

The Other Side of the Street July 27 and August 4, 2008

Comments

Things have been fast and furious as we head into the final month of EMBA work. Last weekend I spent the entire time working on a school paper and then this week watched one of the most astounding month end manipulations in a long time. This is what happens when the watchdogs are helping the burglars load the big screen TV out the window.

In short, we are seeing unfold one of the last hurrahs of if we buy it it will rise. Of course there were plenty of pundits declare yet again THE bottom is in and its time to buy banks. Meanwhile this weekend's Barrons interviews one of the few people who saw this wreck coming last summer. He says losses will be 2 trillion and 1/3 of regional banks will go under. One of the banks he mentioned in the "possible" class Wachovia. Meanwhile, Wachovia sprinted up 10% on Friday afternoon because it was rumored that Goldman Sacs was buying them. This rumor, which will NOT be investigated by the SEC because it was a "good rumor" in that it made something go up, is as absurd as the "Buffet is buying [fill in some struggling pig in housing or sub prime mortgages]" rumors which were a staples last fall. Notably these rumors start with a couple hours to go on thinly traded Fridays.

As we have discussed many times herein, there is a very third world banana republic flair to US capital markets. Very sad to see.

From where I sit, this immediate month end jam job has made predicting the near future a little fuzzy. I think we did not go down far enough for the "this time down is forever" theory. Instead I suspect what will happen is this move up leads to the move down neat mid-July lows. This will then lead to another knee jerk bounce. It will be that failure that sends us into the abyss.

However, as previously stated such "what is happening tomorrow" speculation is largely a parlor game. What is not a parlor game is that puts again are horribly mispriced IMO. I'm buying them with September, October, December and January expirations. In particular, I think the QCOM 55 puts are likely to double, triple and then some particularly the further out we go. I also love the JPM October 40s and WB October 20s. Both stocks will be trading much lower by then. In terms of simply short, it doesn't get much better than JRCC at 40 or DECK at 105.

It will be a very short fall I think . . .

P.S. On the topic of "past performance" – Bill Miller was the toast of Wall Street for more than a decade. We opined that he was the king of "dip buyers" and repeatedly lucked out with stupid investing (but what do we know, we are not "sophisticated investors"). Looks like the piper has called - Miller's Legg Mason Value Trust, which beat the Standard & Poor's 500 Index for a record 15 years, is in its third year of trailing the U.S. benchmark index. The fund had net outflows of \$2.4 billion in the first half of the year, according to data tracked by Morningstar Inc. in Chicago. The fund slumped 30 percent this year through yesterday, compared with the 14 percent decline in the S&P 500.

Stock Notes

- Wachovia swung to a loss of \$8.66 billion from a net profit of \$2.34 billion a year earlier as it booked goodwill charges of \$6.06 billion and added \$5.6 billion to its reserves for loan losses. The bank slashed its quarterly dividend to five cents a share and said it will exit the business of wholesale mortgage origination. Robert K. Steel, CEO and president said, "In the short term, the entire organization is focused on protecting, preserving and generating capital; reinforcing Wachovia's strong liquidity position; and reducing risk."
- [Ford Motor Co.](#), the world's third- largest automaker, posted a second-quarter loss of \$8.7 billion and said it will convert three truck factories to produce small cars as rising gasoline prices sap U.S. truck sales. "This is going to be an extremely painful year," [Mirko Mikelic](#), a senior portfolio manager at Fifth Third Asset Management in Grand Rapids, Michigan, said in an interview before earnings were released. "The F-150 is really where they've made money for years, and that's gone."
- July 24 (Bloomberg) -- [Daimler AG](#), the world's second- biggest luxury carmaker, cut its forecast for earnings this year after second-quarter profit declined 25 percent. Mercedes-Benz Cars has cut 9,700 factory jobs since 2005, reducing costs by 7.1 billion euros. The unit's earnings will rise this year and operating profit will reach 10 percent of sales by 2010, Daimler has predicted.
- July 24 (Bloomberg) -- [Metso Oyj](#), the world's largest maker of rock crushers and paper machines, fell the most since its creation in 1999 in Helsinki trading after the Finnish company missed profit estimates and halved its sales growth target. The Finnish manufacturer said it missed out on some large pulp and paper machinery orders because customers postponed projects and quarterly revenue at the division declined 2 percent. Metso forecast 5 percent to 10 percent sales growth for this year, down from a prior 10 percent target. That overshadowed a record quarter for mining orders, driven by demand in [emerging markets](#) as mineral prices touched records. "In our paper and pulp business, the uncertainty has increased," Chief Executive Officer [Jorma Eloranta](#) said in a statement today in a Hugin statement.

Notes

- Business confidence in [Germany](#), Europe's largest economy, slipped the most since the Sept. 11 terrorist attacks in 2001, signaling growth is faltering. The Ifo institute said its business climate index fell to 97.5 from 101.2 in June. Economists expected a drop to 100.1, based on a Bloomberg survey. "We're very cautious," said [Frederic Hamm](#), a Paris-based fund manager at Agilis Gestion, which oversees \$235 million. "Declines are moving from one industry to the next. Now industrials are feeling the impact of an economy hurt by the banking crisis."
- Deutsche Bank said yesterday that auto sales in the U.S. may drop to 14 million cars this year, down from a previous estimate of 14.5 million. That would be the lowest in 15

years. J.D. Power and Associates today lowered its forecast to 14.2 million sales from 14.95 million in March.

- Washington-based Fannie Mae and McLean, Virginia-based Freddie Mac own or guarantee about half of the \$12 trillion of U.S. home loans outstanding. The companies face mounting losses stemming from the collapse of the subprime market. **``This is about not only our housing markets, but it's about our capital markets more broadly,''** Paulson said in an interview with Bloomberg Television two days ago.

Web links

Credit

July 22 (Bloomberg) -- [Assured Guaranty Ltd.](#) plunged and the cost to protect against a default by the bond insurer and Financial Security Assurance Holdings Ltd. rose to a record after Moody's Investors Service said it may cut their Aaa ratings.

Assured Guaranty fell \$9.76, or 52 percent, to \$8.99 as of 9:46 a.m. in New York Stock Exchange composite [trading](#). Credit- default swaps that protect holders of securities guaranteed by its main bond insurance unit, Assured Guaranty Corp., jumped to 18.5 percent upfront and 5 percent a year, from 15 percent initially and 5 percent a year yesterday, according to CMA Datavision. Contracts on FSA climbed 121 basis points to 769 basis points, CMA prices show.

Moody's said yesterday that it's reviewing the financial strength ratings of Hamilton, Bermuda-based Assured and FSA of New York, which had avoided ratings scrutiny while five competitors lost their top rankings this year because of escalating losses on securities linked to U.S. home loans. Moody's said it's reviewing the financial strength ratings of Assured and FSA because guarantees on certain structured finance securities ``may be inconsistent with the very low risk tolerance implied by a Aaa rating."

Assured Chief Executive Officer [Dominic Frederico](#) said the company was ``concerned by Moody's announcement" at a time when the company ``is experiencing broad market acceptance and investor demand for our insured paper," according to a statement today. ``We believe it is important for investors to know that Moody's action is not at all reflective of a deterioration in Assured's capital base, credit exposure or earnings outlook."

Buffett's Bond Insurer

Credit-default swaps on the insurers pay the buyer face value in exchange for the underlying securities or the cash equivalent in the event they can't make good on their guarantees or debt payments.

The review for downgrade leaves only [Warren Buffett's](#) Berkshire Hathaway Assurance Corp., which was created in December, with a stable outlook on all its top credit ratings. Bond insurers owned by [MBIA Inc.](#), [Ambac Financial Group Inc.](#), [Security Capital Assurance](#), [FGIC Corp.](#),

and CIFG Holdings were stripped of their top ratings over the past six months as losses grew from securities backed by subprime mortgages.

Assured Guaranty and FSA escaped downgrades this year because the two insurers shunned guarantees on collateralized debt obligations backed by subprime mortgages. CDOs repackage assets such as mortgage bonds, loans and derivatives into new securities and have accounted for the biggest slice of the \$453 billion of asset writedowns and credit losses since the start of 2007 at the world's biggest banks.

Attracted Business

FSA and Assured Guaranty attracted more business during the first half as investors devalued guarantees from other companies, and state and local government borrowers chose to insure just 24 percent of the bonds sold through June, down from 49 percent, according to data compiled by Thomson Reuters.

FSA insured \$33.1 billion of new U.S. municipal bonds in the first half while Assured Guaranty backed \$17.6 billion. MBIA, the former market leader, guaranteed just \$1.5 billion of bonds, according to the data.

Billionaire investor Wilbur Ross committed to invest as much as \$1 billion in Assured Guaranty in February and took a seat on the board. FSA's parent Dexia SA contributed \$500 million in capital to the insurer and extended a \$5 billion line of credit after hedge fund manager [Bill Ackman](#) said he was betting against the company. Ackman, who oversees hedge fund Pershing Square Capital Management, bet against MBIA and Ambac before their shares tumbled more than 90 percent during the past year.

Moody's said Dexia's support ``may not be unconditional or sufficient to entirely mitigate potential risks."

Credit-default swaps on Dexia today rose 10 basis points to 205 basis points, CMA data show. Dexia fell 16 percent to 8.06 euros as of 3:40 p.m. in Brussels. **Assured Guaranty Plunges, Bond Risk Soars on Moody's Review**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aXBsfp6fkd9I&refer=home>

Commercial Real Estate

Commodities

Currency

Diversification

Derivatives

- **Dealers in the \$62,000bn credit derivatives market have less than two weeks to reassure the Federal Reserve Bank of New York that they are staying ahead in the**

race to purge trading and settlement risks from one of the world's biggest financial sectors. A sense of urgency has gripped the credit derivatives industry in the wake of Bear Stearns' failure in March. When the investment bank teetered on the point of collapse, the Fed backed a fire sale to JPMorgan because it feared Bear's bankruptcy would plunge credit derivatives into chaos. Major banks and brokerages have become tightly bound by a chain of credit derivative trades. These links between the big dealers and their wider audience of hedge funds and other investors – known as counterparty risk – keeps regulators awake at night. **Gaps in the present trading infrastructure, which has failed to match the growth, complexity and various operational and market risks associated with credit derivatives, are a further worry.** “The tone has changed,” says a managing director at a major dealer. “Regulators are less tolerant of spikes in volatility and the inability of the major dealers to handle it.” **Last month, the New York Fed convened a meeting with dealers and big investment firms to outline a series of goals for the credit derivatives market, such as the creation of a central clearing house and the industry-wide use of automated trade processing, to be achieved by the end of the year. The Fed expects a progress report by July 31.** “Dealers are very mindful of what the Fed and other regulators' hopes and intentions are on this issue ” said Doug Warren, managing director and head of US credit derivatives at Barclays Capital. “The rate of progress will be a function of having 16 dealers and hundreds of buy-side clients involved in trying to standardise a complex infrastructure.” While dealers acknowledge the rules of the game have changed, they are also mindful of retaining control over what has been a very good source of profits and they do not want to let big exchanges or other outsiders gain a foothold. **The credit derivatives market has been the focus of regulators for several years, led by the New York Fed. Although progress has been made on some fronts, full automation has so far remained elusive. In spite of the volumes and complexity, much of the trading is now documented by nothing more than an e-mail, and can take several days to complete.** Unlike an equity trade, which begins and ends with the trade itself, credit default swaps are insurance policies against default for a specified period of time, usually five years. As such, the relationship between the counterparties is significant beyond the day of the actual trade agreement. **Even if it is set up, it would not fully eliminate counterparty risk as under the current plans it involves just the main dealers and only derivatives traded on indices. Meanwhile, established exchanges such as the UK's Liffe are also vying for some share of the market, earmarked by many in the sector as a potential area of growth.** Regulators want the majority of trades to be confirmed and processed on the same day that they are executed, known as T+zero. Until trades across the entire market are being confirmed on the same day, regulators argue that the industry remains vulnerable, particularly when volumes spike during volatile periods. In this area, there are still competing systems being used. There is also a push to reduce trades in the system, especially credit derivatives that are no longer liquid. In a sign of potential future co-operation, Markit and Creditex recently began working together on a “compression” system, which terminates some trades. Another goal is creating a standard protocol that would permit cash settlement of obligations following a default or other credit event. Without it, there are concerns that a rise in the corporate default rate could lead to a freeze in the market and have knock-on effects on the credit-worthiness of participants. Using bonds from the company is not feasible, given the huge amount of credit derivative

swaps. Yet, at a time when banks are facing cash constraints, the costs of overhauling the derivatives infrastructure are daunting, potentially leading to greater dominance of fewer big dealers. "The cost will be prodigious," said the managing director of the major dealer. "You have to reach a certain bar to play this game. If you can't reach it, you need to cut back your volume." **Deadline looms for assurances on risks purge**
<http://www.ft.com/cms/s/0/206ce418-5763-11dd-916c-000077b07658.html>

Housing

July 25 (Bloomberg) -- U.S. foreclosure filings more than doubled in the second quarter from a year earlier as falling home prices left borrowers owing more on mortgages than their properties were worth.

One in every 171 households was foreclosed on, received a default notice or was warned of a pending auction. That was an increase of 121 percent from a year earlier and 14 percent from the first quarter, RealtyTrac Inc. said today in a statement. Almost 740,000 properties were in some stage of foreclosure, the most since the Irvine, California-based data company began reporting in January 2005.

"Rising foreclosures are putting downward pressure on prices, increasing the possibility that homeowners will go upside-down on their mortgages," said Sheryl King, chief U.S. economist at Merrill Lynch & Co. in New York. "That will cause more losses in mortgage portfolios and less willingness from investors to securitize mortgages and therefore fewer mortgages."

About 25 million U.S. homeowners risk owing more than the value of their homes, according to Bill Gross, manager of the world's biggest bond fund at Pacific Investment Management Co. That would make it impossible for them to negotiate better loan terms or sell their property without contributing cash to the transaction.

Falling home values, led by states such as Nevada and California that have the biggest default rate, have prompted RealtyTrac to almost double the projected number of foreclosures this year to about 2.5 million, said Rick Sharga, executive vice president for marketing.

Federal Legislation

"The big variable here is what effect the housing bill now being considered by the Senate is going to have on foreclosure activity in general," Sharga said in an interview. "Based on market conditions themselves, we are nowhere near the end of this trip. Best-case scenario, we're looking at another year of this."

The housing bill aims to help 400,000 Americans with subprime home loans refinance into 30-year, fixed-rate mortgages backed by the government. The measure passed the House of Representatives and President George W. Bush has said he would sign it.

Subprime mortgages were available to borrowers with bad or incomplete credit histories and default at five times the rate of prime mortgages, according to the Mortgage Bankers Association in Washington.

Bank seizures in the first half of the year increased by 154 percent to 370,179 from the same period in 2007, RealtyTrac said. Last year's second-quarter data on bank repossessions was not available, according to RealtyTrac.

Fewer Mortgages

Forty-eight of 50 states and 95 of the 100 largest U.S. metropolitan areas had year-over-year increases in foreclosure filings in the second quarter, RealtyTrac said.

Nevada was the state with the highest rate. One in every 43 households received a foreclosure notice in the quarter, four times the national average and an increase of 147 percent from a year earlier, according to RealtyTrac.

Foreclosure filings tripled in California, where one in every 65 households was affected, the second-highest rate among states. Arizona had the third-highest rate, with one every 70 households, a more than threefold increase from the second quarter of 2007, RealtyTrac said.

Florida, Colorado, Ohio, Michigan, Georgia, Massachusetts and Illinois rounded out RealtyTrac's top 10.

Lenders will cut in half the number of mortgages to purchase homes in 2008 compared with two years ago, said [Guy Cecala](#), publisher of the Bethesda, Maryland-based trade publication Inside Mortgage Finance.

Real Estate-Owned

Bank repossessions, or REOs -- meaning "real estate- owned" -- accounted for 30 percent of total foreclosure activity in the second quarter, up from 24 percent of the total in the first quarter, RealtyTrac said.

Foreclosures push all home values down by an estimated 6 percent, and will contribute to national prices declining another 15 percent by the end of 2009, [Ethan Harris](#) and [Michelle Meyer](#), Lehman Brothers Holdings Inc. economists in New York, said in a report yesterday.

"I believe a big part of the problem we're facing in the market right now is uncertainty," Sharga said. "Buyers aren't sure if this is the right time to get in, lenders aren't sure where to lend, investors aren't sure where to put their money in an environment of depreciating assets. The psychology of the market is as responsible as the financial part of the market."

Seven of the 11 metropolitan areas with the highest rates of foreclosure filings in the second quarter were in California, according to RealtyTrac. The Stockton area, in California's Central Valley, had the highest incidence, with one in 25 households receiving filings.

Inland Empire

In Riverside-San Bernardino, the so-called Inland Empire, where the California Association of Realtors said home prices plummeted 35 percent in May compared with a year earlier, one in 32 households entered foreclosure, according to RealtyTrac.

Bakersfield, Sacramento, Oakland, Fresno and San Diego were the other California metro areas in the top 11.

The Las Vegas area, where home values fell 27 percent in May compared with a year earlier, according to the S&P/Case-Shiller Home Price Index, had the third-highest foreclosure rate, with one in every 35 households, RealtyTrac said.

Fort Lauderdale, Florida, Phoenix and Miami were the other metropolitan areas in RealtyTrac's top 11.

New York filings increased 62 percent from a year earlier to 16,025, with one in every 493 households in a stage of foreclosure, the 30th-highest rate.

New Jersey filings rose 140 percent. One in every 201 households in the state received notice, the 12th-highest rate in the U.S. **U.S. Foreclosures Double as House Prices Decline**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=adFFhHtUhCLY&refer=home>

Housing Finance

Macro Economic

- **FT 7-24 The eurozone's economic slowdown has worsened markedly according to closely-watched surveys that show growth prospects collapsing across the 15-country bloc.** Germany, France and Italy reported sharp falls in business confidence in July, with German business leaders gloomier about the next six months gloomier than for almost six years. Separately, eurozone purchasing managers' indices – regarded as good guides to future growth trends – showed private-sector economic activity had contracted for the second consecutive month. France's performance deteriorated particularly sharply. **“The downturn is gathering pace faster than expected,”** said Chris Williamson, chief economist at Markit, which compiles the purchasing managers' indices. Higher oil prices, the corrosive impact of inflation on consumer spending and fears about the rapidly-deteriorating global economic output had taken their toll, the surveys indicated. After robust growth at the start of the year, a mid-year weak patch had been expected by the European Central Bank and other European policymakers. Although eurozone inflation remains at historic highs, the accelerating pace of the slowdown had reduced significantly the chances of further ECB interest rate increases, analysts said. **“With growth slowing abruptly and inflation expectations off the peak, risks of a near-term ECB hike have diminished substantially,”** said Marco Valli at Unicredit. Earlier this month, the ECB raised its main interest rate to 4.25 per cent. In Germany, the Munich-based Ifo institute said its business climate index had tumbled

more-than-expected from 101.2 in June to 97.5 this month – the lowest since September 2005. The sub-index covering expectations for the next six months dropped particularly steeply, from 94.6 in June to 90.0 – the lowest since November 2002. **“The Ifo index is falling like a stone and the worst might be yet to come,” said Andreas Rees at Unicredit. “We think that the main culprits were the oil price and the massive loss in momentum in major German export markets.”** Insee, the statistics institute in Paris, said French business confidence had fallen this month to the lowest level for more than three years. Italian business confidence was the lowest since October 2001, according to ISAE, the think-tank. In Spain, the effects of a collapsing housing market continued to work through with the country reporting unemployment had risen in the second quarter to the highest level in three years. Meanwhile, eurozone purchasing managers’ indices also made for “unsettling reading,” according to Mr Williamson at Markit. The composite index – covering services and manufacturing – was the weakest since November 2001. For the second consecutive month the index was below 50 – which marks the boundary between expanding and contracting output – dropping from 49.3 in June to 47.8 this month. “With incoming new business falling at the sharpest rate for five years and business confidence in the service sector at a survey record low, the worse may well be yet to come, especially as inflationary pressures are likely to limit scope for interest rate cuts,” Mr Williamson added. France’s composite purchasing managers’ index dropped from 49.7 in June to 47.0, which Markit said was “indicative of a solid decline in private sector economic output”. **Eurozone slowdown worsens**
http://www.ft.com/cms/s/0/b5b7b9ee-5961-11dd-90f8-000077b07658.html?nclick_check=1

July 24 (Bloomberg) -- Chile's energy consumption will stop growing for the first time in 26 years after Argentina cut natural gas supplies and a drought curbed hydroelectric power, Energy Minister **Marcelo Tokman** said. Power usage this year may be the same as last year or even fall, the first time that has happened since 1982 when the economy declined 14 percent, Tokman said in an interview in Santiago. Chile imports two-thirds of its energy needs. “We are in a very critical situation,” Tokman said. “We won't our change our dependence from one day to another.” The rising cost of energy contributed to an inflation rate that accelerated to 9.5 percent in June and forced the central bank to raise its target interest rate 2.25 percentage points since June last year. There won't be a surplus of power until 2010, Tokman said. Chile's central bank cut its forecast for economic growth on May 12 citing increased energy prices. The economy will probably expand 4 percent to 5 percent, the bank said in a monetary policy report, less than the 4.5 percent to 5.5 percent forecast in January. The energy shortage has acted as the “principal brake” on Chile's economy this year and last, Finance Minister **Andres Velasco** said May 23. **Chile Power Use to Stagnate for 1st Time Since '82**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=antykRg8d4vg&refer=home>

London equities slipped back on Tuesday, as investors weighed further evidence of slower consumer spending in trading updates from two blue-chip companies

The FTSE 100 lost 1.3 per cent to 5,335.8 in opening trade, a fall of 69 points after three sessions of gains followed last Wednesday’s three-year low. The FTSE 250 also fell 1.3 per cent to 8,928.2.

Vodafone, one of the most actively traded stocks on the index, became the benchmark's biggest single faller. The mobile phone operator said annual revenue looked set to come in at the bottom of forecast ranges. The company blamed recent economic weakness and lower-than-expected equipment revenue in a further sign of more cautious consumer spending. Vodafone's shares lost 11 per cent to 132.7p.

Enterprise Inns joined the trend, warning of subdued beer volumes across its estate. "Consumer confidence is low and the rising costs of food, fuel, mortgage costs and taxes have put increasing pressures on disposable income and discretionary spend," it said. Shares in the owner of over 7,000 leased and tenanted pubs across England and Wales fell 7.4 per cent to 320.3p.

The renewed alarm bells about the outlook for consumer spending in a slowing economy resonated on the high street. **Kingfisher**, the name behind the B&Q home improvement chain, lost 4.5 per cent to 105½p. **Carphone Warehouse** fell 4.3 per cent to 193p and fashion chain **Next** was 4.4 per cent weaker at 970½p.

Resource stocks prevented wider losses as oil prices held above \$131 a barrel. **BG Group** rose 2.1 per cent to £11.43, **BP** was 1.5 per cent higher at 529.3p and **Royal Dutch Shell** was 1.2 per cent stronger at £18.29.

Paragon, the specialist buy-to-let lender stood out with gains of 18.5 per cent after FT reports of **bid interest** from private equity. Overnight in **New York**, leading indices ended a three-day winning streak as rising oil prices hit consumer-facing stocks and results from Bank of America failed to whet investor appetite for financials. The benchmark S&P 500 fluctuated between gains and losses but closed down 0.1 per cent at 1,260. The Dow Jones Industrial Average lost 0.3 per cent to 11,467.34. **FTSE hit by consumer spending fears**
<http://www.ft.com/cms/s/0/1494d398-57b9-11dd-b02f-000077b07658.html>

Retail

July 21 (Bloomberg) -- **American Express Co., the biggest U.S. credit-card company by purchases, withdrew its 2008 earnings forecast after second-quarter profit fell 37 percent on worse-than-expected consumer defaults.** The shares slumped 11 percent in extended trading. Profit from continuing operations declined to \$655 million, or 56 cents a share, from \$1.04 billion, or 86 cents a year earlier, the company said today in a statement. **The average estimate of 17 analysts surveyed by Bloomberg was 82 cents. American Express said it added \$600 million before taxes to reserves for U.S. loan losses. "By almost any measure, the U.S. economy and business environment are much weaker than the assumptions" the company had in January, Chief Executive Officer Kenneth Chenault said today in a conference call. "Unemployment rates took the largest jump in over twenty years. Home prices declined at the fastest rate in decades and consumer confidence is at one of its all-time low points."** The U.S. economic slowdown worsened in June, affecting even American Express's wealthier cardholders with high credit scores, Chenault, 57, said in the call. Late and uncollectible loans were higher than expectations in the quarter and will rise as the year

progresses, Chenault said. The U.S. lost 62,000 jobs in June, the sixth straight period of shrinking payrolls.

American Express fell \$4.55 to \$36.40 in trading after the close of regular U.S. markets at 5:58 p.m. The company's results sparked a 0.9 percent decline in Standard & Poor's 500 Index futures contracts expiring in September.

Previous Forecast

“They're like any other consumer lender right now, caught behind the 8-ball,” [Craig Maurer](#), analyst at New York-based Calyon Securities who rates the company “buy,” said in a Bloomberg Television interview. “I don't think the environment's going to be helpful to the company over the next nine to 12 months.”

American Express is “no longer tracking” to a prior forecast for 4 percent to 6 percent earnings per share growth for this year, he said. The company won't meet longer-term targets until the U.S. economy improves, Chenault said.

Profit in the company's U.S. card business dropped 96 percent to \$21 million from \$580 million a year earlier as provisions for losses more than doubled to \$1.5 billion from \$640 million. Uncollectible debt in the unit rose to 5.3 percent of loans from 2.9 percent a year earlier.

“We are seeing very affluent people who have had historically very, very strong spending history with us cutting back,” Chenault said.

Discontinued operations related to American Express Bank Ltd., which the lender sold last year, resulted in a loss of \$2 million, compared with income of \$17 million a year ago.

Negative Outlook

American Express, [Capital One Financial Corp.](#) and Discover Financial Services shares have dropped by more than a third in the past year as consumers have a harder time repaying debt of all kinds.

Moody's Investors Service has a negative outlook on credit- card lenders and said defaults “will most certainly” rise this year. Stressed consumers are tapping plastic as access to home- equity loans falls off, New York-based Moody's said in a February report.

American Express's net income declined to \$653 million, or 56 cents a share, from \$1.06 billion, or 88 cents a year earlier, the New York-based company said.

Consumer prices surged 1.1 percent in June on higher food and fuel prices, more than analysts had expected, the Labor Department said this month. The cost of living rose 5 percent in the year leading to June, the biggest increase since 1991.

Rising Defaults

Delinquent credit-card accounts rose more than a full percentage point from a year earlier to 3.99 percent in May, according to [Bloomberg data](#).

Rising defaults hurt second-quarter profit at Capital One, where earnings fell 40 percent to \$452.9 million. The McLean, Virginia-based company said it expected as much as \$7 billion in soured loans in the next year. Discover, based in Riverwoods, Illinois, said last month that profit from continuing operations in the quarter ended May 31 fell 19 percent to \$202 million.

Some of American Express's rising loan losses will be cushioned by about \$4 billion in settlement payments from Visa Inc. and MasterCard Inc. American Express said last month it settled an antitrust suit against MasterCard for \$1.8 billion. Visa and bank partners settled in November for \$2.25 billion.

American Express was ranked first by the total value of purchases and cash advances to U.S. cardholders in the first half of 2007, according to the Carpinteria, California-based Nilson Report, a trade publication. [JPMorgan Chase & Co.](#) and Bank of [America Corp.](#) are ranked second- and third-largest.

Billionaire [Warren Buffett's](#) Berkshire Hathaway Inc. owns the largest American Express stake with 151.6 million shares, 13 percent of outstanding stock at year-end, according to [Bloomberg data](#). **American Express Profit Falls on Higher Defaults**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=adfHH7wZsJjY&refer=home>

Retirement

Risk

Savings Rate

Tech

The Fed

- July 22 (Bloomberg) -- **[Treasury Secretary Henry Paulson's plan to revive U.S. mortgage financing depends on investors buying the same kind of bonds they're shunning in Europe.](#)** Paulson wants to create a version of Europe's market for covered bonds in the U.S. just as sales of the debt have fallen to a six-month low and prices have dropped 2.5 percent this year. While the securities are backed by loans and bank assets to get AAA ratings, most are valued, on average, as if they were three levels lower. The extra yield on covered bonds sold in Europe by Seattle-based Washington Mutual Inc., the biggest U.S. savings and loan, has jumped 13-fold since the sale two years ago to 3.16 percentage points over government notes. The premium for debt of Bank of America Corp., the largest home lender, has quadrupled since June 2007. **“This is absolutely not going to be an instant fix for the U.S. mortgage market if you see how tough it is and how expensive covered-bond funding currently is for established markets in Europe,”** said [Florian Hillenbrand](#), an analyst who follows the securities in Munich for UniCredit SpA, Italy's largest bank. Paulson says the \$3.3 trillion covered-bond market,

which dates back to 18th-century Prussia, is a remedy for the worst housing crash since the Great Depression. **It offers "new sources of mortgage funding" that will cut costs for homebuyers, he said at a forum in Washington on July 8.** Reviving Lending Developing a U.S. market for the securities is the latest of Paulson's initiatives to revive lending among banks crippled by \$452 billion of credit losses and writedowns. His plan for a "SuperSIV" to bail out the \$400 billion market for structured investment vehicles failed last year after Wall Street firms rescued the credit funds independently. Both Democratic and Republican senators are looking for changes in the Treasury secretary's proposal this month to shore up home lending by allowing the government to buy stakes in **Fannie Mae** and **Freddie Mac**. Covered bonds achieve higher ratings than regular notes by augmenting the issuer's pledge to pay with a group of assets such as mortgages that can be sold in a default. The extra security allows lenders to pay less interest. Sales of covered bonds dropped to 17.8 billion euros (\$28.3 billion) in June, the least in six months, as investors demanded the highest rewards on record to hold the debt, according to data compiled by Bloomberg. The average yield climbed to 83 basis points over similar-maturity government rates, from 26 basis points a year ago, according to Merrill Lynch & Co.'s index of covered bonds outside of Germany's market, where the securities are known as pfandbriefe. **WaMu Downgraded** Moody's downgraded 6 billion euros of covered bonds from **Washington Mutual**, the only U.S. issuer of the securities besides Bank of America, to Aa1 from Aaa in March and four more steps to A2 in May after saying the notes were vulnerable to a decline in the quality of residential mortgages. Holders of WaMu's covered bonds due 2011 are demanding yields typical of bonds two grades above high risk, or junk, according to a Merrill Lynch index of BBB rated companies. While S&P and Fitch kept their AAA ratings, Moody's "gave it a very draconian downgrade," said **Tim Skeet**, head of covered bonds at Merrill Lynch in London. "The downgrading suggests that it is somehow on a par with some of the toxic waste that has actually caused the dislocation of the markets, which is a long way from the truth." **WaMu Shows Paulson Mortgage Rescue Plan Is Perilous**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aAAbDzCsg9O4&refer=home>

July 22 (Bloomberg) -- Treasury Secretary **Henry Paulson's** rescue package for **Fannie Mae** and **Freddie Mac** will probably cost \$25 billion, the Congressional Budget Office said.

"There is a significant chance -- probably better than 50 percent -- that the proposed new Treasury authority would not be used before it expired at the end of December 2009," the nonpartisan agency, which provides economic and budget analysis for lawmakers, said in a report today.

Democratic lawmakers were seeking to determine the cost of Paulson's plan to offer emergency funding to **Fannie Mae** and **Freddie Mac**, which own or guarantee almost half of the \$12 trillion in U.S. home loans outstanding. Paulson today said Congress understands "the demands" of the housing downturn and will likely approve this week his request to help the government-sponsored enterprises.

“We need to act in the short-term because the GSEs are vital institutions in our capital markets today and are vital to emerging from the housing correction,” Paulson said in a speech in New York. [Fannie Mae](#) and [Freddie Mac](#) are among the “most interconnected of all global financial institutions,” he said.

[Fannie Mae](#) fell \$1.61, or 11 percent, to \$12.52 at 9:35 a.m. in New York Stock Exchange composite trading. [Freddie Mac](#) dropped \$1.25, or 14 percent, to \$7.50.

Paulson on July 13 asked Congress to grant the Treasury the power for 18 months to buy equity in [Fannie Mae](#) and [Freddie Mac](#) and expand their credit lines with the government after concern that the companies don't have enough capital sent the shares to the lowest in more than 17 years. Paulson also requested expanded powers for the Federal Reserve to oversee capital requirements.

Political Pressure

The [cost](#) of the plan will depend upon terms of the credit, whether the companies have to put up collateral, pay fees or commit a portion of profit to the Treasury, said [Marvin Phaup](#), a CBO economist for almost 20 years who retired in 2007 and is now a research scholar at George Washington University in Washington.

“This is a very very difficult thing to do and of course the political pressure will be great to make the cost estimate zero,” Phaup said in a telephone interview last week. “You can make a reasoned argument that it will be zero with some probability, but of course, it's also with some probability it could be very costly to taxpayers.”

Neither the Treasury nor the White House budget office has estimated publicly the cost of the bailout. Paulson has said the plan would restore investor confidence in the companies and thereby pose little cost to [taxpayers](#).

Lawmakers have negotiated with Paulson over the details, with the goal of putting the package to a vote in the House of Representatives tomorrow. The Senate would also need to vote.

The Federal Reserve is talking with the Office of Federal Housing Enterprise Oversight, the regulator for [Fannie Mae](#) and [Freddie Mac](#), to determine whether the companies have enough capital to offset credit losses.

More Market Stress

“The Federal Reserve is working with Ofheo to get a better understanding of the issues facing the GSEs,” Fed spokesman [David Skidmore](#) said. The New York Times earlier reported that the Fed and the Comptroller of the Currency are examining the books of [Fannie Mae](#) and [Freddie Mac](#) to evaluate their health, citing an interview with Paulson.

Paulson said the Treasury has no plans to execute the financial backstop plan, and added that before doing so he would consult with the Congress and the companies. Paulson said financial

market turmoil will take ``additional time" to be resolved and that progress ``won't come in a straight line."

``Until the housing market stabilizes further, we should expect some continued stresses in our financial markets," he said.

Savior No More

The Bush administration is depending on Fannie Mae and Freddie Mac to help pull the U.S. out of the worst housing slump since the Great Depression. The companies, which buy mortgages from banks, face mounting credit losses stemming from the collapse of the subprime-mortgage market.

Freddie Mac may cut purchases of home loans from banks and bonds backed by housing debt to shore up its capital amid record delinquencies.

[Freddie Mac](#), which last week registered with the U.S. Securities and Exchange Commission for the first time, is also considering selling securities and reducing its dividend while it prepares to issue \$5.5 billion of stock. JPMorgan Chase & Co. analyst [Matthew Jozoff](#) said last week that growth in the mortgage holdings of Freddie Mac and [Fannie Mae](#) will be ``weak."

``This just means much less credit availability for mortgage borrowers," said [Paul Colonna](#), who manages more than \$100 billion as chief investment officer for fixed income at GE Asset Management in Stamford, Connecticut. ``They were teed up to be saviors of the mortgage crisis, but now they've got their own capital issues."

Mortgage Losses

Combined losses at the companies will probably total \$48 billion through 2009, Jozoff said in a July 18 report.

``Mortgage losses are significant, and will probably foster capital conservation from the agencies rather than portfolio growth," he said.

House Financial Services Committee Chairman [Barney Frank](#), a Massachusetts Democrat, has said he agrees with Paulson that the cost of a rescue would be insignificant.

Lawmakers will probably cap federal aid by counting any liabilities against the government's debt limit, Frank said. Such a safeguard may reassure lawmakers concerned about taxpayers' exposure to losses, he said.

Minimum Capital

[Fannie Mae](#), created in [Franklin Delano Roosevelt's](#) New Deal plan, and [Freddie Mac](#), started in 1970, have the implicit backing of the U.S. government and get access to funds at lower [rates](#)

than banks, became more indispensable this year after private providers of mortgages collapsed or were acquired.

At the end of March Freddie Mac had \$6 billion more than the minimum capital required by its regulator, and Fannie Mae had surplus capital of \$5.1 billion. [The companies](#) already raised \$20 billion in the past year to cover losses and meet Ofheo rules.

Freddie Mac will probably report a surplus exceeding the minimum 20 percent required for the second quarter, according to a company filing with the SEC last week. The SEC registration and equity raising will allow the company to reduce its capital surplus level to 10 percent. **Fannie, Freddie Rescue May Cost Taxpayers \$25 Billion, CBO Says**

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

UPDATE 1-US SEC short-selling curb seen likely extended

Mon Jul 21, 2008 7:28pm EDT

(Adds groups urging SEC against extending short sale rule, paragraphs 9-10)

By Rachele Younglai

WASHINGTON, July 21 (Reuters) - An emergency rule to curb abusive short selling will likely be extended beyond 19 major financial firms as pressure mounts on the U.S. Securities and Exchange Commission to broaden the measure.

The impact of the SEC's rule is being closely monitored as brokers and dealers are now required to borrow stock before executing a short sale in 17 major Wall Street firms and mortgage finance giants Freddie Mac (FRE.N: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and Fannie Mae (FNM.N: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)).

The rule, which went into effect on Monday and can last up to 30 days, also requires investors to deliver securities on the settlement date.

The SEC announced its rule July 15, after bank regulators seized IndyMac July 11 and the Federal Reserve and Treasury Department announced emergency support on July 13 to ensure Freddie and Fannie would have access to capital if needed.

Although short selling is a legitimate investment strategy and can prevent stocks from becoming overvalued, lawmakers and corporate executives have called for a probe of short sellers since the demise in March of investment bank Bear Stearns.

The SEC has already said it will consider rules to address abusive short selling issues across the entire stock market. But it is unknown how the agency will craft that rule.

"We cannot have a segregated market where only the large and connected get protected by the SEC," said former SEC commissioner Roel Campos, now a partner at law firm Cooley Godward Kronish.

The American Bankers Association is lobbying the SEC to include all publicly traded banks and bank holding companies such as Washington Mutual Inc (WM.N: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and Wachovia Corp (WB.N: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)), which have been under pressure.

But the Coalition of Private Investment Companies and the Managed Funds Association said they sent a letter to SEC Chairman Christopher Cox on Monday urging against extending the order in either duration or the securities currently covered.

"Such action would severely burden short selling activity, which the SEC itself repeatedly has acknowledged plays a vital role in the stability of securities markets," said James Chanos, a well known short seller, who chairs the coalition.

The SEC's order only covers the primary dealers that have access to the Federal Reserve's discount window and many of those firms are foreign-based such as Swiss-based UBS AG (UBSN.VX: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and London-based HSBC Holdings (HSBA.L: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)).

"I don't think you could limit it to those 19 names pushed on the SEC by the Federal Reserve, to protect all dealers in government securities," said John Coffee, professor at Columbia Law School.

Under pressure from the exchanges and the Securities Industry and Financial Markets Association, the SEC on Friday granted a partial exemption for market makers, or those who facilitate trading in certain stocks.

Market makers don't have to pre-borrow stock before executing a short sale in the 19 financial companies but must deliver the stocks within the settlement period.

"I do think they will extend it (past the 30 days), because the exemption... will largely nullify its effect," said Coffee.

Short sellers arrange to borrow shares they consider overvalued and sell them in hopes of making a profit when the price drops. When an investor does not pre-borrow the shares before shorting the stock, it's called a "naked" short sale, which is illegal if done intentionally.

The SEC's rule is designed to end July 29, but can be extended for a total of 30 days if the commission deems it necessary to protect investors.

Within that time frame -- which is seen as a trial period by some -- the agency will most likely have to prove that this action has had some kind of impact on abusive short sales.

"The SEC will have to have better evidence that this is a useful thing to do," said Jay Brown, a securities professor at University of Denver Sturm College of Law. "What they can't do, is do the same thing over again. They will either have to expand the number of companies or kill it," Brown said.

Henry Klehm, a partner at Jones Day representing financial institutions and others, said he would be surprised if the SEC developed a permanent rule for specific stocks.

"They have to consider these things on a broader basis," Klehm said. I don't think they want to go with a specific class of securities in the long run."

The SEC's emergency rule rattled the trading community, which scrambled to understand how the rule would be enforced. The unprecedented rule came after the SEC announced plans to crackdown on rumormongering and has started examining whether broker dealers and investment advisers have controls in place to prevent market manipulation.

Others have been calling on the SEC to reinstate the so-called tick test rule -- a rule that was adopted after the 1929 stock market crash.

The tick test, which was repealed June 2007, only allowed short sales when the last sale price was higher than the previous price. That meant a trader could not short a stock if the movement prior to the short sale was down. One lawmaker, Rep. Gary Ackerman, a Democrat from New York, has introduced legislation to reinstate the rule but there is little time left in the legislative year.

The SEC has pointed to studies that said the tick test did not really make a difference to volatility or to how the market performed and some think reversal unlikely.

"The whole process of eliminating the tick test was a long regulatory debate," said Klehm, the securities lawyer.

Dylan Wetherill, president and founder of short interest tracking service ShortSqueeze.com said the SEC's action on rumors and short sales are speaking pretty clearly on what they are trying to achieve.

"The rule extends protection to the downside," he said. "They are testing it out, wanting to see the market's reaction. If it does what they want it to do, they will continue it." (Reporting by Rachele Younglai; Editing by Tim Dobbyn)

<http://www.reuters.com/articlePrint?articleId=INN2146507520080721>

Wall Street

July 25 (Bloomberg) -- [Legg Mason Inc.](#), the U.S. money manager with [the worst-performing stock](#) this year, reported a second straight quarterly loss because of subpar fund returns and costs to bail out money-market investors.

The net loss was \$31.3 million in the fiscal first quarter ended June 30, or 22 cents a share, compared with a profit of \$191 million, or \$1.32, a year earlier, the Baltimore-based company said today in a statement. Revenue fell 13 percent to \$1.05 billion.

Legg Mason, buffeted by bad fund investments, has shed 48 percent of its [market value](#) in 2008. The company injected \$2.15 billion into seven [money funds](#) to cover potential losses on debt issued by structured investment vehicles. Stock funds run by [Bill Miller](#) and [Bruce Sherman](#) have been hit by investor withdrawals after losses on companies including [UnitedHealth Group Inc.](#) and Bear Stearns Cos.

“Their core asset-management business has been struggling, and that is not good,” [Matt Snowling](#), an analyst at Friedman Billings Ramsey Group Inc. in Arlington, Virginia, said in an interview before results were announced.

Snowling expected a loss of 3 cents a share, including the money-fund costs. Nine analysts who included that expense in their estimates expected the company to lose 15 cents a share, data compiled by Bloomberg show.

Legg Mason posted a loss of \$255 million in the prior quarter, the first since going public in 1983. The company inherited the money-market funds in December 2005, when it completed the swap of its stock brokerage for New York-based Citigroup Inc.'s fund unit.

Value Trust

Miller's [Legg Mason Value Trust](#), which beat the Standard & Poor's 500 Index for a record 15 years, is in its third year of trailing the U.S. benchmark index. The fund had net outflows of \$2.4 billion in the first half of the year, according to data tracked by [Morningstar Inc.](#) in Chicago. The fund slumped 30 percent this year through yesterday, compared with the 14 percent decline in the S&P 500.

The \$13.7 billion [Western Asset US Core Plus Bond Portfolio](#), the mutual-fund version of the unit's largest fixed-income strategy, fell 4.6 percent this year, trailing 91 percent of competing funds, according to Morningstar. The \$6.3 billion Western Asset Core Bond Portfolio dropped 4.2 percent, lagging behind 89 percent of its peers, the data show.

July 22 (Bloomberg) -- “Everything is over!”

So wrote Emanuel Lehman, one of three brothers who founded the cotton-trading company that bore his name. The year was 1862. The cause of alarm: the Civil War, which had cut off communications between Montgomery, Alabama, where [Lehman Brothers](#) was founded a dozen years earlier, and New York, where much of its business was transacted.

Lehman's despair, contained in a letter to in-laws in the U.K., was premature, it turned out. He and brother Mayer moved the firm to New York after the war, underwrote their first stock offering two decades later for a manufacturer of steam pumps and went on to become one of Wall Street's most powerful investment banks.

The panic kept coming back though. It reappeared in 1929, when the stock market crashed; in 1973, when the firm lost \$6.7 million betting the wrong way on interest rates; and in 1984, when internal dissension led to a takeover by [American Express Co.](#) It surfaced again in 1994, when

[Lehman Brothers Holdings Inc.](#), newly independent, faced a capital shortage -- losses had depleted shareholder equity to less than 2 percent of assets -- and in 1998, when Russia defaulted on its debt.

So when the bank confronted doubts about its survival this spring, it was *deja vu* for Chief Executive Officer [Richard Fuld](#), 62, who has spent his entire 39-year career at Lehman, the past 15 in the top job.

“To put your head under the covers and hide is a useless exercise,” Fuld told friends in June, as he scrambled to regain the confidence of *investors*. “When you get dealt a hand, react to it. Don't pretend it's going to go away. Create a plan, execute it and get back to work.”

Longest-Serving CEO

That was the lesson that Fuld, the longest-serving CEO on Wall Street, says he learned in 1998, when the company's shares fell 63 percent in four months on speculation the bank was about to fold. This time around, when the shares fell 70 percent in six months, Fuld didn't duck. Nor did he absent himself at bridge tournaments, like his counterpart at Bear Stearns Cos., James “Jimmy” Cayne.

Instead, he raised \$14 billion of capital, sold \$147 billion of assets, increased cash holdings and reduced the fourth-largest U.S. securities firm's reliance on short-term funding to create a buffer against a possible bank run. When none of those measures worked, he replaced Lehman's No. 2, [Joseph Gregory](#), his trusted lieutenant of 30 years, with a younger man known for his cautious approach to risk taking. And he moved aside Lehman's high-profile Chief Financial Officer [Erin Callan](#), who had a spat with hedge fund manager [David Einhorn](#), a short seller of Lehman stock. (Callan was hired by Credit Suisse Group AG in July to head a unit at the rival firm that advises hedge funds.)

Fuld's Blunders

Yet Fuld, who declined to be interviewed for this article, also made a series of blunders that threaten to take the firm down or end its independence, and to taint his legacy, says [Richard Bove](#), an analyst at Ladenburg Thalmann & Co.

“What he inherited and what he created out of it is amazing,” Bove says. “He's one of the best out there. Yet he messed up this time around.”

What Fuld messed up was mortgages. He expanded rapidly into subprime lending in 2004, buying BNC Mortgage LLC so he could have a steady flow of debt to package into bonds. In the first quarter of 2006, BNC was lending more than \$1 billion a month.

He also bought Aurora Loan Services LLC, a mortgage lender that makes so-called Alt-A loans, a notch above subprime, to more-creditworthy borrowers who don't provide full documentation for their assets. Aurora was originating more than \$3 billion a month of such loans in the first half of 2007.

Mortgage-Market Trouble

Last year, as the market collapsed, Lehman underwrote more mortgage-backed securities than any other firm, accumulating an \$85 billion portfolio, 44 percent more than Morgan Stanley's and almost four times the \$22.5 billion of shareholder equity Lehman had as a buffer against losses. Lehman saw trouble in the mortgage market in late 2006 and still didn't move fast enough to reverse course, according to people familiar with the firm's internal workings.

“Lehman's problem is mortgages,” says [Brad Hintz](#), an analyst at Sanford C. Bernstein & Co. “They grew the balance sheet too fast. While diversification has been pretty good in recent years, Lehman still doesn't have the investment banking or asset management businesses at the same level as rivals.”

Lehman's troubles reflect the challenges faced by all Wall Street firms. The implosion of the U.S. subprime mortgage market and the fire sale of Bear Stearns, once the fifth-largest U.S. investment bank, have exposed an inherent competitive disadvantage shared by all brokers: the lack of a stable funding base.

Glass-Steagall Repeal

The repeal of the Glass-Steagall Act in 1999 allowed commercial banks to compete with brokers on every level. To stay in the game, Lehman and its peers ratcheted up their leverage, using their balance sheets to borrow money from banks, hedge funds and other investors. They then lent the cash for buyouts and used it to purchase mortgages they packaged into securities.

When the music stopped, the banks found themselves holding billions of dollars in loans and bonds they couldn't sell. They've written down \$422 billion in the value of those holdings since last year. The biggest casualty was Lehman's closest rival, Bear Stearns. It ran out of cash in March, when creditors refused to lend the company money in the overnight market amid speculation that the firm was facing bigger losses. On March 16, the U.S. Federal Reserve engineered the takeover of Bear Stearns by [JPMorgan Chase & Co.](#)

‘Under Siege’

While commercial banks, including JPMorgan, lost as much or more than investment banks, they didn't have to worry about nervous lenders pulling back their loans; much of their funding comes from depositors whose savings are guaranteed by the government. [Citigroup Inc.](#), the largest U.S. bank by assets, had lost \$43 billion from its mortgage investments as of the end of March. While that's five times more than Lehman has lost, Citigroup has \$831 billion of deposits, which reduces investors' concern about the bank's running out of cash.

“The brokerage model is under siege, with many of the major business drivers facing uphill battles,” says [David Hender](#), a credit analyst at CreditSights Inc. “While everybody was taking risks during the mortgage boom, the brokers had the most at stake because they don't have the deposits to rely on. They blew it.”

Now investors are worried that No. 4 Lehman -- which trails investment bank rivals [Goldman Sachs Group Inc.](#), Morgan Stanley and [Merrill Lynch & Co.](#) -- might fail the way Bear Stearns did, even though the Fed now allows broker-dealers to borrow directly from the central bank.

Short Selling Lehman

Many investors have sold the stock short, borrowing shares to sell with the expectation that they can be repurchased at a lower price to pay back the loan. Some have bought put options, which give buyers the right, but not the obligation, to sell by a specific date, betting the price will go down by another 69 percent to \$5.

Einhorn, the most vocal of the short sellers, challenged former CFO Callan's credibility in a May 21 speech, saying she changed her story about how the firm had valued a private equity investment during private conversations with him. Einhorn's allegations contributed to the stock's decline over the next few weeks amid speculation about the firm's financial health.

On one day, July 10, Lehman's shares fell 12 percent on rumors that Pacific Investment Management Co., manager of the world's biggest bond fund, had stopped trading with the firm, even though Pimco denied the rumor. The next day, the stock fell an additional 17 percent on concern that government-backed mortgage finance companies [Fannie Mae](#) and [Freddie Mac](#) would have to be bailed out. On July 15, the U.S. Securities and Exchange Commission imposed temporary restrictions on so-called naked short selling of brokerage stocks, requiring traders to hold or reserve the shares of the company before betting against them.

Diversification Plan

Fuld has spent the past decade diversifying Lehman, making sure it would have other businesses to depend on if one collapsed. Equity trading accounted for one-third of Lehman's revenue last year, and the firm was the largest trader of stocks on the London Stock Exchange and Euronext. It ranked as high as No. 5 among mergers and acquisitions advisers in 2007, when it had a role in one-fifth of all corporate takeovers, according to data compiled by Bloomberg. Its research teams in equities and fixed income have ranked at the top of surveys of money managers conducted by Greenwich Associates, an industry consulting firm. Non-U.S. revenue accounted for half of the total in 2007 for the first time.

Yet Lehman could lose it all. As the shares remain under pressure -- they were down 72 percent so far this year as of July 21 -- and talk about the firm's future continues, clients could desert one by one, says [Bruce Foerster](#), a former Lehman executive who now runs investor advisory firm South Beach Capital Markets in Miami.

Burgers, Fries

“Lehman could bleed to death slowly,” Foerster says. “Will the firm outlive the speculation, or the speculation hurt business enough to actually bring it down? It's a tough call.”

Fuld, who has worked at Lehman since he was 23, is a trader by nature and nurture. He's highly competitive, keeps a straight face and has played on U.S. teams at international squash tournaments. Even when he's under stress and eats compulsively -- as he did one marathon weekend in June, when associates say he gorged on hamburgers, fries and turkey sandwiches every hour -- he doesn't appear to put on weight or break a sweat.

He learned the trade at the feet of a master: the late Lewis Glucksman, who battled Pete Peterson and the band of bankers that ran Lehman during much of the 1970s for control of the firm, only to lose the company to American Express in 1984.

Fuld Becomes First CEO

Glucksman and many others left soon after the sale. Fuld, who was in charge of trading at the time, stuck around. In 1993, he became CEO of what was then the Lehman Brothers unit of American Express. When American Express spun off Lehman as a public company in 1994, Fuld became its first chief executive.

“The battle within Lehman in the 1980s was one sign of the rising power of traders on Wall Street,” says [Peter Solomon](#), one of the banker partners who fought on Peterson's side. “In the last 10 years, trading has dominated Wall Street.”

Traders have a bigger appetite for risk than bankers. They leverage their capital to magnify returns and hope their bets are right more often than wrong.

“Lehman, like the others, ended up playing big games with too little capital by taking on too much leverage,” says Solomon, who turns 70 in September. Peterson, 82, declined to comment for this story.

South Beach's Foerster, a managing director at the firm at the time of the spin-off, credits Fuld with saving the new company, which was saddled with losses, inhibited by insufficient capital and handicapped by a 30 percent share decline. Four years later, amid rumors Lehman had been badly hurt by Russia's debt default and the collapse of hedge fund firm Long-Term Capital Management LP, Fuld went door to door to convince creditors that the bank had enough capital and cash to pay its debts.

Risk Management

Then he set his sights on Lehman's bigger rivals. While global and product diversification was part of the catch-up plan, it was the booming mortgage market that provided Fuld with the additional profits he needed to invest in other businesses. In 2005 and '06, only Bear Stearns underwrote more bonds backed by mortgages than Lehman.

Toward the end of 2006, people familiar with Lehman's risk management operations say, executives at the firm started seeing trouble in the mortgage market. The securitization division raised rates on its bonds to reflect higher risk, which meant higher interest on the loans Lehman's mortgage units made to home owners. When that didn't slow borrowing, lending standards were

tightened, a decision that was met with resistance by BNC and Aurora executives, whose fees depended on volume, the people say.

Hedging Home Loans

By the end of 2006, Lehman started hedging against its mortgage exposure. Some traders were allowed to bet against the prices of home loans by shorting indexes tied to mortgage securities.

Still, Lehman President Gregory didn't move fast enough to reduce risk, the people say. And at least two executives who urged caution were pushed aside.

One was [Madelyn Antoncic](#), 55, head of risk, who was moved to a government relations job in September 2007. Two months later, at a risk management conference in New York, she said that hedging mortgage positions had curtailed Lehman's profit, which was difficult for top management to accept.

The second was [Michael Gelband](#), 49, who ran fixed income and was pushed out altogether in May 2007 after he balked at taking more risk, people familiar with the situation say.

“Lehman at one time had very good risk management in place,” says [Walter Gerasimowicz](#), who worked at Lehman from 1995 to 2003 and now heads Meditron Asset Management in New York. “They strayed in search of incremental profit and market share.”

Leveraged-Loan Losses

Lehman's hedges helped offset [losses](#) in the second half of 2007 and the first quarter of 2008. While the firm wrote down the value of mortgage-related assets by more than \$10 billion, the net reduction to profit was only \$3.3 billion.

Some of Lehman's losses in that period were from leveraged loans, which are used by private equity firms and others for buyouts. The firm was stuck with the loans, which they had aimed to package and sell, when the leveraged buyout market froze in the second half of 2007.

Fuld used the temporary recovery of credit markets in the first quarter, which ended in February, to offload one-fifth of the firm's leveraged-loan portfolio. Yet he also tried to gain market share by borrowing against the firm's capital to trade other fixed-income products for Lehman's clients, people say. That increased Lehman's risk in the event of a renewed downturn, as did its growing inventory of Alt-A loans.

Wrong-Way Bet

Fuld had bet the wrong way: In March, markets tumbled as defaults by homeowners surged, housing prices fell further and the U.S. headed toward a recession. Reversing course, he ordered his associates to hunker down, people say. Traders were told to sell troubled assets or buy credit protection for further potential losses, which meant that if prices were to recover, Lehman couldn't benefit. In other words, things weren't going to turn around anytime soon.

“The current environment remains challenging,” Fuld told the company's shareholders on April 15.

Selling \$147 billion of assets in a jittery market, as Lehman did in the second quarter, meant taking significant losses. On top of that, people familiar with the transactions say, some of the hedges didn't work.

For example, Lehman bet against the CMBX index, a gauge of bonds backed by commercial mortgage bonds, to hedge its residential mortgage portfolio. In the second quarter, the index improved -- the cost of protecting against losses on commercial mortgage bonds narrowed to 100 basis points from 150 -- while the prices of residential mortgages continued to drop, resulting in losses on both sides of the trade. (A basis point is 0.01 percentage point.)

\$2.8 Billion Loss

The firm was also too late slowing its commercial mortgage business, calculating that the rout in residential mortgages wouldn't spread to the commercial market, people familiar with the thinking at the time say. More than half of Lehman's mortgage exposure is to commercial mortgages and real estate, which have also declined in value this year.

On June 9, after Fuld's hamburger-fueled marathon weekend, Lehman preannounced second-quarter losses of \$2.8 billion, four times more than the worst analyst estimate. It also arranged a \$6 billion share sale. “As painful as this quarterly loss has been, now is the time to look forward,” Fuld wrote to employees. “In past down cycles, the firm has always emerged stronger. We have done it before, and we will do it again.”

McDade's Mandate

Herbert “Bart” McDade, 49, who replaced Gregory as Lehman's president three days after the preannouncement, doesn't have much time these days to work in the garden behind his Rye, New York, home or watch his two teenage sons play soccer and basketball. Instead, he's busy fighting short sellers, hosing down rumors and trying to save Lehman.

A graduate of Duke University in Durham, North Carolina, who holds a Master of Business Administration from the University of Michigan in Ann Arbor, McDade started at Lehman as a corporate bond trader in 1983. He became head of fixed income in 2000 and, five years later, was named to run the equities division, with a mission to grow it. Under his watch, revenue tripled as the business expanded overseas and into new products.

McDade was the first to assign research analysts to the trading desk, where instead of publishing reports on companies, they were tasked with creating trading ideas for clients. The model was followed by competitors such as Merrill Lynch as hedge funds gained prominence on Wall Street and demanded more short-term trading ideas instead of in-depth analytic reports.

Duke, Michigan

McDade earned a reputation as a prudent risk manager, someone who hedges his bets. [Kevin Cronin](#), head of investments at Putnam Investments, the 16th-largest holder of Lehman shares, who has known McDade professionally and personally for two decades, says his hedging skills apply even to the sports teams he roots for -- Duke basketball and Michigan football, both of which have high winning percentages. If one team has a bad year, Cronin says, the odds are that the other won't.

``Bart's been all about diversifying into other areas in the businesses he ran," Cronin says. ``He saw that as the best hedge."

Although McDade long had ambitions to replace Gregory, say people familiar with internal politics at the firm, his style wasn't confrontational. Dissension didn't sit well with Fuld. Instead, McDade stayed on the sidelines, those people say, allowing Gelband, his handpicked successor in the fixed-income business, to fight some battles on his behalf. (Gelband, who lost his job last year, has since been rehired by McDade.)

Righting the Ship

When losses mounted and the stock tanked, McDade made his move with the backing of executives who had long seen him as the firm's future leader. McDade declined to comment on any aspect of the succession.

``If there's someone who can help right the ship, he's definitely the right candidate because he has a good track record," [Douglas Sipkin](#), an analyst at Wachovia Corp., says of McDade. ``But he faces several challenges: keeping employees motivated, gaining back the credibility of investors and clients and continuing to work through some of the balance sheet exposures."

Fuld is counting on McDade's help to convince investors that Lehman can go it alone and that further losses on its mortgage portfolio won't be at the level of the second quarter, says South Beach Capital's Foerster.

`Bear Case Scenario'

Morgan Stanley analyst [Patrick Pinschmidt](#) estimates Lehman will have as much as \$2.5 billion of writedowns in the second half of the year compared with \$4.9 billion in the second quarter alone. In what he calls a ``bear case scenario," the losses could be \$5.4 billion in the last two quarters, which would mean Lehman would have to raise \$1 billion more in capital, Pinschmidt wrote in a June 30 report.

Meanwhile, rumors continue to haunt Lehman. Speculation that London-based Barclays Plc would buy the firm for a 25 percent discount caused Lehman stock to fall 11 percent on June 30. Both firms said the speculation was groundless.

``Fuld would be out of character if he sought a buyer," says [Michael Holland](#), who has worked on Wall Street for more than four decades and now heads Holland & Co., managing \$4 billion of assets. ``He has consistently defied predictions of the firm's being sold."

Takeover Candidate

Still, Fuld might not have a choice. A depressed share price -- the company's market value is about 40 percent of what its assets would fetch in the event of a sudden liquidation -- makes Lehman an obvious takeover candidate. It also increases the likelihood that its most prized employees will leave, since most of their pay is in the form of Lehman stock.

“Lehman wanted to be like the bigger guys, and for a while it looked like they were catching up,” says CreditSights' Hendler. “But they failed to see the risks and ended up in this situation. It will be tough to survive. They're the weakest of the big four investment banks.”

Hendler says a hookup with Minneapolis-based U.S. Bancorp, the sixth-largest U.S. bank by assets, could provide Lehman with the necessary stable funding base. U.S. Bancorp declined to comment.

Not everyone thinks Lehman needs to merge with another bank.

“They can survive thanks to the Fed's liquidity facilities and realign their businesses when things change,” says [Corne Biemans](#), a Boston-based senior portfolio manager at Fortis Investments, which oversees about \$200 billion. “In every downturn, people think Wall Street's model is completely broken and it can't go on. Each time, Wall Street firms reinvent themselves. They'll come up with something again. I don't know what, but they will.”

Apocalyptic Prediction

The recovery won't be easy. Taking lower risk with the balance sheet means reducing profitability. A smaller balance sheet, along with \$65 billion of hard-to-sell assets tied to mortgages, gives the firm little wiggle room to expand into areas such as emerging markets, where it might be able to increase profits. It will be several years before Lehman can achieve the 15 percent return on equity it set as its goal in June, says Wachovia analyst Sipkin.

Fuld and McDade are now in the eye of what may be the fiercest storm to have hit Lehman. As the markets have done before, they will again determine whether the firm will survive, and in what form, or whether Emanuel Lehman's apocalyptic prediction will come to pass 146 years late. **Lehman Fault-Finding Points to Last Man Fuld as Shares Languish**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aKlvv3EUW8lk&refer=home#>

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

Best of the Dog

It is Tuesday morning and we see why markets have such a tough time going down when years of “dip buying (i.e. very bad habits)” have been rewarded. The market opened down and sprinted straight up.