

The Other Side of the Street June 15, 2008

Comments

For those of you who recall numerous market wide rallies last January and February because MBIA was going to keep its AAA rating, you will probably be amused that not only did MBIA drop to AA it reneged on its promise to move money down to the sub at issue. Don't expect that news to be widely reported.

On a more macro front, we sit once again at the precipice. Think back to the June news last year that there were emerging problems in sub prime. Think about how that news was roundly ignored as talk of second half rallies, bottoms in housing, and "the Fed will save us" was bantered about. It actually worked for a while as the all-time high was set in October in the Dow (the same month the Bear Stearns chief said the credit problems were over.

How different are today's pundits? I heard this morning that the "rescission that never happened is over". We have heard for months that the credit crisis is nearing the end. The latest tomfoolery is that the Fed can impact inflation (and I mean other than to run it up even further).

The major difference between this year and last is that the bullets have long since exited the government meddling guns. You now have a situation where the state governments are broke and even the central nanny state will be precluded from further "rebate give aways".

Yet we continue to see the charlatans play mark up the quarter and manipulate high beta stocks so they can money. This game will lead to a December/January last revisited should the betas get chased through June 30.

We also have the china Olympics and one would think a serious run up in anything Chinese into the games. This will then provide a great risk reward derivative shorting opportunity.

All in all the next six months should prove to be very ugly for the bulls.

Stock Notes

- It's a big weekend for another **Marvel (MVL)** (the toys, not the chips) as the "re-imagined" version of *The Incredible Hulk* opens at a theater near you this weekend. I could be wrong (I didn't see *Iron Man* knocking the box-office cover off the ball) but I'd be leery of buying Marvel today picturing a rally on monster ticket sales. Jeff Macke
- **This week's \$6 billion capital raise diluted shareholders by about 30%.** M&A advisory fees and equity and fixed income underwritings have slowed to a trickle. **In fact, Lehman's business has slowed so much that -- even if you ignore write-downs still to come -- Lehman's annualized earnings power has likely shrunk to the range of \$1-2 per share.** Its deleveraged balance sheet will lower

risk, but it will also lower future returns on equity. Just because the stock is down more than 50% this year doesn't mean it's cheap. Yesterday, Lehman's President Joe Gregory and its CFO, Erin Callan, stepped down. Callan has held her position since only last fall, so she wasn't even responsible for establishing Lehman's mortgage-backed security "sausage factory." The blame for that strategic error should go right to the top. In recent months, though, Callan also wasn't very forthcoming about Lehman's balance sheet risk. Let's see how forthcoming Lehman's new CFO will be, come Monday. DR

Notes

What's more, "**nonborrowed bank reserves continue to sink into record territory**," reports government watchdog [John Williams](#). According to data released by the Fed, nonborrowed reserves have sunk to negative \$129 billion.



What does that mean? The Fed requires banks keep money in reserve. This data shows that the U.S. banking system at large could meet these reserves only by borrowing more than 100% of the amount the Fed requires. In fact, in order to meet the Fed's minimum requirements, financials have had to borrow \$129 billion in excess.

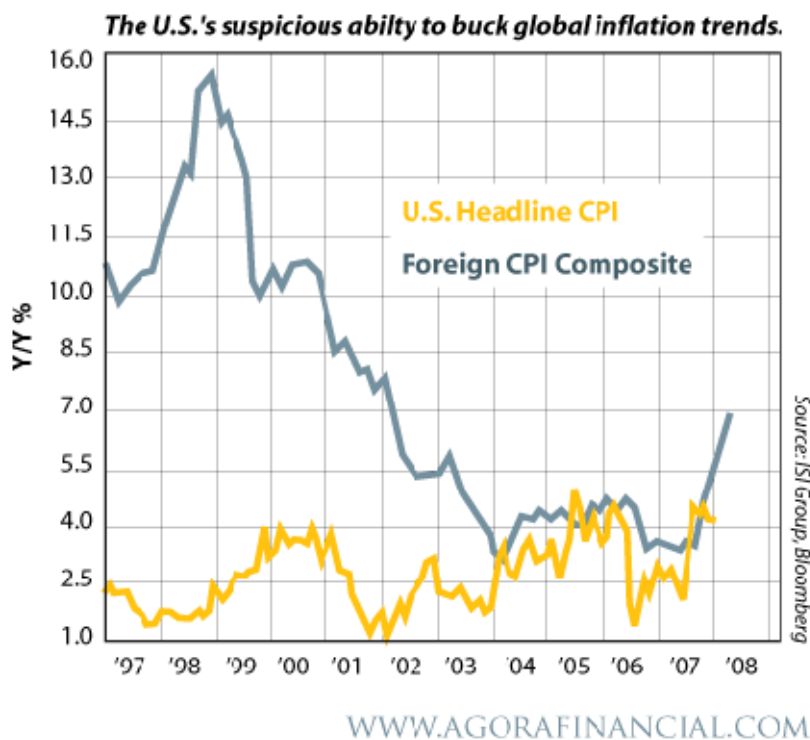
We've mentioned it before... when this chart crossed the zero threshold in January, it was the first time nonborrowed reserves were negative since the Great Depression.

- **Consumer sentiment sank to a 28-year low today. Just a few hours after the CPI report this morning, the University of Michigan announced its preliminary consumer sentiment reading for June. It's down to a score of 56.7, the worst since 1980. All facets of the survey -- inflation expectations, current conditions and future expectations -- fell more than economists expected. For comparison's sake, U of M's sentiment index scored an average of 85 in 2007.**

- **The majority of the world believes the global economy is “bad,”** reported the Pew Research Center yesterday. Of the 24,717 people from 24 nations surveyed, 61% say their homeland economy is in bad shape. 50% felt the same this time last year.
- Speaking of bubbling crude, saw an interesting brief on Bloomberg this morning noting that oil is now up nearly 700% from the Nov. 2001 low of \$17.75. That’s more than the Nasdaq dotcom bubble increase of 640%.
- [Friday June 6], amid the smoke and dust of the battle, in rode the ‘crude oil vigilantes,’ guns blazing. The news from the Labor Department seems to have set them off, but they seemed to be itching for a fight anyway. Soon, they had driven up the price of oil more in one day than ever before. A barrel of crude rose \$11. To put that in perspective, that’s about the whole price of oil 10 years ago. At the end of the day, the oil price was at a new record high: \$139.
- **The U.S. Congress has quietly approved the biggest government budget in the history of mankind.** Late last week, Democrats gave final approval to the \$3.1 trillion annual budget proposed by President Bush back in February.
- **Congress earmarked a law in the latest budget to raise the national debt ceiling.** The U.S. can now owe the world \$10.6 trillion, an \$800 billion increase.

“I’ll tell you an area where we’ve been foolin’ ourselves,” writes Bill Gross in his latest monthly missive, **“and that’s the belief that inflation is under control.”** Here’s the cornerstone of Gross’s argument... the averaged inflation rates of 24 global nations versus the U.S. government’s measure of American inflation:

Inflation Investigation



“Looks a mite suspicious,” understates Gross. “Sure, inflation was legitimately much higher in selected hot spots such as Brazil and Vietnam in the late ’90s and the U.S. productivity ‘miracle’ may have helped reduce ours a touch, compared to some of the rest, but the U.S. dollar over the same period has declined by 30% against a currency basket of its major competitors, which should have had an opposite effect, everything else being equal. “I ask you: Does it make sense that we have a 3-4% lower rate of inflation than the rest of the world? Can economists really explain this with their contorted Phillips curve, output gap, multifactor productivity theorizing in an increasingly globalized, ‘one price fits all,’ commodity-driven global economy? I suspect not. Somebody’s been foolin’, perhaps foolin’ themselves. According to Gross, if inflation were measured more accurately, a “readjustment of investor mentality” would push bond, stock and real estate prices down 5-10%.

- In their monthly “trade balance” report, the government reported that trade was... well... rather unbalanced. **The April trade deficit widened 7.8%, to \$60.9 billion.** That’s the biggest gap since March 2007. Oil imports were largely to blame. The U.S. imported a record \$29 billion worth of crude, up \$4 billion from last month. Interestingly, the U.S. paid an average price of \$96 a barrel in April. We’ll go way out on a limb here and forecast that there’re more crude import records to come.

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Web links

Credit

- June 12 (Bloomberg) -- **Moody's Investors Service**, under pressure from regulators and state treasurers, will change the way it rates municipal bonds and rank them on the same scale it uses for corporate and sovereign debt. Moody's announced today it will "transition our public finance ratings to our global scale" after decades of holding municipal bonds to a higher standard. It began a review in March after California Treasurer Bill Lockyer began a campaign to alter the way Moody's, Standard & Poor's and Fitch Ratings assess tax-exempt debt. House Financial Services Committee Chairman **Barney Frank** also threatened legislative changes. "Given that Moody's assigns municipal ratings to over 28,000 security types, the pace and method of such wholesale transition needs to be carefully considered," the New York-based company said in its press release today. "As such, we will strive to ensure that such transition is implemented in a transparent and efficient manner." **Moody's Set to Change Municipal Bond Rating Scale**
http://www.bloomberg.com/apps/news?pid=20601087&sid=anbsymTjM_uo&refer=home
- June 11 (Bloomberg) -- **MBIA Inc. won't contribute \$900 million to its bond-insurance unit, downgraded from AAA by Standard & Poor's last week, as the company re-evaluates its business strategy. The holding company will keep the money, raised through the sale of shares in February, as it considers options for supporting the bond insurance market,** Armonk, New York-based MBIA said in a statement sent by Business Wire. The funds aren't needed to pay claims at the insurance unit, MBIA said. "Our landscape has changed," Chief Financial Officer C. Edward Chaplin said in the statement. S&P and Moody's Investors Service "made it clear that, at this point, maintaining Triple-A ratings for MBIA Insurance Corporation would be dependent on other factors besides the amount of capital or claims-paying resources we have," he said. MBIA, Ambac Financial Group Inc. and other bond insurers stumbled after expanding beyond municipal bonds to guaranteeing securities linked to **subprime mortgages** and home-equity loans that are now defaulting at record rates. MBIA and Ambac, which had been trying to preserve their AAA status, balked when credit-rating companies raised the standards that would have to be met. "They're walking away from their policyholders and their surplus noteholders," William Ackman, managing partner of hedge fund Pershing Square Capital Management LP, told reporters today at a conference in New York. Pershing Square had set up trades designed to profit from a decline in MBIA and Ambac shares, which have plunged more than 90 percent in the past year. Higher Standards MBIA raised \$2.6 billion last quarter as ratings companies said MBIA Insurance Corp. needed more capital to protect the AAA ranking as losses on securities backed by **subprime mortgages** mounted. Moody's said June 4 it's likely to lower the rating despite the additional capital. S&P cut its rating a day later. **While MBIA said in February that most of the proceeds from its capital raising would be contributed to its insurance unit, it still retained the money at its holding company in May. MBIA said May 12 that after talks with regulators, it would move \$900 million within 30 days. The company reversed course after the**

ratings actions last week. Surplus Notes The bond-insurance unit raised \$1 billion of capital in January by selling so-called surplus notes. The New York insurance department can restrict payment on the notes if it determines the unit needs to preserve capital. MBIA posted a \$2.4 billion first-quarter **net loss** compared with profit of \$198.6 million a year earlier. Ambac had a loss of **\$1.66 billion**, compared with \$213.3 million a year earlier.
MBIA Reconsiders \$900 Million Capital Deployment

- June 11 (Bloomberg) -- **The British Bankers' Association's first overhaul of the London interbank offered rate in a decade may fail to rebuild investor confidence in the benchmark interest rate for \$360 trillion of derivatives, bonds and loans.** The London-based trade group said yesterday that it plans to increase the number of banks that set the Libor and consider adding a second daily survey to reflect U.S. trading. The proposals came three months after the Bank for International Settlements said in a report that some BBA members may have understated rates to avoid being seen as having difficulty raising financing. **“It's clearly a step in the right direction but the announcement sounds like another public relations exercise by the BBA,”** said Stuart Thomson, a money manager at Glasgow, Scotland-based Resolution Investment Management Ltd., which oversees about \$46 billion in bonds. **The changes disappointed investors who wanted the BBA to require members to provide quotes for short-term rates that reflect actual trades.** Some analysts also recommended that banks quote borrowing costs anonymously, reducing the incentive to understate Libor, which is used to calculate rates on financial products ranging from corporate bonds to U.S. mortgages. **“Libor will remain prone to misquotings as long as the BBA fails to ask banks to submit actual transacted rates,”** said Marius Daheim, a senior bond strategist in Munich at Bayerische Landesbank, Germany's second-biggest state-owned bank. **“Adding more banks to the Libor panel would be a clear improvement.”** Member Survey ICAP Plc, the biggest broker of transactions between lenders, today unveiled a new measure of U.S. bank rates as an alternative to Libor. The **three-month New York Funding Rate, or NYFR, was 2.7715 percent, ICAP said in a statement today. That is 1.66 basis points below the 2.7881 percent three-month dollar Libor. One-month NYFR was 2.4646 percent, compared with one-month Libor of 2.47688 percent, London-based ICAP said. Libor gained attention in August as losses from subprime-contaminated securities suddenly made banks wary of lending to each other. Three-month Libor soared to 2.40 percentage points above yields on Treasury bills on Aug. 20, the widest margin since December 1987 and up from 0.39 percentage point a month earlier. The gap was 0.79 percentage point today.** Investors said they were convinced banks were reporting incorrect Libor figures after the BBA threatened on April 16 to ban members that deliberately understated rates. The **cost of borrowing** in dollars for three months rose 0.18 percentage point to 2.91 percent in the following two days, the biggest increase since the credit markets seized up in August. **“A Lie’ Banks routinely misstated borrowing costs to the BBA to avoid the perception they faced difficulty raising funds as credit markets seized up, turning Libor into ‘a lie,”** according to **Tim Bond, head of asset allocation at Barclays Capital, a unit of Barclays Plc** The seizure in credit markets exposed Libor's flaws, according to **Peter Hahn, a London-based research fellow for Cass Business School and a former managing director at Citigroup Inc.** The BBA publishes names of contributors and their rates, giving lenders an incentive to underestimate borrowing costs. **Libor Overhaul May Fail to Restore Confidence in**

Rate

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

- June 10 (Bloomberg) -- **Some of the U.S. mortgage bonds at the center of the yearlong credit crisis are slipping toward new lows, as climbing gas prices, unemployment and interest rates deepen concern that homeowner defaults will increase. The benchmark Markit ABX index linked to the last-to-be repaid of originally AAA rated subprime-mortgage bonds from the first half of 2007 fell today to a record low of 50.55, down about 16 percent from May 19, suggesting a corresponding drop on similar securities.** Top-rated bonds of "option" adjustable-rate mortgages are also falling, according to a report yesterday from RBS Greenwich Capital. "There's a tremendous amount of extraneous events going on away from the mortgage market that are making people scared," said David Castillo, a senior trader at Further Lane Securities in San Francisco. **Market activity over the last two weeks is down significantly over the previous four weeks. [if there is no market for mortgages, fewer will be initiated]** May Rally The debt, along with other credit markets, had generally rallied through mid-May after the Fed backed the bailout of Bear Stearns Cos. and began lending directly to investment banks in March, signaling the central bank's willingness to prevent bank failures and easing a logjam in debt markets. **Markets have since reversed, as banks and securities firms including Lehman Brothers Holdings Inc. report fresh losses.** Investor Demand Renewed investor demand remains strong for the types of AAA rated subprime-mortgage bonds that are the first to be repaid with principal returned from the underlying loans, "with little price discovery in other tranche types," according to a report yesterday from Countrywide Financial Corp. analysts including Anand Bhattacharya and Bill Berliner. In mid-March, super-senior option ARM securities typically were trading at about 78 cents, while more-junior AAA classes were at 55 to 68 cents, according to UBS AG analyst estimates at the time. **Mortgage Bonds Resume Stumble; Some Debt Nears Lows**

http://www.bloomberg.com/apps/news?pid=20601087&sid=a3N3qhN_oAJ8&refer=

- June 10 (Bloomberg) -- **The British Bankers' Association, yielding to pressure from investors and regulators, will increase the number of banks that set the London interbank offered rate in the biggest change to Libor in 10 years.** The London-based trade group will also "take soundings" on adding a second survey of members to reflect U.S. trading hours when it sets the global benchmark rate, it said today in an e-mailed statement. Libor, used to calculate rates on about \$360 trillion of financial products, was last changed in 1998. **The BBA, which holds its annual banking conference in London today, has been urged to overhaul the 24-year-old system since the Bank for International Settlements said in a March report some members may have understated their rates to avoid being seen as having difficulty raising financing.** The changes will boost the "confidence of its many users," the BBA said. "It's a step in the right direction but I think we need a few more enhancements to make Libor accurate again," said Jan Misch, a money-market trader in Stuttgart at Landesbank Baden-Wuerttemberg, Germany's biggest state-owned bank. **At the moment it's a lot of guesswork.** In the first four months of 2007, the difference between the highest and lowest rates for three-month dollar Libor didn't exceed 2 basis points, according to

JPMorgan Chase & Co. In the same period this year, it was as wide as 17 basis points. Banks will be asked to explain "erroneous rates," she added. The credit crisis exposed Libor's flaws, according to **Peter Hahn**, a London-based research fellow for Cass Business School and a former managing director at Citigroup Inc. That's because the BBA publishes the names of contributors and their rates, giving lenders an incentive to underestimate borrowing costs. Libor "Lie" **Banks routinely misstated borrowing costs to the BBA to avoid the perception they faced difficulty raising funds as credit markets seized up, turning Libor into "a lie," according to Tim Bond, head of asset allocation at Barclays Capital, a unit of Barclays Plc.** Rates offered by UBS and Lloyds TSB, the U.K.'s largest provider of checking accounts, underscore the range in quotes to the BBA since July. UBS, which took \$38 billion of writedowns and losses, replaced its chief executive officer and chairman and saw its stock tumble 60 percent, **quoted rates below Libor on 85 percent of the days between July and mid-April.** The average was 1.3 basis points less than its peers. Lloyds TSB quoted rates that were 0.04 basis point above Libor on average. The last time the BBA changed the system was in 1998, when the deteriorating creditworthiness of Japanese banks inflated the rates they contributed to yen Libor. The association responded by changing the contributor panels. "Panel members should be made to "prove they can transact" at the rates they submit to the BBA, Misch said today. **Libor to Be Set by More Banks as BBA Boosts Scrutiny** http://www.bloomberg.com/apps/news?pid=20601087&sid=abdrGsfc_YDk&refer=home

Commercial Real Estate

Commodities

Currency

- June 15 (Bloomberg) -- **Finance ministers from the Group of Eight nations said surging food and fuel prices have replaced the credit squeeze as the biggest threat to the world economy. "The predominant concern is the inflationary effect that oil in particular and also food prices are having,"** U.K. Chancellor of the Exchequer Alistair Darling said yesterday after G-8 officials ended talks in Osaka, Japan. Deputy German Finance Minister **Thomas Mirow** said oil's rise to a record means "an enormous withdrawal of purchasing power." Inflation is accelerating after the price of oil reached an unprecedented \$139.12 a barrel on June 6 and food costs from rice to soybeans set records this year. Central banks are already shifting toward tighter monetary policy even as worldwide economic growth cools. "The G-8 is turning up the volume in terms of its inflation concern," said **Claudio Piron**, a currency strategist at JPMorgan Chase & Co. in Singapore. **In a statement, the ministers said the global economy faces "headwinds" and that risks to growth persist, with higher commodity prices posing a "serious challenge." The ministers stuck to their practice of not making a joint comment on currencies when central bankers are absent from the talks.** Even so, U.S. Treasury Secretary **Henry Paulson** and French Finance Minister **Christine Lagarde** spoke in favor of a strong dollar. "Nation's Interest" "A strong dollar is in our nation's interest," Paulson said. Lagarde said she was "happy to hear" that view. **Japanese Finance Minister Fukushiro Nukaga said intervention in the currency market wasn't discussed by the G-8 ministers.** The dollar had its biggest weekly gain against the euro since 2005 on bets

the G-8 governments would signal they favor further increases. The currency has dropped 30 percent on a trade-weighted basis since 2002. The ministers cited further declines in U.S. house prices and stresses in financial markets as other growth risks, while noting conditions improved since they identified the credit squeeze as the major worry at their last meeting in April. **The doubling in the price of oil in the past year was described as a "strong" concern by the officials, who urged producing nations to increase output and enhance their refinery capacity. Markets should promote transparency and consumers must use energy more efficiently, they said. Emerging economies were pushed to cease subsidizing food and fuel prices. [That is not heavy handed is it? The bullies who use all the resources want the little guys to show restraint???** IMF Forecast The International Monetary Fund predicts the fastest inflation in advanced economies since 1995 this year even as growth is the slowest in seven years. Rising prices threaten to damp growth further by sapping household budgets and boosting production costs. Prices have also sparked protests from Malaysia to Spain. The inflationary outbreak is grabbing the attention of central banks after 10 months in which they focused on insulating growth from the credit squeeze. **The Federal Reserve is set to leave its key interest rate at 2 percent this month after seven cuts since September. The European Central Bank may raise its main rate to 4.25 percent in July. [let's see, euro higher interest, dollar not, that's our "strong dollar" policy]** Disagreement on Oil **There were disagreements over what's driving the surge in commodity prices. Lagarde and Russian Finance Minister Alexei Kudrin argued investors are buying oil and food as a hedge against the dollar's drop. Paulson downplayed the link by noting oil's gain outpaced the dollar's decline since 2002.** The U.S. Treasury secretary also refused to blame speculators for higher prices, saying "all the evidence" points to tight supply and robust demand. Italian Finance Minister Giulio Tremonti disagreed by calling on governments to "fight speculation" and proposed limiting it by raising deposits for investors trading in futures markets, effectively making it more expensive to bet on oil prices. **The G-8 has had limited success in tempering oil prices since first lobbying for more supply in 2004, when crude cost about \$40 a barrel.** Goldman Sachs Group Inc. and Morgan Stanley predict oil may soon pass \$150. Oil Consumers, Producers Oil consuming and producing nations are to meet later this month in Saudi Arabia. While OPEC President Chakib Khelil this week said "supply is more than enough," Saudi Oil Minister Ali al-Naimi yesterday called record prices "unjustified" and the state oil company signaled it may soon start pumping from a new field. The G-8 is composed of the U.S., Japan, Russia, Germany, France, the U.K., Italy and Canada. Its finance ministers met to form an agenda for when leaders convene next month in Hokkaido. **G-8 Says Commodity Prices Replace Credit Squeeze as Major Risk**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aUIYpoCQGxrs&refer=home>

- June 16 (Bloomberg) -- **Finance ministers from the world's richest nations face another week of inflation headlines after signaling concern that the global economy risks a dose of stagflation as commodity prices soar.** Officials from the Group of Eight ended talks in Osaka, Japan, on June 14 by saying record fuel and food costs threaten to spur inflation. They also pose a "serious challenge" to growth, eclipsing the credit squeeze, the ministers said. **"Commodity prices have powered ahead of the financial crisis to become the number one priority of international policy makers,"**

said **Marco Annunziata, chief economist at Unicredit Markets and Investment Banking in London. ``Stagflation is clearly the underlying, unspoken concern.**" After acknowledging policy making is ``more complicated," the ministers' apprehension about an inflation outbreak may mount this week. **Economists forecast reports to show consumer prices last month rose the most since 1997 in the U.K. and the fastest in 16 years in the euro area, while U.S. producer prices are predicted to have gained 1 percent from April.** The G-8 officials didn't propose any new policies, apart from promising to take ``appropriate actions." **They repeated their call of the past four years for producers to pump more crude and consumers to use it more efficiently.** `Strong Dollar' The absence of central bankers meant there was no mention of currencies in their statement, although U.S. Treasury Secretary **Henry Paulson** backed a ``strong dollar." The ministers met after the price of oil doubled in a year to an unprecedented \$139.12 a barrel on June 6. Costs of foods such as wheat and rice have set records this year. **More expensive commodities create a dilemma for officials by sapping growth and spurring inflation, forcing them to decide which problem to address. The Organization for Economic Cooperation and Development this month predicted the weakest growth since 2002 this year and the fastest inflation in seven years.** ``The predominant concern is the inflationary effect that oil in particular and also food prices are having," U.K. Chancellor of the Exchequer **Alistair Darling** said. Deputy German Finance Minister **Thomas Mirow** said oil's rise means ``an enormous withdrawal of purchasing power." The global inflation picture may deteriorate this week. U.K. consumer prices probably jumped 3.2 percent in May from a year earlier, according to economists surveyed by Bloomberg News. That would be enough for Bank of England Governor **Mervyn King** to pen a letter of explanation to Darling, as required by law. ECB's Inflation Target **In the euro area, inflation is forecast to violate the European Central Bank's target of just below 2 percent for a ninth month by clocking 3.6 percent.** Meantime, the U.S. **Labor Department** is predicted to say producer-price inflation accelerated, after it estimated last week that consumer prices increased 0.6 percent from April to May, more than economists anticipated. **Canadian** May household inflation is projected to rise the most since January. **Switching Focus** Central banks are increasingly choosing to focus on inflation after 10 months of supporting growth amid the credit squeeze. **Such wariness of inflation means few, if any, economists see a return to 1970s-style stagflation when unemployment and inflation entered double figures. Deutsche Bank AG said this month the fact that bankers won't let prices spiral and increased competition are reasons to consider the chance of stagflation is ``fairly low."** Prices often lag behind a slowdown of growth, they said. **The G-8 ministers also indicated they are less worried that tight credit poses an obstacle to growth than they were when they met in April, noting conditions in financial markets have improved.** **Divergence on Oil** The officials disagreed on what's propelling oil and told the IMF to study the topic. Paulson and Darling blamed constrained supply and robust demand, rebuffing Italian Finance Minister **Giulio Tremonti's** argument that speculation is behind it. Ministers were also split over whether the dollar's 30 percent decline in trade-weighted terms since 2002 explains the surge in commodity costs. France's **Christine Lagarde** and **Alexei Kudrin** of Russia suggested investors are buying oil and food as a hedge against the weaker dollar. Paulson said oil's gain had outpaced his currency's dive. The absence of a joint comment on currencies by

the G-8 ``may come as a slight disappointment for the dollar," said [Sophia Drossos](#), a currency strategist at Morgan Stanley. The dollar last week rose the most against the euro since 2005 on speculation the G-8 would criticize its slide. **Paulson, Darling Face `Stagflation' Risk as Oil Prices Surge**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aSW5grvTYd24&refer=home>

- June 11 (Bloomberg) -- **The slumping Canadian dollar may get a reprieve as the Bank of Canada shifts focus from economic growth to fighting inflation.** The currency rose against its U.S. counterpart yesterday for the first time in eight days, snapping the longest slide since 2005, and rallied versus the euro and yen after central bank Governor [Mark Carney](#) unexpectedly kept the target interest rate on overnight loans between banks at 3 percent. All 30 economists surveyed by Bloomberg expected a reduction. ``It's very clear that the Bank of Canada's inflation assessment has shifted," said [Jens Nordvig](#), a strategist at [Goldman Sachs Group Inc.](#) in New York. ``The bank seems to be firmly on hold for now. The U.S. dollar will have a harder time to significantly break higher in the near term as the market digests this shock." Canada's dollar strengthened to C\$1.0173 per U.S. dollar at 7:49 a.m. in Toronto, from C\$1.022 yesterday and C\$1.0233 on June 9. One Canadian dollar buys 98.26 U.S. cents. The currency fell as low as C\$1.0323 before the central bank's announcement, the weakest since April 1. Goldman advised clients to close out trades betting on a decline in the loonie, as the currency is known because of the bird on the one-dollar coin, before the rate decision. Nordvig still expects the currency to weaken to C\$1.06 this year. ``Today's surprise should be bullish for the Canadian dollar in the near term," [Daniel Waldman](#), the New-York-based senior foreign exchange economist at Barclays Capital Inc., wrote in a note to clients. Barclays expects the currency will end the year at C\$1.01. Canada's dollar surged 17 percent in 2007 as the price of crude oil rose 57 percent. Commodities, such as oil and gold, account for about half of Canada's exports. The currency traded one-for-one with the U.S. dollar in September for the first time in three decades. The dollar is still forecast to decline to C\$1.08 in the first quarter of 2009, according to the median forecast in a Bloomberg survey of 32 analysts. ``You're seeing a significant adjustment on the interest- rate side after the Bank of Canada's surprise move," said [Tom Fitzpatrick](#), New York-based global head of currency strategy at [Citigroup](#). Canada's [annual inflation](#) unexpectedly accelerated for the first time in five months in April on higher fuel and mortgage costs. Consumer prices rose 1.7 percent from a year earlier, and [0.8 percent from March](#), the most in more than a year. **Canada Dollar Slump May Slow With Inflation Focus**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aXMdgnuLToM4&refer=home>

- June 10 (Bloomberg) -- **The dollar rose to a three-month high against the yen after Federal Reserve Chairman Ben S. Bernanke said the risks of a ``substantial downturn" in U.S. economic growth have diminished. The U.S. currency extended gains against the euro after Bernanke also said the central bank will resist a jump in price expectations, signaling the Fed has finished lowering interest rates. U.S. Treasury Secretary Henry Paulson said yesterday in an interview with CNBC that he would ``never" rule out currency intervention to prop up the dollar.** ``The dollar is being bought, as Bernanke kept the focus on inflation risks," said Masafumi

Yamamoto, head of foreign-exchange strategy in Tokyo at Royal Bank of Scotland Group Plc, the world's fifth-largest foreign-exchange trader. **``He is aiming to stem inflation expectations without raising actual interest rates.**" The dollar rose to 106.78 yen, the highest since Feb. 27, before trading at 106.77 yen at 9:22 a.m. in Tokyo from 106.31 yen late yesterday in New York. Against the euro, the dollar rose to \$1.5581 from \$1.5646. Japan's currency traded at 166.27 per euro from 166.33. The dollar may rise to \$1.54 a euro and 108 yen by Sept. 30, Yamamoto forecast. Paulson told CNBC he hasn't ruled out any policy option, including intervention in the foreign-exchange market. He declined to say whether the Treasury was currently contemplating such a move. The dollar rallied on June 3, when Bernanke said the central bank is ``attentive" to the currency and will guard against a jump in inflation expectations. **``This seems quite a significant change in U.S. currency policy," said Masanobu Ishikawa, general manager of foreign exchange at Tokyo Forex & Ueda Harlow Ltd., Japan's largest currency broker. ``Officials are drawing a line in the sand now with verbal intervention to prevent the dollar from falling to a level where actual intervention is likely. The tide of dollar- negative sentiment is about to turn.**" The dollar has fallen 11 percent against the euro and 9 percent versus the yen since September, when the Fed began to lower borrowing costs from 5.25 percent. UBS AG, the second- biggest currency trader, yesterday cut its one- and three-month dollar forecasts against the euro to \$1.60 and \$1.53, from \$1.50 and \$1.47, previously. G-8 Action Finance ministers of the Group of Eight industrialized countries may consider joint action to deflate the price of oil and prop up the dollar at their meeting June 13-14 in Japan, said DBS Group Holdings Ltd. in a report to clients. **``The market has linked a weaker U.S. dollar to higher oil prices, and vice versa," the firm said. ``That's why a lot is riding on the weekend meeting.**" The last time the major industrialized countries intervened was on Sept. 22, 2000, when they bought the euro after it tumbled 27 percent from its 1999 debut. They last propped up the dollar in 1995, when it sank almost 20 percent in four months against the Japanese yen to a post-World War II low of 79.95 yen. ECB Rate The greenback dropped 1.4 percent against the euro last week, the most since March, after European Central Bank President **Jean-Claude Trichet** said on June 5 that policy makers may raise borrowing costs in July to contain inflation and the U.S. Labor Department reported the next day that the jobless rate increased the most in May in more than two decades. **``Oil got punished, and that helped keep the dollar firm," said Tim O'Sullivan, chief foreign exchange trader at Forex.com, a unit of online currency trading company Gain Capital in Bedminster, New Jersey. ``Treasury yields are higher, which is extremely dollar-positive."** **Dollar Rises Against Yen as Bernanke Sees Less Risk to Economy**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ad5M8BrHd5MI&refer=home>

Diversification

Derivatives

- **MORAL HAZARD and ANTI-TRUST institutionalized – it is truly a proud moment in the US capital markets -** June 10 (Bloomberg) -- Regulators and banks

agreed to changes aimed at easing the risk of a collapse in the \$62 trillion market for credit-default swaps. **Morgan Stanley, Deutsche Bank AG and Goldman Sachs Group Inc. are among the 17 banks creating a system to move trades through a clearinghouse that would absorb a failure by one of the market-makers, the Federal Reserve Bank of New York said yesterday in a statement following a meeting with the firms.** This will reduce "the systemic risk when a large counterparty fails," Tim Brunne, a Munich-based credit strategist at UniCredit SpA, said in an interview today. "A large portion of the market would be trading against the central counterparty, and that would be a good thing." A central counterparty, more automated trading and settlement and other fixes "will help improve the system's ability to manage the consequence of failure by a major institution, and we expect to make meaningful progress over the next six months," New York Fed President **Timothy Geithner** said in a speech to the Economic Club of New York yesterday. 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 should the company fail to adhere to its debt agreements. Investor concern that the market may fail was fueled in March when **Bear Stearns Cos.**, then the fifth-biggest U.S. securities firm, faced a cash squeeze. The central bank agreed to back an emergency sale of Bear to **JPMorgan Chase & Co.** in part because of the systemic losses that would have resulted if the firm had filed for bankruptcy, Geithner said.

Liquidity 'Key' The Fed has conferred with banks since September 2005 to improve processing and settlement in the market. Ten of the 17 banks at the meeting yesterday were owners of Chicago-based Clearing Corp., which has said it will start guaranteeing credit-default swap trades by September. A guarantee may encourage more trading of credit-default swaps, said **NanaOtsuki** of UBS AG, one of the banks involved in the agreement. "Increasing liquidity as a result of the settlement house would be the key," said Otsuki, head of debt and equity research for Japanese financial institutions at UBS in Tokyo. "Larger trading volume means higher efficiency." The group will reduce the volume of outstanding contracts through multilateral trade terminations. They also agreed to extend the changes in credit-default swaps to other derivatives contracts backed by equities, interest rates, currencies and commodities. **Fed, Banks Agree Default-Swap Changes to Reduce Risk**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=asNCB5JkQOyE&refer=home>

Housing

- Foreclosure filings rose 48% from a year ago and bank repossessions more than double in May, according to the latest report from RealtyTrac. One in every 483 U.S. households received a foreclosure filing during the month, the highest monthly foreclosure rate since RealtyTrac began issuing its report in January 2005. **Bank repossessions (REOs) accounted for 28 percent of the total activity and the biggest increase among the three types of foreclosure filings tracked in the report. REOs were up 35 percent from the previous month and 158 percent from May 2007, RealtyTrac said. The Countrywide (CFC) Foreclosures blog (see their REO charts here) does a great job of tracking REO's. Why are REO's worth tracking? Because these properties - bank**

owned properties - are the least price sensitive. An increase in REO's translates into further downward pressure on prices. Minyanville

Housing Finance

- **Elsewhere in Washington, the Federal Housing Administration quietly admitted yesterday a \$4.6 billion loss.** The FHA, the government's mortgage financier and insurer, is suffering unexpectedly high default rates on home loans. Gasp! Can you believe it?! The FHA has found its own special way to put its business in jeopardy: the seller-financed down payment mortgage. **That's when the seller covers the buyer's down payment and then adds the payment to the total price of the loan... an awesome way for people with zero capital and horrible credit to own a home.** Who would have thought these wouldn't pan out? Not the FHA... seller-financed down payment mortgages account for over 30% of their loan portfolio. FHA officials announced that it had to extract over \$4 billion from its measly \$21 billion capital cushion to cover the losses. "No insurance company can sustain that amount of additional costs year after year and still survive," admitted FHA chief Brian Montgomery. "Unless we take action to mitigate these losses, FHA will soon either have to shut down or rely on appropriations to operate."

Macro Economic

- June 13 (Bloomberg) -- **After six decades of ever-expanding international commerce, the high tide of free trade is ebbing.** As tens of thousands of South Koreans protest U.S. beef imports, rising commodity prices push nations to keep more food for domestic consumption and the U.S. chooses a new president who might be less supportive of free trade than his immediate predecessors, the world may be facing the end of a cycle that began in the immediate aftermath of World War II. **The liberalization of global trade has come ``to a screeching halt," said Fred Bergsten, director of the Peterson Institute for International Economics in Washington. ``It'll take years to rebuild the foundations of free-trade policy."** The cause is more political than economic. "This is a challenging time to be in the pro-trade wing of any party in virtually any country," U.S. Trade Representative **Susan Schwab** said June 12 at the U.S. Chamber of Commerce. "It's hard to be for open trade, whether you are in India or the European Union or in China." **Fueling the backlash is a convergence of trade-related anxieties: national-security concerns, worries about food safety and sufficiency, the desire to protect local jobs and the environment. In addition, the benefits of trade are often widely dispersed --** think low prices at Wal-Mart -- and entail high adjustment costs, including the loss of manufacturing jobs. Beggar-Thy-Neighbor The modern era of trade dates to the late 1940s, when the U.S. and United Kingdom pushed for the establishment of a global organization to avoid the beggar-thy-neighbor policies often blamed for exacerbating the Great Depression. **The General Agreement on Tariffs and Trade, established in 1948, succeeded in cutting industrial duties in developed countries from an average of 40 percent to about 4 percent over six decades.** Now known as the World Trade Organization, it is stuck in negotiations that began in 2001 over U.S. and European agricultural subsidies. The Doha Round, as the talks are called, has also been

held up by disagreements between rich and poor countries about how much to reduce import taxes. "The Doha Round isn't dead yet, but it's being pushed around a nursing home," said [Doug Goudie](#), director for international trade at the National Association of Manufacturers in Washington. The EU's Concerns European Union trade negotiators expressed concern this week about "a re-emergence of protectionist sentiment in the U.S." after Congress approved a new \$289 billion farm bill that extends price supports and other subsidies developing nations oppose. The bill "heads agriculture policies in the wrong direction at a decisive juncture" of WTO negotiations, a group of agriculture-exporting countries led by Brazil said in a June 3 statement. "The unfair competition brought by subsidies hinders the process of market liberalization." **Reservations about a new WTO agreement have grown into a general aversion to free trade in many countries, including France and Italy, where cheap imports are blamed for job losses.** That's causing some governments to rethink their pro-trade policies. Most important is the U.S., the world's largest economy and biggest importer. Democrats, who took control of Congress in 2007, have postponed a decision on a trade deal with Colombia by amending so-called fast-track authority, which guards against amendments and filibusters and requires a timely vote. Undermining the Foundation **Their action "undermined the whole foundation of U.S. trade policy," Bergsten said, adding that it creates a loss of confidence in the U.S. to lead the way on trade. Luis Guillermo Plata, Colombia's trade minister, said April 11 that U.S. rejection of the accord would be tantamount to imposing "trade sanctions" on one of America's staunchest allies.** Meanwhile, Democratic presidential candidate [Barack Obama](#) says that if elected, he might reopen the world's largest trade deal, the North American Free Trade Agreement with Canada and Mexico. All these developments "are portents that the politics of trade are certainly becoming more difficult," said [Claude Barfield](#), a trade expert at the American Enterprise Institute in Washington. Shaking South Korea **Nowhere is that more evident than in South Korea, where public anger related to a pact aimed at increasing trade with the U.S. by 20 percent is shaking the government of President Lee Myung Bak.** Lee has seen his popularity plunge from 50 percent when he took office in February to 17.1 percent in a poll this month by Korea Research and the YTN cable news network; his cabinet this week offered to resign over the dispute. New Barriers The 60 percent increase in the [price](#) of rice, wheat, corn and other food commodities since the beginning of 2007 has led some nations to erect new barriers to exports to make sure they have adequate supplies at home. India, the world's second-biggest producer of rice and wheat, has banned shipments of the food grains. Egypt, Vietnam and Indonesia have also banned certain food exports. And Philippines President [Gloria Macapagal-Arroyo](#) said her country wants to become self-sufficient in food production by 2010. **For a long time, it made sense to buy food from the international market," Arthur Yap, the Philippines agriculture minister, said in an interview. "The situation has changed."** [Doug Irwin](#), an economic historian at Dartmouth College in Hanover, New Hampshire, and author of "Free Trade Under Fire," said much of the current opposition to trade may subside when [commodity prices](#) fall and the U.S. economy recovers. "Free trade is always being attacked," Irwin said. "The question is, how high is the threat level?" **Free-Trade Era May Be Nearing End Amid Food, Growth Concerns**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a2TmFExZud8A&refer=home>

- June 13, 2008 FT **Inflation is rising so quickly that the Treasury is preparing to receive on Tuesday only its second letter from the Bank of England explaining the jump, even before it has seen the figures.** Speaking ahead of the Group of Eight finance ministers' meeting in Osaka, Alistair Darling, chancellor of the exchequer, said: **"The twin shocks of the credit crisis and commodity price inflation are affecting economies right across the world, including our own."** "These are global issues which will require concerted international action and will be at the heart of discussions at the G8 meeting this weekend." **Mervyn King, the Bank governor, is required to write to the chancellor if consumer price inflation moves more than a percentage point from its target rate of 2 per cent, explaining why it has shifted so far and what the Bank is doing to address it.** In its 10 years of independence, the Bank has only had to write one letter, last April. Only one letter was needed last year as CPI fell quickly from its peak of 3.1 per cent, **but Mr King has indicated that he now expects to write a series of letters because high inflation will be more persistent. He must pen a new letter every three months that inflation remains above 3 per cent.** The parts of the governor's letter explaining inflation's rise will be easy to draft – oil prices have nearly doubled in the past year and food prices in commodity markets have gone up by 40 per cent. But having cut interest rates three times since last summer, and with the public's expectations of inflation over the coming year having risen to 3.9 per cent, **the elements explaining what the Bank is doing to address high inflation will be trickier to draft.** Speaking last month, Mr King said in a pointed reference to the US Federal Reserve: **"I think we might point out in that letter that we did not fall prey to the sirens who were pressing us to cut interest rates as rapidly as some other central banks have done".** **Treasury braces for inflation letter from King** http://www.ft.com/cms/s/0/fb1af71e-3943-11dd-90d7-0000779fd2ac.html?nclink_check=1
- June 13 (Bloomberg) -- **Babcock & Brown Ltd.** plunged to a record low in Sydney amid a "crisis of confidence" among investors after the company's market value fell below a level allowing lenders to review A\$2.8 billion (\$2.6 billion) of debt. Babcock tumbled as much as 32 percent, and the company's market value has more than halved this week. UBS analyst **Jonathan Mott** cut his stock rating on the manager of infrastructure assets such as ports and railways to "neutral" from "buy," citing a "crisis of confidence" among investors. "The market is sending a very clear message to Babcock that it no longer has confidence the company can keep on bucking the effects of high debt levels," said **Geoff Wilson**, who helps manage \$385 million at Wilson Asset Management in Sydney. "The banks may try to keep it alive, but it looks like investors have had enough."
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a4.YJ6V1bGKA&refer=home>
- June 12 (Bloomberg) -- **Babcock & Brown Ltd.**, Australia's second-largest securities firm, dropped to the lowest in almost four years in Sydney trading as the company said it's being targeted by short sellers. "There are investors out there who don't believe in Babcock's business model anymore," said **Michael Birch**, who helps manage the equivalent of \$140 million at Wallace Funds Management in Sydney. "Babcock has highly geared assets, and people are nervous about debt right now." Babcock and larger

rival [Macquarie Group Ltd.](#) have slumped this year, even as they avoided the worst of the U.S. subprime contagion that's led to writedowns and credit losses of more than \$390 billion worldwide. **Babcock Slumps in Sydney Trading on Short-Selling**
http://www.bloomberg.com/apps/news?pid=20601087&sid=a.Msr_GjT1Mk&refer=home

- June 10 - Investors in China, however, had no such dilemma. **The Shanghai Composite plunged 7.7% as we slept last night.** Chinese markets were closed the day before, so this morning's session was the first chance to react to Friday's bloodbath on Wall Street. **Plus, the Chinese central bank announced it would be raising the required reserve ratio for banks yet again. The People's Bank of China has moved the RRR 15 times in the last year and a half.** That may be a welcome relief for those watching Chinese growth and inflation... but for Shanghai Composite investors, already down 42% this year, it was just another reason to sell. DR
- June 9 (Bloomberg) -- Sky-high gasoline prices aren't just raising the cost of Eugene Marino's 120-mile (193-kilometer) round-trip to his job in the Washington area. They're reducing his wealth, too. House prices in his rural subdivision beyond the Blue Ridge Mountains in Charles Town, West Virginia, have plunged as commuting expenses have soared. A four-bedroom home down the street from his is listed for \$239,000, after selling new for \$360,000 five years ago. Homeowners in the exurbs aren't the only ones whose assets have taken a hit because of the surge in energy costs. Companies such as [General Motors Corp.](#) are writing off billions of dollars in plants and equipment that are no longer viable in an age of dearer oil. The destruction of wealth and capital will weigh on U.S. growth for years to come. **“Our whole economy reflects the relative costs of energy: the cars we drive, the houses we occupy, the kinds of factories we have and the equipment in them,” says Dana Johnson, chief economist at Comerica Bank in Dallas. “I’m expecting relatively large changes in all of these things.”** The loss of wealth could be a double whammy for the U.S. economy. In the short run, it depresses demand as homeowners save more and spend less, and companies fire workers. **Longer run, it curbs productivity growth, as firms shift their focus from increasing worker efficiency to reducing energy costs.** The lifestyle of the exurban commuter may be one casualty. Emerging suburbs and exurbs -- commuter towns that lie beyond cities and their traditional suburbs -- grew about 15 percent from 2000 to 2006, nearly three times as fast as the U.S. population, as Americans moved further out in search of more affordable houses or the bigger ones that are sometimes derided as McMansions. “It was drive until you qualify” for a mortgage, says Robert Lang, director of the [Metropolitan Institute at Virginia Tech](#) in Alexandria, Virginia. “You can't do that anymore. Your cost of transportation will spike too much.” The 38-year-old Marino, an archeologist for the U.S. Fish and Wildlife Service, is among those feeling the pinch. “Eating out and discretionary income are a thing of the past for us,” he says. Declining Value He reckons he once could have sold his 2,700 square-foot (250 square-meter), four-bedroom house for around \$450,000 based on the value of other homes in the neighborhood. Now he figures it's worth about \$330,000. **Gasoline prices have doubled his commuting costs since he bought his home in 2003, he says.** “Gas prices are really hurting demand here,” says Celia Lainez, a broker at Keller Williams Rice Realty in Martinsburg, West Virginia. She says she has yet to receive a bid on the house down the street from Marino's, which has been on the market for five months. **Nationwide, home prices in**

neighborhoods with long commutes and no public transportation are falling faster than prices in communities closer to cities, according to a study by Joseph Cortright, an economist at Impresa Consulting. For example, his study found that prices in distant suburbs of Tampa fell 14 percent in the last 12 months, versus a 9 percent drop in areas nearer the city. Suburbs, Exurbs ``The decline in almost every case is worse in the suburbs and exurbs than it is in close-in neighborhoods because transportation costs are so much more of a factor," says Cortright, whose Portland, Oregon, firm studies regional economies. Americans are trying to cope by switching from gas-guzzling trucks and sport-utility vehicles to more energy-efficient cars. Asian automakers outsold Detroit's Big Three in the U.S. for the first time last month as buyers left GM and **Ford Motor Co.** trucks on dealer lots in favor of Honda Civics and Toyota Corollas. ``This is a fundamental change," Ford Chief Executive Officer **Alan Mulally** told reporters last month. The Dearborn, Michigan-based company plans to temporarily idle its Wayne, Michigan, SUV plant and cut production at its Louisville, Kentucky, pickup-truck facility. `Obsolete' Capital Stock ``The change in energy prices makes a portion of the capital stock obsolete," says **Richard Berner**, co-head of global economics at Morgan Stanley in New York. ``That will depress demand." Zandi at Moody's Economy.com says permanently higher fuel costs will depress productivity growth during the next three to five years as companies retool to boost energy efficiency. That's what happened in the 1970s, as successive oil shocks, coupled with increased environmental regulation and other factors, led to a sharp slowdown in productivity growth. Federal Reserve Chairman Ben S. Bernanke said in a June 4 speech at Harvard University that he doesn't see a return of 1970s-style stagflation, in part because the economy is more flexible and adaptable than it was back then. That doesn't mean the future will be pain-free, others say. ``We're going to see some companies go out of business," says economist **Philip Verleger**, president of PKVerleger LLC in Aspen, Colorado. ``There is going to be a large amount of wealth destroyed." **Wealth Evaporates as Gas Prices Clobber McMansions**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aFc9HNAhHrPc&refer=home>

Retail

Retirement

- Both asset managers and advisers are vying to provide new retirement-income strategies for investors, according to a new report. The analysis, titled "Product Development in an Evolving Portfolio Construction Environment," was done by Boston-based Cerulli Associates Inc. and obtained exclusively by *InvestmentNews*. Two-thirds of asset managers surveyed are planning to develop alternative investments or products that blend traditional and alternative strategies, according to the study. The vast majority of offerings are packaged products, the report says. In 2007, open-end funds, closed-end funds, ETFs and variable annuities made up \$8.9 trillion of the \$10.2 trillion in assets under management. Portfolio solutions accounted for only \$1.3 trillion under management. Despite these findings, the study shows that there are still opportunities for portfolio construction. Faced with loss of controls and declining profit margins, many asset managers hope to develop higher fee revenue from retirement-income strategies and other advice-product solutions. "Broker/dealer home offices and platforms want to

maintain control over portfolio construction, and many advisers still view portfolio construction as the principal value they add to the client relationship, which may limit the opportunity for asset-manager-controlled-portfolio-solution-type products,” the report stated. The majority of asset managers agreed that financial advisers currently enjoy the greatest degree of control over portfolio construction. But they believe that broker-dealers will acquire more control over the next five to 10 years.

<http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080613/REG/536211869/1094/INDaily01>

Risk

Savings Rate

Tech

The Fed

- Chairman Ben S. Bernanke At the Federal Reserve Bank of Boston’s 52nd Annual Economic Conference, Chatham, Massachusetts June 9, 2008 Before turning to those issues, however, I would like to provide a brief update on the outlook for the economy and policy, beginning with the prospects for growth. **Despite the unwelcome rise in the unemployment rate that was reported last week, the recent incoming data, taken as a whole, have affected the outlook for economic activity and employment only modestly. Indeed, although activity during the current quarter is likely to be weak, the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so.** Over the remainder of 2008, the effects of monetary and fiscal stimulus, a gradual ebbing of the drag from residential construction, further progress in the repair of financial and credit markets, and still-solid demand from abroad should provide some offset to the headwinds that still face the economy. However, the ongoing contraction in the housing market and continuing increases in energy prices suggest that growth risks remain to the downside. One of the most effective means by which the Federal Reserve can help to restore moderate growth over time and to reduce the associated downside risks **is by supporting the return of financial markets to more-normal functioning. [This is priceless. Government intervention to return free markets to “normal functioning”. Guess what - a free market does NOT INCLUDE government meddling – that is why it is called a FREE market]** We have taken a number of actions to promote financial stability and remain strongly committed to that objective. Inflation has remained high, largely reflecting sharp increases in the prices of globally traded commodities. Thus far, the pass-through of high raw materials costs to the prices of most other products and to domestic labor costs has been limited, in part because of softening domestic demand. However, the continuation of this pattern is not guaranteed and future developments in this regard will bear close attention. Moreover, the latest round of increases in energy prices has added to the upside risks to inflation and inflation expectations. **The Federal Open Market Committee will strongly resist an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for**

inflation. [still standing by aren't you Ben???

<http://www.federalreserve.gov/newsevents/speech/bernanke20080609a.htm>

- The *Wall Street Journal's* website today says New York Federal Reserve Bank president Timothy Geithner thinks we need more central bank regulation of financial markets. Like it or not, Geithner is drawing the shape of things to come. If not from me, take it from an old hand, Paul Volcker, the former Fed chairman who raised interest rates to kill inflation in the 1970s and 1980s. **Volcker says the Fed's actions earlier this year "extended to the very edge of its lawful and implied power, transcending certain long embedded central banking principles and practices."** "Transcend" in this case is a euphemism for "throw out the window." Volcker also said the Fed's earlier moves "will surely be interpreted as an implied promise of similar action in times of future turmoil." More crises. More Fed intervention... making everything worse.
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Wall Street

- June 9 (Bloomberg) -- It's been at least 10 years since *Lehman Brothers Holdings Inc.* Chief Executive Officer *Richard Fuld* watched his company's share price drop 50 percent from the peak, assets on the books shrink 15 percent from their highs, and his bankers rush to raise enough capital to withstand any run on his firm. Now, as Lehman reports a \$2.8 billion loss -- its first since the company's spinoff from American Express Co. in 1994 -- Fuld is doing everything he can to ensure that the fourth- largest securities firm survives another year if not the next 10. **Trouble is he's discarding some of the elements that enabled New York-based Lehman to report faster earnings growth from 2002 to 2007 than any of his competitors except Goldman Sachs Group Inc.** "They're doing all the right things, such as de-leveraging aggressively, but these are stressful times, and they don't always get the credit they deserve," said UBS AG analyst *Glenn Schorr*, who has a "neutral" rating on Lehman. "Although Lehman is very different than Bear, there's one similarity, and that's what could undo all the other positives: perceptions can become reality." **Lehman said last week it trimmed its so-called matched book, made up of short-term lending backed by short-term borrowing, during the second quarter, helping increase the firm's cash position by about one third to \$45 billion.** Capital Lehman has more than twice as much cash as Bear Stearns before its sale to *JPMorgan Chase & Co.* It will have almost three times as much capital -- \$35 billion after today's planned capital raising -- as Bear Stearns had. After the asset sales and \$4 billion of Tier 1 capital raising during the quarter, **Lehman's leverage ratio -- total assets compared with equity -- fell to 25 from 32 at the end of the first quarter, compared with 34 at Bear Stearns, 33 at Morgan Stanley and 24 at Goldman Sachs, the biggest U.S. securities firm by market value, data compiled by Bloomberg show.** Lehman may sell about \$120 billion more of assets this year, *Ladenburg Thalmann & Co.* analyst *Dick Bove* estimates. With the planned capital boost, Lehman's leverage ratio would drop to about 15, based on Bove's forecast. **By de-leveraging, Lehman is reducing its chances of ever being as profitable as it was in 2006, said Michael Hecht, a New York-based analyst at Bank of America Corp. The firm's return- on-equity will be half its average of the past 10 years, according to Hecht. The decrease in risk taking by Lehman will inevitably mean lower**

profitability, according to Sanford C. Bernstein & Co. analyst Brad Hintz in New York. Risk Profile "For the next couple of years, Lehman limps along with earnings that will be significantly below what they were earning in previous years," Bove said. Lehman has shed 6,400 jobs since last July, or 25 percent of the workforce, the highest percentage of cuts among banks and brokers, according to Bloomberg data. Chief Financial Officer Erin Callan said in April that the decline in risk profile would be somewhat offset by the higher premium Lehman and other Wall Street firms can charge clients in a market where credit is scarce. Citigroup Inc. analyst Prashant Bhatia expects return on assets to climb because of "a premium being put on capital going forward." "We are buyers of the stock on the assumption that Fuld will steady the Lehman ship and, with greater stability, the stock will appreciate," Deutsche Bank AG analyst Mike Mayo wrote in a report to clients last week. Loss Compounded Lehman's second-quarter loss was compounded by market bets against mortgage indexes that were made in preparation for the company's de-leveraging effort, according to people familiar with the investment bank's finances. Lehman lost \$500 million to \$700 million from the trades when the indexes rose, the Financial Times reported last week, citing people close to the matter. "Fuld should have known better than piling on assets as the mortgage market was peaking," Bove said. "But Fuld is a hands-on manager, so he's biting the bullet and bearing losses as he sells assets. Lehman will come through with this." Hedge fund manager David Einhorn, who has bet Lehman's shares will fall, has criticized the firm's accounting techniques, saying it hasn't taken realistic markdowns on its mortgage portfolio. Although an index of commercial mortgage-backed bonds fell 10 percent in the first quarter, Lehman's writedowns on its \$39 billion portfolio was 3 percent, Einhorn said in a speech last month. While Einhorn expects Lehman's losses to increase as it takes further asset writedowns, he said last week that he doesn't expect the company to collapse. Market Sentiment At the end of the first quarter, the company had the largest ratio of mortgage-related assets to equity among its Wall Street competitors, according to Hintz of Sanford Bernstein. The reduction in the second quarter still leaves about \$100 billion of hard-to-sell assets, including leveraged loans, on the balance sheet, and there may be further losses as Lehman unloads them, said David Trone, a New York-based analyst at Fox-Pitt Kelton Cochran Caronia Waller. Lehman has lost more than half its market value this year, making it the worst performer in the 11-company Amex Securities Broker/Dealer Index. After Standard & Poor's downgraded Lehman, Morgan Stanley and Merrill Lynch & Co. last week, Lehman fell twice as much as its New York-based rivals. "Every time something bad happens in the markets, Lehman shares go down the most because they're seen as more vulnerable," said Corne Biemans, a Boston-based senior portfolio manager at Fortis Investments, which oversees about \$200 billion. The global financials fund Biemans manages doesn't own Lehman shares, though other Fortis funds do. Last week's decline was triggered by S&P's downgrade to A from A+ and worsened with speculation that Lehman was borrowing from the Federal Reserve because it faced a cash shortage. Officials at the firm denied the Fed facility gossip on June 3 and three analysts published reports in the next two days urging investors to buy the stock. Lehman still fell 12 percent last week in New York Stock Exchange composite trading to close at \$32.29 on June 6, bringing this year's decline to 51 percent and to 62 percent since February 2007, when the subprime crisis began. Hedge-Fund Clients As the company hunkered down with asset sales and capital

raisings, it gained a powerful weapon that Bear Stearns didn't have: access to federal funds. The day it brokered the sale of Bear Stearns to JPMorgan, the third-biggest U.S. bank by assets, the Fed made a new facility available to all broker-dealers, allowing them to borrow cash directly just like commercial banks. **“The Fed has telegraphed that nobody is going down this time, but that doesn't seem to be enough to erase the concerns,” said Peter Goldman, a managing director at Chicago Asset Management, which oversees about \$500 million.** Bear Stearns failed to raise any capital, even as concerns about its future increased. Lehman sold \$1.9 billion of perpetual preferred shares in February and followed that up with a \$4 billion capital infusion on April 1 from the sale of preferred stock. Pension Fund Talks Unlike Bear Stearns, Lehman has “better friends around the Street” to turn to for money in times of need, UBS's Schorr said. Among those are clients of Lehman's asset-management business, which accounted for about 25 percent of **first-quarter revenue**, said Ladenburg Thalmann's Bove. Fuld spent the past five years diversifying the firm's business. He has made Lehman the largest trader of stocks on the London Stock Exchange and Euronext, and the fifth-biggest adviser of U.S. mergers. Today, half of Lehman's revenue comes from outside the U.S. `Rational Analysis' **“Market reactions** these days aren't based on rational analysis; it's all about sentiment,” Jalics said. “With the turmoil in the market and the uncertainty about funding and liquidity issues, nobody knows for certain what might happen.” **“The U.S. financial sector cannot see another bank go sour,” said Marino Marin, a former Lehman banker now a New York-based managing director at investment bank Gruppo, Levey & Co. “It would be devastating for the global financial system and hurt confidence.” [moral hazard] Lehman Cuts \$130 Billion of Assets to End Bear Stigma**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=awH4ISOm6eDk&refer=home>

Don't Fight The Fed

I Disagree . . . and why

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Trader, father, veteran, convict

As famous CEOs marched off to jail, so did lots of guys like Craig Gile. The Citigroup trader had a wonderful life - until the Feds decided to make an example of him. Was it fair?

By [Betsy Morris](#), senior editor

(Fortune Magazine) -- To friends, the idea that Craig Gile would end up in prison just didn't make sense. He was the guy on the tennis court who went out of his way to correct line calls.

For most of his 44 years, Charles Craig Gile led a charmed life. Honor student, captain of the basketball team, degrees from Vanderbilt and Wharton, medals for service as a naval aviator in Desert Storm, a Citigroup commodities trader with a cedar-shingle house on the Connecticut shore and a Christmas-card-perfect family - a lovely wife and three rambunctious boys.

Since last August, though, he has been Inmate No. 59449-054, dressed in a dark-green prison uniform in a place he had never on his worst day imagined he'd spend time: the federal prison camp in Jesup, Ga. "This notion of a Club Fed is terribly inaccurate," he said recently. "That place doesn't exist. No golf. No tennis. No lobster. No nice meals - unless you consider the bologna soup we had a couple of weeks ago a nice meal. I live in an open-air cinderblock building. Sleep in a triple-decker bunk bed. There are six toilets. Seven showers for 78 men."

It has been a far cry from the life he was used to - barbecues and tennis, homework and Little League. In prison, breakfast is at six. Room inspection at 7:45. On Wall Street he traded complex energy derivatives. At Jesup his first job was washing windows. He moved up to teaching math, science, and finance classes to other prisoners, getting paid \$9.80 a month. Dinner is at 3 P.M. The day is punctuated by roll calls to make sure nobody has escaped. Each month a prisoner is allotted 300 minutes to phone home. For Gile it has been nine months of shame and sadness, severe back pain, and homesickness. "It's been a horrible experience," he said in one of two interviews with Fortune in prison. "This will forever leave a mark on me and my family."

In May 2007, Craig Gile was sentenced to a year and a day in prison after pleading guilty in U.S. District Court in Manhattan to one count of conspiracy to falsify bank records and commit wire fraud at Citigroup, where he was head of American sales and trading on the commodities desk. Federal prosecutors accused Gile and his boss, David Becker, of overstating the value and understating the risk of their trading positions in complex energy-based derivatives in late 2003 and early 2004 in order to boost their year-end bonuses. They had allegedly inflated their department's profits by a total of \$20 million, with the help of a broker in Englewood, N.J., who was supposed to be independently verifying their calculations to Citi.

Is Gile guilty? That's how he pleaded to avoid the risk of a much longer sentence. He told the judge he was "truly sorry." But his real sorrow was that he had to give up what he desperately wanted: the chance to clear his name. He had little hope that a jury would understand or accept his rationale for the valuation of complex derivatives, let alone that he could convince it that his efforts to fix the problem were a sign of his good intentions rather than a cover-up. His lawyers warned him he could end up spending as much as five years in prison, not to mention \$1 million on a trial, if he were to lose. So after months of anguish, he took a plea deal, and on the last day of school in Longwood, Fla., where he had moved his family, he fired up the grill on his backyard patio for an end-of-school barbecue and sat down his three sons (ages 13, 11, and 9) to explain why their dad would be going to prison.

Following orders

He was following his boss's orders, he told them. He was probably too trusting. He didn't know exactly what the rules were. He used examples the boys could relate to, recalls his wife, Maureen

And she reports all the names to the police, then you're in trouble too, even if you didn't throw the ball." His name is pronounced like "guile," but any similarity seems to end there. Recently, sitting at a folding table in the cinderblock training center at the Jesup prison, it is clear that Gile is a mix of sadness, regret, some denial, and sheer wonder at how things could've gone so wrong so fast. "I think there are hundreds, if not thousands, of traders who work on Wall Street every day valuing their portfolios, and they view it as being an internal bookkeeping function, and they don't realize that they are at risk of ending up here."

At sentencing, the judge said he was sorry too, but felt he had to make a point. U.S. District Judge Robert W. Sweet ordered Gile to repay the bank \$185,819 as restitution for the inflated bonus. And a prison sentence was necessary, the judge said, to act as a deterrent. "I regret it. I wish it were otherwise.... But I think you have been a participant in a culture about which one cannot be tolerant."

Actually, it's more complicated than that, which is why Craig Gile is more a parable than a criminal. His is the story of a good guy navigating an especially tricky era of American business. You could call it the wink-and-a-nod era. Bosses want results but not too many details. At what point does a stretch goal become a step over the line? When does adept managing become managed earnings? Seeing the distinction is made all the more difficult by extreme innovation and hyper-competition. This is especially true on Wall Street, where it's commonplace to trade exotic derivatives that are so illiquid they might only have one customer. As a result, it's also common for traders to book the highly subjective value of their own complicated and volatile derivative trades, despite the obvious inherent conflict of interest.

Wherever the line is, it was thoroughly trampled as every major financial institution, including Citigroup, ([C, Fortune 500](#)) rushed to get in on the derivatives-trading boom. The generals at those firms made clear that they wanted a big piece of the action, and the foot soldiers on the trading desks reacted accordingly. When Becker also pleaded guilty, his lawyer told the court his motivation was not to get a bigger bonus but to make his budget and please his superiors. "The type of conduct that got Craig Gile ensnared in the criminal justice system is conduct that I believe is in many ways routine on Wall Street," says Roland Riopelle, Gile's lawyer, who handles many white-collar cases. The kind of derivatives that Gile was "attempting to value on the books of his employer are extremely hard to value and I believe are often overvalued by those who deal in them. I think this is a common practice."

As Gile was settling into his new job on the Citigroup commodities desk in 2003, two countercurrents were in full swing. One was a post-Enron crackdown on white-collar fraud that would eventually ensnare not just Kenneth Lay and Jeffrey Skilling but hundreds of other executives (yes, hundreds), ranging from VPs to CEOs. The other was the derivatives-trading boom that would come to grief a few years later, when securities tied to subprime mortgages came crashing down. While banks have written off tens of billions of dollars and the Federal Reserve has been forced to inject billions to prop up the credit market, the captains of this industry, who led disastrous charges into derivatives, have so far suffered only damaged reputations - while collecting fat severance packages. Gile, who took a step into a million-dollar gray area, went to prison. "There are numerous banks and investment banks that have taken billions and billions of dollars of write-offs, and to my knowledge nobody has been charged with

anything - never mind anybody going to jail," says Gile's friend Eric Blattman, a former hedge fund manager and now a private investor. "When you look at the whole scope of things, what Craig's accused of is like the fly on the back of the elephant."

For anybody who knew him, the idea that Craig Gile would end up in prison just didn't make sense. If it could happen to him, it could happen to anybody. He was the guy on the tennis court who went out of his way to correct line calls- even when they went against him, says a tennis partner. "I can see this or that guy getting caught with his hand in the cookie jar," says John Maloney, a friend and neighbor who started the youth basketball league with Gile in Rowayton, Conn. "But Craig's just not that guy." There was nothing in his past that would suggest a career trajectory like this. He was the kind of eager-to-please kid who left a trail of awards, report cards, and newspaper clippings that his mother, Jean, now sifts through somewhat painfully. There's Craig on the Biddy Basketball team in Norwalk, on the Orange Park All Stars, on the dean's list at Vanderbilt. "Everybody should have a kid like this," says his father, Spike. Craig loosened up a little bit at Vanderbilt, which he attended on an ROTC scholarship, joining a fraternity and playing the kazoo in the popular All Toy Band. But as his friends went off to jobs or grad school, he left for Navy flight school in Pensacola, Fla., and ended up a navigator bombardier on an A-6 Intruder, flying 23 combat missions in Operation Desert Storm. In a letter asking the court for leniency, a fellow pilot described how Gile chided him when he didn't want to take off again to refuel a stranded jet after having just landed on the aircraft carrier in a harrowing thunderstorm. "Craig chastised me and reminded me that our friends were counting on us 'to get them some gas or they're going to be swimming.' He never once thought about himself."

Trader, father... (page 2)

By [Betsy Morris](#), senior editor

By 1996 he had married Maureen, whom he would ever after, on a daily basis, refer to as "the lovely Maureen," or "TLM" in writing, and moved his growing family to Rowayton, a place he never intended to leave. He had fulfilled his ROTC commitments teaching at Penn while simultaneously getting an MBA at Wharton, and then headed straight to Citi to trade bonds. For a family man like Gile, Rowayton was the perfect place from which to catch the 5:37 A.M. Metro North train to Grand Central Terminal - an idyllic little commuter town on Long Island Sound where the husbands spill off the train on Friday nights and head to Bayley Beach. There, they know, the kids will be playing some kind of sport and the wives will be waiting to barbecue. A lot of traders go out drinking in Manhattan after a long day, but Gile couldn't wait to get home. He was a treasurer of the civic association and founder of the youth basketball league.

His annual Christmas letters were filled with humor and happiness. "Maureen has immersed herself and the boys into roughly one gazillion activities," he wrote in 1997. "I think there was one time this calendar year when I phoned home and they were actually there. I didn't know what to say to something other than the answering machine, so Maureen just assumed it was a crank call." In 1998, with Maureen pregnant, he joked, "Should we have another boy, we will be taking donations for straitjackets for TLM," but later added, "The Gile boyz are super-sweet, super-active, and a super good time." The next several years were filled with jokes about the trials and tribulations of tearing down and rebuilding the house the Giles had bought in the beachfront neighborhood of Bell Island. Each letter ended cheerfully with sincere pleas to visit and to have a

"fantabulous holiday season."

'Head-in-the-sand syndrome'

Which is what made the strange odyssey that began for the Giles in early 2004 all the more astonishing. On a winter day in late February, Maureen went to pick up the kids after school, and there at the playground was Craig, in the middle of the afternoon, dressed in his business suit. "Hi," she said, caught off-guard. "What are you doing here?" Later, when the boys were out of earshot, he told her that he was on paid leave for a few days, she recalls. "He said there was an investigation going on: 'They are looking at our books.' He didn't seem too concerned." Over the next two weeks Citi would call him in to answer questions, and he complied. "I never in my wildest dreams thought I would lose my job," he says, looking back. "I thought they would do some investigating, find some systemic problems, fix them, and move on." (He would later, in letters to Maureen from prison, call this his "head-in-the-sand syndrome.")

Then, two weeks later, in mid-March, he got a call. He'd been fired. It was a shock. The Giles were hurt and angry. The termination cost him stock and options worth about \$1.5 million and a job that was earning him an annual bonus of more than \$800,000. But they moved on, and by May, Craig had a new job at Graham Capital, a hedge fund based in Rowayton, managing an energy portfolio that would grow to about \$40 million. That December the Christmas letter told how he'd "parlayed a three-hour-commute adventure into five minutes," with a new office across the street from the kids' school, close enough to catch the occasional after-school play. "I hope this doesn't come across as bragging, but I DOMINATE in kickball," he wrote. His December was darkened, though, by hearing third-hand that federal agents were questioning some of his old colleagues on the commodities desk.

Then, at the end of January 2005, the rumors turned horribly real. After dinner Craig and Maureen were helping with homework and herding the boys toward bed when the doorbell rang. Gile went to the door. There, in the cold, dark night, were two men in suits. One of them flashed a silver badge. They were from the FBI. The agents wanted to ask him some questions. His heart sank, and he told them his lawyers had advised him not to talk. Then he went through the motions of the nighttime routines - the homework, the stories, the good-night kisses. "Generally I can sleep in any condition," he says. That night neither Craig nor Maureen got much sleep.

In the months that followed, the Giles kept hoping the investigation would go away based on reports from his lawyers, who were in touch with the prosecutor's office. He had rejected one of the options the prosecutor had presented, which was to testify against Becker. Instead, says McKay Chauvin, a college buddy and circuit court judge in Kentucky who would become Gile's main confidant through the ordeal, the events unfolding in the U.S. Attorney's Office for the Southern District of New York were building into "the perfect storm of circumstances for Craig." Neither Gile nor his lawyers ever knew for sure why a case as relatively small as theirs would be the one the prosecutors would decide to take on. But they later speculated it was because Citigroup, which had been front and center in scandals ranging from Enron to the securities-analysis debacle, wanted to demonstrate its enthusiasm for law enforcement. Citigroup's only comment to Fortune: "Mr. Gile was terminated after an internal investigation in 2004, and Citi cooperated with the authorities during their investigation of the matter." In any event, at the time,

the Giles couldn't possibly imagine the course his case would take once it did get on somebody's to-do list at the federal prosecutor's office. In Manhattan it's an entirely different philosophy, argues Chauvin, from how it worked in Kentucky, where he had been an assistant U.S. attorney for five years. Think Main Street vs. Wall Street. "As a former U.S. attorney, I generally appreciate the raw power you have to ruin a person's life," says Chauvin. "If you can't say with a clear conscience that this guy ought to be in prison, then you should just say no. It's not a contest. It's not a game. "

But when it comes to Wall Street, in the absence of clear rules and a lack of close regulatory supervision, the thinking among prosecutors and judges seems to be that the aggressive pursuit of a select few will be a deterrent to thousands of other traders who might be similarly tempted. Jonathan Streeter, the assistant U.S. attorney who handled the case, said he couldn't comment. However, an attorney who formerly worked in the Southern District says there are very stringent rules in the office about how far a prosecutor can bend to show leniency to a defendant. "Once that train gets on that track," says Chauvin, "it is almost impossible to derail."

Through the months that followed, the investigation began to cast a cloud over the clambakes at Bayley Beach, the family gatherings, the Little League games. "Hey, Coach," one Little Leaguer prompted, trying to get a call from Gile, his first-base coach; Gile had forgotten to wave the kid to second. Gile looked over at his friend Blattman, who was also coaching, and shrugged. "My bad," he called. In Rowayton rumors flew. People asked each other questions. Sometimes they asked the Giles. But Gile's attorneys had told them to keep quiet, so they kept their frustrations and fears - and their side of the story - to themselves. "It was hard," says Maureen.

In spring 2005 the Giles decided to uproot the family. It was wrenching; they had built their dream house. "I had gone to the quarry to pick out the stone for the fireplace and picked out all our tile," Maureen recalls. But after living in the house only a year and a half, they could sell it for \$3.2 million and buy one for less than half that in Longwood, Fla., a suburb of Orlando. Craig badly needed a change, and his parents were ready to retire from their decorating business there. Florida would provide a clean slate in a new community. They moved into a gated community called Alaqua Lakes, as different from Rowayton as golf is from sailing - New South, transient, filled with kids, and free of judgmental banker types.

The Giles jumped right in, signing the kids up for sports, playing tennis, and joining the Homeowners' Association, for which Craig was enlisted to help plan a hoedown. He quickly settled into his new job - selling shutters and blinds - and from then on rarely wore anything but cargo shorts. "My assumption was that Craig had made a little money in New York and did his thing and now was going to enjoy life," says his golf and tennis partner, David Graef. Every morning he saw his kids off at the bus stop with the subdivision's other dads, and every Tuesday night he played tennis with them. The move "gave us a little bit of fresh air," explains Maureen.

The gathering storm followed them south. In November, as Gile was out on a job measuring windows, he got a cellphone call from his attorney. The prosecutors had decided to go forward. It was "like a shot to my gut," Gile recalls. He finished the job and went home bearing yet more horrible news to the lovely Maureen. This was the point at which he decided to seek advice from Judge Chauvin, his old Vanderbilt fraternity brother. Gile told his friend that he was unhappy

with his lawyers because they wanted him to agree to a plea bargain- and he couldn't understand why. After Gile explained the whole thing, Chauvin recalls, he had a visceral reaction like Gile's, but for a different reason. "It was like I'd been punched in the stomach. Not because I felt my friend had just robbed a bank, but because I knew what he was about to step into. He was feeling like 'I'm an honest guy- how bad can this be?' And I knew exactly how bad this can be."

At Citigroup, Gile had been trading in energy derivatives based on futures and options that had been originally designed for businesses to hedge exposure to price volatility and other risks. One such derivative was based on the crack spread option, named after the refinery process of "cracking" crude oil into products like gasoline, and based on the difference in price between the products. While such instruments are freely traded in places like the New York Mercantile Exchange, derivatives traders can create positions so highly leveraged, illiquid, and long-term that keeping track of their value becomes a down-the-rabbit-hole computation. The government accused Gile and Becker of taking advantage of that situation in a variety of ways to inflate the value of the department's positions in order to pump up profits - and their 2003 year-end bonuses. In Gile's case the government alleged that he made changes on Oct. 8, 2003, to the mathematical relationships in a computer model that artificially inflated the present value of some of the desk's options by more than \$2 million. All told, according to the charges filed in U.S. District Court, "the commodities desk appeared to perform significantly better during 2003 than it actually performed."

The government also charged Gile with giving false derivative-price quotes to an independent broker in order to deceive Citigroup. The broker arrangement had been set up, Gile explained in an e-mail he eventually sent to friends, because Citi wanted independent verification of each position. Gile believed the broker was to get quotes from other firms as well before he vouched for accurate numbers to the bank. Eventually, Gile began to realize that wasn't happening. "I knew this probably wasn't ideal, but I figured as long as I gave him reasonable quotes, it was no big deal," he would later say.

Trader, father... (page 3)

By [Betsy Morris](#), senior editor

One of the most problematic charges for Gile was that in at least two specific instances he reversed changes made by a colleague that had inflated the values of the desk's positions. This was presented as evidence that he knew of the pattern of false valuations. Since he took a plea, Gile never had a chance to talk to the prosecutors directly or to answer the allegations directly in court. He told friends: "Late in 2003 it came to my attention that there were some inconsistencies in many of our marks. I went through the marks in question and did my best to correct the situation.... To be honest, I chalked it up to sloppiness and difficulties with our system."

Chauvin believes that some of the best evidence the jury would have against Gile was that he went back to fix the valuations. "Craig never intended to steal anything from anybody," he says, but "if you presume a guy is guilty, he's covering up. If you presume he's innocent, he's fixing it." Even if Gile had the best of intentions, his friend says, "ironically, that was covering up a crime."

Still, Gile was prepared to go to trial, right up until the day that his boss, Becker, accepted a plea deal and said he was prepared to testify against Gile. That tipped the balance. "If I was trying this case, I could probably convict you," Chauvin had to tell his friend. That could well mean a prison sentence of three to five years, as opposed to the likelihood of doing no time at all if he also took a plea deal. "And that was very hard advice to give a very, very good friend who you know didn't believe he'd committed a crime."

The Giles couldn't imagine the kids growing up without their dad. If Craig were to lose the case, oldest son Carter would be nearly off to college before Craig got out of prison. "We felt we were in a corner," says Maureen. Craig was solemn, deflated, serious, sad. But he had to convince her he should take the plea. "It was the biggest risk we couldn't take." So on Oct. 19, 2006, Gile flew to New York and pleaded guilty. It was so hard to get the words out, his lawyer had to nudge him. Afterward, Gile recalls, "we held out hope - maybe it was me keeping my head in the sand - that the judge would come to the conclusion that incarceration wouldn't serve any good purpose."

On May 17, the day of sentencing, the Giles were still hopeful, even though Becker had been sentenced two months earlier to 15 months in prison. But Craig had served in the military, after all; he'd fought in a war. Dozens of friends had written letters to the judge. Still, that morning, at a meeting in Riopelle's office near Carnegie Hall, the attorney told the Giles that - just as a precaution- they needed to think about which prison they'd choose. They had a right to make a request, he told them, handing them a book describing federal prisons. Stunned, the Giles took the book and went to a nearby Starbucks. They thumbed through the book, comparing prison amenities, and chose Pensacola because it was on a Navy base, offering jobs there for inmates and visiting hours that would let Maureen bring all three boys. After that, they walked around New York and stopped at a church to say a prayer.

In court that afternoon, after Riopelle made his argument, prosecutor Streeter spoke in favor of prison time, warning, "The press has followed this.... I think Your Honor can imagine the message to other traders out there ... that one can do this and still get a probationary sentence." Then, as Maureen and Craig sat squeezing each other's hands, Judge Sweet spelled out his sentence, saying, "I find these sentences under these circumstances extremely difficult.... But the issue of what is appropriate for what has been termed 'white-collar crime' I think is a very hard line."

In the next few weeks a letter arrived informing Craig that he would not be going to Pensacola. He would need to report instead to a detention center in downtown Miami, with no ball fields, more hardened criminals, higher security, and restricted visiting hours. It would take a prison consultant (fee: \$2,500) to straighten out the mess and help arrange a change to Jesup, Ga. Why couldn't Gile go to Pensacola? He'd been deemed an escape risk, his lawyer told him. Apparently, because of his naval experience, somebody in the bureaucracy had determined there was a chance he'd hijack a plane and flee.

A few days before he was to leave for Jesup, the neighborhood had a big sendoff for him. They called it a "send Craig off to camp party." On Aug. 1, Gile's wife and father drove him to Jesup and left him with the only two belongings he was allowed: his eyeglasses and his wedding ring. For a long time after she returned home, Maureen would find little love notes in odd nooks all

over the house.

At Jesup, Gile pretended he was back in the Navy aboard a ship, which helped him put up with the miserable routines. The biggest problem at first was how to kill time. He had to beg to wash windows instead of dishes or toilets. He spent his very long evenings mostly writing letters or reading. He read seven books the first month. He could have visitors on weekends, and at first Maureen tried to visit every couple of weeks. But there was nothing for the boys to do except see him in a dreary visitors' room or, on nice days, in an outdoor pavilion. They weren't allowed to have a ball - or anything else, for that matter, besides a deck of cards. So the family played a lot of spades and blitz and blackjack. After a while "they'd get kind of antsy," Maureen says. The family visits dropped to about once a month, but neighbors took up the slack.

Gile tried to make the best of it, getting to know the other prisoners, many of them serving decades-long terms under harsh sentencing rules for first-time drug possession. He formed a "nacho group" and a "pizza group," buying those snacks at the commissary, to meet on nights that the prison served the dreaded liver and bologna soup. He called it "our own little happy hour." Since he was getting letters from 130 people - too many to respond to - each month or so he would write one and send it to Maureen, who would type it into an e-mail. He became a big fan of the white-collar-crime cartoons in *The New Yorker* and the *Wall Street Journal*, and routinely made them into greeting cards that he sent to his friends - like the one of two men behind bars captioned, "I just consider myself as living in a gated community."

But he was also having a harder time than his letters would suggest. In September he injured his back while running. He could no longer exercise, and at times he could barely walk, but the strongest medicine the prison would give him was ibuprofen. (An MRI after his release indicated he had a ruptured disc that needed surgery.) He was cheerful for visitors, but he missed his family terribly, especially playing catch with the kids and going to their ball games, he told Fortune: "I miss those moments more than anything." He worried incessantly about how the experience might change him. "I'm doing my best to stay as unaffected by this place as possible," he wrote to Maureen in November. "I refuse to succumb to being a prisoner." In February he wrote to her, "I'll probably be less trusting, a little paranoid, and more careful in everything I do. Hopefully I'll be more considerate and understanding of people. I'll have a lot less faith in the justice system. Hopefully I'll be more tidy."

Now, after having given it months of thought, he says, "I take full responsibility for my role in the situation. It was never my intention to willfully mismark the portfolio, and it was never in my mind to deceive the bank. I've always been a man of integrity. And doing something like that is completely against everything I stand for." If he could do it all over, he would tell the bank's financial controllers that some of their requested numbers were not available in the market and that getting a concrete valuation of some of the trades was unrealistic. He'd ask more questions, he says. He would be more proactive.

Gile's term ended May 14 (he was released three months early), but his saga didn't. His sentence included a month in a halfway house in an Orlando industrial park to help him transition back into society (he will also be on parole for two years). Although the place has better food, in some ways it's equally frustrating. He was supposed to get a job, so he did - as an administrative

assistant at Paradies Gifts, thanks to a friend. He makes minimum wage, 25% of which goes back to the halfway house. He could drive the nearly three miles to work, but there's a waiting list for parking at the halfway house, so he decided to walk. The first day, he got so lost that he had to climb a fence and scale an embankment to find his way home. It took more than two hours plus a lot of stress, since he's supposed to check in frequently via a landline. "Right now, wandering aimlessly around Orlando would not be a good career move for me," he told Fortune after he got back.

Still, it's good to finally be making some plans. As soon as he's out, in mid-June, he'll tend to the family business. But it will take more than that to offset all the lost time and income. His net worth, which was \$2.5 million at the end of 2006, is now "a fair amount less," he says. He would like to start another business, maybe even a hedge fund. Some friends have said they would back him. "I'm going to look into it," he said recently. He's done a lot of reading in prison, and "as far as I know, there's nothing from a regulatory standpoint to deter me." But he really isn't sure, because with a felony conviction and starting from scratch, Craig Gile is in uncharted territory. When the subject came up during an interview in prison, it was as if a dark cloud passed over him momentarily. "I always hear that it's a nation of second chances," he said, looking off toward the window. "I'm hoping it's not just a nation of second chances for substance-abusing teenagers." Because it's clear that what he'd really like to do is get back to trading, get back to Wall Street, just get back.

Best of the Dog