

The Other Side of the Street June 8, 2008

Comments

Sorry I have been gone so long. I have all prior weeks in some sort of “work in progress” but have not found the time to finalize any.

We are now heading back into the abyss after the latest visit to fantasyland. The top of the spring 2008 bear rally has been seen. We will now head back down near the lows, likely get a last bounce sometime this summer. And then crush through the lows on another significant leg down in the US equity markets. The sole issue as it has been the last nine months is the exact timing.

PS the VIX after the 400 point drop Friday is all the way up to 23.58 (for those playing at home this is a “virtually no fear” level – it is still “all a buying opportunity” at Wall and Broad).

Stock Notes

Notes

- About 10% of the homes built since 2000 sitting vacant, with delinquencies and defaults still rising, and with the real problem – people voluntarily giving up their homes – beginning to kick in,
- On June 2, 2008, the Federal Reserve will offer \$75 billion in 28-day credit through its Term Auction Facility. Additional information regarding the auction is listed below; the auction will be conducted as specified in this announcement,
- **The combined profits of all FDIC-insured banks plunged 46% in the first quarter.** Banks in the U.S. made \$14 billion less last quarter than they did the year before. Here’s what makes that stat remarkable. FDIC banks had “voluntarily” set aside \$37 billion by the end of the first quarter to cover losses they expect in the near future -- a 20-year high. But even in spite of these cash cushions, the banking industry’s “coverage ratio” -- the percentage of troubled loans that could be rescued by such reserves -- is at a 15-year low. “This is a worrisome trend,” admitted FDIC chairwoman Sheila Bair. “It’s the kind of thing that gives regulators heartburn.”
- Regardless, the Fed seemed content to exchange \$16 billion worth of Treasury notes for mortgage- and asset-backed securities last Thursday. In its 10th Term Securities Lending Facility (TSLF), the Fed gave desperate investment houses another chance to dump their worthless derivatives for good ol’ American IOUs. To date, brokerage firms have dumped \$175 billion on the Fed’s balance sheet.
- “Everyone's trying to pick the bottom in financials, and what the news flow is showing you is that we're not there yet," said [Paul Kandel](#), a New York-based money manager at Sentinel Asset Management, which oversees about \$5 billion. “Certainly the changing command at Wachovia isn't helpful and the downgrades aren't helpful.”

Web links

Credit

- June 9 London times They have never shrugged off their seedy image, the patina of shame that welcomes, if that is the right word, a customer every time that he or she comes through the door, and for a while times have been tough for America's pawnbrokers. But not any more. The credit crunch has left millions struggling with their mortgages and the steeping petrol price has hit motorists and motor manufacturers alike - and pawnbrokers are rubbing their hands. Americans are turning to them in the hunt for alternative means of raising cash. **Moreover, it is not only the poor without bank accounts who are turning to the traditional lender of last resort. Families on higher incomes are doing business under the three spheres - the traditional sign of pawnbrokers' stores across the United States. Attracted by the high price of gold, which has risen by about 10 per cent this year to \$899 an ounce last week, pawnbrokers are reporting a surge in the number of middle-class Americans raiding their jewellery boxes.** Rick Sussman, of the Northwestern Loan Company in Baltimore, one of the oldest pawnbrokers in Maryland, said: "We see more people coming in to raise money in these uncertain economic times. In better times, you might see people from the lower end of the socioeconomic class getting loans, and in bad economic times you tend to see additionally people who are middle class trying to raise money." **The National Pawnbrokers Association (NPA) estimates that the average pawn loan is about \$60 (£30) and typically is lent against goods for between one and three months. Interest rates can be as high as 20 per cent when redeeming goods. David Adelman, of the NPA, said that such loans helped borrowers to "pay the rent, keep the lights on and gas in their cars to get to work".** For those who are put off by the thought of visiting a pawnshop, online gold brokers, such as GoldFellow and Gold4Cash, have emerged, allowing Americans to register over the internet, post their jewellery and receive payment directly into their bank accounts. **Americans have been forced to be more innovative in their attempts to raise cash, with US households owing more on credit cards than at any other time. [think about this last sentence. How sad is it that we have become such a debtor nation that we "need to raise cash" by hawking their keepsakes to pay for gas in an economy where the government argues 94.5% of the people are employed.] According to data published by the US Federal Reserve, the American central bank, in March Americans owed a record \$957 billion on their credit cards, which had risen by 8per cent compared with the same period the year before.** Banks, facing their own liquidity problems, have become more circumspect about extending lines of additional credit, such as increased overdraft facilities and credit card limits. **According to the Transamerica Centre for Retirement Studies, there has been a sharp increase in the number of Americans taking out retirement-plan loans, a type of borrowing that allows an individual to get a loan secured on the value of his pension.** Other lenders are emerging. Annuity buyers acquire insurance policies or structured settlements and take on the obligation of meeting monthly repayments. In return, the customer receives a cash lump sum at a significant discount to both the future value of the policy at the time of maturity and at a

discount to the repayments already made. It is not unusual for a holder of a life insurance policy to receive as little as 15 per cent of the value of the investment. **Boom for pawnbrokers as credit crunch bites**
<http://business.timesonline.co.uk/tol/business/economics/article4092631.ece?&EMC-Bln=OOZF39>

- June 3 (Bloomberg) -- Bradford & Bingley Plc, the U.K. lender struggling to raise cash in a rights offering, must buy about 2.1 billion pounds (\$4.1 billion) of mortgages by the end of next year from GMAC LLC. **Customer payments are more than three months late on 5 percent of loans purchased from Detroit-based GMAC, the car and home lender trying to avert bankruptcy for its residential mortgage unit.** That's more than double the average rate for mortgages held by the Bingley, England-based bank, it said yesterday in a statement. "This is what has spooked everybody," said Alan Beaney, who manages \$2.1 billion of stock as head of investments at Principal Investment Management in Sevenoaks, England. **"They are committed to keep buying these things." Rising loan defaults were "by far the biggest factor" in Bradford & Bingley's decision to sell a 23 percent stake to U.S. leveraged buyout firm TPG Inc., Chairman Rod Kent told analysts on a conference call. The bank fell 24 percent in London trading yesterday, the most since the initial public offering in 2000, after it slashed the price of the rights offering by a third and said the U.K. housing market is deteriorating.** The bank first agreed in 2002 to buy loans from GMAC. Steven Crawshaw, who stepped down June 1 as Bradford & Bingley's chief executive officer, renewed the deal in December 2006 and committed to buy as much as 4 billion pounds of loans a year through 2009. Late Payments Bradford & Bingley, the U.K.'s biggest lender to landlords, reduced its purchases of GMAC loans to "the minimum under contract," or about 1.4 billion pounds a year, the statement said. **The company is required to buy the loans "only if GMAC can originate them,"** spokesman Neil Vanham said. Arrears for Bradford & Bingley's acquired mortgages "have been higher than anticipated," the bank said. Late payments on its 409 million pounds of GMAC loans rose to 5.04 percent in April from 3.3 percent at year end. The U.K.'s overall arrears rate on buy-to-let loans in the first quarter was about 1 percent, the Council of Mortgage Lenders said last month. **The GMAC loans are "materially worse quality than Bradford & Bingley's self-sourced book," said Alex Potter, a London-based banking analyst at Collins Stewart who rates the stock "sell."** Bradford & Bingley agreed in April 2007 to buy as much as 2 billion pounds of mortgages over two years from London-based Kensington Group Plc. The agreement with Kensington, purchased this year by Investec Corp., includes so called self-certification loan in which borrowers verify their own incomes. 'Too Many Mistakes' "We've made too many mistakes recently," Kent told analysts on the conference call. "It's my job to correct those." **"The question that many will ask is why was the previously agreed and fully underwritten deal canceled,"** Keefe, Bruyette & Woods Ltd. analysts said in a note to clients yesterday. "There may well be speculation that further issues lurking within the loan book led to a renegotiation," said analysts led by James Hutson, who cut his rating on the stock to "underperform" because of the "shock" increase in customer arrears and the credit quality of the GMAC loans.

Bradford & Bingley Must Buy 2.1 Billion Pounds of GMAC Loans

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a4ITi4qNBe4A&refer=home>

Commercial Real Estate

Commodities

Currency

- June 9 (Bloomberg) -- The dollar traded near a one-week low against the yen on speculation an industry report today will show the worst housing slump in a quarter century is weighing on the U.S. economy. **The U.S. currency also traded at the lowest in almost two weeks versus the euro after a government report June 6 showed the U.S. unemployment rate climbed the most in two decades.** The dollar was near its weakest level in 25 years against Australia's currency as investors reduced bets the Federal Reserve will raise interest rates this year. "The optimism about the U.S. economy has faded away," said Toru Umemoto, chief currency strategist in Tokyo at Barclays Capital Inc., Britain's third-biggest bank. "The dollar is being sold as the U.S. unemployment rate was a shocking number. It's unbelievable to talk about a Fed rate hike, when we see such bad data." The dollar traded at 105.11 yen as of 9:37 a.m. in Tokyo, from 104.93 in late New York on June 6, when it declined 1 percent following the jobs report. It fell as low 104.43 yen today, the weakest since June 3. The U.S. currency traded at \$1.5775 per euro from \$1.5778 late last week. The yen traded at 165.80 a euro from 165.54. The U.S. currency may move between 103 yen and 106 yen this week, Umemoto said. Trading volumes may be less than usual as financial markets in Australia, China, Hong Kong and the Philippines are closed today for public holidays, said Tetsuhisa Hayashi, chief manager of foreign-exchange trading in Tokyo at Bank of Tokyo-Mitsubishi UFJ Ltd. Australian Dollar The dollar traded at 96.25 U.S. cents per Australian dollar from 96.26 cents on June 6, near the 25-year low of 96.54 cents reached May 21. The U.S. currency traded at \$1.9696 against the British pound from \$1.9708, and was at 1.0168 versus the Swiss franc from 1.0185. The Dollar Index traded on ICE futures in New York, which tracks the currency against those of six trading partners, fell for a third day to 72.286 from 72.390 on June 6. The dollar has fallen 12 percent against the euro and 9 percent versus the yen since September when the Fed began cutting interest rates from 5.25 percent to 2 percent to help avert a recession. Futures on the Chicago Board of Trade on June 6 showed a 62 percent chance the Fed will increase the target rate by at least a quarter-percentage point by December, compared with 77 percent odds a week earlier. **Dollar Trades Near One-Week Low Against Yen Before Housing Data**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aaUKXF2717Ms&refer=home>

Diversification

Derivatives

- June 4 (Bloomberg) -- **Interest-rate derivatives traders are betting banks' difficulties obtaining needed cash to fund holdings and shore up balance sheets will worsen.** The difference, or spread, between the three-month dollar London Interbank Offered Rate and the overnight index swap rate, traded forward three months, is greater than similar spreads expiring this month, according to data tracked by Credit Suisse Holdings Inc. **“The movement in the forward Libor-OIS spreads is telling you that the market is concerned that things can get even worse before they get better,”** said Carl Lantz, an interest-rate strategist in New York at Credit Suisse, a primary dealer. **“Until all banks' balance sheets are cleaned up and they've re-capitalized, there is going to be funding pressure.”** Forward Spreads Wider The three-month Libor-OIS spread traded forward to Sept. 15, or the date the September Eurodollar futures contract expires, was 72 basis points yesterday, while the forward spread corresponding to the June Eurodollar expiration was 67 basis points. **The market has grown more pessimistic since April 30, the September spread was 6 basis points less than June, according to Credit Suisse.** Credit Ratings Cut Standard & Poor's lowered credit ratings for Morgan Stanley, Merrill Lynch & Co. and Lehman Brothers Holdings Inc. on June 2, saying the investment banks may have further writedowns on devalued assets. The British Bankers' Association has been under fire since the Bank for International Settlements said in March the banks that set Libor understated their borrowing costs to avoid speculation they were in financial straits as losses in credit markets mounted. The association, after completing a review of its rate setting process, announced on May 30 that it will strengthen “oversight.” Details will be revealed “in due course,” it said. **“Instead of being an immediate bank liquidity problem, Libor is now being affected by a longer-term capital problem,”** Chowdhury said. The market “had previously expected the liquidity problems that had boosted the Libor-OIS spread to dissipate relatively quickly, and thus, the forward basis spread curve was sharply inverted.” An inverted rate environment is when rates with shorter maturities are above those on longer maturities. “Now the basis spread curve is relatively flat, indicating a longer-lasting problem with Libor,” Chowdhury said. **Derivatives Traders Signal Banks' Credit Woes Likely to Worsen**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a6Ygig7G0bvA&refer=home>

Housing

Housing Finance

Macro Economic

- June 4 (Bloomberg) -- Japanese businesses cut investment in the first quarter as a global slowdown and waning profits dissuaded companies from building factories and buying

equipment. **Capital spending** excluding software fell 5.3 percent in the three months ended March 31 from a year earlier, a fourth straight quarterly decline, the Ministry of Finance said today in Tokyo. Profits plunged 17.5 percent. **Japan Capital Spending Falls as Profit Plunges 17.5%**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=avwWz1HuzyIk&refer=home>

- June 3 FT - Just what the global economy does not need: another turbulent housing market. **Protracted weakness in new home sales in Japan suggests the world's second biggest economy is suffering more than a technical blip.** Japan is no stranger to real estate boom-and-busts. Residential land prices – the main determinant of housing costs in a country where buildings are typically pulled down rather than resold – only began climbing in 2006, ending 15 years of decline. Up 4 per cent last year, residential land prices are still half the peak levels. The more recent slide in new home sales began in July after the government clamped down on architects who had been fabricating earthquake compliance certification. Stricter rules meant a temporary fallow period for housebuilders was pretty much inevitable. **But new housing starts have been falling on a year-on-year basis for 10 consecutive months and were down 9 per cent in April compared with the same month last year.** Almost half of all new condominium units that came on to the market in January remained unsold at the month's end, a 16-year low. This so-called contract ratio has since crept up to 63 per cent, but it remains on a two to three-year downtrend. This is particularly worrying since condominiums had been a pocket of strength. Demographics make apartments more appealing: since 1980, the proportion of single-person households has risen by half to 30 per cent. By 2030, according to a government research unit, married couples will account for just half of all households, and about half of these will be childless. But now, with higher land and construction costs, developers are less willing to start big projects. Buyers, meanwhile, are deterred by the sluggish economic outlook and an expectation that prices will fall. Japanese affordability ratios, while more robust than other markets thanks to low interest rates, have deteriorated as house prices rise and wages stagnate. Another market best avoided by bricks-and-mortar investors. **Japanese housing**
<http://www.ft.com/cms/s/1/3e77162a-314a-11dd-b77c-0000779fd2ac.html>

Retail

Retirement

Risk

Savings Rate

Tech

The Fed

- June 3 (Bloomberg) -- Federal Reserve Chairman **Ben S. Bernanke** signaled he's done cutting interest rates for now and raised his biggest concerns yet about the inflationary effects of the dollar's 16 percent drop in the past year against the euro. **The Fed is working with the Treasury to ``carefully monitor developments in foreign exchange markets'' and is aware of the effect of the dollar's decline on inflation and price expectations, Bernanke said today in his first speech on the economic outlook in two months. In addition, interest rates are ``well positioned'' to promote growth and stable prices, he said.** Bernanke's comments are a shift from past remarks by Fed officials that have highlighted both the spur to exports from a cheaper dollar and the pressure it puts on import prices. **The dollar climbed after the speech indicated exchange rates will be a consideration in setting rates. ``I can't recall such a strong defense of the dollar from a Fed chairman,''** said Sophia Drossos, a currency strategist at Morgan Stanley in New York who used to work at the New York Fed, where she helped manage the central bank's foreign-exchange holdings. **``The Fed is putting its marker down in letting the market know that a weaker dollar would be detrimental.'' [to the extent ``the markets'' are foolish enough to believe this nonsense, we might see a wonderful sale on gold and silver]** Bernanke, 54, spoke via satellite to the International Monetary Conference in Barcelona, Spain. European Central Bank President Jean-Claude Trichet also spoke at the event, where he reiterated that **``monetary policy stays firmly focused on delivering price stability.'' ``For now, policy seems well positioned to promote moderate growth and price stability over time,'' Bernanke said. ``We will, of course, be watching the evolving situation closely and are prepared to act as needed to meet our dual mandate.'** The remarks come as the central bank's optimism that inflation is abating and growth will start to pick up has been dashed by the unexpected surge in oil prices, which is eroding the potential benefit to the economy from more than \$100 billion in federal tax rebates. **The dollar strengthened to \$1.5450 per euro from \$1.5537 earlier today. Gold dropped 1.3 percent to \$879.69 an ounce.** Crude oil fell 2.8 percent to \$124.15 a barrel. Fed `Attentive' **``We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations,'' Bernanke said. The Fed's commitment to price stability and maximum employment ``will be key factors ensuring that the dollar remains a strong and stable currency.'' [this is an interesting comment given the freefall in the dollar during his tenure]** During the dollar's decline over the past six years, some Fed officials have said foreign demand for U.S. assets may fade. Bernanke's predecessor, Alan Greenspan, told a European audience on Nov. 19, 2004, that **``given the size of the**

U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point." `Financial Stability' **David McCormick**, Treasury's undersecretary for international affairs, said in a Bloomberg Television interview today that **Bernanke's and Paulson's remarks this week ``are consistent in that they are advocating policies that will strengthen the U.S. economy and ultimately ensure ongoing financial stability within the global markets."** Asked about the dollar at a congressional hearing Feb. 27, Bernanke at the time noted that its decline ``does increase U.S. competitiveness." He also noted its impact on inflation. `Significant Headwinds' **Today, Bernanke said financial-market conditions ``remain strained," and consumers face ``significant headwinds" from declining home prices, a weaker labor market, stricter lending standards and higher energy costs.** The U.S. economy grew at an annualized 0.9 percent pace in the first quarter, capping the weakest six-month performance in five years, government figures showed last week. The second quarter is ``likely to be relatively weak," Bernanke said, leaving out his mention in an April speech of a possible contraction. The second half may have ``somewhat better economic conditions," and growth may pick up further in 2009, he said. **``Until the housing market, and particularly house prices, shows clearer signs of stabilization, growth risks will remain to the downside," Bernanke said. ``Recent increases in oil prices pose additional downside risks to growth."** Supply and Demand Bernanke, in a question-and-answer period, said soaring oil costs are more the result of supply and demand than the weaker dollar. ``The effect of the dollar on commodity prices is relatively modest," he said. Supply and demand conditions are ``by far the strongest and most important factor." **Crude oil has climbed 93 percent in the past year.** Gasoline prices have also hit a record, impairing spending by consumers who are already buffeted by a slump in home values. ``The possibility that commodity prices will continue to rise is an important risk to the inflation forecast," Bernanke said. Higher public inflation expectations are also a ``significant upside risk" to prices and may ``ultimately become self-confirming," he said. **Bernanke Says Rate `Well Positioned,' Watching Dollar**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aLHohn3ZULt8&refer=home>

Wall Street

- **[Jane caught this one for us – hard to get more absurd that this as a “buying opportunity”]** June 6 (Bloomberg) -- The biggest rise in the unemployment rate since 1986 is an ``aberration" and investors who sold equities today are ``completely misreading" the outlook for economic growth, according to **JPMorgan Chase & Co.** The **Dow Jones Industrial Average** fell as much as 412 points today after the Labor Department said the jobless rate increased by half a percentage point to 5.5 percent, the highest since October 2004, as an influx of students into the workforce drove the biggest jump in teenage unemployment since at least 1948. **``The surge in unemployment is probably an aberration," Thomas J. Lee, the New York-based chief U.S. equity strategist at JPMorgan, said in an interview. ``It's not because there were fewer jobs, it's because there were more people looking for jobs. Stocks are completely**

misreading the situation." [This guy is either a complete moron or has prostituted himself into bold faced lies. Assuming he has even the slightest understanding of the underlying numbers he KNOWS that the "jobs" number contained about 250,000 make believe birth/death jobs] Lee, 39, wrote in an e-mail that "stocks should be up" after the report, which also showed payrolls fell by 49,000 in May, a smaller decline than economists surveyed by Bloomberg News had forecast. The strategist said the Dow industrials posted a 30 percent average gain in the 12 months following a jump in the unemployment rate by half a point or more since 1950. A rise in joblessness of that magnitude has occurred 16 times during that period, he said. **"Surges in unemployment happen at the end of the cycle," Lee said. "This is showing you what happened in May, it's not telling you what's going to happen in the next 12 months. Unfortunately a lot of economic data is backward looking." Lee expects the Standard & Poor's 500 Index to climb to 1,450 by the end of this year, according to a Bloomberg News survey on June 2.** The S&P 500 dropped 3.1 percent to close at 1,360.68 today, while the Dow average fell 3.1 percent to 12,209.81, the steepest slide in 15 months. Crude oil rose almost \$11 to settle at \$138.54 a barrel. "At the end of the day we still have things overhanging on stocks, we still have high oil prices and we still have the credit cycle we're going through," Lee said. "But ultimately the economic data is showing the economy is pretty resilient." **Buy Stocks as Investors 'Misread' Jobs, JPMorgan Says**

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

• **[Ask yourselves why all this new capital is needed when the credit crisis is over according to the DC and Wall Street gangs]** June 9, 2008 Lehman Brothers Holdings Inc. is close to raising more than \$5 billion of fresh capital from an array of investors including the New Jersey Division of Investment, according to a person familiar with the matter. The move comes as the firm is set to report a second-quarter loss of more than \$2 billion, this person said. Until recently, most analysts who follow Lehman have been predicting a loss of about \$300 million. On Sunday afternoon, the firm was still pulling together final details of the capital raising, which could be announced Monday or Tuesday. **Additional capital raisings are sure to follow for other banks. Barclays PLC, the big British bank, also is moving toward raising capital from outside investors such as those in the Middle East or Asia, according to people familiar with the matter.** Last month, the bank left the door open for a capital injection but skipped seeking money from existing shareholders in a rights issue. Lehman canvassed the globe in its capital raising but in the end found a group of primarily U.S. investors. Lehman's stock has tumbled about 50% this year as concerns have mounted over its financials and its exposure to the mortgage market. So far, the firm has strong commitments from the New Jersey Division of Investment, which manages the state's \$80 billion of pension funds and recently invested in Merrill Lynch & Co., and from C.V. Starr, the investment vehicle of Maurice R. "Hank" Greenberg, former chairman and chief executive officer of American International Group Inc. A significant foreign investment remained a possibility. Lehman officials didn't respond to calls seeking comment, nor did New Jersey officials. A spokesman for C.V. Starr declined to comment. So far, Friday's market turmoil hasn't deterred the outside investors, but Lehman may decide to see if markets stabilize on Monday before announcing its plans. A

big capital increase from Lehman could help calm nervous investors and stabilize the broader market. **The capital raising would come primarily through common shares, the first such issue since Lehman went public in 1994. So far this year, Lehman has raised almost \$6 billion, but that was mostly in the form of preferred shares, a stock-bond hybrid that doesn't dilute the ownership of common shareholders.** While a common-share issue would hurt Lehman's already-suffering shareholders by diluting their ownership stake, rating companies and regulators are likely to look favorably toward a greater capital cushion. **Lehman's larger-than-expected second-quarter losses stem partly from asset write-downs and hedges used to offset losses in real estate and other securities, according to people familiar with the matter.** The firm bet that indexes tracking markets such as real-estate securities and leveraged loans would fall. If that happened, it would book profits that would make up some of its losses from holding these securities and loans. However, in an unexpected twist, some of the indexes rose, even as the assets they were supposed to hedge against continued to lose value or stayed relatively flat. **Lehman Aims to Raise More Capital**
<http://online.wsj.com/article/SB121296377617855623.html?mod=djemalertMARKET&apl=y&r=145487>

- June 9 (Bloomberg) -- The worst two months for the U.S. Treasury market since 2004 failed to turn two of Wall Street's biggest bulls into bears, and history suggests they may be right. While **Barclays Plc** says faster inflation means more "carnage" is in store for the fixed-income market after U.S. debt lost 2.89 percent in April and May, **Goldman Sachs Group Inc. and Lehman Brothers Holdings Inc. predict a rally in two-year Treasury notes.** Goldman, the most profitable securities dealer, and Lehman, the top-ranked bond research firm in Institutional Investor's annual survey for eight years, **bet the economy is too weak to spark runaway inflation and an increase in the Federal Reserve's target interest-rate for overnight loans between banks.** Though futures traded on the Chicago Board of Trade show a 62 percent chance policy makers will boost the fed funds rate by year-end, they haven't started to raise borrowing costs with growth below an annualized 2 percent rate since 1980. **"The capital markets are underestimating how sluggish the economy is going to be,"** said **Thomas Girard**, a managing director at New York-based **New York Life Investment Management**, which oversees \$110 billion in fixed income assets. **"Any tightening priced into the fed funds futures market is premature at this stage of the game."** **[this assumes that the Federal Reserve can control what investors will demand. This is wrong and rates will rise not because of the Fed but because inflation will dictate that "investors" will not lend at negative real rates.]** Two-year Treasuries, more sensitive than longer-maturity debt to changes in expectations for monetary policy, rose last week by the most since the period ended Feb. 29, pushing yields down 27 basis points to 2.38 percent, according to **BGCantor Market Data**. The price of the benchmark 2.625 percent security due in May 2010 gained 1/2, or \$5 per \$1,000 face amount, to 100 15/32. A basis point is 0.01 percentage point. Bernanke's "Concern" **Goldman forecasts that two-year yields will fall to 1.9 percent by year-end, while Lehman expects 1.8 percent.** The median estimate of 49 economists and strategists surveyed by Bloomberg is for 2.24

percent. In September 2001, when the fed funds rate was 3 percent both firms correctly foresaw that it would decline to at least 2 percent. The median forecast was 2.5 percent. Growing speculation that the Fed may boost rates this year drove the yield to 0.69 percentage point more than the fed funds rate on May 29, the most since May 2005. In January it was 1.90 percentage points below the rate, currently 2 percent. Fed Chairman Ben S. Bernanke said in an address June 4 at Harvard University in Cambridge, Massachusetts, that data showing the public expects price increases to accelerate is a "significant concern" for the central bank. Weaker Case **The case for an increase became weaker on June 6, as the Labor Department said that the unemployment rate surged to 5.5 percent in May from 5 percent in April. The gain was the biggest since February 1986.** "The economy is not performing at a rate that even remotely suggests they should raise interest rates along the lines that the markets are implying," said Edward McKelvey, a senior U.S. economist at Goldman in New York. In the first three months of the year the economy grew at a 0.9 percent annual pace, the Commerce Department said May 29. The median estimate for 2008 is 1.30 percent, according to a survey of 78 economists by Bloomberg News. For 2009, it's 2 percent. **While growth is slow now, faster inflation may force investors to demand higher yields, according to Barclays.** The inflation rate has almost doubled since August, with consumer prices rising by 4.1 percent on average since November. Barclays expects two-year yields will rise to 3.2 percent by year-end. Barclays Says 'Sell' "U.S. bond markets are a sell," Tim Bond, head of global asset allocation at Barclays in London, wrote in a report on May 23. **"The combination of easing credit-market pressures, better U.S. growth and soaring inflation is likely to cause carnage in the fixed-income markets this summer."** Brian Wesbury, the chief economist at the Joint Economic Committee of Congress from 1995 to 1996 who is now at First Trust Advisors LP in Lisle, Illinois, concurs. He predicts a rise in yields to 3.45 percent. Though not as bearish, Morgan Keegan Inc. in Memphis, Tennessee, and the National Association of Home Builders in Washington both forecast an increase to 2.9 percent. Lehman Counters **Lehman counters that the futures market turned out to be more than a year early when pricing in rate increases as the recessions of 1990-1991 and 2001 ended. [the good old "well if it happened one way twice it must always happen that way" illogic of those who manage OPM]** The Fed's target was 6 percent at the end of March 1991, when the National Bureau of Economic Research says the recession that began in July 1990 ended. Policy makers kept slashing borrowing costs until September 1992, when the rate fell to 3 percent. When the 2001 recession ended in November, the rate was 2 percent; the Fed didn't stop lowering its target for the fed funds rate until it reached 1 percent in June 2003. Futures "are trying to anticipate an old-fashioned business cycle recovery when the economy would come roaring back and the Fed would be hiking almost immediately," said Ethan Harris, Lehman's chief U.S. economist. "The last two business cycles have had very muted recoveries. They didn't match previous history. This business cycle is going to be the same." While Bernanke indicated the Fed isn't likely to lower borrowing costs, he also said that **"we see little indication today of the beginnings of a 1970s-style wage-price spiral."** **Fed's Feint to Higher Rates Fails to Persuade Goldman, Lehman**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aMrmX4OyOXVU&refer=home>

- June 3 (Bloomberg) -- Wachovia Corp. Chief Executive Officer Kennedy Thompson sounded like a gambler who'd spotted a sure thing in 2006 when he paid \$24.6 billion for Golden West, a California lender specializing in adjustable-rate mortgages. **“Golden West is a very conservative lender,” Thompson said in an interview that May. “You would have to have huge unemployment and a huge downdraft in home values before this product got hit in any big way.”** Amid record home foreclosures and price declines, **Thompson yesterday became the sixth CEO of a worldwide financial institution in 11 months to lose his job to the fallout from subprime mortgages. The number and speed of departures is unprecedented since World War II, reaching higher into the ranks of Wall Street's biggest banks than the savings-and-loan crisis of the late 1980s, said Charles Geisst, a finance professor at Manhattan College in New York.** “It was a classic case of monkey-see, monkey-do,” Geisst said. Wachovia's Thompson, Citigroup Inc.'s Charles Prince and Merrill Lynch & Co.'s Stan O'Neal saw rival bank executives profiting from subprime mortgages and decided, “Well, he did it, so why can't we?” said Geisst, author of “100 Years of Wall Street.” (McGraw-Hill, 2000, \$29.95.) Thompson follows other executives burned by subprime mortgages, those issued to the least credit-worthy buyers. Prince left in November, as New York-based Citigroup headed for a record fourth-quarter loss of almost \$10 billion. Merrill's largest quarterly loss in 94 years led to O'Neal's departure from the New York company in October. Switzerland's UBS AG, which expanded its subprime exposure at the peak of the U.S. housing market, ousted CEO Peter Wuffli last year, and Chairman Marcel Ospel stepped down in April. Bear Stearns Cos. Chairman James “Jimmy” Cayne gave up his CEO title in January, months before the New York firm's near-collapse forced the Federal Reserve to assist in a takeover by JPMorgan Chase & Co. Northern Rock Plc CEO Adam Applegarth, who ran the U.K. mortgage lender bailed out by the Bank of England, stepped down in November. Yesterday, a seventh leader, Seattle-based Washington Mutual Inc. CEO Kerry Killinger, was stripped of his chairman's title.

Damage Continues The damage -- and the departures -- probably aren't over, said William Fitzpatrick, an analyst at Optique Capital Management in Racine, Wisconsin, which manages \$1.5 billion including shares of Wachovia. He said Lehman Brothers Holdings Inc. CEO Richard Fuld may be among those still vulnerable. **“We haven't seen a financial crisis of this magnitude ever,” Fitzpatrick said. “There has to be accountability. Heads need to roll.”** “Lehman has handled itself better than Bear Stearns,” said Richard Bove, an analyst at Ladenburg Thalmann & Co. Standard & Poor's Corp. lowered credit ratings for Lehman, Morgan Stanley and Merrill Lynch yesterday, saying more writedowns may be coming. Lehman, the fourth-largest U.S. securities firm, may report a loss in the second quarter because of weakness in capital markets, Oppenheimer & Co. analyst Meredith Whitney wrote yesterday in a research note.

Writedowns and Losses The biggest banks and securities firms have booked about \$387 billion of writedowns and credit losses since the beginning of last year, as the collapse of the U.S. housing market led to losses on securities tied to the value of home prices.

Rising Profits Golden West, led by the husband-and-wife team of Herb and Marion Sandler, had boosted profit 172 percent in five years by selling adjustable-rate mortgages. The ARMs let borrowers pay only a portion of the principal and interest due on their mortgages: in effect, a bet that housing prices would keep rising and interest rates would stay low. **Thompson and Herb Sandler, interviewed by Bloomberg Television**

on a New York street corner after they announced the deal, said it would take an unprecedented decline in U.S. housing prices to slow the company. His interviewer asked how much. "More, my dear, than has ever taken place in your lifetime," Sandler replied. On April 14, Wachovia said it may take a 7 to 8 percent loss on its \$121 billion of option adjustable-rate mortgages because of declining home prices and "unprecedented consumer behavior." The S&P/Case-Shiller home-price index fell 14.4 percent in March from a year earlier, the most since the figures were first published in 2001. Late payments on Wachovia's option-ARM loans were 3.1 percent, double the previous record during the early 1990s, according to Moody's Investors Service analyst **Wachovia's Thompson Joins Prince, O'Neal Topped by Subprime**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aHpjzcyqgtUQ&refer=home>

- June 3 (Bloomberg) -- Moody's Investors Service, Standard & Poor's and Fitch Ratings are near an agreement with New York Attorney General **Andrew Cuomo** to end an investigation into the credit-rating companies' role in the subprime-mortgage crisis, according to people with knowledge of the joint agreement. The settlement would allow the rating firms to avoid sanctions, said the people, who declined to be identified before a public announcement that may come as early as this week. The companies won't admit wrongdoing and will have six months to implement policies such as a new fee structure and increased disclosure about the deals they rate, the people said. Cuomo would terminate his nine-month probe of the ratings companies, started as part of a broader investigation into the mortgage industry. Cuomo said in February he was focused on "the role played by the ratings agencies in the mortgage meltdown" that caused more than \$386 billion in credit losses and writedowns at banks. **The ratings companies would be paid by bond issuers for any preliminary work reviewing the structure of U.S. subprime- mortgage securities, as well as for a rating on debt, the people said. That way the firms would be paid even if they aren't selected to give a final rating, reducing the incentive to give a favorable assessment. Currently, the companies are paid only if they are selected to give a ranking, the people said.** The companies will also be required to disclose on their Web sites details of collateral backing U.S. subprime mortgage debt they assess, and the issuer of the debt, the people said. "Stock investors may be thinking that the rating agencies are going to get paid whether they screwed up or not," said **Andrew Harding**, who helps manage \$18 billion as chief investment officer for fixed income at Allegiant Asset Management in Cleveland **Moody's, S&P Reach Settlement Agreement With Cuomo, People Say**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=azlGhfhVz3JU&refer=home>
- June 3 (Bloomberg) -- **Lehman Brothers Holdings Inc. denied borrowing from the Federal Reserve today and said the firm's cash holdings have increased, as the shares dropped to the lowest level in five years.** Lehman, the fourth-largest U.S. securities firm, had more than \$40 billion of liquid assets at the end of the quarter, up from \$34 billion three months earlier, **Paolo Tonucci**, treasurer of the New York-based firm, said in an e-mailed statement. The last time Lehman borrowed from the Fed was on April 16, he said. "We did not access the primary dealer facility today," Tonucci said in response to speculation among traders that the firm had turned to the Fed for funds. The central bank set up a lending program for investment banks after the collapse of **Bear Stearns Cos.** in March. Lehman may seek as much as \$4 billion by selling common

stock, the Wall Street Journal reported today, citing unidentified people with knowledge of the matter. The company has raised \$8 billion since February amid asset writedowns and losses from the collapse of the U.S. subprime mortgage market. Lehman has declined 53 percent in New York trading this year. Fed Speculation "Equity investors are acting first and asking questions later," said Brad Hintz, an analyst at Sanford C. Bernstein in New York, who has a "market perform" rating on Lehman. **"Just the fact that Lehman would discuss the prospect of raising common equity capital nine months after the beginning of the credit problems is concerning to investors. Why take a chance in a difficult economic/financial environment?"** Lehman probably will post a second-quarter loss of 50 cents to 75 cents a share, analysts at Oppenheimer & Co. and Bank of America Corp. have said. The New York-based company holds "very large, illiquid" assets and "we can't rule out equity issuance" to replenish the balance sheet, Merrill Lynch & Co. said in a report yesterday. "Shaky Ground" **Chief Executive Officer Richard Fuld said at the annual shareholders meeting in April that "the worst is behind us" in the credit-market contraction** that has cost the world's biggest banks and brokerages more than \$387 billion. The firm is scheduled to report second-quarter earnings the week of June 16. "Wall Street is starting to look like the boy who cried wolf, and investors are worried that we're not in the clear," said Billy Groeneveld, head trader at vFinance Inc. in Boca Raton, Florida. "The bottom line is that we are still on shaky ground in the financial sector and it's not just Lehman." Financial-services firms have been forced to raise \$283 billion to cover the losses, according to data compiled by Bloomberg. Citigroup Inc., the biggest U.S. bank, has raised the most, pulling in more than \$44 billion with a combination of stock sales and private offerings to investment funds controlled by foreign governments including Abu Dhabi. **Lehman Denies Fed Borrowing, Says Cash Holdings Rose**

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

- June 3 (Bloomberg) -- **Lehman Brothers Holdings Inc.** may seek more capital to allay investor concerns as the securities firm prepares to report its first quarterly loss since going public in 1994, according to analysts. The fourth-biggest U.S. securities firm probably will post a **second-quarter loss** of 50 cents to 75 cents a share, analysts at Oppenheimer & Co. and Bank of America Corp. have said. **New York-based Lehman holds "very large, illiquid" assets and "we can't rule out equity issuance" to replenish the balance sheet, Merrill Lynch & Co. said in a report yesterday.** Lehman may seek as much as \$4 billion by selling common stock, the Wall Street Journal reported today, citing unidentified people with knowledge of the matter. The company has raised \$8 billion since February amid asset writedowns and losses from the collapse of the U.S. subprime mortgage market. Lehman spokesman **Mark Lane** declined to comment. Credit-Default Swaps Credit-default swaps tied to Lehman bonds climbed 2 basis points to 242 basis points, according to London-based data provider CMA Datavision. The contracts rise when investors' perceptions of credit quality decline. **Chief Executive Officer Richard Fuld said at the annual shareholders meeting in April that "the worst is behind us" in the credit-market contraction** that has cost the world's biggest banks and brokerages more than \$387 billion. The firm is scheduled to report second-quarter earnings the week of June 16. Financial-services firms have been forced to raise \$283 billion to cover the losses, according to data compiled by

Bloomberg. **Citigroup Inc., the biggest U.S. bank, has raised the most, pulling in more than \$44 billion with a combination of stock sales and private offerings to investment funds controlled by foreign governments including Abu Dhabi.** Lehman Chief Financial Officer **Erin Callan** said last month at an industry conference in New York that the firm's leverage-- the ratio of assets to equity -- declined to 27 to 1 from almost 32 to 1 at the end of the first quarter. "I understand they are seeking to raise additional capital," Hinton said. "From our point of view that is a good thing." She said Lehman is "getting near" its cap on selling so-called hybrid securities. The S&P downgrades may make it harder for the banks to sell derivatives such as credit-default swaps that are tied to bonds or loans, said **Brad Hintz**, an analyst at Sanford C. Bernstein in New York, who has a "market perform" rating on Lehman. "Lehman needs to reduce its leverage ratios to reflect the new realities of the fixed-income marketplace," Hintz wrote in a report to clients today. "This will not be good for the firm's revenue base."

Lehman May Need to Raise Capital as Analysts See Loss

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a5XsUuBojTGw&refer=home>

- June 2 (Bloomberg) -- Leave it to Wall Street to profit from its own distress. **Merrill Lynch & Co., Citigroup Inc. and four other U.S. financial companies have used an accounting rule adopted last year to book almost \$12 billion of revenue after a decline in prices of their own bonds.** The rule, intended to expand the "mark-to-market" accounting that banks use to record profits or losses on trading assets, allows them to report gains when market prices for their liabilities fall. **The new math, while legal, defies common sense.** Merrill, the third-biggest U.S. securities firm, added \$4 billion of revenue during the past three quarters as the market value of its debt fell. That was the result of higher yields demanded by investors spooked by the New York-based company's \$37 billion of writedowns from assets hurt by the collapse of the subprime mortgage market. **"They can post substantial gains as a result of a decline in their own creditworthiness," said James Cataldo, a former director of treasury risk management for the Federal Home Loan Bank of Boston and now an assistant professor of accounting at Suffolk University in Boston. "It's completely legitimate, but it doesn't make sense by any way we currently have of thinking of net income."** "The piper will have to paid eventually," said **Robert Willens**, a former Lehman Brothers Holdings Inc. accounting analyst who left the New York-based firm earlier this year to become an independent consultant. Statement 159 The debate over what is known as Statement 159 adds to the number of accounting techniques called into question as the U.S. debt market unravels. Investors have criticized banks for booking some writedowns in an accounting category called "other comprehensive income" that bypasses their income statements. Accounting rulemakers are now proposing changes to standards that let banks use off-balance-sheet vehicles to juice earnings without tying up precious capital. Lobbying Effort The rule was enacted after lobbying by New York-based companies, led by Merrill, **Morgan Stanley**, Goldman Sachs Group Inc. and Citigroup, which wrote letters to FASB arguing that it wasn't fair to make them mark their assets to market value if they couldn't also mark their liabilities. "We do not believe it would be appropriate" to let investors consider creditworthiness when valuing bonds if the issuing company couldn't do the same, wrote **Matthew Schroeder**, managing director of accounting policy at Goldman, the largest U.S. securities firm by market value, in an

April 2006 letter. **Companies are allowed to decide for themselves which of their outstanding bonds, loans and other liabilities will get mark-to-market treatment. That's an unprecedented degree of leeway, said Willens, who is also an adjunct professor at Columbia University in New York.** "It's kind of a dumb rule," Willens said. "In the entire panoply of accounting, this is the most flexible and elective and optional rule that we have." The Fed Objects Here's how it works, according to [Richard Bove](#), an analyst at New York-based Ladenburg Thalmann & Co. A company decides to designate \$100 million of its subordinated bonds as subject to mark-to-market accounting. The price of the bonds drops to 80 cents on the dollar from 100 cents. So the firm books \$20 million on the "presumed savings that you have on your liabilities," Bove said. **"In the real world you didn't save a dime," he said. "You still owe the \$100 million. It's another one of these accounting rules that basically takes you further and further away from reality."** The Federal Reserve, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and Office of Thrift Supervision objected to the rule before its passage, **saying in a joint 2006 letter to the FASB that it would "have the contrary effect" of increasing a bank's net worth at the same time its "financial condition is deteriorating."** Split at FASB The regulators remain so skeptical that they refuse to let banks apply the phantom revenue toward minimum capital requirements, according to reporting rules posted on the Web site of the Federal Financial Institutions Examination Council. [Deborah Lagomarsino](#), a Washington-based spokeswoman for the Federal Reserve, declined to comment. Merrill's Liabilities Merrill designated about \$166 billion of liabilities, or 17 percent of its total, as fair-value instruments subject to mark-to-market accounting at the end of 2007, according to its annual report. Included in the amount were \$76.3 billion of long-term borrowings and \$89.7 billion of payables under securities-financing transactions. Merrill has said its gains from the liabilities don't add to true earnings power. **In a spreadsheet posted on its Web site, Merrill says that investors who want a "more meaningful period-to-period comparison" should exclude the \$2.1 billion of revenue recorded in the first quarter.** Lehman to Goldman Lehman, the fourth-biggest securities firm, has reported \$1.9 billion of gains related to a widening of its own bond spreads. Citigroup, the largest U.S. bank by assets, has booked \$1.7 billion; Morgan Stanley \$1.7 billion; JPMorgan Chase & Co., the third-biggest bank, \$1.7 billion; and Goldman Sachs \$550 million. 'Shell Game' So far, most banks' writedowns are "unrealized," meaning they've been unwilling or unable to liquidate distressed assets. If prices reversed, the banks would record mark-to-market profits. The same is true for the liabilities. Companies can't "realize" the mark-to-market gains on their debt unless they buy it back at the discounted price. They're unlikely to do so, because the deterioration in creditworthiness means they'd have to replace the debt with higher-cost borrowings, Willens said. **"No one's going out in the market and actually retiring this debt," Willens said. "It's a shell game."** David Moser, Merrill's managing director for accounting policy, acknowledged that concern in an April 10, 2006, letter to the FASB. **"It seems counterintuitive that when a company's credit spreads are widening, it would recognize a gain in earnings," Moser wrote. "The amounts are typically not realizable and therefore less relevant."** Market Reversal **Bear Stearns Cos., which adopted the new standard this year, reported a \$305 million windfall in the fiscal first quarter, which ended in February, as bond spreads widened on concerns the company might face a funding**

shortage. Then in March, after the New York-based securities firm was forced to sell itself to JPMorgan, Bear Stearns's bond spreads tightened, resulting in a \$372 million loss, according to a regulatory filing in April. Worthington estimates that similar tightening of bond spreads at Merrill, Morgan Stanley, Lehman and Goldman Sachs may cause them to reverse \$5.96 billion of revenue by the end of the year. Standard & Poor's, which relies on banks' financial statements to issue credit ratings, said in April 2006 that the new rule might lead to **``diminished analytical transparency.**``
``Equity may be overstated as a result of these illusory gains that may never be realized, hindering the analysis of the equity cushion to absorb losses,`` S&P Chief Accountant Neri Bukspan wrote in a letter to the FASB. If and when the ``illusory`` revenue is reversed as losses, the banks and brokers may have to work harder to convince investors to ignore them, Willens said. **Wall Street Says -2 + -2 = 4 as Liabilities Get New Bond Math**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=a2ppBYA0ELaU&refer=home>

Don't Fight The Fed

I Disagree . . . and why

Article of the week:

Best of the Dog