

The Other Side of the Street November 2, 2008

The financial system problems are a result of the proliferation of exotic financial instruments called derivatives. Historically mortgages were held at the originating lender, a government regulated bank or savings and loan. However, financial firms in an effort to generate substantial fees devised ways for lenders to package loans and sell them to investors. This worked well as long as the borrowers paid. Now that many borrowers have ceased paying, these derivative instruments have grown in risk and loans to nonsubprime borrowers are being impacted. Should the deterioration spread into other loans, great economic pain is likely to follow. – Southern Vanity magazine article March 2007

The S&P 500 was valued at 10.7 times estimated profit when trading opened today, the cheapest compared with the multiple using trailing profit since 1985. The MSCI World Index traded near the cheapest relative to earnings since at least 1995. – October 28, 2008 Bloomberg

The slump has made stocks cheap by historical standards. [Demonstrates yet again how meaningless ‘historical standards can be] Europe's Stoxx 600 is valued at 11.1 times its companies' profits, the lowest since at least 2002, according to data compiled by Bloomberg. The 1,953-member MSCI World has a price- earnings ratio of 14.3, the cheapest since at least 1998. - Financial Times article January 2008 with concurrent MJK comment in red

Outstanding credit-card debt has risen 75 percent since 1999, while real wages have grown 4 percent in the same period, - Bloomberg November 1, 2008

“Let's imagine that you bought the Dow Jones Industrial Average in 1929,” Eric entreats, “AFTER it had already fallen 42% from its high. (Why 42%? Because that's the amount that the modern-day Dow just fell.) How do you think you would have fared? Do you think you would have made money very quickly or very slowly? “The answer is ‘both’ -- you would have enjoyed a quick bounce. But if you did not sell into that bounce, you would have lost 80% of your capital during the next two years. If you had held on, however, you would have recouped your original investment... 22 years later!”

Comments

Thanks!

I want to thank those of you who have an interest in my thoughts and read what I write. I thought of this because in a recent piece Andy Rooney commented on how writers are very

egotistical in that they think what they write is worth reading. Thus those of you who read this are giving me a gift by your interest in what I am thinking.

With that idea in mind, I have both macro and micro thoughts. Later in these comments I have some ideas I wrote during the week identified by the time at which I wrote them. The following are thoughts from Sunday morning.

I was out throwing toys in the pool with Buddy and reading the Economist. I came up with the following:

- The lead articles are about change in the U.S. and how different things look in 2008 than they did in 2000. One article goes on to posit that in 2017, 8 years hence, “a combination of demography and the rising costs of America’s huge entitlement programs will be starting to bankrupt the country.” How truly frightening is that. In essence, 2009 might be the “good old days”.
- Given the foregoing, I think anyone who trusts the financial advisor “just stick with the long term plan” will be destitute. I think the only way to avoid calamity is what I have always recommended and this is taking personal responsibility for your finances and spend time each year looking at where you are, where you want to be and how you intend to get there.
- I think it less important to figure out how to finance your future than it is to figure out what you would like your future to be. The vast majority of us are content to think that everything works out in the long run and allow day to day events to take us through the months, years and ultimately decades. Living for the day is in fact a plan. In a society that may collapse financially, it can be argued that such a plan makes more sense than trying to provide for a future when the majority of others do not. In essence all of the bailouts are transferring wealth and security from those who tried to act responsibly to those who did not. Thus one might decide that since the likely future is bleak that one should live for the moment and simply get in the free cheese line with everyone else in the future. (I have a particular axe to grind on this one having read that Chase is redoing mortgages for those who are having problems. Well . . . I have a mortgage with Chase . . . I had very serious financial problems caused largely by the government continuing manipulating the markets, abrogating contracts, and making midnight rule changes . . . No one called me up for a do over on my mortgage, NOR WOULD I HAVE ACCEPTED ONE . . . My solution was a more time honored one – I went WITHOUT for a long while. As a result I am not in a position to not only pay my own way but to subsidize those who made not effort to . . . but enough of that rant for now.)
- Since we did such a miserable job of guessing what the last 8 years would yield, I think it nuts to try to extrapolate anything from the nut jobs who have been calling market bottoms because XYZ indicator shows that the time is now. For those of you my age and up, does this not sound lots like the magic 8 ball – “the spirits say the outlook is good!” Instead the sole way to manage money to try for

- So in my instance, what I am doing is taking time out to think. The past 18 months have demonstrated that rational planning can not account for the bastardization of the system created by government manipulation nor can it allow for the effects of tremendous overleverage of irresponsible players (yes think gold and silver right now – it is absurd that they have not soared in light of the trillions of give aways. However, what “should happen” is irrelevant, what is happening is the only thing that matters. BTW I believe that the opportunity to buy leverage in gold and silver futures options or in GLD options is the greatest risk reward opportunity I have ever seen as long as you go out 15 months or more.
- It is critical to have a plan, understand your plan and be willing to stick to it. Today’s “what is my balance” mentality will never lead to success. The sole metric that matters is: the purchasing power value of my investments the day I need to buy something with it. What happens between today and that moment in time is irrelevant.
- Your “investments” are not your accounts; your real investment is your life. Figure out a way to enjoy it with the resources you are likely to have and you will have a wonderful one. Try to keep up with the Jones and not only will your life be less fulfilling but you will also be unlikely to achieve “financial security or investment success” unless you wish to devote your life to investing.
- If you’ve read this far, I will spare more philosophy for now and simply let you know that I am in fact going to spend more time in the next few months looking for the “new plan”, the old one being “get out of this market and into fixed investment” as the easy part of the collapse is now over and the “sit in cash” will destroy value now more than preserve it. To the extent you feel the need to sit in some interest bearing safe harbor look at Canadian government bonds. . . .

Wednesday morning: So now it has come to bailout out large hedge funds because they took outside positions shorting Volkswagen and got burned. Well guess what hedge funds are supposed to be hedged and not instead to make huge bets on one position. It may come as a surprise to you all but I have in fact lost lots of money on many positions from time to time. The worst beatings this year caused by gross market manipulation by the U.S. government, yet I hope I have never written that the government or anyone else should bail me out. The bottom line is that no one held a gun to my head and made me take any position. Similarly there has not been one person who lost money on anything in the markets or in the mortgages (including those who took on mortgages they could not afford) who was forced into those transactions. Instead they were all done by people who thought they would get a benefit. The fact they were wrong is

almost entirely as a result of the failure to think through the consequences of events transpiring differently than they had hoped.

Thoughts for a Monday afternoon [penned AH October 26]: It is difficult to find anyone writing about the equity markets without some version of “this is the greatest buying opportunity ever” or “we will see one last big wash out and then we will see a great buying opportunity”. I characterize either as optimistic because in the later, the assumption is that while there are others who will still panic, the savvy investors are simply waiting them out. Puzzling over this and thinking about the slow motion crash that has occurred, I am wondering if in fact we are now in a situation where there is so much dissemination of information and so much group hand holding that we will not in fact ever see the panic wipeout. Instead, what no one seems to be looking for is a continuing leak of the balloon to much lower lows. Further the structure of investing has now changed so there are many intermediaries between the ultimate investor and the money. Institutions that drink the Kool-Aid of “it is all a buying opportunity” have most of the money. The pensioners have no ability to bail on the pension funds, which are by and large run by computer mandate to stay fully invested in something. The mutual funds are sold by legions of brokers and financial advisors who are all harping on the “stay invested, it works in the long haul”. The marginal players the hedge funds and those running their own money are unlikely to be panicking as much as they are being margined slowly to death or long ago have moved to the sidelines. The ones with lots of money to some extent are looking for the big wipe out before they step in. Further, the vast experience all of us have is that history has shown in the last 25 years or so that every major drop ended up being a good time to buy, thus the longer we go without a gut wrenching collapse, does it not make it more likely that one will not happen? This also factors back in to the idea that information is much more widely disseminated, and, due to 401Ks, IRAs, etc, a much larger percentage of the population feels like they have some understanding of investing. So with all that, who is it that will panic???

So what will happen? As I have said repeatedly no one knows. However, what is unlikely to happen is what is widely expected. The true wild card in all this is whether any of the actions being taken will create the confidence needed to allow the leverage game to continue. As discussed many times, the system as a whole is levered on the concept that people believe in the currency and other mediums of exchange. This idea is in tatters and until sufficient people stop trying to hoard assets and/or can reach a point where they are not forced to sell, anything can happen. Thus, despite all the bravado found on TV and in political speeches, there is no evidence that we are anywhere other than groping around in the dark collectively hoping that we aren't wandering towards a deeper abyss. To the extent there is to be a cataclysmic sell off, I for one am not seeing the catalyst, however I am one of those waiting for it so I can buy (i.e. no panic here). Thus I end as I began, with many more questions than answers on a Monday afternoon . . .

Stock Notes

- American Express plans to cut about 7,000 jobs, or about 10%, of the company's work force, and is also suspending management salary increases and instituting a hiring freeze.

Notes

In the third quarter of 2008, consumers reigned in their spending by the greatest margin in 17 years. Looking closer at [yesterday's GDP data](#) , we see that the Commerce Dept.'s measure of consumer spending fell by an annual rate of negative 3.1% -- the first significant consumer spending pullback since 1991, and the biggest since 1980.

- So the EU wants the U.S. to expand debt to save the world. Much like the drug dealer trying to get the addict to go steal stuff to buy more drugs IMO - "If Mr Obama wins, the Democratically-controlled executive and legislative branches could work quickly together to forge an aggressively expansionary fiscal policy that could lead to a more optimistic mood not only in the US but in the capital markets more generally." -FT
- **Still, according to the Bank of England today, global credit crisis losses now exceed \$2.8 trillion. In its semiannual Financial Stability Report, the BoE reported global banks are financially unstable and losing money.**
- Another momentous day arrived in the global financial markets yesterday. The Dow Jones Industrial Average fell to a fresh five-year low, while Japan's Nikkei Index fell to a fresh 26-year low. Most of the rest of the world's stock markets also tumbled to new multi-year lows. Many of the year-to-date declines look like misprints: London's FTSE Index is down 53%, Hong Kong's Hang Seng Index is down 60%, Russia's RTS Index is down 76%.

Web links

Credit

- Nov. 1 (Bloomberg) -- **India's central bank unexpectedly cut interest rates for the second time in two weeks and reduced the amount of money lenders must hold in reserve in a bid to protect the economy from the global slowdown.** The Reserve Bank of India lowered its [repurchase rate](#) to 7.5 percent from 8 percent, reduced the amount of deposits that lenders need to set aside as [reserves](#) to 5.5 percent from 6.5 percent, and cut the amount of money lenders are required to keep in government bonds to 24 percent from 25 percent. The steps signal a U-turn from the Reserve Bank's policy stance just a week ago, when Governor [Duvvuri Subbarao](#) said a "heightened vigil" was needed to fight inflation. The U.S. Federal Reserve, the Bank of Japan and other central banks also slashed borrowing costs this week in an attempt to prevent a global credit crunch from pushing the world into recession. "This is a strong message that growth has become the central bank's priority," said [Sujan Hajra](#), chief economist at Anand Rathi Securities Ltd. in Mumbai. "He has room to cut rates because global interest rates are coming down as well, and so the risk of a further weakening of the rupee is limited." Growth 'Moderation'
The Bank of Japan yesterday cut its key overnight lending rate by 20 basis points to 0.3 percent after the Fed three days ago lowered its target rate for overnight loans to 1 percent, matching a half-century low. Norway, China, Taiwan and Hong Kong also trimmed their benchmark rates this week. India's decision to lower borrowing costs was taken "in view of the ebbing of upside inflation risks and also to address concerns

relating to the moderation in the growth momentum," the central bank said today. Credit Squeeze ``It's a good set of measures that addresses the most pressing need of the hour, which is to ease liquidity constraints in the system" and support growth, said [Arvind Sampath](#), head of interest-rate trading at Standard Chartered Plc in Mumbai. ``This kind of fund injection is required to bring in stability in the financial market," said [Jayesh Shroff](#), who helps manage about \$6 billion at SBI Asset Management Co. ``The system has been under stress because of liquidity shortfall." Cash dried up in India's banking system as overseas investors pulled out \$12.7 billion from India's stock markets. **India Unexpectedly Cut Interest Rates to Spur Growth**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=abPM9GUQijz8&refer=home>

- Oct. 28 (Bloomberg) -- Sales of longer-term commercial paper soared 10-fold after the [Federal Reserve](#) began buying the corporate IOUs, a sign that the central bank's efforts to unlock the market may be working. Companies yesterday sold more than 1,500 issues totaling a record \$67.1 billion of the debt due in more than 80 days, compared with a daily average of 340 issues valued at \$6.7 billion last week, according to data published by the Fed. Most of the difference was probably absorbed by the Fed, said [Adolfo Laurenti](#), a senior economist at Mesirow Financial Inc. ``**That's the very first really good news in quite some time,"** said Laurenti, who is based in Chicago. ``**It's probably something the government can do and the normal investor would not otherwise do."** **[It will be a good sign when the private sector believes it can invest in this debt.]** The Fed began buying commercial paper from companies yesterday to reduce rates, lure back investors and unlock the market, which seized up last month following the bankruptcy of [Lehman Brothers Holdings Inc.](#) General Electric Co., which sold debt to the Fed yesterday, Korea Development Bank and [Morgan Stanley](#) are among several dozen companies that have signed up for the program, which was announced on Oct. 7. Fed's Rate The Fed today set the rate it's willing to accept for 90-day unsecured commercial paper at 2.89 percent, including a 1 percentage point credit surcharge, up 0.01 percentage point. The 90-day secured asset-backed rate is 3.89 percent, according to Fed data compiled by Bloomberg. The rates are set under the Fed's Commercial Paper Funding Facility and are available on CPFF. Many companies use commercial paper, which typically matures in 270 days or less, to finance their daily operations. Lehman's bankruptcy filing on Sept. 15 caused the market to lock up, preventing many borrowers, particularly financial companies, from selling anything but overnight paper. Quoted rates on 90-day commercial paper fell 15 basis points to 3.19 percent, according to yields offered by companies and compiled by Bloomberg. Rates on the highest-ranked commercial paper due in 30 days rose 6 basis points today to 2.94 percent, the highest in a week. **The average yield financial companies paid yesterday to issue 90-day commercial paper plunged 70 basis points to 2.55 percent, or 1.05 percentage points more than the target lending rate, according to the Fed, signaling the program may be working. Historically the rates are about the same.** Financial company yields reached a nine-month high of 3.99 percent on Oct. 6. By contrast, non-financial issuers paid 1.95 percent yesterday. Companies on Oct. 10, 2003, sold \$32.9 billion of commercial paper due in more than 80 days, the previous record, according to Fed data.

Commercial Real Estate

Commodities

- October 28 2008 23:32 FT **Output from the world's oilfields is declining faster than previously thought, the first authoritative public study of the biggest fields shows.** Without extra investment to raise production, the natural annual rate of output decline is 9.1 per cent, the International Energy Agency says in its annual report, the World Energy Outlook, a draft of which has been obtained by the Financial Times. The findings suggest the world will struggle to produce enough oil to make up for steep declines in existing fields, such as those in the North Sea, Russia and Alaska, and meet long-term demand. **The effort will become even more acute as prices fall and investment decisions are delayed.** The IEA, the oil watchdog, forecasts that China, India and other developing countries' demand will require investments of \$360bn each year until 2030. The agency says even with investment, the annual rate of output decline is 6.4 per cent. The decline will not necessarily be felt in the next few years because demand is slowing down, **but with the expected slowdown in investment the eventual effect will be magnified, oil executives say.** "The future rate of decline in output from producing oilfields as they mature is the single most important determinant of the amount of new capacity that will need to be built globally to meet demand," the IEA says. **The watchdog warned that the world needed to make a "significant increase in future investments just to maintain the current level of production".** The battle to replace mature oilfields' output could even offset the decline in demand growth, which has given the industry – already struggling to find enough supply to meet needs, especially from China – a reprieve in the past few months. It expects oil consumption in 2030 to reach 106.4m barrels a day, down from last year's forecast of 116.3m b/d. The projections could yet be revised lower because the draft report was written a month ago, before the global financial crisis deepened after the collapse of Lehman Brothers. All the increase in oil demand until 2030 comes from emerging countries, while consumption in developed countries declines. As a result, the share of rich countries in global demand will drop from last year's 59 per cent to less than half of the total in 2030. This is the clearest indication yet that the focus of the industry on the demand – not just the supply – side is moving away from the US, Europe and Japan, towards emerging nations. **World will struggle to meet oil demand** <http://www.ft.com/cms/s/0/e5e78778-a53f-11dd-b4f5-000077b07658.html>
- The 1970s also had two major oil price spikes. The first in 1973-74 and the second in 1979-80. We've already had one oil spike now, if a second one arrives in the next few years, it could push prices through \$200 a barrel. That's because the global oil industry has not been re-investing very actively in developing new production. America's neglect of "making things" is very evident in the oil business. Phillips says the U.S. has a "dated, ghost-of-glories past petroleum infrastructure." He writes that the major oil companies "are wealthy, but aging behemoths, hard-pressed to maintain production levels, despite large exploration outlays, and no longer enjoying access to overseas oil fields they once commanded." Exxon Mobil, once the largest oil company in the world, now ranks 25th

by booked oil reserves. The top 10 are all state-owned national oil companies (NOCs). The top 13 NOCs own four-fifths of the world's known oil reserves. They don't share them cheaply. A look at where we get our oil is not encouraging. Most of these sources of supply are not particularly reliable. As Phillips opines (the table below comes from his book): "Of the eight principal 2007 suppliers of petroleum to the United States as of August, only one, Canada, could be called secure and reliable." Mexico seems secure, but exports have been falling since 2004, as Mexican production has fallen. It could become an insignificant source of oil by 2012. And we are not alone in competing for these oil reserves. China became a net oil exporter in 1993, and its appetite grows every year. It is now the world's second largest consumer of oil, behind only the U.S. China actually imports more oil from Saudi Arabia than the U.S. This partnership is not surprising, given the dynamics of the New Silk Road. The "New Silk Road" is a term I use for the boom in trade between countries from the Middle East to China. In matters of energy, you see a lot of deals inked on the New Silk Road. Saudi Arabia and China get together regularly like newfound pals. Sinopec, a Chinese oil company, recently got the OK to explore the Saudis' Empty Quarter for oil and gas. Saudi Aramco, the big oil company, put \$750 million toward a huge plant in China.

Currency

Diversification

Derivatives

Housing

- The S&P/Case-Shiller home-price indexes, a closely watched gauge of U.S. home prices, showed prices in August continue to decline, with areas along the Sun Belt being hit hardest. In 20 major metropolitan areas, home prices dropped 16.6% from the prior year, and 1% from July. Just two of the 20 regions were able to avoid price declines in August over July - Cleveland, with 1.1% growth, and Boston, which eked out a 0.1% gain. Year over year, all fell.
- New home sales are still down 33% from this time last year. The average price is down too, 9% from September of 2007. The average new house sells for \$218,400, the lowest median price since 2004.

Housing Finance

Macro Economic

- Nov. 1 (Bloomberg) -- China's manufacturing contracted as the worst financial crisis since the Great Depression eroded export demand. The [Purchasing Managers' Index](#) fell to a seasonally adjusted 44.6 last month from 51.2 in September, the China Federation of Logistics and Purchasing said today in an e-mailed statement. That was the lowest since the gauge was launched in July 2005. A reading below 50 reflects a contraction, above 50 an expansion. China's cabinet has pledged extra infrastructure spending to stimulate the

world's fourth-biggest economy amid the global slowdown. The government has already lowered rates three times in the past two months, increased export rebates and cut property transaction taxes. "The government needs effective stimulus measures to spur growth," said Wang Qian, a Hong Kong-based economist at JPMorgan Chase & Co. "The external economic outlook is worsening rapidly." Manufacturing contracted in July for the first time since the survey began in 2005. It also shrank in August. The October index was a record low. China's economy grew at the slowest pace in five years in the three months through September as export orders shrank and industrial production waned. The expansion cooled for a fifth straight quarter, to a 9 percent gain from a year earlier. **China Manufacturing Contracts as Crisis Trims Exports**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=asxpXKBhstjU&refer=home>

Percentage wise, at 10.8%, the rally ranks sixth. The S&P and Nasdaq trundled alongside the old lady like puppies.

After finding a new "credit crisis" low on Monday, traders on Wall Street snapped back with vengeance. But it's not the higher highs we'll be watching for the rest of the week -- but lower lows. During each sell-off since extreme volatility began three weeks ago, we've reached all-new lows.

The Japanese market performed in a similar way through the entire decade of the '90s. It rallied at least 30% higher five times since 1992, before finding new lows again, and again... and again. ¹

ABC News' Huma Khan reports: In testimony before the House Committee on Ways and Means, New York Gov. David Paterson chided the federal government for not providing enough oversight to prevent the financial crisis and urged it to provide aid to states to curb their budget deficits. In contrast, South Carolina Gov. Mark Sanford called for less federal involvement in state matters and more flexibility.

"There is no doubt we are currently in a statewide recession," Paterson said. "And if history is any guide, the recession will be more severe and longer lasting in New York state than it is in the nation as a whole."

Paterson said he will propose the largest spending reductions in the history of the state next year.

"Funding for many worthy programs, several of which I personally support, will have to be curtailed dramatically," he said. "This is not something I want to do, but it must be done."



Paterson said he expects the needs for social services to increase while investment in infrastructure by states declines. He proposed federal funding for states for transportation and water improvement projects.

He called on the federal government to assist states, especially in the form of “direct and immediate fiscal relief” to help close budget deficits. He emphasized that New York had been “shortchanged” by federal officials in terms of aid, saying that the post-9/11 recovery package the federal government promised the state was never given.

Other measures he proposed included: an extension of Emergency Employment Compensation benefits and modernization of the unemployment insurance system, a temporary boost in funding for the food stamp program and a moratorium on federal regulations that negatively impact state budgets.

“States didn’t cause this crisis and we shouldn’t be left to deal with it alone,” he said. “A rescue package from the federal government will help soften the blow for average Americans. It could make the difference between targeted, surgical spending reductions that will help heal our fiscal condition... Unless states receive fiscal relief, I believe the goal of stabilizing the economy cannot be achieved.”

Trenton, N.J. Mayor Douglas Palmer echoed the theme, emphasizing that a partnership needs to exist between the federal government and city governments.

Sanford, meanwhile, strongly urged Congress to not approve a new stimulus package, saying that it would only boost the national budget deficit.

“I believe that some time in the not-so-distant future we’re going to reach a breaking point when that \$52 trillion will come due, and that our potential inability to pay will have frightening ramifications by either completely trashing the value of the dollar or creating hyperinflation, which robs from every middle class worker across America,” he said.

Sanford was referring to a stimulus package under consideration by Congress that would help states in financing infrastructure projects. The size of the new plan is expected to be between \$150 and \$300 billion, although an exact dollar figure is not yet known.

The economic crisis, Sanford said, was predictable “for the simple reason that gravity always works... One could go as far back as Biblical times and look at the passage of the seven fat and seven skinny cows coming out of the Nile in Pharaoh’s dream to remember that this notion of business cycles, credit cycles, the up-and-down of the economy, is one of the constants in history.”

Sanford questioned the need for more federal government expansion and involvement in states’ affairs, instead asking for more state freedom and flexibility.

An expansion of federal government scope “will create strong negative unintended consequences, particularly with the \$52 trillion dollars of liability the federal government already has,” he said.

Sanford recommended to instead give states relief from unfunded mandates so that they have more options.

Most of the speakers placed emphasis on the need for more infrastructure investment for schools and education, citing the decline in quality of schools.

“With the frightening rise in mortgage foreclosures, schools are seeing record numbers of students who are homeless or poor enough to qualify for free school meals,” said Dennis Van Roekel, president of the National Education Association.

There was also discussion on more job creation and infrastructure investment.
<http://blogs.abcnews.com/moneybeat/2008/10/ny-governor-cal.html>

- **Ukraine and Hungry are getting emergency bailouts from the IMF.** Ukraine will get a 2-year loan of \$16.5 billion, while Hungry will get a similar amount to be announced later this week. They’ll mark the first and second nations to get official bailouts from the IMF during this credit crisis, but likely not the last.
- Further to the left on the map, **Kuwait has slipped into crisis mode.** The Kuwaiti government propped up Gulf Bank, its biggest bank, by suspending trading on GB stock and guaranteeing its deposits. Kuwaiti market makers responded with a walkout at the KSE, their second tantrum in the last four days. Most of the traders marched to the closest government building for an orderly bout of pissing and moaning. “We want the government to intervene,” a protestor told the AFP, “to rescue the bourse and traders. We want the government to buy stocks. This month, I have already lost half my investments in the bourse.” [we want the government to pay us for losses while we keep gains, how wonderful the new American ideals are spreading!!]
- We’ve been [writing](#) about Japan’s “lost decade” since 2002, when it looked like the U.S. was going to enter an economic cycle similar to the boom and bust that wrecked the Nipponese economy in the 80s and 90s. Now, it appears we’re looking at three lost decades. Sayonara. DR²
- **The Shanghai Composite found a new low of its own this weekend, too.** The Shanghai Composite is now down 72% from its 2007 high, a two year low.

Retail

- Nov. 1 (Bloomberg) -- Home Depot Inc., Sears Holdings Corp. and other retailers may lose as much as 8 percent of their holiday sales this year because lenders and stores are clamping down on financing. **Almost a quarter of shoppers say banks cut the spending limits on their credit cards, according to a survey by America's Research Group, which also provided the sales-loss estimate.** More people are being rejected for new cards, hurting sales for bigger purchases. Demand is being pinched just as retailers prepare to enter the holiday selling season, which accounts for as much as 35 percent of their annual revenue. "Banks just don't have the money," said David Bassuk, a New York-based managing director at consulting firm AlixPartners LLP. **The tightening credit is putting retailers "at big risk to lose those sales or lose those customers," he said. "There is a big concern there with the holiday spending."** [how about that . . . people are not going to be able to spend money they don't have . . . despite what the retailers might think this is actually GOOD for the long term health of the nation with long term being YEARS, what a novel concept!] U.S. consumer spending, the biggest part of the economy, tumbled in September, and a purchasing managers' survey showed the biggest deterioration since 1968. That foreshadows a deeper slump for gross domestic product, which contracted at a 0.3 percent pace in the third quarter. **About two-thirds of holiday purchases are made using credit cards, estimates America's Research Group Chairman Britt Beemer. That excludes gift cards, three-quarters of which are also bought using credit cards,** he said. His Charleston, South Carolina-based firm surveys 10,000 consumers a week. First Decline Beemer predicts holiday sales will decrease at least 4 percent, the first decline since he started forecasting in 1979, as consumers grapple with sinking home and stock values. His projections have been correct in 16 of the past 17 years. Retailers that offer zero- or low-interest financing -- which is often backed by banks -- **may also rein in the credit they extend to shoppers to avoid being left with bad loans when customers can't pay them back.** [again, what a novel concept -- thinking about the ability of those borrowing to repay loans before extending them] If financing is "offered, it's going to be to a much smaller segment of the population," said Red Gillen, a senior analyst at Boston consulting firm Celent LLC. "It's great to attract customers with these financing deals, but you don't want to be holding delinquencies." **A quarter of consumers polled in a Standard & Poor's survey released Oct. 15 said they're at or near the limits on their primary credit card, and 20 percent said they're approaching the limit on their secondary cards.** Lending Standards Wal-Mart Stores Inc. executives told analysts at a meeting this week that customers have "maxed out" their credit cards. **Outstanding credit-card debt has risen 75 percent since 1999, while real wages have grown 4 percent in the same period,** according to a report last month by Innovest Strategic Value Advisors, headquartered in New York. **Consumer credit outstanding fell in August for the first month since January 1998, the Federal Reserve said Oct. 7.** Best Buy Co. and other sellers of big-ticket items such as flat-screen televisions may be the hardest hit as in-store financing becomes less available and shoppers seek out cheaper items, said George Whalin, president of Retail Management Consultants in Carlsbad, California. Buying pricier products would push many to their credit limits, he said. Credit ratings on new accounts

have declined, particularly in areas like Florida and California that were hurt the most by the housing shakeout, **Kohl's Corp.** Chief Executive Officer **Kevin Mansell** said in an Oct. 29 interview. Kohl's has lowered approval rates in those regions, he said. Banks are mailing fewer card applications to consumers, according to Synovate Mail Monitor, a division of New York research firm Synovate. In the three months through June, the most recent data available, the number of mailed credit-card offers dropped 17 percent, to 1.27 billion, from a year earlier, it said. That's the lowest since late 2003. Fewer Applications Synovate predicts a further decline in mailed applications this year "as issuers continue to cut back due to economic uncertainty," Vice President **Andrew Davidson** said in an e-mail. **Citigroup said last month that it's reducing credit limits, tightening underwriting requirements and insisting on higher credit scores for cash advances.** Chase Card Services, a unit of JPMorgan, "has lowered the credit limits of customers who have shown signs of increased risk," spokeswoman **Tanya Madison** said in an e-mail. It's still boosting them for its most credit-worthy customers. **The less credit available to consumers, the more it "impacts their confidence," National Retail Federation spokesman Scott Krugman said. Credit "is their safety net."** **Sears, Home Depot May Lose 8% of Holiday Sales on Credit Limits**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aTVEGdCJauGI&refer=home>

Retirement

Risk

Savings Rate

Tech

The Fed

Wall Street

- **[Now the shorts have to be bailed out! This is absurd. The "investors" who were short were not planning on giving money back if they made too much. Perhaps if we allowed stupid people to lose money we would not have so many stupid investors.]** Oct. 29 (Bloomberg) -- **Porsche SE** climbed the most in at least 12 years on speculation the sports-car maker will profit from **Volkswagen AG's** fourfold increase as it takes steps to ease a so-called short squeeze. Volkswagen tumbled. Porsche, which is Volkswagen's largest shareholder, jumped as much as 43 percent to 65.98 euros in Frankfurt, the steepest gain since at least January 1996. **Volkswagen slumped as much as 48 percent to 491 euros.** The maker of the 911 sports car has options equivalent to 31.5 percent of Volkswagen's common stock, and said today that it may settle as much as 5 percent of the contracts to increase the supply of shares. The 5 percent stake increased in value by 10.8 billion euros (\$13.8 billion) in this week's first two days of trading, data compiled by Bloomberg show. "It's a huge gain for them," said **Albrecht Denninghoff**, a Frankfurt-based analyst at BHF-Bank AG. "For Volkswagen, it will get easier for short-sellers than in the last two days. But getting to normal levels, that is something else."

Volkswagen is the most shorted stock in Germany's benchmark DAX Index.

Porsche's announcement Oct. 26 that it plans to raise its stake in the German carmaker to 75 percent forced short-sellers to cover their positions and triggered a short squeeze that at one point yesterday made Volkswagen the largest company in the world by market value, surpassing Exxon Mobil Corp. `State of the Market' ``Porsche SE intends -- depending on the state of the market -- to settle hedging transactions in the amount of up to 5 percent of the Volkswagen ordinary shares," the company said in a statement to the stock exchange. ``This may result in an increase in the liquidity of the Volkswagen ordinary shares." Had Porsche acquired the options at Volkswagen's closing price last week, the sports-car maker would have gained more than 734 euros per share, before taxes, if the options were exercised at yesterday's closing price. A 5 percent stake in Wolfsburg, Germany-based Volkswagen's common stock equals 14.7 million shares, data compiled by Bloomberg show. Volkswagen's common shares had lured short-sellers who speculated the stock's 35 percent rise in 2008 through the end of last week was overdone given the outlook for car sales. Some investors have called for regulators to investigate Porsche's transactions. `Acted Irresponsibly' ``**Porsche has acted irresponsibly and that has damaged capital markets considerably," Henning Gebhardt, who helps manage the equivalent of \$220 billion at DWS Investment GmbH in Frankfurt, said yesterday. ``Porsche snuck up on Volkswagen. They knew about the short sellers, and it must have been clear to them that there would be a massive short squeeze."** [So Fritz what would be improper about trying to make money by using public information to take positions in stocks????????????] Hedge funds may face billions of dollars of losses because they wrongly expected Volkswagen shares to fall, the Wall Street Journal reported, citing unidentified prime brokers familiar with the positions. [Once again, the nanny state can't allow any speculators to lose on their stupid investments. This is why the markets are in disarray and continuing to prop up idiots will not fix anything.] Funds affected include Greenlight Capital Inc., SAC Capital Advisors LLC, Glenview Capital Management and Perry Capital LLC, the Journal said, citing unidentified people familiar with the funds. Until Oct. 26, Porsche had said it was aiming only for a stake exceeding 50 percent, and Chief Executive Officer Wendelin Wiedeking said at the Paris Motor Show early this month that a stake of as much as 75 percent would be ``not realistic" because of market turmoil. Deutsche Boerse AG, operator of the Frankfurt stock exchange, said late yesterday it will reduce Volkswagen's weighting in the benchmark DAX Index to 10 percent after the stock's surge. VW represented 27 percent of the DAX after yesterday's rally, an increase from 6.8 percent on Oct. 24. The share surge meant Volkswagen was having an outsized effect on the DAX. While it was the only company out of 30 in the index that gained on Oct. 27, Volkswagen's 147 percent jump was enough to drive the measure up 0.9 percent. Germany's financial-markets regulator yesterday said it's looking into trading of Volkswagen shares. BaFin said it's monitoring Volkswagen and hasn't started a formal probe. Porsche ``denies all responsibility for these market distortions and for the resulting risks to which the short sellers have exposed themselves," the company said. ``Allegations of price manipulation by Porsche" are ``without any foundation whatsoever," the company said.

http://www.bloomberg.com/apps/news?pid=20601087&sid=ai_m6Q0oIJ_U&refer=home

- Oct. 28 (Bloomberg) -- U.S. stocks rallied, following gains in [Asian and European markets](#), as the cheapest valuations in more than two decades lured investors back into equities. [Alcoa Inc.](#), the largest U.S. aluminum producer, jumped as much as 7.1 percent after the shares slid to their lowest price- to earnings ratio on record. [Exxon Mobil Corp.](#) advanced 6.6 percent and AT&T Inc. rallied 5.7 percent after analysts advised buying more stock in the companies. Morgan Stanley lost as much as 26 percent on concern [Mitsubishi UFJ Financial Group Inc.](#) needs more money to pay for its stake in the bank. The [Standard & Poor's 500 Index](#) added 28.34 points, or 3.3 percent, to 877.26 at 2:29 p.m. in New York. The [Dow Jones Industrial Average](#) climbed 310.63, or 3.8 percent, to 8,486.4. All 24 industries in the S&P 500 advanced. Hong Kong's benchmark index surged 14 percent, its best gain in 11 years, while Germany's climbed 11 percent and Brazil's jumped 8 percent. **``Anyone who has a long-term view and looks at earnings multiples and inflation will say it's a cheap moment to buy stocks,''** said [Linda Duessel](#), equity market strategist at Pittsburgh-based [Federated Investors Inc.](#), which manages more than \$333 billion. **The S&P 500 was valued at 10.7 times estimated profit when trading opened today, the cheapest compared with the multiple using trailing profit since 1985. The MSCI World Index traded near the cheapest relative to earnings since at least 1995. \$12 Trillion Lost Equities around the world tumbled this month, wiping out more than \$12 trillion of market value, after money markets froze, banks' credit losses climbed to almost \$678 billion and economic growth weakened.** The S&P 500 dropped 3.2 percent yesterday, adding to its 25 percent slump during October. The Fed will announce its decision on interest rates tomorrow. Futures trading suggests a 38 percent chance the central bank will cut the benchmark rate by three-quarters of a percentage point, to 0.75 percent. By contrast, only one of 64 economists foresees that outcome, according to a Bloomberg survey. The rest of the Fed funds futures bets point to a half- point cut. <http://www.bloomberg.com/apps/news?pid=20601087&sid=arQ4T0GG.tK0&refer=home>
- Where have all the buyers gone? As stock markets around the world are crushed by the big unwind, few investors seem willing to buy on the mother of all dips, not even the usual buyers of last resort. Insurance companies, as it turns out, were ahead of the game. The likes of [Aviva](#) and [Aegon](#) have been steadily reducing their equity exposure for years. They are presumably not filling their boots now. What of their customers, though? Aviva said it saw resilient sales in life and pensions and long-term savings. But it seems fair to wonder whether, in the short term, consumers will be more focused on having cash in hand as they worry more about their jobs than their equity exposure. As for retail investors, they have probably been shocked into paralysis by an unrelenting stream of dreadful economic news. For the moment, it is also rational for them to hang onto cash when the relative value of all other assets is going down. Then there are asset managers. But even cash-rich hedge funds are going through their own horror show. **Redemptions and sinking performance could shrink the industry's assets by 25 to 30 per cent in the second half of 2008, according to Morgan Stanley. Traditional asset managers, meanwhile, face competition for client money from banks, which want to attract deposits.** One might think that pension funds could feel tempted to rebalance their portfolios given that the stock market fall will have left them looking underweight. But

equally, their appetite for equity-type risk has also diminished. Sovereign wealth funds, from Russia to Kuwait, meanwhile have their own problems. That leaves governments, which are already doing their bit by buying into banks, or corporates themselves. Some, like energy group BG, have launched takeovers. Others, like Microsoft, Nike, Oracle and Hochtief plan to buy back stock. **But many more will prefer to hoard cash given how expensive debt raising has become.** One glimmer of hope is a recent small inflow in European equity mutual funds. Hats off to anyone with such nerves of steel. FT [this would seem to be the flip side to my "where is the panic" idea]

- Oct. 27 (Bloomberg) -- Tom Bosh lowered the telephone receiver into its cradle, making a decision on the way down. "We're not buying any more," he told his traders at Bank of New York Co. "Nothing." It was May 2007, and Bosh, who managed \$25 billion from the bank's 13th-floor trading room above Times Square, had just hung up on Ralph Cioffi at Bear Stearns Cos. a dozen blocks away. Bosh had invested \$50 million in notes from an issuer Cioffi controlled, and he was ready to pull the plug. "I had a bad feeling," Bosh, 45, recalled. "Cioffi was just bulldogging everyone. He was saying, 'These assets are good, the collateral is paying down, and I know more than you.' That type of attitude." Bosh's premonition, a month before two of Cioffi's funds blew up, struck a death knell for structured finance, the system Wall Street banks devised to fuel more than two decades of unprecedented borrowing. The system allowed financial companies to lend beyond their capacity and outside the reach of regulators -- until it crashed this year. Biggest U.S. Export **The bundling of consumer loans and home mortgages into packages of securities -- a process known as securitization -- was the biggest U.S. export business of the 21st century.** More than \$27 trillion of these securities have been sold since 2001, according to the Securities Industry Financial Markets Association, an industry trade group. That's almost twice last year's U.S. gross domestic product of \$13.8 trillion. The growth over the past decade was made possible by overseas banks, which saw the profits U.S. financial institutions were making and coveted the made-in-America technology, much as consumers around the world craved other emblems of American ingenuity from Coca-Cola to Hollywood movies. **Wall Street obliged, with disastrous results: two-thirds of a trillion dollars in bank losses, about 40 percent of them outside the U.S.** "Securitization was based on the premise that a fool was born every minute," Joseph Stiglitz, a professor of economics at Columbia University in New York, told a congressional committee on Oct. 21. "Globalization meant that there was a global landscape on which they could search for those fools -- and they found them everywhere." Eager Adopters European banks, in particular, were eager adopters. Securitizations in Europe increased almost sixfold between 2000 and 2007, from 78 billion euros (\$98 billion) to 453 billion euros, according to the European Securitization Forum, a trade organization. **Three Icelandic banks borrowed enough to buy \$228 billion of assets, most of them securitizations, turning the country's financial system into a hedge fund. All three banks have been nationalized by the government, leading Prime Minister Geir Haarde to advise citizens to switch from finance to fishing.** In Germany, one bank, Landesbank Sachsen Girozentrale, bought \$26 billion worth of subprime-backed investments, putting the state of Saxony on the hook for \$4.1 billion. **In Japan, Mizuho Financial Group Inc., the nation's third-largest bank, acquired an entire structured-finance team, which proceeded to lose \$6 billion issuing mortgage-backed securities.** Shadow Banking The damage reaches all the way

to Australia, where the town council of Wingecarribee, a municipality outside Sydney with a population of 42,000, bought \$20 million of securities from [Lehman Brothers Holdings Inc.](#) Now, Lehman is in bankruptcy, the town council is in court and the securities are worth about 15 cents on the dollar. **Securitization is a shadow banking system that funds most of the world's credit cards, car purchases, leveraged buyouts and, for a while, subprime mortgages. The system, which pools loans and slices up the risk of default, made borrowing cheaper for everyone, creating a debt culture that put credit cards in wallets from Seoul to Sao Paolo and enabled people to buy luxury cars and homes. It also pumped out record profits for banks, accounting for as much as one-fifth of their revenue over the last decade.** Beginning about three years ago, investment banks revved the system's engine to boost earnings. They raised revenue by funding more subprime mortgages and cut costs by relying increasingly on the \$4.2 trillion sitting in U.S. money-market funds. As it turned out, those decisions would prove fatal. **During the mid-1980s, mortgage-bond traders at Salomon Brothers devised a method of lending without using capital, a technique at the heart of securitization. It works by taking anything that has regular payments -- mortgages, car loans, aircraft leases, music royalties -- and channeling the money to a trust that pays bondholders principal and interest.** Off-Balance-Sheet The word "securitization" implies safety. Investors with less appetite for risk buy higher-rated securities and get paid first at lower interest rates. Those with a bigger appetite get paid later and receive more interest. **Securitization's biggest innovation was the use of off-balance-sheet accounting. If a bank couldn't sell a bond or didn't want to, the asset could be sold to a trust within a so-called special-purpose entity, incorporated in a place such as the Cayman Islands or Dublin, and shifted off the books. Lending expanded, and banks still booked profits.** With this new technology, a bank could originate \$100 million in loans, sell off some to investors, transfer the rest to a special-purpose entity and not have to hold any capital. The profit could be as much as 1.25 percentage points of the amount loaned, or \$1.25 million for every \$100 million issued. **"The banks could turn a low return-on-equity business into one that doesn't use any equity, which was the motivation for this," said Brad Hintz, a Sanford C. Bernstein & Co. analyst and former chief financial officer at Lehman. "It becomes almost like a fee business because it requires no capital."** 'Capture the Prize' Like most new products, securitization found a market at home before going abroad. Bankers at Salomon and First Boston Inc. raced from bank to bank to convince issuers it was the wave of the future. The strategy was detailed in Ocampo's 282-page book "Securitization of Credit: Inside the New Technology of Finance," which he co-wrote with McKinsey consultant [James Rosenthal](#). Ocampo, who received an MBA from Harvard after graduating from the Massachusetts Institute of Technology, and Rosenthal, a Harvard Law School graduate, argued that banks could be more profitable if they used securitization. Exporting Debt **As securitization caught on, borrowing increased. U.S. consumer debt tripled in the two decades after 1988 to \$2.6 trillion, according to the Federal Reserve.** Foreign banks used the new technology to expand lending, seeking borrowers on their home turf. **"One of the things the United States exported overseas was a debt culture,"** Haley said. While consumers were snapping up credit cards, [Nicholas Sossidis](#) and [Stephen Partridge-Hicks](#) at Citibank in London were figuring out a way to sell the new bonds. Their solution: Alpha Finance Corp., the first off-balance-sheet

structured investment vehicle, or SIV. **Alpha was created in 1988 as a way for Citibank, and later Citigroup Inc., to vertically integrate its business like an oil company. The raw material was found in a loan, refined into a security, then sold to a SIV at a profit.** Citigroup, formed in a merger of Citicorp and Travelers Group Inc., which owned asset-backed pioneer Salomon, also got a new product to sell: capital notes that boast returns of more than 20 percent a year. Owners of these notes receive all the excess return when borrowers pay their bills on time, though they are the last to be paid when times get hard. **Mismatched Funding Starting around 2005, securitization began to rely more on short-term money-market funds for financing. This was especially true for securities made by pooling other bonds, known as collateralized debt obligations, or CDOs. Investors were loath to buy long-term debt of issuers that didn't have a track record, so new issuers sold asset-backed commercial paper that matured in less than a year. While money markets are the cheapest way to finance, they can also be the most dangerous for borrowers because they can mature as soon as the next day.** "What happened in 2005 was that because of subprime and some other changes, commercial paper and asset-backed securities offered a bigger spread than anything that had ever been in the market before," said **Deborah Cunningham**, chief investment officer of Federated Investors in Pittsburgh, who oversees \$235 billion in commercial paper. "It was hundreds of basis points, as opposed to 10 or 20 basis points before." **SIVs, banks and CDOs sold trillions of dollars of asset-backed commercial paper between 2005 and 2007 in maturities ranging from nine months to overnight. In the U.S., the amount outstanding marched higher almost every week beginning in April 2005, peaking at \$1.2 trillion for the week ending Aug. 8, 2007.** "Huge Appetite' Once money-market funds began to be tapped for financing, Ocampo said, "it created a huge appetite for high-yield assets, far more than could be originated on a sound basis." **To accommodate the demand, banks funded more subprime mortgages, with an average life of seven years, replacing car loans with an average life of three years and credit-card bonds paid off within 18 months. Among conservative lenders, that rang an alarm: Bankers are taught to avoid such mismatched funding, in which a lender has to pay back money before the borrower has to pay the principal.** "Most of the terrible things happening now are because of the presence of money-market assets, taking what used to be long-term funding and making it short-term," **Bruce Bent**, 71, who started the first money-market fund in 1970, said in an interview in July. Reserve Funds Bent, chairman of New York-based Reserve Funds, said he didn't buy any asset-backed commercial paper until 2007, when the market froze in the wake of the collapse of the Bear Stearns hedge funds. That's when his **Reserve Primary Fund** began buying castoffs of asset-backed commercial paper at cut-rate prices from other funds. Yet asset-backed securities weren't Bent's undoing. His fund also owned \$785 million in Lehman debt, bought before the firm filed for bankruptcy Sept. 15. In the two days following the bankruptcy, Reserve clients asked to pull about \$40 billion from the \$62.5 billion fund, and its net asset value fell to 97 cents. It was the first time that a money fund "broke the buck," or fell below \$1, in 14 years. The fund is now being liquidated, and Bent hasn't given an interview since. Reserve Primary Fund's implosion, and the subsequent seizing up of two Commonfund portfolios used by universities and endowments to hold cash, triggered a panic in U.S. money markets, cutting off this form of credit to industrial companies and banks. No one could be sure whether the banks held

securitizations that had dropped in value, making them insolvent. That set off a series of bank takeovers and bailouts around the world, including a \$64 billion capital injection by the U.K. government into that nation's financial institutions and 400 billion euros in loan guarantees pledged by Germany. `Absolute Disaster' ``We've created an absolute disaster," said Nouriel Roubini, a New York University professor of economics, who predicted the failure of investment banks in a paper he wrote in February titled ``Twelve Steps to Financial Disaster." ``**The reputation of the United States as a financial center and a leader has been tarnished significantly.**" Also tarnished, if not blackened, is the securitization business itself. Sales of European asset-backed securities, including bonds for car loans and credit cards, fell by 40 percent to 12.7 billion euros in the second quarter, and CDO sales fell by two-thirds to 10 billion euros. In the U.S., mortgage bonds issued by entities not affiliated with the government plummeted to \$10.8 billion in the first half of the year, one-twentieth of the \$241 billion sold in the same period in 2007. Cioffi, Bosh The authors of the 1988 McKinsey handbook on securitization have moved on. Rosenthal, who declined to be interviewed, became a managing director at Lehman and is now in charge of information technology at Morgan Stanley. Ocampo received a patent for risk-controlled investing and founded an institutional fund-management firm, Trajectory Asset Management. The firm doesn't have any structured-finance obligations. Bear Stearns's Cioffi, 52, was indicted on charges of misleading investors by assuring them that his hedge funds were healthy when he knew they weren't. Cioffi, who now works out of his home in Tenafly, New Jersey, has pleaded not guilty. He declined to comment. The Bank of New York's Bosh lost his job when his company was merged with Mellon Corp. in June 2007. He's still looking for work. ``You try to do the right thing," Bosh said in an interview this month. ``And this is what happens." http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=a0jln3.CSS6c

- Oct. 27 (Bloomberg) -- **Joseph Ambrosini says the deal looked so easy. JPMorgan Chase & Co. bankers told him there was really no risk.** All he had to do was sign a public financing contract, and the bank would give \$280,000 to his school district in New Castle, Pennsylvania. ``**They basically said, unless the world goes under the sea, we'd be in good shape,**" says Ambrosini, the district's business manager. In September, Ambrosini says, his 3,400-student district went underwater. On Sept. 25, the week after Lehman Brothers Holdings Inc. collapsed, the New Castle Area School District's interest rate on \$9.7 million of financing arranged by JPMorgan hit 10.6 percent, more than doubling since the month began, as investors demanded **skyrocketing returns** for municipal debt. While JPMorgan has been relatively unscathed by the subprime crisis that hit Bear Stearns Cos., Merrill Lynch & Co., Lehman and other Wall Street firms, a little-known part of the largest bank in the U.S. made a tidy profit peddling a different kind of corrosive debt to hundreds of counties and school districts earlier this decade. **Financings arranged by JPMorgan and other banks are forcing hundreds of public agencies to spend billions of dollars they don't have to pay for increased interest payments and penalties.** No Bailouts These come in municipal bond and derivative deals that have turned poisonous. **Unlike JPMorgan, which has benefited from federal bailouts, the towns and schools the bank has financed have received no help from Washington.** Behind the glow of favorable publicity in which JPMorgan has basked, its municipal derivatives unit has operated in obscurity. The financings it arranged have

sparked lawsuits from local governments alleging fraud. Criminal Investigation **The muni derivatives unit has become snarled in the largest-ever criminal investigation of public finance by the Department of Justice.** Prosecutors have informed at least five former JPMorgan derivative bankers that they're targets in an investigation of whether banks conspired to overcharge local governments, according to the Financial Industry Regulatory Authority, or Finra, the largest self-regulator for securities firms doing business in the U.S. **Nowhere have JPMorgan's derivative deals wreaked more havoc than in Jefferson County, Alabama, home of Birmingham, the state's largest city. A combination of soaring rates on its bonds and interest-rate swaps is threatening the county with the biggest municipal bankruptcy since Orange County, California's default in 1994.** Jefferson County said it couldn't make its \$84 million interest payment on Oct. 1. JPMorgan and other creditors gave it a month to come up with a plan to rework its debts. In April, the county's financial adviser approached the Fed and the Treasury in Washington to explain its dilemma. On Oct. 6, Alabama Governor **Bob Riley** asked the Treasury for financial help for Jefferson County. Washington turned down the request. **'Getting Crushed' ``A lot of people are getting killed; they're getting crushed,' says Steve Goldfield, a financial adviser at Public Resources Advisory Group in Media, Pennsylvania, which was hired by a school district now suing JPMorgan. ``Nobody is talking about the impact on the debt side to taxpayers, how much school districts are going to pay in extra interest expense because of this blowup,' he says.** The seeds of JPMorgan's municipal derivative deals were planted in the late 1980s. In 1987, the Fed relaxed provisions of the Glass-Steagall Act, the Depression-era legislation that prevented commercial banks from underwriting corporate securities and many types of local bonds. The decision, which followed requests from Bankers Trust Corp., Citicorp and JPMorgan, allowed all banks -- not just securities firms -- to expand their sales of public debt. **Landing Deals Just as lenders that offered subprime mortgages relied on an army of local brokers to sign up less-than-creditworthy borrowers, JPMorgan developed ties with local municipal bond firms, advisers and lawyers to land deals.** JPMorgan gave these firms work in return for promoting the bank to elected officials, **Charles LeCroy**, JPMorgan's top revenue producer in public finance, told an outside lawyer for the bank in 2004, according to court filings in Philadelphia. In 2005, LeCroy, 54, and JPMorgan banker **Anthony Snell** pleaded guilty in Philadelphia to charges of filing false invoices in connection with swap and bond deals steeped in corruption. LeCroy was sentenced to three months in jail. Snell was sentenced to 90 days of house arrest and fined \$15,000. Philadelphia Treasurer **Corey Kemp** was found guilty after a trial in Federal District Court in Philadelphia in 2005 and is serving 10 years in prison. On Feb. 19, 2003, **White** told Kemp that JPMorgan was pushing swaps to generate fees, not because they were in the city's interest, according to a tape recording by the Federal Bureau of Investigation. **``You know, they don't watch your back,' White said. ``They're about getting fees and getting the most fees they can get. If there was an issue between whether to do a bond deal or a swap, they gonna take the swap, even though it may not be the best thing.''** White died of cancer before the trial. Conflicts of Interest **Many municipalities, including Butler County, Jefferson County and Philadelphia, hired financial advisers to analyze prices, fees and interest rates to determine whether swap contracts were fair. Local officials didn't recognize the conflicts of interest created by the relationships between the advisers and the banks.**

Banks routinely pay these advisers and often refer them to government issuers.
`Overwhelming Greed' ``Motivated by overwhelming greed, Wall Street thrashed around creating financing structures divorced from reality and good sense -- and paid lots of people way too much money," he says.

http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aIL9gsK5wG40

- Stocks are much higher in Europe and are finding support from overnight gains in Asia. Automakers are leading the pack as shares of Volkswagen (VLKAY \$118) continue to soar after Porsche (POAHF \$55) said it is increasing its stake in the automaker. Aided by massive short covering, Volkswagen surged over 120% yesterday and is adding another 60% today. According the Financial Times, analysts believe there may be hedge fund failures related to losses from the short squeeze that has caused shares to more than triple in recent days.

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

Voices of Reason Still in the Wilderness

“Karl Marx (1818-1883) originated the idea that recurrent crises are inherent in the unhampered (free) market economy. Mises has shown that ‘the trade cycle is... on the contrary, the inevitable effect of manipulation of the money market’”

-- Percy L. Greaves Jr., Mises Made Easier

Dear *Gold & Options* reader,

Occasionally I hear the odd guest on CNBC or Bloomberg Radio who lays blame for the crisis in exactly the right place -- the Federal Reserve System in the U.S.... or central banking more broadly.

These extremely influential institutions ostensibly exist to regulate prices, employment and interest rates by way of control over the money supply. They do this by inflating bank reserve credit, on which the banks can pyramid, thus essentially abrogating the role of interest rate determination by the market.

That is, the central bank tries to determine interest rates as far as it can. The rationale for this policy is to attain full employment and price stability, and to otherwise manage economic affairs.

Any economist whose lenses aren't blurred by the fatal errors of the neo-classical doctrines is immediately capable of spotting the problem with that policy foundation. Unemployment could scarcely exist on a free market, where the government did not interfere with the price of labor.

Just like shortages of goods cannot really exist in a market where their price is free to adjust to the reality of existing conditions, there can be no excess labor unless the government intervenes to artificially boost its price. It's the same principle. It is a simple economic fact -- free of political considerations. Labor is an economic good primarily because it is scarce.

Moreover, whether we are talking about labor legislation or the central bank trying to manage growth, prices and interest rates, it amounts to economic management, even planning.

The apparent effect of the policy is to bring about a boom in investment and consumption... the building up of bubble companies and uneconomic enterprises relying on the continued increases in the selling prices of the goods they deal in -- be it widgets, homes or securities.

These price increases are afforded by regular money debasement, which is one of the economic consequences of an increase in the supply of money in particular. So it is illusory.

In reality, as Rothbard points out, the boom *"is actually a period of wasteful misinvestment. It is the time when errors are made, due to bank credit's tampering with the free market"*.

So this policy, and the booms it engenders, crowds out real savings (by pushing rates below market), and investment comes to rely on the continued "stimulus" of money creation or from borrowing overseas. Ultimately, it further lays the seeds of its own demise because the process invariably arrives at a point at which the central bank must desist if it does not want to prompt a run of confidence in its notes, leading to hyperinflation.

This is why we say the policy is "unsustainable."

Thus it tries to withdraw the stimulus or "tighten" money and credit -- explaining that the overheated economy might produce inflation. The error in its thinking is that it is managing a delicate balance between price stability and growth...that it checks market failures, and can know the unknowable (the future).

In fact, almost all economists would agree, it cannot produce growth. It's like the analogy of pushing on a string.

The Fed's policy can only increase employment by decreasing the relative cost of labor through inflation (the expansion of money supply relative to demand). And as one of the largest of interventions conducted by government policy, it only produces more instability -- i.e. the boom-bust cycle as well as interest rate and foreign exchange volatility eventually.

Technically, tampering with the rate of interest produces disequilibrium as a mismatch between consumer preferences and producers' investment plans -- during the boom phases.

Effectively, it taxes long run growth, and is but a massive redistribution of wealth from savers to borrowers and speculators.

The bust, which often begins with the onset of a financial crisis, brings much pain, and threatens job losses on a wide-scale. But this is because the artificially low rate of interest produced by the previous policy, which could not be sustained, produced waste, a “cluster of error” as Rothbard called it. This “malinvestment” or uneconomic activity is essentially exposed as the subsidy is withdrawn.

In his book, *America’s Great Depression*, Rothbard posits the error in Marx’s reasoning,

“In the purely free and unhampered market, there will be no cluster of errors, since trained entrepreneurs will not all make errors at the same time.”

What you see then is basically the widespread failure of parasitic enterprises that could not survive on their own -- without the handouts and support of the central bank. This is the empirical evidence that should indict any inflation policy. But, the bust still merely represents a return to natural market ratios.

“The ‘depression’ is actually the process by which the economy adjusts to the wastes and errors of the boom, and reestablishes efficient service of consumer desires. The adjustment process consists in rapid liquidation of the wasteful investments” (Rothbard)

It follows then, that *“Attempts to interfere with free and flexible prices, wage and interest rates prevent recovery and prolong the depression period”* (Mises Made Easier)

Efforts to stabilize the bust with even more inflation effectively prevent the liquidation of uneconomic enterprises necessary to return the economy to equilibrium, where markets reflect actual conditions.

Now, I’m not a policy maker. I don’t want to suggest the best way to fix the world or argue why these theories are true. My chief concern is the future. And the evidence that most people would side with Marx on this (over Mises et al) is all I need to predict more inflation, war and higher gold prices.

Joe Public can’t for the life of him figure out why it matters if interest rates are 1.5% or 1%. He cannot connect the escalating price at the pump to the process of money creation required to bring about such a modest change in the interest rate. The tech bust was the fault of irrational speculators, and greedy investment bankers. The housing bust is blamed on Wall Street’s larceny, his mortgage and real estate brokers, or the thrust toward deregulation. The painful increase in commodity prices is caused by too much growth. The growing trade deficit is caused by new competition from foreign countries. And so on.

For, Joe takes his cue not from Mises, but from the media and political classes under heavy influence by the progressive institutions.

Political leaders in Europe, meanwhile, are taking full advantage of Joe to wage a new war on capitalism from the left on grounds that American style capitalism is in dire need of more regulation.

This is the great evil of the inflation policy.

It is insidious. The great economists have all recognized this truth. It only produces the opposite of what it claims to accomplish. It also funds the growth of government and anti-capitalist sentiment, and other confused ideas that may lead, ultimately, to the general disintegration in the division of labor, the fabric of society. It promotes moral degradation and corruption, conflict, and finances wars. It is 80% of what's wrong with the world.

But for the most part, the voices of reason that point to this cause are trampled over by the rhetoric of the larger political class, which fear mongers people into clamoring for more money and credit.

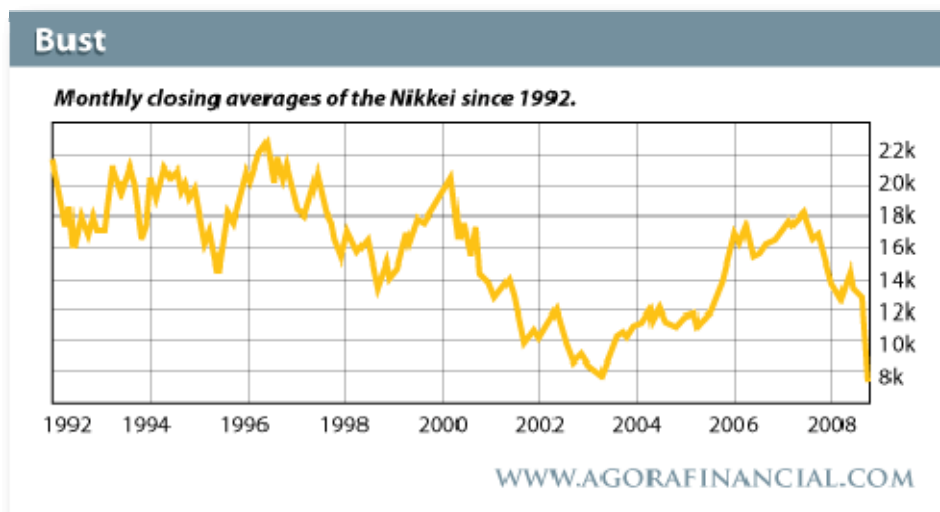
This truth is evident in the Fed's actions. It has abandoned any remnants of conservatism, as have the other central banks worldwide. The helicopter blades are in full swing. So any enthusiasm about the world having reached this place where it is ready to turn a new leaf must be tempered by this fact.

The voices of reason, though on the beltway, are still only voices in the wilderness.

This alone suggests we are going to continue to see more inflation, taxes and government. The scary part is that this process is accelerating.

The next bubble may well be in gold

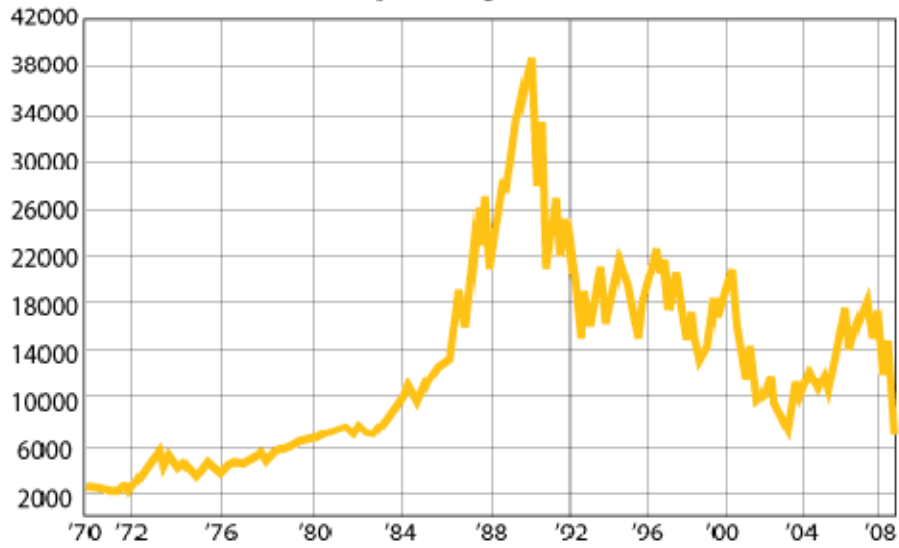
Best of the Dog



1

The Red Sun Setting

The Nikkei 225 fell 6% today, reducing the index to lows unseen since 1982.



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2

The S&P/Case Shiller continued its swan dive in August, the group reports today. Annual declines in home prices are down by another annual record, 17.7% for its 10-city composite, 16.6% for the 20-city.

S&P / Case-Shiller Home Price Index

