insurance subsidiary will step in and write reinsurance on the municipal bonds that lose protection in the event of ABK/MBI failure. **But Warren Buffett is very unlikely to insure structured credit. He's long been a critic of that particular business.**"
- **The English are officially suffering a bear market.** As the world oohs and ahhs at the daily strife here in the States, the FTSE 250, an English mid-cap benchmark index, has quietly fallen 20% from its all-time high set last May. English big caps, measured by the FTSE 100, are doing their part to catch up, down an average 13% from their all-time highs. "The U.K. has problems much like the U.S., only on a smaller scale," reports Chuck Butler. "It won't be long before interest rates there begin to come down. This all weighs on pound sterling, and will continue to do so going forward." **[this was from last Friday and does not include the 5.5% loss on MLK day]**
- "Too many bubbles have been going on for too long," Former Fed chairman Paul Volcker says in an interview in The New York Times Magazine coming out on Sunday. "The Fed is not really in control of the situation... Bernanke is in a very difficult situation."
- **Merrill Lynch announced a \$14 billion write-down this morning,** bringing its total past \$22 billion in the last two quarters alone. The investment bank was forced to take a \$10 billion loss during the quarter, its earnings statement reported, the largest dollar loss

in the bank's 94-year history. Thus, this week alone, banks marked down some \$34 billion in bad subprime bets -- \$18 from Citi, \$1.3 from JP Morgan yesterday, and now \$14 from Merrill.

- Of course, holding "cash" if it's in U.S. dollars isn't exactly a smart move these days, either. **Today's Consumer Price Index (CPI), for example, shows that prices for food, energy and haircuts rose an average 4.1% in 2007** -- their highest rate since 1990. Energy soared an impressive 17%. And food is up nearly 5% since this time last year. Of course, if you don't eat, drive, heat your home, turn on lights or watch football on TV, your cost of living got only 2.4% more expensive this year. Looking at the most recent numbers, CPI rose 0.3% in December. Over the last three months of the year, consumer inflation rose at an annual rate of 5.6%. Wherever you're holding "cash," if it is in U.S. dollars and not yielding 6%, you're losing money.
- And the Baltic Dry Index, which is a measure of freight costs for shipping dry goods like coal and grains, just recorded its biggest two-day drop since its inception back in 1985. It's now down about 30% from its all-time high in November. . . . **The Baltic Dry Index fell for its sixth consecutive day yesterday.** The measure of global raw material shipping fell by about 4.2% -- we hear its biggest drop since 1989.
- **Inflation, for example, at the wholesale level rose to 26-year highs in 2007**, reports the Labor Department this morning. While the producer price index managed a tiny 0.1% fall in December, the government reported this morning that total 2007 producer inflation rose to 6.3%, a level not achieved since 1981.
- The retail season was rather anemic, too. **Total monthly retail sales fell 0.4% in December**, says the Commerce Department Jan 15. The "biggest shopping month of the year" proved to be the sharpest monthly decline in retail sales in six months. November sales were revised down to a 1% gain, from a previously recorded 1.2%. And if that didn't fan the recession fire enough, the National Retail Federation also lowered its 2008 sales forecast to 3.5% -- its weakest pace in six years.
- According to The Economist, almost 60% of Americans believe we are in recession.
- **U.S. mutual fund investors will likely be hit with the biggest tax bills in market history this April.** According to the Financial Times, American mutual funds will most likely ring in a record \$350 billion in capital gains taxes for their 2007 performance. Despite a rocky second half, 2007 mutual fund investors will pay more in taxes this year than during the height of the tech boom, whether they sold their positions or not... ouch.
- Allstate has seen a significant spike in arsons among homes in foreclosure, reports Fortune magazine. In California, one of the states hit hardest by the subprime crisis, "questionable" residential fires increased by 76% in 2007. With "untold thousands of homeowners struggling with ballooning subprime mortgage payments," reads a report from the Coalition Against Insurance Fraud, "fraud fighters are watching closely for a spike in arsons by desperate homeowners who can no longer afford their home payments." Apparently, this is a common problem when the housing market slows down.
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Web links

Credit

- Jan. 21 (Bloomberg) -- The U.K. government, struggling to find a buyer for Northern Rock Plc, said it will guarantee a sale of bonds backed by the bank's home loans and gave bidders two weeks to come forward with proposals. Mortgages, consumer loans and some investment-grade securities of the Newcastle, England-based bank would be packaged as debt and sold to investors, the Treasury said today. Bids based on the new funding plan must be submitted by Feb. 4. Northern Rock rose 46 percent in London trading on speculation the proposal will revive interest among potential buyers such as Richard Branson's Virgin Group Ltd. Northern Rock sparked the first run on a U.K. bank in a century when it sought aid from the Bank of England in September. Borrowings have since swollen to about 24 billion pounds (\$47 billion), hampering a sale and forcing the government to consider nationalization. "It seems a very reasonable solution for Northern Rock," said Simon Maughan, an analyst at MF Global Securities Ltd. in London who has a "neutral" rating on the stock. "The problem comes when the competition cries foul." **U.K. to Back Northern Rock Debt in Plan to Spur Sale**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=axe3p7U0wi1Y&refer=home>

Commercial Real Estate

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Derivatives

- Jan. 21 (Bloomberg) -- ACA Capital Holdings Inc., the bond insurer being run by regulators after subprime-mortgage losses, won a month's grace to unwind \$60 billion of credit-default swap contracts that it can't pay. ACA, under the control of the Maryland Insurance Administration, extended an agreement that waives collateral requirements, policy claims and termination rights until Feb. 19, the New York-based company said in a statement on Business Wire late yesterday. The insurer said it's working with trading partners "to develop a permanent solution to stabilize its capital position" after losses of \$1.04 billion in the third quarter. **[would have been better off unwinding months ago then they will end up. A good example of the "wait until it gets better" does not always work]** Standard & Poor's cut ACA's rating 12 levels to CCC last month, casting doubt on the company's guarantees and triggering collateral requirements. ACA, which lost 97 percent of its market value in the past 12 months, caused Merrill Lynch & Co. to write down \$1.9 billion of securities last week and Canadian Imperial Bank of Commerce to sell more than C\$2.75 billion (\$2.7 billion) in stock to cover writedowns. Bond insurers' shares plunged last week and credit-default swaps rose to a record on concern the companies may be unable to meet their obligations as the subprime-mortgage securities and

collateralized debt obligations they guarantee slump in value. Ambac Cut Ambac Financial Group Inc., the second-largest bond insurer, had its AAA credit ranking cut to AA by Fitch Ratings. Both Ambac and its larger rival, MBIA Inc., are under threat of losing the top grades from Moody's Investors Service and S&P, **a move that would throw doubt on the ratings of \$2.4 trillion of securities.** An after-hours call to ACA last night by Bloomberg News wasn't immediately returned. ``ACA is an important case to follow because it shows how the banks' react to fast-deteriorating counterparty creditworthiness," said Toby Nangle, who helps oversee \$37 billion as head of global aggregate business at Baring Asset Management in London. The bond insurers, also known as monolines, guaranteed \$127 billion of CDOs backed by subprime-mortgage securities as of June 30, according to S&P. CDOs are created by packaging debt or derivatives into new securities with varying ratings. Market Valuations Most of those guarantees are in the form of derivatives. Unlike insurance, these contracts are required to be valued at market rates. Derivatives are contracts whose value is derived from assets including stocks, bonds, currencies and commodities, or from events such as the weather or changes in interest rates. ACA was founded in 1997 by former Fitch executive H. Russell Fraser, who left the ratings company in 2001 as it shifted focus to structured finance from municipal bonds. Fraser said his idea was to start an A-rated municipal bond insurance company to guarantee a new crop of borrowers he sometimes called ``the cream of the crap." ACA's larger competitors such as Ambac and MBIA had enough cash to get the top AAA ratings on their insured bonds. ACA backed \$51.5 million of bonds sold to finance the construction of a jail in Pinal County, Arizona, and \$4.7 million of bonds for the city of Deadwood, South Dakota. CDOs were created by Wall Street by repackaging assets such as mortgage bonds and buyout loans into new obligations for sale to institutional investors. The insurers agreed to pay CDO holders, many of them banks that created the securities, in the event of a default. CDO Downgrades The tipping point came last year when the three major rating companies downgraded thousands of CDOs. Ratings on more than 2,000 CDOs were cut in November alone, according to a Dec. 13 UBS AG research report. Maryland Insurance Administration held off filing delinquency proceedings last month while ACA sought capital. ACA was required under its credit-default swap contracts to post collateral if its rating fell below A-. ACA gained 2 cents, or 4 percent, to 48 cents in over-the-counter trading on Jan. 18 in New York. ``The monolines are dead, their business model is dead," said David Roche, head of investment consultancy Independent Strategy in London. ``The government is going to have to recapitalize this industry or there will be communities in the U.S. where they can't even flush their toilets" because they can't afford the services. Default Risk Prices for contracts that pay investors if Armonk, New York-based MBIA can't meet its debt obligations imply a 71 percent chance the company will default in the next five years, according to a JPMorgan Chase & Co. valuation model. Contracts on New York-based Ambac imply a 72 percent probability. Credit-default swaps are financial instruments based on bonds and loans that are used to speculate on a company's ability to repay debt. They pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its debt agreements. A rise indicates deterioration in the perception of credit quality; a decline, the opposite. New York State Insurance Superintendent Eric Dinallo is examining whether to limit the types of debt that can be guaranteed by bond insurers, department spokesman David Neustadt said last

week. The Federal Reserve may need to organize a bailout, Nangle at Barings said. "More generalized monoline meltdown would be a situation that would require intervention by the New York Fed," said Nangle. The regulator should "get all the banks into a room, have them open their books, and then lean on them to inject capital." **ACA Customers Allow More Time to Unwind Default Swaps** <http://www.bloomberg.com/apps/news?pid=20601087&sid=a6ssiI6UQT0I&refer=home>

Housing

Housing Finance

Macro Economic

- The FTSE 100 on Monday suffered its biggest one-day fall since the terrorist attacks on the World Trade Centre more than six years ago as fears about the prospects for the global economy took hold. In a tumultuous session, the index fell as much as 5.6 per cent as dealers capitulated following sharp falls on Asian markets overnight. This is just short of the 5.7 per cent fall at the close on September 11 2001. "The acrid smell of fears hangs over the City. I've never seen fear like this," said David Buik at Cantor Index. In late afternoon trade, the index was down 4.9 per cent at 5,610.9, a loss of 291½ points. The slump had begun in Asia as investors were left underwhelmed by US President George W. Bush's package of measures aimed at stimulating the US economy. Hong Kong's Hang Seng index tumbled 5.5 per cent overnight while the Nikkei 225 in Japan had closed down 3.9 per cent. After some sharp early falls, the FTSE 100's slide accelerated as the morning wore on amid even more violent slides in Europe. Both the Dax in Germany and the CAC-40 in France were down as much as 7 per cent - also the biggest falls since September 11 2001. **The slide in the CAC-40 took its fall to more than 20 per cent from its June high - the definition of a bear market.** US markets are closed for Martin Luther King Day, adding to the uncertainty. **As investors shunned risk, the European iTraxx Crossover index, a closely watched measure of risk appetite, continued its rise into uncharted territory, jumping 33 basis points to 480 basis points.** This means it costs €480,000 annually to insure €10m of mostly junk-rated corporate debt against default over five years. Martin Slaney, at GFT Global Markets, said: "A gloomy concoction of poor economic and corporate news plus a growing acceptance that the sub-prime fall-out has much further to go has created the highly distressed conditions for a global sell-off in equities." "The latest rumour is that the Bank of China may write off as much as \$1bn in sub-prime related losses have added to the negativity," he added. Simon Denham, strategist at Capital Spreads, said: "The more you look at the long term charts, the more they appear to show a 'double-top' formation from June and October last year and - if this is what the big investors are watching - then we could be in for some rather more serious falls ahead." **Shares suffer biggest fall since September 11 2001** http://www.ft.com/cms/s/0/17df8940-c7fd-11dc-94a6-0000779fd2ac,s01=1.html?nclick_check=1
- Jan. 21 (Bloomberg) -- Stocks plunged in Germany, Hong Kong and India on mounting speculation that the global economy is slowing and company defaults will increase.

Europe's Dow Jones Stoxx 600 Index fell the most since the Sept. 11 terrorist attacks and sank into a bear market, as Allianz SE and BNP Paribas SA slid. Hong Kong's **Hang Seng Index had its biggest drop in six years** after BNP Paribas said Bank of China Ltd. may write down overseas securities by \$4.8 billion because of losses from U.S. subprime mortgages. The MSCI World Index slipped 2.6 percent to 1,400.38 at 12:07 p.m. in London, the steepest retreat since March 2003. India's Sensitive Index lost the most since 2004, while Germany's DAX slid the most since 2001. Futures on the Standard & Poor's 500 Index sank 4.3 percent. Trading in the U.S. is closed today for Martin Luther King Day. **“It's the worst I've ever seen,”** said Johan Stein, who helps manage the equivalent of about \$14 billion at Nordea Asset Management in Stockholm. **“The financial system is in terrible shape, and no one knows where this will end.”** The risk of European companies defaulting soared to a record today on concern credit-rating cuts at bond insurers including Ambac Financial Group Inc. may trigger forced asset sales. European Central Bank council member Nout Wellink said economic growth in the region may slow more than policy makers had expected. Market Crisis **“This is a stock-market crisis and it deepens as the market realizes bit by bit that the U.S. is in a bad way,”** said Alberto Roldan, head of research at Inverseguros SVB in Madrid. **“Investors believe that neither a government package nor a huge rate cut is going to help evade a recession in the U.S.”** The Stoxx 600 slid 5.6 percent, extending its drop from a 6 1/2-year high on June 1 to 23 percent. A drop of more than 20 percent is the common definition of a bear market. France's CAC 40 lost 5.8 percent. The U.K.'s FTSE 100 sank 4.4 percent, and Germany's DAX declined 6.8 percent. The MSCI Asia Pacific Index lost 3.7 percent. Australia's S&P/ASX 200 Index slumped for an 11th day. Hong Kong's Hang Seng Index lost 5.5 percent. Japan's Nikkei 225 Stock Average dropped 3.9 percent as the Finance Ministry cut its evaluation of five of 11 regional economies as housing investment fell and employment worsened. **‘Sharp Contraction’** **“The market is finally catching on to the fact that a recession will lead to a sharp contraction in earnings,”** said Jane Coffey, head of equities at Royal London Asset Management, where she helps oversee about \$11 billion. **“We need to see more aggressive changes to forecasts before investors become more positive about looking through the downturn.”** **“We see on-going downside risk to earnings and stock performance until we have better visibility,”** London-based analysts including Ben Cohen wrote in a report to investors. Commonwealth Bank of Australia, the country's second largest, dropped 2.5 percent to A\$51.89. National Australia Bank Ltd., the nation's largest, declined 2 percent to A\$35.55. Morgan Stanley raised its 2008 forecast for loan-loss charges at the country's major banks by 26 percent, analyst Richard Wiles wrote in a note today, citing a deteriorating global economy and **“the difficulty faced by some companies in refinancing maturing debt.”** **The slump has made stocks cheap by historical standards. [demonstrates yet again how meaningless “historical standards can be]** Europe's Stoxx 600 is valued at 11.1 times its companies' profits, the lowest since at least 2002, according to data compiled by Bloomberg. The 1,953-member MSCI World has a price- earnings ratio of 14.3, the cheapest since at least 1998. **Stocks Plummet in Germany, Hong Kong, India in Global Rout**
http://www.bloomberg.com/apps/news?pid=20601087&sid=aXz_C0OpmoXA&refer=home

- Jan. 20 (Bloomberg) -- **Persian Gulf shares declined on speculation prices have outpaced prospects for earnings growth after Saudi Basic Industries Corp. reported**

its lowest quarterly profit increase since 2006. Saudi Basic, the world's largest chemicals company by market value, had its biggest one-day drop since July 2006. Nama Chemicals Co. also retreated after reporting fourth-quarter earnings. Arabtec Holding Co., the company building the world's tallest tower in Dubai, fell even after it said quarterly earnings almost tripled. "It's profit taking by short-term investors who have been buying on the rumor of good earnings," said Eric Swats, head of asset management at Rasmala Investments in Dubai, which has \$800 million under management. "As those numbers come out, they don't see the next catalyst." The MSCI GCC Countries Index, a measure of more than 140 companies in six Gulf Arab states, surged 19 percent since Nov. 30., compared with an 11 percent loss for the MSCI World Index. Shares in the MSCI GCC Countries Index are valued at an average of 34 times estimated earnings, according to data compiled by Bloomberg. That compares with a multiple of 14 for shares in the MSCI World Index, a global measure. **Persian Gulf Stocks Retreat After Sabic's Profit Growth Slows**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a5kN682uny8Q&refer=home>

Retail

Retirement

Risk

Savings Rate

Tech

Wall Street

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

Best of the Dog

Tuesday, January 15, 2008 at 17:54 CDT

a brief update

INTC's earnings have been very poorly received. INTC is below 20.

there will be a dramatic gap down tomorrow. This is likely to break all the August lows in all the indices. This is likely to lead to massive volume that will build on itself. it will be a very bad day to be long anything tech.