

The Other Side of the Street March 2, 2008

Comments

Happy 18 K.C. Wade!!!!

That was the only concurrent note (and more important than anything else in here). The following are observations made March 23 on the events noted below.

So what is a VIE (Variable Interest Entities)? As of this point in time, I do not know. I will be next week though.

Under the derivatives section is an interesting analysis of CDO issues by the US Comptroller of Currency. Interesting in part because I never saw any news of this and it has a very significant potential impact in extension of credit. It is yet another example of why I always want to look at original source materials.

You will also see below the late February reports of huge losses by Freddie and Fannie. It was these same real time disasters that ran up 50 plus percent the week of the BSC implosion. Using BSC as an example, I feel comfortable stating their common will be worth less than 2 bucks by this time next year.

Stock Notes

- Meanwhile, government-sponsored mortgage-lender **Fannie Mae (FNM, \$27.27, 0.30, Spy)** posted a huge fourth-quarter loss, as the dismal housing and mortgage markets continued to drag on performance. For the quarter, Fannie swung to a loss of -\$3.6 billion, or -\$3.80 per share, from a profit of \$604 million, or 49 cents per share, a year ago. The results were far worse than the -\$1.24 per share loss analysts were predicting. For the year, the company reported a total loss of -\$2.05 billion, or -\$2.63 per share, compared with a profit of \$4.05 billion, or \$3.65 per share, in 2006. Shares of Fannie Mae were up 1.1% at day's end.
- In related corporate news, Fannie Mae and **Freddie Mac (FRE, \$25.09, -0.12, Spy)** will have restrictions lifted that had limited the amount of mortgages that the companies could hold on the books. The Office of Federal Housing Enterprise said it would boost the limits on Saturday. The restrictions had been imposed in 2006 after accounting lapses at the government-sponsored companies. The increased limits mean the mortgage companies will now have billions of dollars in free funds that can be used to invest in the housing market. Freddie Mac's stock closed -0.5% lower.
- In earnings news, **Freddie Mac (FRE, \$24.49, -0.60, Spy)** posted a wider-than-expected fourth-quarter loss, but said it does not anticipate raising new capital this year unless things get "dramatically worse." The government-sponsored mortgage lender reported a Q4 loss of -\$2.45 billion, or -\$3.97 per share, versus a loss of -\$401 million, or -73 cents per share, in the prior year. Had it not been for a change in the way it accounts for certain obligations,

the company said its fourth-quarter loss would have totaled -\$3.7 billion. Freddie's loss far exceeded the general consensus of analysts who were predicting a loss of -\$2.34 per share. Freddie's stock was -2.4% lower at the close.

- **Feb 25 - Aunt Fannie (FNM)** and **Uncle Freddie (FRE)** were downgraded to "sell" this morning at **Goldman Sachs** following similar sentiments by **Merrill** on Friday.
- Merrill Lynch released a report last week saying the bank messed up its cash flow numbers for 2005, 2006, and 2007. The "error was due to an adjustment that incorrectly reflected cash flows received from certain customer transactions. The adjustment resulted in an overstatement of cash flows received from derivatives financing transactions (financing activities) and was offset by a corresponding overstatement in cash flows used for trading liabilities (operating activities)." If anyone at Merrill Lynch really knows what that means, we haven't seen any evidence of it. When the people running the company don't want you to know what their disclosures mean, sell... as fast as you can.
- Wall Street knew the fourth quarter at **AIG (AIG)** would be bad, but few thought it would be [this bad](#). The travails of the largest property and casualty insurer in the United States show just how quickly eroding values of derivatives on derivatives can get out of hand: \$5.3 billion loss in the 4Q, the largest in the firm's 90-year history \$11.1 billion in write downs on [credit default swaps](#) backing subprime CDOs \$2.6 billion in write downs on its general investment portfolio \$6.2 billion in annual income, down 56% from last year [Earlier this month](#), AIG spooked investors with news its auditors had found a "material weakness" in its accounting systems and that it would take larger than expected losses on subprime derivatives. The company revealed that write downs for October and November would be close to \$5 billion; write downs in December accelerated to over \$6 billion. Minyans wanting a reminder of how write downs can effect a company's balance sheet should review Professor Depew's insightful - - and hilarious -- [primer on credit-related write downs](#). Financial markets haven't exactly stabilized since the beginning of the year, as [concerns over solvency at bond insurers](#) **Ambac (ABK)** and **MBIA (MBI)**, coupled with [failing auction rate securities markets](#), have struck fear in the hearts of investors. It's safe to assume AIG's results for the first two months of 2008 likewise haven't improved much. The company said that, although write downs may have a material effect on operating results for a single reporting period, they "will not be material" to the company's financial condition. The evaporation of over \$15 billion in asset value evidences how easily derivatives created out of thin air can disappear into that same vacuous space. Minyanville
- Fourth-quarter profit at **Deckers Outdoor (DECK, \$110.64, -15.82, Spy)** almost tripled on strong demand for its UGG brand products, but shares plunged -12.5% on soft first-quarter guidance. The footwear maker posted net income of \$35.4 million, or \$2.69 per share, up from \$12.2 million, or 95 cents per share, last year. Sales surged in the quarter to \$194.2 million, a 57% increase from \$124.4 million

a year ago. General consensus showed analysts were looking for a profit of \$2.41 per share on \$184 million in sales. Looking forward, however, Deckers said it is looking for sales to improve 25% compared with 2007, but that first-quarter earnings would be "the same or moderately higher" than the 75-cent profit posted in 2007. Analysts were predicting a Q1 profit of 92 cents per share.

- **Bond insurers Ambac and MBIA will keep their coveted AAA credit ratings, announced Standard & Poor's Feb 25 ...** confirming the corruption and consistent inaccuracy in the ratings industry. Debt issued by both of these insurers will maintain the same credit rating as bonds from the likes of GE and Exxon Mobil... at least for now. **MBIA -- a company with a \$1.8 billion market cap -- insures over \$670 billion in bonds.**
- **Not surprisingly, home wares supplier Lowe's turned in a doozy of an earnings report yesterday.** Fourth-quarter profit fell an impressive 33%. Same store sales dropped 7.6% during the last quarter of 2007, and the company said sales will continue to fall at least 5% in the current quarter.

Notes

- The monetary system of planet earth, circa 2007, is simple. Arab nations export oil. Europe exports luxuries. Asia exports autos and gadgets. America exports dollars. Yes, dear reader, the buck gets around. It has more stamps in its passport than we do. The Treasury Department tells us that most of the world's dollars are now outside the 50 states. Sixty percent of them pass from hand to hand without hearing an English word or getting a chance to go to a baseball game. The same is true for U.S. government debt. There's three times as much of it in the hands of foreigners – \$2.11 trillion – as there is in American mitts. DR
- **Winter weather and drought have damaged some 23 million hectares of Chinese farmland.** A severe drought in northern China, coupled with abnormally frigid temps in south and east China, has scared a plot of land collectively the size of Idaho... one-sixth of China's entire farmable landscape. Unless Mother Nature provides a quick turnaround, much of this land may not be usable for the 2008 growing year, and some may not recover for years... if at all. Add this to last week's reports of Chinese consumer prices spiking to 11-year highs of 7%, a massive recent global run-up of grain prices, a current bear market in Chinese stocks and the ever-looming "global economic slowdown."
- **Two of the nation's largest 401(k) stewards saw frightening retirement withdrawals and loans in the fourth quarter.** Fidelity Investments, the U.S.'s largest mutual fund provider, said yesterday that 401(k) withdrawals jumped 17% in December, the biggest decrease in the company's history. Great-West, which manages 3.5 million retirement accounts, also recently reported a 14% yearly increase in 401(k) withdrawals in 2007. DR
- **"History shows,"** Rogers wrote in the foreword to our book back in 2002, **"people who save and invest grow and prosper, and the others deteriorate and collapse.** "Artificially low interest rates and rapid credit creation policies set by Alan Greenspan

and the Federal Reserve caused the bubble in U.S. stocks of the late 1990s... **Now policies being pursued at the Fed are making the bubble worse. They are changing it from a stock market bubble to a consumption and housing bubble. “When those bubbles burst, it’s going to be worse than the stock market bubble.** No one, of course, wants to hear it. They want the quick fix. They want to buy the stock and watch it go up 25%... because that’s what they say on TV.” DR

- “Government’s lone fiscal watchdog resigns,” is the relevant headline. It refers to David Walker, head of the Government Accountability Office. **Mr. Walker has been alarmed at the growing indebtedness of the U.S. government for a long time.** He regularly travels, doing what he calls the ‘Fiscal Wake-Up Tour’, warning all who will listen that the United States is headed for big trouble if it doesn’t get its finances under control. The basic problem is well known and has been frequently illustrated throughout history. Democracy responds to the mob of voters; and the mob wants bread and circuses – at someone else’s expense, of course. **In America, circa 2008, Congress responds to the desires of people who vote in current elections.** The voting age has been lowered to 18, but the next generation, the unborn generation, has no voice in modern government. Not even a whimper. **Inevitably, politicians pander to the living in order to get votes...and inevitably the next generation gets the bills. The last time we looked, the shortfall between what had been promised – in the form of Treasury bonds, Medicare, Medicaid, Social Security and the like – and what might reasonably be collected in taxes totaled up to some \$50 trillion, or about a half a million dollars per family.** In other words, the whole country is bankrupt...and the financial obligations of the U.S. federal government should be regarded by investors as though they were subprime debt. It is a huge debt that the debtor cannot pay. As headman at the General Accounting Office, David Walker, has been fretting about this for years...and trying to get the politicians to cut spending and balance the budget. He might as well have been trying to get a pack of wolves to eat Greek salads for lunch. It has been a thankless, frustrating job, especially during the Bush II years. **This ‘conservative’ administration added more to America’s burden than all the administrations since George Washington – put together.** During an interview for *I.O.U.S.A.*, Addison found out that Mr. Walker had read our book – *Empire of Debt* – on his own accord. This, we believe, is what pushed him over the edge. So, now he’s resigned...but isn’t giving up on the cause he’s been fighting for all of those years at the GAO. Pete Peterson, Commerce Secretary under Richard Nixon and founder of the Blackstone Group, has set up a foundation and given Mr. Walker a job. He’ll have \$1 billion to work with...and the impossible task of trying to bring U.S. government finances in order. DR
- In the United States, as we keep pointing out, the supply of paper money is rising three times the speed of GDP growth. In places like Russia...it is growing five or six times as fast as GDP. China’s inflation is at an 11-year high...and at more than 7% is becoming alarming. Don’t expect Chinese exports to hold down prices in the United States anymore...now they’re just another inflationary pressure. Meanwhile, the masses are deeply in debt. Their major asset is what they live in, and house prices are about the only thing going down. Their only other major resource is their own labor – which is overpriced in global terms. Inflation will bring it down to more competitive levels. The government is deeply in debt too. It has let out notes it can’t pay...sold bonds it can’t

honor...and made promises it can't keep. Inflation, there too, would reduce the burden.
DR

- **As oil flirts with new highs every day, Congress is doing its part to ensure it reaches \$150 per barrel.** The House approved a multibillion-dollar oil tax bill yesterday. Should the bill be approved by the Senate and President Bush, the bill will roll back two tax breaks for the U.S.'s five largest oil companies... one helps manufacturers compete against foreign state-owned oil companies, and the other gives U.S. companies tax breaks for using American oil and gas services. Authors of the bill estimate the bill will cost those five U.S. oil companies \$18 billion. The bill would then, in turn, use that money to invest in alternative energy research. DR
- **IPOs worth more than \$21 billion have been pulled off the global docket so far this year,** reports Thompson Financial. Following 2007, the biggest year for IPOs in history, the \$21 billion in dead deals marks the highest on Thompson's record. In fact, this month will go down as the first February since 1992 when IPO activity declined from January. DR
- Meanwhile, there are trillions of dollars worth of derivative contracts outstanding. Here, the problem is not so much that the banks are hiding their losses...but that they don't know what their losses are. Even Robert Rubin, formerly the head man at Goldman and the U.S. Treasury, says he didn't really know much about CDOs either, until they began to blow up last summer. And then, two weeks ago, the world's leading insurance company, with a trillion dollar balance sheet, and net income greater than the GDP of some sovereign nations, announced that it had made a mistake. It had "discovered a material weakness in its internal control over financial reporting and oversight relating to the fair value valuation of the super senior credit default swap portfolio." Anybody can make a mistake, of course. And whether AIG made a mistake when it first analyzed its swaps...or a mistake when it reconsidered its swaps...or will make another mistake when it rethinks them again...is anyone's guess. Our guess is that there are more "mistakes" to be uncovered...because, as we will explain in some future *Daily Reckoning* ramble, the whole proud tower of modern financial business is based on a compounded series of frauds, subterfuges and mistakes-waiting-to-be-discovered. In retrospect, the \$15 billion investors wiped from AIG's market cap may turn out to be wishful thinking. The losses could go much, much higher...and take many years to be discovered. DR
- Feb 29, 2008 - UBS reported today that financial firms will lose at least \$600 billion once this crisis plays out. So far, banks have only announced \$160 billion in losses. What will cause the extra \$440 billion? Variable Interest Entities (VIEs). **Bond research firm CreditSights estimates VIEs will cause \$88 billion in losses for financial firms.** And Goldman Sachs warned it may see \$11.1 billion in losses at the hands of VIEs. We've been saying for a long time that Goldman wouldn't escape the credit debacle without taking a large loss. And \$11 billion is even bigger than we expected. If you want to look inside the company that gave AAA ratings to MBIA and Ambac, **just talk to Tanya Azarchs, managing director for financial institutions at S&P. As she tells it, the ratings don't mean much anyway. Azarchs discussed a lesser-known off-balance sheet entity called variable interest entities (VIEs) with Bloomberg: "The disclosure on VIEs is hopeless. You have no idea of the structure or how that structure works. Until**

you know that you don't know anything. It's like every day you come into the office and another alphabet soup has run off the rails."

- Feb 27, 2008 -New home sales in January 2008 fell 2.8% from the prior month and fell 33.9% from the prior year, to 588,000.
- March 3 (Bloomberg) -- Australia's central bank will probably increase interest rates to a 12-year high to cool an economic expansion stoking the fastest inflation in almost two decades. Governor Glenn Stevens will raise the overnight cash rate target by a quarter point to 7.25 percent, adding to last month's increase, according to all 27 economists surveyed by Bloomberg News. The economy, now in its 17th year of expansion, probably grew 0.8 percent in the fourth quarter from the previous three months, a separate survey showed.
- **Apollo: Time Not Right Yet For Distressed Investing.....**The economic conditions aren't yet right for distressed investing, Apollo Management founding partner Leon Black said Tuesday. "The banking system is more broken than it's ever been but, we have not yet had the economic downturn that makes for great distressed investing," Bank loan spreads are at an all-time high, but high-yield spreads have yet to reach their 1990 and 2001 levels. "In 2001 the S&P (index) fell 45% peak-to-trough. Now it's only 15% down," said Black.
- Feb. 26, 2008 The euro hit an all-time high versus the dollar Tuesday as weak U.S. data combined with concerns over further interest-rate cuts to send the greenback down sharply across the board.
- In the face of growing volatility and uncertainty in the market, the Federal Deposit Insurance Corp. is strengthening its ranks in preparation for the possibility of failing financial institutions, according to The Wall Street Journal. The FDIC will seek to rehire 25 of its own retired members, many of whom specialize in bank closings and who dealt with such matters in the the 1980s and 1990s. The agency now employs 233 people, mainly based in Dallas. The agency is also searching for a company experienced in bank closings to assist them: On Sunday the FDIC ran a newspaper ad seeking a company that could deal with mortgages and student loans in the event of a bank failure.
- **Bond insurers Ambac and MBIA will keep their coveted AAA credit ratings, announced Standard & Poor's yesterday ...** confirming the corruption and consistent inaccuracy in the ratings industry. Debt issued by both of these insurers will maintain the same credit rating as bonds from the likes of GE and Exxon Mobil... at least for now. Ambac stock rose 13% on the news. MBIA shot up 17%. DR
- **MBIA -- a company with a \$1.8 billion market cap -- insures over \$670 billion in bonds.**
- **"The U.S. is in recession,"** Jim Rogers told reporters on a visit to Dublin yesterday. "It is going to get worse. They [the U.S. central bank] are printing money and are trying to prevent the recession -- they are putting on Band-Aids," he said. "The Japanese did it and the Japanese still have not recovered 18 years later. As long as the [U.S.] central bank and the federal government keep making the mistakes, you will have a longer period of slowdown and it will be perhaps one of the worst recessions we have had in a long time in America."
-

Weblinks

Credit

Commercial Real Estate

Commodities

Currency

- **Feb 28, 2008 Middle Eastern nations who drop their dollar peg would significantly decrease inflation, Alan Greenspan told Saudis at a conference in Jeddah yesterday. Inflation in the Saudi kingdom is surging at roughly the same rate as the U.S.'s PPI, up 7%, a 27-year high. Likewise, in the UAE, inflation is climbing at a rate of 9.3%, a 19-year high. "In the short term, free floating," Greenspan said, "will not fully dissipate inflationary pressure, although it would significantly do so."** As if the dollar weren't in bad enough shape... the former chairman of the Fed is telling Saudis to ditch the greenback. "Talk about a shot across the dollar's bow," cries Chuck Butler from the EverBank trading desk. "A slap in the face! All those types of metaphors rolled together. The former Fed chairman who had his hands deep into the mess that started all this is telling people to abandon the dollar! DR
- But inflation reduces the value of wages. The gold-linked dollar was never a perfectly stable currency. It went up and down. But the dollar of 1930 was still worth about as much as the dollar from Washington's era. Then, the link with gold was weakened; between '30 and '71, the greenback lost about 70% of its value. After 1971, there was no link to gold at all and the dollar fell even faster. If a dollar was worth 100 cents in 1930, by 1971 it was worth only 30 cents...and by 2007...only about 5 cents. DR
-

Diversification

Derivatives

- February 27, 2008 - NEW YORK — Comptroller of the Currency John C. Dugan today outlined steps that should be considered in response to the very large losses incurred by banks and other investors who held tranches of securities that were considered so safe as to be almost impervious to loss. **"These better-than-triple A tranches were supposed to be the least risky parts of the subprime securities pyramid," Mr. Dugan said in a speech to the Global Association of Risk Professionals. "Instead they have generated the clear majority of reported subprime write downs in capital markets, which in turn have been at the core of several of the worst episodes of the market's disruptions."** The losses came from so-called "super senior" tranches of collateralized debt obligations consisting of securities backed by subprime mortgages, or "subprime ABS CDOs." **Because these CDO tranches carried triple A ratings, even risk averse and regulated firms, like banks, insurance companies, and money market mutual**

funds, felt comfortable investing in these securities, either directly or indirectly through conduits, and some of the firms involved in structuring the securities apparently felt safer in keeping very large concentrations of these assets on their books. But the systematic weakening in subprime underwriting standards, combined with a significant decline in house price appreciation throughout the country, resulted in a sharp spike in defaults and delinquencies. And that in turn led to rating downgrades and exceptionally large mark-to-market losses on the super-senior tranches of ABS CDOs. **Among the steps that should be considered, Comptroller Dugan said, are improvements in underwriting standards for subprime mortgages. “While national banks were not the primary originators of subprime mortgages that have gone bust – they originated just 10 percent of such mortgages in 2006, for example, with lower delinquency rates than the national average – the OCC has joined other regulators in raising standards across the board for all banking organizations,” the Comptroller said. “The challenge will be to extend these standards in a meaningful way to nonbank lenders and brokers regulated exclusively by the states.”** The Comptroller also urged changes in the approach rating agencies take to rating subprime ABS CDOs. While “investors should never rely exclusively on credit ratings in making investment decisions, the plain fact is that triple A credit ratings are a powerful green light for conservative investors all over the world,” he said. One critical characteristic of the triple A tranches of securities that caused so much trouble is that they perform differently from other types of triple A rated securities, including corporate securities. **In times of severe stress, they may incur exceptionally large losses. “At a minimum, I believe that the credit rating agencies need to do a much better job in disclosing the distinctions between the likely performance of triple A-rated structured securities and triple A-rated corporate securities,” Mr. Dugan said. “If triple A means different things in different contexts, then we all need to know that.”** However, he said, neither investors nor regulators should rely exclusively on credit ratings when evaluating the credit risk in a highly rated tranche of an ABS CDO. “This may seem obvious to everyone now, but exclusive reliance on ratings has been all too common a practice,” he added. “There is really no excuse for institutions that specialize in credit risk assessment – like large commercial banks – to rely solely on credit ratings in assessing credit risk.” **The Comptroller also said that packagers of ABS CDOs should not retain large concentrations of super-senior tranches on their balance sheet, no matter how low they perceive the risk to be. “What most differentiated the companies sustaining the biggest losses from the rest was their willingness to hold exceptionally large positions on their balance sheets – which in turn led to exceptionally large losses,”** Mr. Dugan said. Finally, Mr. Dugan said that regulators should reconsider the part of the Basel II capital rules that apply to senior tranches of securitized structured credit such as subprime ABS CDOs. “For example, should the securitization provisions of Basel II establish a unique set of higher risk weights for ABS CDOs and other re-securitizations, reflecting the higher vulnerability to systemic risk as evidenced by recent events?” he asked. The Comptroller said that policy makers and market participants should actively consider whether these and other steps might be necessary to avoid future market disruptions. “I have only touched upon a few of the questions facing policy makers in the coming months, Comptroller Dugan said. “There are many others, and I believe it is our collective responsibility to learn from the current

disruptions and take steps now to help prevent a recurrence of the problems in the future.” Comptroller of the Currency John C. Dugan (<http://www.occ.gov/dugan.htm>)

Housing

- The national median existing-home price for all housing types was \$201,100 in January, down 4.6% from a year ago. But the price decline is easily explained away says the NAR, because the slowdown in sales is greater in high-cost markets. NAR President Richard Gaylord, a broker with RE/MAX Real Estate Specialists in Long Beach, CA, said, “Keep in mind the biggest slowdown in home sales last year was in high-cost markets, which were hard-hit by the credit crunch and notably higher interest rates for jumbo loans, but relief is on the way.” What relief might that be? Why, the higher FHA and conventional loan limits for **Fannie Mae (FNM)** and **Freddie Mac (FRE)**. **“Once buyers have greater access to higher loan limits, it will take a few months for increased shopping activity to translate into higher sales,”** Gaylord said. **“We should see some movement of pent-up demand by this summer, but higher loan limits need to be implemented fully and promptly to have maximum benefit.”** Meanwhile, Lawrence Yun, NAR chief economist, said, “As the increased limits for FHA and conventional loans are implemented, more buyers will have access to safer FHA loans and lower interest rate loans in high-cost areas, **which could lead to steadily higher home sales later in the year.”** **[MORE shameless pumping]**
- **Existing home sales fell for the sixth month in a row in January to a new record low.** Such sales fell 0.4% last month, to an annual rate of 4.8 million units sold, reports the National Association of Homebuilders yesterday. That’s the slowest pace since at least 1999, when the NAR started keeping track. For what it’s worth, sales of existing homes are now down an amazing 20% from their 2005 high. The inventory of unsold homes also rose in January, by 5.5% to a 10.3-month supply, just short of a multidecade high. For perspective, during the peak of the housing boom in 2005, inventory fell as low as a four-month supply. As of January, over 4.2 million homes were for sale in the U.S.
- House resales are at a 9-year low. And the **housing slump** is working its way into family budgets. The housing boom of ‘97-’07 raised the real value of residential U.S. real estate by approximately \$8 trillion. **Americans “took out” \$3 trillion, according to an estimate we saw recently. That \$3 trillion boost was responsible for much – or perhaps all – of U.S. GDP growth over the past five years.** But now that housing prices are going down, the implied wealth in residential housing is shrinking. And instead of taking money out of their homes, mortgage lenders are demanding that they put it back in. Millions of families are already said to be ‘upside down’ with more mortgage than house. If they sell – and many must sell – lenders expect them to make up the difference.
DR
- But housing isn’t done yet. **New home sales fell 2.8% in January, to an adjusted annual rate of 588,000.** That’s a 34% decline year over year -- the slowest rate since 1995. Likewise, the median price of a shiny new house slid 4% from December, to

\$216,000, said yesterday's Commerce Department report. One year ago, the median new home price was \$254,400, 15% more than today. DR

- "NAHB's housing forecast now shows a 25% decline in total housing starts for 2008, with the single-family component down by 31% for the year. We still expect starts to begin edging up in the final quarter of this year. Downside risks to our housing forecast for 2008-2009 remain considerable, largely because of the heavy inventory overhang and the uncertain outlook for house prices, mortgage foreclosures and mortgage credit conditions." **Existing home sales fell for the sixth month in a row in January to a new record low.** Such sales fell 0.4% last month, to an annual rate of 4.8 million units sold, reports the National Association of Homebuilders yesterday. That's the slowest pace since at least 1999, when the NAR started keeping track. For what it's worth, sales of existing homes are now down an amazing 20% from their 2005 high. The inventory of unsold homes also rose in January, by 5.5% to a 10.3-month supply, just short of a multidecade high. For perspective, during the peak of the housing boom in 2005, inventory fell as low as a four-month supply. As of January, over 4.2 million homes were for sale in the U.S. What's more, the national median home price fell yet again, now down to \$201,100. This time last year, the average existing home fetched nearly 5% more...
- **Foreclosure filings skyrocketed 57% in January, year over year**, reports RealtyTrac this morning. 233,001 homeowners filed in January, up 8% from December. Of those homes, over 45,000 were repossessed by loaners... in January alone. Nevada, California and Florida led the way last month. An incredible one in every 167 homes in Nevada was in some stage of foreclosure during the month.

Housing Finance

- **Foreclosure filings skyrocketed 57% in January, year over year**, reports RealtyTrac this morning. 233,001 homeowners filed in January, up 8% from December. Of those homes, over 45,000 were repossessed by loaners... in January alone. Nevada, California and Florida led the way last month. An incredible one in every 167 homes in Nevada was in some stage of foreclosure during the month.
- Just how extraordinary is this downturn in housing? Well consider that former Federal Reserve Vice Chairman Alan Blinder wrote a piece for the [New York Times](#) over the weekend advocating the resurrection of the Home Owners' Loan Corporation (HOLC). What is this Home Owners' Loan Corporation and why do we supposedly need it? The HOLC was part of the Home Owner's Refinancing Act, a Franklin D. Roosevelt New Deal agency established in 1933... during the Great Depression. The purpose of the HOLC was to provide homeowners with refinancing to prevent foreclosure. Part of its legacy was the extension of mortgage payments from a then-standard 15 year term to 30 years. As Blinder notes in his op-ed piece, HOLC at one point owned nearly one in every five mortgages in the U.S. Almost 20% of those borrowers defaulted anyway, leaving the HOLC with the titles on about 200,000 houses. Expect more of these proposals resurrecting New Deal agencies and bailouts to pop up in the months and years ahead. What is extraordinary is not merely the fact these agencies are being proposed in the first place, but that no one seems to bat an eye about advocating a return to economic policies

last implemented during the Great Depression! Are we the only ones who find this stunning? We're not heading into a recession. We're already *in* a Stealth Depression. Minyanville

•

Macro Economic

- **Durable goods orders fell 5.3% in January -- the steepest drop in five months** , evidence that the slowdown conceived in the housing sector is spilling over into the “real” economy. Yesterday’s Commerce Department report showed the first net fall in durable goods orders since October. But the larger-than-expected 5.3% drop erased all gains made over the past two months. Defense orders led the way, you might be surprised to learn, falling nearly 20% in January. Orders for “transportation equipment” were down too, falling 13% last month. Computers and fabricated metals fared poorly as well, down 11% and 4%. DR
- Feb. 28 (Bloomberg) -- **The U.S. economy expanded less than forecast in the fourth quarter as domestic spending declined and only an increase in exports prevented an overall contraction.** Gross domestic product rose at a 0.6 percent annualized rate, unchanged from the initial estimate last month, after a 4.9 percent gain in the third quarter, the Commerce Department said today in Washington. “There's a better-than-even chance that we have actually entered a recession,” Harvard University economist [Martin Feldstein](#) said in a Bloomberg Television interview. “The numbers for December and January have basically been flat to down.” The report, combined with figures today showing claims for unemployment insurance jumped last week, reinforced traders' expectations that the Federal Reserve will cut interest rates again and helped drive the dollar to a record low against the euro. Investors raised the odds of a three-quarter point cut in the benchmark rate by the end of the next meeting on March 18 to 34 percent from 10 percent yesterday. Fed Chairman [Ben S. Bernanke](#), testifying to the Senate Banking Committee today, signaled he's ready to lower interest rates again to sustain the expansion. The median estimate in a Bloomberg News survey of 74 economists was for a 0.8 percent increase in GDP. **Jobless Claims** Harvard's Feldstein is also president of the National Bureau of Economic Research and a member of the group's business-cycle dating committee, which marks the beginning and end of expansions. He said in the interview it could be months before the NBER declares if a recession has officially started. The Labor Department said initial **claims** for unemployment insurance climbed 19,000 last week to 373,000, higher than forecast. The level was the second-highest since a surge in claims in the aftermath of Hurricane Katrina in 2005. “**We have absolutely no momentum going into the first quarter,**” said [Josh Shapiro](#), chief U.S. economist in New York at Maria Fiorini Ramirez Inc. “Things are looking pretty grim for the economy. If we're not in a recession already, we're very close.” The **trade deficit** narrowed to an annualized \$506.8 billion, adding 0.9 percentage point to GDP. **Excluding the improvement in trade, the economy would have shrunk at a 0.3 percent annual pace, the first decline since 2001, when the U.S. was last in a recession.** **Rate Cuts, Stimulus** “Obviously there's been slowing and that's what we expected,” said [Ed Lazear](#), chairman of the White House Council of Economic Advisers,

said in an interview with Bloomberg Television. **“We do think the Fed has moved quickly enough to help get the economy going,”** along with the \$168 billion fiscal stimulus enacted this month, he said. Consumer **spending**, which accounts for more than two-thirds of the economy, rose at a 1.9 percent annual rate in the fourth quarter, down from the 2 percent increase estimated last month, according to today's report. Deteriorating sentiment is likely to keep restraining spending. Purchases may grow at a 1 percent pace this quarter, according the median estimate in a Bloomberg survey. The survey also projected 0.5 percent growth this quarter. Slowdown, Not Recession “I don't think we're headed to a recession, but there's no question there's a slowdown,” President George W. Bush told a press conference in Washington today. Consumer **confidence** fell this month to the lowest level since 2003 as the job market deteriorated, according to a report this week from the Conference Board, a New York-based research group. Americans' expectations for the next six months dropped to the lowest level since January 1991. Adding to concerns about spending, revisions for the third and fourth quarters also showed smaller gains in incomes, according to today's report. Personal income increased at a 4.1 percent annual pace from October through December, compared with an initial projection of 4.5 percent. Income growth may slow further in coming months as the labor market softens. The U.S. lost jobs for the first time in four years in January and weekly initial jobless for jobless benefits have risen. Revisions Fourth-quarter estimates for commercial construction, business investment on new equipment, government spending and inventories were also revised down. **Residential construction decreased at a 25 percent pace, more than previously estimated and the most since 1981.** Declines are likely to continue through much of 2008. Lowe's Cos., the world's second-largest home-improvement retailer, said this week that fourth-quarter profit fell and several “challenging” quarters remain as the worst housing slump in more than 25 years deepened. “It will still be a tough housing market through the balance of 2008,” Lowe's Chief Executive Officer **Robert Niblock** said in a Feb. 25 interview. “It'll probably be into 2009 before you're seeing a recovery.” **U.S. Economy: GDP Rose 0.6%, Less Than Anticipated**
http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=ajKoVr4x0qIk

- Feb. 26 (Bloomberg) -- U.S. consumer confidence fell to the lowest level in five years and wholesale inflation picked up, limiting the Federal Reserve's room to maneuver as it tries to avert a recession. **The Conference Board's index of confidence dropped to 75.0 in February, lower than forecast, from 87.3 in January, the New York-based group said today. The Labor Department reported that producer prices rose 1 percent last month.** Excluding food and energy, expenses climbed 0.4 percent, the most in almost a year. Consumers, whose spending accounts for most of the economy, are being buffeted by lower home values, rising unemployment and elevated gasoline and food prices. Fed Vice Chairman Donald Kohn, speaking today ahead of Chairman Ben S. Bernanke's Congressional testimony tomorrow, signaled the central banker is willing to keep interest rates low to revive the economy. “It's maybe a mini bout of stagflation and it's troubling,” Nigel Gault, chief U.S. economist at Global Insight Inc. in Lexington, Massachusetts, said in an interview on Bloomberg Television in New York. “It does limit the extent to which the Fed's going to be able to act further.” Home prices in 20 U.S. cities fell in December by the most on record, a separate report showed today. The

S&P/Case-Shiller home-price index dropped 9.1 percent from a year ago, after a 7.7 percent decrease in November. Home Depot Inc., the world's largest home-improvement retailer, today said fourth-quarter profit fell and forecast earnings below analysts' estimates. Economists expected the Conference Board's measure would fall to 82 from a previously reported 87.9, according to the median of 66 forecasts in a Bloomberg News survey. Estimates ranged from 76.3 to 87. The share of consumers who said jobs are plentiful declined to 20.6 percent, from 23.8 percent last month. Those saying jobs are hard to get increased to 23.8 percent from 20.6 percent a month ago. The proportion of people who expect their incomes to rise over the next six months decreased to 17.0 percent from 18.1 percent. The share expecting more jobs dropped to 9 percent from 10.5 percent. **“I do not expect the recent elevated inflation rates to persist,” Kohn said in the text of a speech to the University of North Carolina, Wilmington. “The adverse dynamics of the financial markets and the economy have presented the greater threat to economic welfare in the United States.”** Mishkin's Concern Other Fed officials, including Governor Frederic Mishkin yesterday, have warned that higher prices may stoke inflation expectations. “What you've got is a lot of inflationary pressures building,” said Roger Kubarych, chief U.S. economist at Unicredit Global Research in New York, who correctly forecast the rise in core prices. For now, “the Fed will put them in second position in terms of priority until this financial strife settles down,” he said. **Over the past 12 months, producer prices rose 7.4 percent, the most since October 1981.** Wholesale prices excluding food and energy advanced 2.3 percent in the year through January. The median forecast of 70 economists in a Bloomberg News survey was for wholesale prices to rise 0.4 percent from December. Core prices were expected to advance 0.2 percent, according to the survey median. Food Costs Escalate Energy costs increased 1.5 percent after falling 3 percent in December. The price of gasoline rose 2.9 percent. Food prices climbed 1.7 percent, the most since October 2004. Crude food prices, which cover costs of corn and wheat, increased 2.7 percent. Kellogg Co., the largest U.S. cereal maker, last week affirmed its 2008 profit forecast after boosting prices to counter rising wheat and energy costs. **“Unprecedented commodity and energy inflation” forced Battle Creek, Michigan-based Kellogg to raise prices, Chief Executive Officer David Mackay said at conference in Boca Raton, Florida. The increases were “across our global portfolio and across almost all segments.”** **U.S. Economy: Confidence Falls, Producer Prices Rise**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=ab89U80BVTYs&refer=home>

Retail

Retirement

Risk

- **Standard & Poor's has affirmed the credit ratings of beleaguered bond insurers MBIA and Ambac Financial at AAA, its highest rating.** S&P also recently affirmed the AAA rating of another insurance company: Berkshire Hathaway. It said Berkshire's AAA rating would not be hurt by the company's recent entry into the bond insurance

market. It said the rating is based on "its extremely strong competitive position, extremely strong insurance and reinsurance capitalization, and extremely strong financial flexibility." I wonder how many of those same attributes S&P finds at MBIA and Ambac? Strong competitive position? Writing new business must be hard for MBIA and Ambac, given their current and ongoing state of implosion and Berkshire's recent entry. Strong capitalization? Their equity could easily be wiped out by the losses on all the toxic asset-backed garbage they've guaranteed. Strong financial flexibility? Well, they've been granted a temporary stay of execution by the ratings agencies, and they managed to raise a little new capital. **But I doubt anyone in the Western world could describe their current financial condition as "flexible."** It's probably more like "arthritis." Says our friend Whitney Tilson, whose firm is short both MBIA and Ambac, **"This kabuki dance [of re-affirmed AAA ratings] is likely to be meaningless in the end because these companies... are likely to incur tens of billions of losses."** Another short seller, Doug Kass, adds simply, "If you want AAA, buy batteries, not MBIA stock." DR

Savings Rate

Tech

Wall Street

- Feb. 26 (Bloomberg) -- Even Goldman Sachs Group Inc. and Lehman Brothers Holdings Inc. may find they haven't dodged the credit crisis. The new source of potential losses: so-called variable interest entities that allow financial firms to keep assets such as subprime-mortgage securities off their balance sheets. VIEs may contribute to another \$88 billion in losses for banks roiled by the collapse of the housing market, according to bond research firm CreditSights Inc. **Goldman, which hasn't had any of the industry's \$163 billion in writedowns, said last month it may incur as much as \$11.1 billion of losses from the instruments.** The potential for a fire-sale of the assets that would bring another round of charges has "always been our greatest fear," said Gregory Peters, head of credit strategy at New York-based Morgan Stanley, the second-biggest securities firm behind Goldman in terms of market value. VIEs, known as special purpose vehicles before Enron Corp.'s collapse in 2001, finance themselves by selling short-term debt backed by securities, some of which are insured against default. Now that Ambac Financial Group Inc. and other guarantors have started to lose their AAA financial-strength ratings, Wall Street firms may be forced to return those assets to their books, recording the declining value as losses. MBIA Inc., the biggest insurer, said yesterday it plans to separate its municipal and asset-backed businesses, a move Peters said would likely result in a lower credit rating for the types of assets owned by VIEs. **'Significant Consequences'** Wall Street's writedowns stem from a surge in mortgage delinquencies among homeowners with the riskiest subprime-credit histories. The industry's VIEs, also known as conduits, had \$784 billion in commercial paper outstanding as of last week, according to Moody's Investors Service and the Federal Reserve. **"There's a big number at work here and it will have significant consequences," said J. Paul Forrester, the Chicago-based head of the CDO practice at law firm Mayer Brown. "The great fear is that a combination of subprime CDOs, SIVs and conduits result in a flood of assets into an already-stressed market and there's a price collapse."**

CreditSights has one of the highest projections for additional losses. Moody's says the fallout from VIEs, collateralized debt obligations, and other deteriorating assets may run to \$30 billion. CDOs are packages of debt sliced into pieces with varying ratings. 'Lightning Rod' One type of VIE that's already been forced to unwind or seek bank financing is the structured investment vehicle, or SIV. Like SIVs, VIEs often issue commercial paper to finance themselves and may have multiple outside owners that share in the profits and losses. Because banks agree to back VIEs with lines of credit, they have to buy commercial paper or notes when no one else will. Ambac, the world's second-biggest bond insurer, and two smaller competitors lost a AAA rating from at least one of the three major ratings companies in recent months. Standard & Poor's yesterday affirmed the AAA ranking of MBIA, the largest "monoline," though it said the outlook is "negative." MBIA yesterday eliminated its quarterly dividend and said it won't write new guarantees on asset-backed securities for six months. The more widespread the downgrades, the more likely the assets in the VIEs will be cut. Some buyers of the debt demand the highest ratings, giving banks a vested interest in helping the insurers salvage their ratings. Ambac Financing New York-based Ambac may get \$3 billion in new capital with the help of Citigroup Inc. and Dresdner Bank AG as early as this week, the Wall Street Journal reported yesterday. MBIA raised money by selling common shares and warrants to private-equity firm Warburg Pincus LLC and issuing \$1 billion of surplus notes. "The lightning rod of the monoline fix is so important to so many banks," said Thomas Priore, chief executive officer of New York-based Institutional Credit Partners LLC, which manages \$12 billion in CDOs. Accounting rules allow financial firms to keep VIEs off their balance sheets as long as they're not the ones that stand to gain or lose the most from the entity's activities. A bank would also have to account for its portion of a VIE if prices for the debt owned by the fund fall too far or if the bank is forced to provide financing. Goldman, Lehman Goldman, the most profitable Wall Street firm, and Lehman, the biggest commercial-paper dealer, have avoided much of the pain so far. Goldman, which earned a record \$11.6 billion in the year ended in November 2007, said it avoided writedowns by setting up trades that would profit from a weaker housing market. Now the threat is \$18.9 billion of CDOs in VIEs, the firm said in a regulatory filing on Jan. 29. Goldman spokesman Michael DuVally declined to comment. Merrill Lynch & Co. analyst Guy Moszkowski today cut his estimate for Goldman's first-quarter earnings for the second time this month, citing growing losses from assets outside residential mortgages. Lehman, which wrote down the net value of subprime securities by \$1.5 billion, guaranteed \$6.1 billion of investors' money in VIEs and \$1.4 billion of clients' secured financing as of Nov. 30, according to a filing also made on Jan. 29. "We believe our actual risk to be limited because our obligations are collateralized by the VIE's assets and contain significant constraints," Lehman said in the filing. Spokeswoman Kerrie Cohen wouldn't elaborate. Citigroup Losses Citigroup, which has incurred \$22.1 billion in losses from the subprime crisis, has \$320 billion in "significant unconsolidated VIEs," according to a Feb. 22 filing by the New York-based bank. New York-based Merrill Lynch, which recorded \$24.5 billion in subprime writedowns, has \$22.6 billion in VIEs, according to CreditSights. Merrill spokeswoman Jessica Oppenheim declined to comment, as did Citigroup's Danielle Romero-Apsilos. The securities in the VIEs may be worth as little as 27 cents on the dollar once they're put back on balance sheets, according to David Hendler, an analyst at New York-based

CreditSights. Hender based his estimate on the recent sale of \$800 million of bonds by E*Trade Financial Corp. Predictions for losses vary widely because banks aren't required to specify the type of assets being held in the VIEs or how much they are worth, said Tanya Azarchs, managing director for financial institutions at S&P. "The disclosure on VIEs is hopeless," Azarchs said. "You have no idea of the structure or how that structure works. Until you know that you don't know anything. It's like every day you come into the office and another alphabet soup has run off the rails." **Goldman, Lehman May Not Have Dodged Credit Crisis**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=alExwdst38cQ&refer=home>

- Feb. 26 (Bloomberg) -- Blackstone Group LP, manager of the world's biggest private-equity fund, plans to bypass Wall Street firms and directly find lenders for leveraged buyouts, President Hamilton James said. The firm is contacting hedge funds and mutual funds to provide loans for takeovers, James said after a panel discussion today at the Super Return conference in Munich. Other firms may follow New York-based Blackstone's lead, he added. "We're bypassing the banks," James said. "There's still ultimately demand for this paper out there if you can go directly to the buyers." **The move may cut fees for Wall Street firms** led by JPMorgan Chase & Co., which earned \$412 million last year arranging loans for U.S. buyouts, more than twice its takeover advisory fees, according to data compiled by New York-based research firm Freeman & Co. and Thomson Financial. Banks are trying to cut a \$230 billion backlog of debt they agreed to provide, making them less willing to back new buyouts. **Blackstone Plans to Line Up LBO Lenders, Bypass Banks**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=apKFdUbJq1UU&refer=home>

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

UM EMBA

Best of the Dog

Sunday, March 02, 2008 at 12:10 CDT

Happy Birthday to K.C.

and thanks for 18 years of joy to all of us. Congratulations also on your Ivy League indoor performance (I heard that the Princeton training regime was riding around on a golf cart - good work if you can get it)

as for the markets. should be a very wild Monday. once again it will be interesting to see if a large gap down brings frenzied buying.

Saturday, March 01, 2008 at 08:09 CDT

checking in from Virginia indoor track states!

where I enjoyed watching my dear niece Colleen a freshman run a splendid leg of the 4 by 800. She posted a PB.

On the market front, the Dow's October PB looks a little safer after this end of week drubbing.

As noted earlier, irrational reaction to news can only last so long. What was "special" in the news that caused the late week sell off? nothing.

instead what was insane was the previous two weeks mid-day rallies on non-news. Speaking of which, do you think the SEC will investigate CNBC's Charlie Gasparino Friday afternoon market pumps???? How many tens of billions changed hands due to his deceitful report thirty minutes before the market closed that six banks were going to bail out Ambac last Monday or Tuesday (for those of you who did not know it caused a minus 100 plus day to turn into a 100 plus day). Did not happen did it???

The fraud and chicanery on Wall Street has never been higher in recent memory and I do remember Enron and the junk bond/S & L years. Sadly the people that end up paying are the investing public. It will take many years to work through the excess. This will adversely impact the remaining lives of the boomers because 20-50% losses in the next few years can not be made up before retirement.

and how about the food and energy prices? thank goodness those are excluded from core inflation. great none of us have to eat right? let's see who probably spends more as a percentage of income on food, the fat cats on wall street whose irresponsible actions caused the current credit crisis or retirees whose fixed income investments are being thrown under the bus by the interest rate cuts?

well, back to the short term were the market goes from here news that most of you read the dog to see.

simple. down and at an accelerating pace. there is a very ominous bear wedge. when this breaks it will break to the downside and another significant leg down will follow. we will then see the same "bottom is in buying" and such action will characterize the tape the rest of the year.

I am frequently asked where we end the year. The answer is I do not know, nor does anyone else. I do know that the economy will NOT be rebounding in the second half. I do know that until hands are burned very badly there will be those who want to "buy the dips" and call the bottoms. Unless there is some, to me, unforeseeable stability that suddenly pops into the credit market and lenders begin to loosen not tighten the purse strings, the bottom buyers will get burned just as the February Fools are about to be.

In the very near term, expect the January lows to be tested, for buyers to be found, for the lows to then be retested and broken. time frame, best guess is the next five weeks (said six weeks last week, so five is merely to be consistent, no magic).

Wednesday, February 27, 2008 at 11:04 CDT

take a hard look

at the green today and ask yourself, “what is it that is priced in?”

the latest in stock promotion is that the market keeps rallying on horrendous news because the bad news is “priced in.” This despite the fact that the “news” continues to be much worse than the analysts predicted and the economists envisioned.

on the flip side we saw yet another moonshot because Bernacke is testifying that the fed stands ready to make more cuts. This is news? To whom? That the Fed intends to abandon the savers to bail out its buddies on Wall Street has been expressly clear since August.

What is currently more than priced in is a V shaped economic recovery with one of the greatest second halves in many years.

It will NOT happen. The second half will be much worse than the first half.

As for today, I doubt there are enough February Fools left with money to hold the tape up into the close. Look for significant selling in the last 2-3 hours and out on the lows. If not, there will be yet another wave of bad news to turn the tide tomorrow.