

The Other Side of the Street November 18, 2007

Comments

[A look a ways back:](#)

The seemingly improbable happens all the time in financial markets. A year [before the LTCM collapse, which LTCM described as a one in 4 billion years event in] August 1997, the Dow had fallen by 7.7 per cent in one day (probability: one in 50 billion). In July 2002, the index recorded three steep falls within seven trading days (probability: one in four trillion). And on October 19, 1987, the worst day of trading in at least a century, the index fell 29.2 per cent. The probability of that happening, based on the standard reckoning of financial theorists, was less than one in 10(to the power 50) — odds so small they have no meaning. **The (mis)Behaviour of Markets: A Fractal View of Risk, Ruin, and Reward**, by Benoit Mandelbrot and Richard L. Hudson.

[A look not so far back:](#)

What's going wrong in the financial sector is not so unusual after all. One of the funniest moments in the great credit crunch of 2007 came in the summer. "We are seeing things that were 25-standard deviation events, several days in a row," said David Viniar, CFO of the smartest financial firm in the world, Goldman Sachs. That Viniar. What a comic. According to Goldman's mathematical models...August, Year of Our Lord 2007, was a very special month. Things were happening then that were only supposed to happen about once in every 100,000 years. Either that...or Goldman's models were wrong. — Bill Bonner DR 11/17/07

[And a look forward:](#)

A slump in global credit markets will force banks, brokerages and hedge funds to cut lending by \$2 trillion, triggering the risk of a "substantial recession" in the U.S., Jan Hatzius, chief economist in New York at Goldman Sachs Group Inc., wrote in a report dated Nov. 15. Bloomberg 11/16

[By comparison, is it really improbable that a significant recession is on the way that will wipe out 20-30% of more of current US equity values?](#)

[This week we saw the inevitable knee jerk bounce. One of the trademarks of bear markets are sharp short term rallies. That this one only lasted a day and half and that volume was so weak is telling. The foretold "race to the exits" is underway. All rallies will be sold. The August lows will break soon. A good bet will be the week after Thanksgiving. Retail sales will be horrible as the consumer does in fact understand that the end game is here. There are no more credit avenues open. It will be interesting to see what happens this Friday. Friday is amateur day in the markets. The little guys have a day off and buy buy buy stocks based on the "malls](#)

are packed” stories that will fill the local news. Should that not happen and Friday is a down day, it will foreshadow a very ugly Monday.

On a less cheery note, the world-wide markets will not be taking a holiday week. The Hang Seng will be of particular interest. In the first 12 trading days in November, it has dropped from 31,353 to 27,614 (almost 12%). As noted earlier, the Chinese have made it clear that the anticipated influx of money from the mainland is not happening as soon as hoped. The Hang Seng 40+ percent jump was based on a belief that valuations would match the absurd levels in the captive China exchange. Hang Seng movement is important to watch as an indicator that the global equity boom is one trade unwinding.

It is after noon in Jellystone Park . . .

PS. My thanks to TH for sharing this analysis of the structured finance industry

http://www.youtube.com/watch?v=SJ_gK4g6ntM

Accounting Issues

- Nov 16 – Schaeffer Opening email - Others making headlines this morning include U.S. mortgage lender Fannie Mae (FNM: sentiment, chart, options), which is slated to hold a Q&A-like press conference at 9 a.m. The stock scaled down 10% on Thursday after Fortune magazine alleged the company could be masking credit losses.

Credit

- Nov. 11 (Bloomberg) -- Bank of America Corp., Citigroup Inc. and JPMorgan Chase & Co., the three biggest U.S. banks, agreed on the structure of a fund of at least \$75 billion intended to help calm credit markets, the New York Times reported, citing an unidentified person involved in the talks. The proposed fund could begin operating by the end of December, the newspaper said, citing the unidentified person. The banks may begin asking about 60 financial institutions to contribute money as soon as Nov. 16 or early next week, the newspaper said, citing the person. The plan requires approval by the major credit-rating companies, and the banks are still negotiating a fee structure of between 75 to 100 basis points, the Times said. The agreement on a simpler fund structure, reached late Nov. 9, concluded almost two months of negotiations, the Times reported. The fund won't require structured-investment vehicles, known as SIVs, to obtain approval of at least 75 percent of investors if they want to participate, and the fund won't distinguish between the risk levels of different SIV assets, the newspaper said. **U.S. Banks Reach Agreement on SIV Backup Fund, N.Y. Times Says** [keep in mind that markets are expected to price in news. Thus, this should be fully priced in and the markets have not stabilized in the least. Another example of the sell side propaganda that continues to spew]
http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aH61hTFT.9w
- Nov. 17 (Bloomberg) -- European two-year government note yields held near the lowest in eight months this past week as signs U.S. subprime-mortgage losses are spreading stoked appetite for the safest assets. Two-year notes gained for a second day yesterday, pushing yields lower, as investors seeking shorter-dated paper widened the spread, or

yield difference, with 10-year debt to the most in five weeks. Goldman Sachs Group Inc. this past week said the slump in credit markets may reduce bank lending by \$2 trillion, stoking speculation market turmoil will limit the European Central Bank's scope to raise interest rates. "The market is taking direction from what happens in the financial sector," said Marc Ostwald, a fixed-income strategist at Insinger de Beaufort SA in London. **"Risk aversion is still there. There's a lot of caution in the market."** [the market is not in fact "waiting" on the Super SIV. It has discounted it and credit players know that it will be a long while before things get better] Losses related to record U.S. home foreclosures using a "back-of-the-envelope" calculation, may be as high as \$400 billion, Jan Hatzius, Goldman's New York-based chief economist, wrote in a report published Nov. 15. The effects of the losses on the economy will be amplified because banks and hedge funds have borrowed heavily to finance their investments, Hatzius wrote. Barclays Plc, the U.K.'s third-biggest bank, meanwhile this past week announced about 1.3 billion pounds (\$2.7 billion) of writedowns on credit-related securities. The chance of European companies defaulting on their debt jumped to a three-month high yesterday, credit-default swaps trading showed, on concern the Federal Reserve's decision to inject the most cash into the U.S. financial system in six years signals more problems for banks. The central bank Nov. 15 added \$47.25 billion in temporary reserves after short-term borrowing costs surged. Worse to Come? U.S. Treasury Secretary Henry Paulson yesterday said there may be worse to come in the subprime crisis. He spoke in an interview from Cape Town, broadcast on Johannesburg's 702 Radio. **Risk aversion**, which "was on the decline, **is coming back**," said Peter Schaffrik, a fixed-income strategist at Dresdner Kleinwort in Frankfurt. **"The fire is at full blaze again, and that helps government debt and products low in risk."** German bunds may come under pressure on speculation euro-region interest rates will increase. European Central Bank council member Klaus Liebscher said borrowing costs may have to rise to curb quicker-than-forecast inflation among the 13 countries sharing the euro, Dow Jones Newswires reported Nov. 15, citing an interview. **European Government Yields Hold Near Eight-Month Low on Risk** <http://www.bloomberg.com/apps/news?pid=20601087&sid=awh.mLHsv1cw&refer=home>

- Nov. 17 (Bloomberg) -- **Treasuries rose to the highest since 2005 as credit-market losses related to delinquent subprime mortgages drove investors to the safety of government debt.** Two-year notes gained for a fifth straight week, extending their rally to the longest in eight months on speculation the Federal Reserve will cut borrowing costs a third time this year. The Fed will release minutes of its October meeting next week, and the Commerce Department is expected to report that housing starts fell to the lowest since 1993. Citigroup Inc. and Merrill Lynch & Co. **have led companies writing down more than \$50 billion on securities linked to subprime mortgages.** The risk of further losses by banks has pushed their borrowing costs above the average for investment-grade companies. "The credit stories continue," said Paul Horrmann, a strategist in Jersey City, New Jersey, at ICAP Plc, the world's largest inter-dealer broker. "The addition of this one, of that one, add up to a sizeable amount, and we're starting to feel it. There is some doubt now about global growth." **In a sign of increased short-term credit risk, the three-month London interbank offered rate, or Libor, for dollars rose 7 basis points to 4.95 percent, the biggest weekly gain in two and a half months** Fed Governor Randall Kroszner said yesterday in a speech in New York that an

economic "rough patch" in coming months won't be enough to warrant additional rate cuts. St. Louis Fed President William Poole told Dow Jones that he's an "optimist" about credit market problems clearing up. **"The Fed is trying to jawbone the market away from the view that they will ease again in December,"** said Thomas Atteberry, who oversees \$2.8 billion in fixed income in Los Angeles at First Pacific Advisors LLC. "We continue to see mortgage and credit problems worm their way into different places and causing concern for people." **Treasuries Rise to the Highest in Two Years on Credit Concern**

http://www.bloomberg.com/apps/news?pid=20601087&sid=aJUm_Ig1xowE&refer=home

- A fuller answer comes in a familiar metaphoric form: **The tide has turned**, we think. And when the tide turns, sailors on the high seas barely notice. There is still plenty of water beneath them. But out on the edges...in the shallow marshes...and the tidal flats – the liquidity disappears. Many marginal subprime borrowers...and his marginal subprime lenders...already find themselves high and dry. House prices are falling. Hedge funds and financiers are losing money. Relatively few people feel the water moving between their toes. But soon, the outgoing ebb will be more apparent to everyone. The middle class will begin to come up a little short at the end of the month...companies will see their profits fall...investors will sell their stocks...and savers will begin to look at their dollars, pounds and euros and wonder what they are really worth. DR 11/16
- There were some interesting comments made yesterday by **Wells Fargo (WFC)** CEO John Stumpf from the Merrill Banking and Financial Services Investor Conference. Most news services focused on the gritty headline making stuff: "Wells Fargo Chief Says Housing Market Worst Since the Great Depression." What we found interesting, however, were these comments made by Stumpf: *"As the adverse current trends emerge we tightened credit standards early in 2007 and stopped correspondent originations altogether in the third quarter. In response to the decline in housing, we have taken a number of other actions across our home equity portfolio including reducing the maximum combined loan to values for all sales channels and further tightening underwriting in weakening markets. We have also been anticipating higher credit losses in the portfolio for some time, but losses have turned out to be greater than expected because home prices have declined faster and deeper than expected. As we said in the third quarter, given the current real estate market conditions credit losses in the home equity portfolio are likely to increase in the fourth quarter and remain elevated into 2008."* Wells Fargo has minimal exposure to CDOs and asset backed commercial paper, but the company is not immune from overall credit deterioration and what is interesting here is the overall structure of how WFC handled weakening markets: they followed the typical, reasonable path toward risk aversion by tightening credit standards and in certain markets ceasing originations altogether. **This, in a nutshell, is why credit problems are so difficult to "contain." The transition from easy credit conditions to tighter credit conditions tends to induce one thing: even tighter credit conditions. In other words, risk aversion begets more risk aversion.** Key to understanding this transition is understanding from where it began. The battle between bulls and bears is over the following question: did loose underwriting standards and excessive credit creation in the subprime residential mortgage market exist in a vacuum? If one believes that it did, and consequently that the paradigm within which loose

underwriting standards and excessive credit creation came into being were isolated to that segment of the market, then overall credit conditions here are too tight and higher-quality segments of the market are being unfairly punished. **However, if one believes that the paradigm within the subprime segment is simply a weaker version of the larger credit market paradigm - that loose underwriting standards and excessive credit creation is the norm across all market segments, not just subprime - then we are still in the first inning of these credit issues. In fact, if that is the case, we may not even have seen the first out of the first inning yet.** <http://www.minyanville.com/articles/FNM-WFC-GS-JCP/index/a/14910>

- **What strikes me the most about the recent credit market crisis is how fast the world is trying to go back to business as usual. In my view, the crisis wasn't an accident. We didn't get unlucky. The crisis came because there have been a lot of bad practices and a lot of bad ideas. Securitization is a mediocre idea. Re-securitization of already securitized assets into a CDO is a bad idea. Re-securitization of CDOs into CDO-squared is a really bad idea. So is funding a pool of long-term illiquid assets with very short-term funding in the so-called asset-backed commercial paper market. And... it is a horrendous idea to delegate most of the responsibility for assessing credit risk to a group of credit-rating agencies paid for by the issuers rather than the buyers of bonds.** – David Einhorn, speaking Oct. 19 at the annual Graham & Dodd breakfast (and quoted on Whitney Tilson's Value Investing Congress website). Einhorn manages the hedge fund Greenlight Capital and is a former board member of New Century Financial.
- Nov 16 – London times - The chief executive of Experian, the world's largest credit-checking group, has said that market conditions will continue to decline and warned of slowing sales growth for the company as banks cut back on lending. Don Robert said: **"I've been in this business a long time and this is as big of a market challenge as I've seen in the last couple of decades."** He revealed a decline in Experian's second-quarter revenue growth as lenders refuse new loans in an attempt to reduce their exposure to the sub-prime crisis in the United States. Shares in the FTSE 100 company, which conducts consumer credit checks for banks, retailers and other companies, plummeted by almost 20 per cent at one stage, closing down 9.5 per cent at 429¾p. About £600 million was wiped off the value of the company. http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2879761.ece?EMC-Bln=JPTCG4
- Nov. 16 (Bloomberg) -- The slump in global credit markets will force banks, brokerages and hedge funds to cut lending by \$2 trillion, triggering the risk of a "substantial recession" in the U.S., according to Goldman Sachs Group Inc. Losses related to record U.S. home foreclosures using a "back-of-the-envelope" calculation may be as high as \$400 billion for financial companies, Jan Hatzius, chief economist at Goldman in New York wrote in a report dated yesterday. The effects may be amplified tenfold as companies that borrowed to finance their investments scale back lending, the report said. "The likely mortgage credit losses pose a significantly bigger macroeconomic risk than generally recognized," Hatzius wrote. "It is easy to see how such a shock could produce a substantial recession" or "a long period of very sluggish growth," he wrote. **Goldman's forecast reduction in lending is equivalent to 7 percent of total U.S.**

household, corporate and government debt, hurting an economy already beset by the slowing housing market. Wells Fargo & Co. Chief Executive Officer John Stumpf said yesterday that the U.S. housing market is the worst since the Great Depression. **Hatzius said his report is based on a "conservative estimate" of investors cutting lending by 10 times the loss to their capital.** Investors realizing half of the potential losses, at \$200 billion, would have to scale back lending by \$2 trillion, he said. Joseph Stiglitz, the Nobel-prize winning former World Bank economist, said in an interview today that the U.S. faces a "very major slowdown, maybe recession" because a "consumption binge" fuelled by household borrowing. **Goldman Sees Subprime Cutting \$2 Trillion in Lending**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a1FuVkSEJuS4&refer=home>

- Nov. 16 (Bloomberg) -- For **the first time in at least a decade, the world's biggest financial institutions are paying more to borrow in the corporate bond market than the average company.** Bonds of banks, brokerages and insurance companies yield 1.49 percentage points more than U.S. Treasuries, matching a record high set in October 2002, according to indexes compiled by New York-based Merrill Lynch & Co. The average industrial company bond trades at a yield premium of 1.34 percentage points. Investors are demanding extra compensation for the risk of owning Citigroup Inc., Merrill Lynch and Barclays Plc on concern that the \$50 billion in losses already reported from subprime mortgages will increase. The total damage may reach \$400 billion worldwide, Deutsche Bank AG analysts said this week in a report, and Wells Fargo & Co. Chief Executive Officer John Stumpf said the housing market is the worst since the Great Depression. **"The fear is that we haven't seen the losses yet, we've only seen the estimates of the losses and the credibility of the banks and brokers to assure people they have a good handle on it is really the key issue,"** said John Atkins, corporate bond analyst at research firm IDEAGlobal in New York. Until the subprime-mortgage crisis erupted, banks had always paid less than the average company, according to Merrill indexes that began in 1996. Financial company yield spreads began trading higher in August and the gap between the two reached a record Nov. 13. Investors two days ago punished Citigroup for its \$17 billion in credit-market losses, driving yields on 10-year notes the company sold to the highest in the bank's history. **The cost of protecting European bank bonds against default rose above the premiums for non-financial company debt for the first time in at least three years this month.** Europe's iTraxx Financial Index of credit-default swaps on 25 financial companies including Barclays and UBS AG rose 2 basis points to 52 basis points today, according to JPMorgan Chase & Co. prices. The index has more than doubled the past month. **"Until credibility can be restored, the banks are going to have to pay prices to investors that they thought were unthinkable until six months ago,"** IDEAGlobal's Atkins said. **"But they have little choice as they need to keep the capital taps open."** Risk Perception The perception of risk is also seen in credit-default swaps, derivatives that pay the buyer face value in exchange for the underlying securities or the cash equivalent should a company fail to adhere to its debt agreements. Credit-default swaps tied to Merrill Lynch have risen 35 basis points to 122 basis points since Oct. 24, according to broker Phoenix Partners Group in New York. A basis point is 0.01 percentage point. Citigroup contracts have climbed 28 basis points to 81 basis points. Citigroup contracts earlier this month reached

the widest in at least five years, while Merrill Lynch touched the highest in at least six years, Credit Suisse Group data show. A basis point on a credit-default swap contract protecting \$10 million of debt from default for five years is equivalent to \$1,000 a year. **Citigroup Pushes Bank Borrowing Costs Above Companies**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aXGZ4nRDYb9M&refer=home>

- Nov. 15 (Bloomberg) -- **The crisis of confidence in bond insurers that bestow top credit ratings on debt sold by borrowers from the New York Yankees to Citigroup Inc. may cost investors as much as \$200 billion.** The AAA ratings of MBIA Inc., Ambac Financial Group Inc. and their five smaller competitors are being reviewed by Moody's Investors Service and Fitch Ratings. **Without guarantees, \$2.4 trillion of bonds may fall in value and some issuers would get shut out of the capital markets.** "We shudder to think of the ramifications," said Greg Peters, head of credit strategy at New York-based Morgan Stanley, the second-biggest U.S. securities firm by market value. **"You have politicians, taxpayers, municipalities, states. It just opens up a Pandora's box. That is a huge destabilizing force."** For more than 20 years, the safety of insurance has eased the way for elementary schools, Wall Street banks and thousands of municipalities to sell debt with unquestioned credit quality. Now, mounting downgrades on insured bonds backed by assets such as mortgages are raising doubts about the stability of the guarantors. Armonk, New York-based MBIA, the world's largest, has a 28 percent probability of default, and Ambac's is 40 percent, prices of derivatives show. Bondholders may lose about \$9 billion on municipal bonds, according to data compiled by Bloomberg and Lehman Brothers Holdings Inc. indexes. More than \$30 billion would disappear from the value of collateralized debt obligations held by banks, based on the values that Citigroup and Merrill Lynch & Co. assigned to their holdings in the past month. Another \$150 billion may evaporate from bonds backed by home-equity lines of credit and other mortgages and loans, according to investors and traders. **Moody's and Fitch, both based in New York, are examining the insurers on concern that a slide in the credit quality of some of the 80,000 securities they guarantee has eroded their capital so much that they no longer deserve AAA ratings.** Lower Ratings The ratings companies said New York-based Ambac, FGIC Corp. in New York, and CIFG Guaranty of Hamilton, Bermuda, have a high or moderate chance of being told to add capital or forfeit their top status. Fitch and Moody's said MBIA has a low risk of a downgrade. Borrowers would see their costs increase if they lose top rankings. Municipalities ranked A pay \$190,000 more a year in interest on \$100 million of debt than those with AAA bonds, according to index data compiled by New York-based Lehman Brothers Holdings Inc. Lower ratings would force some investors to sell securities. About 110 municipal bond mutual funds are required to hold most of their assets in AAA debt, according to data compiled by Bloomberg. As many as half of all municipalities have an underlying credit strength equivalent to AAA, according to Lehman Brothers strategist Peter DeGroot. If yields on half of all insured munis were to rise by 19 basis points, reflecting the difference between AAA insured yields and A rated yields, the loss in value would be \$9 billion. CDO Guarantees When home sales soared this decade, insurers increased their guarantees of securities created from mortgages, including subprime loans to people with poor credit and home-equity loans. **They now guarantee almost \$100 billion of CDOs backed by subprime-mortgage securities as**

of June 30, according to an Aug. 2 report by Fitch. CDOs are created by packaging debt or derivatives into new securities with varying ratings. **Banks and investors in CDOs may be forced to write down the debt by more than \$30 billion if the debt became uninsured,** based on the values that New York-based Citigroup and Merrill Lynch assigned to their holdings in the past month. Merrill wrote down 29 percent of its CDOs and other securities linked to subprime mortgages and Citigroup cut 21 percent. Insurers are required by accounting rules to reflect the current market value of the guarantees on the bonds they insure through derivatives contracts. Home Equity **Then there is the \$1 trillion market for insured securities backed by assets such as home-equity and consumer loans.** Concerns about the underlying quality of the assets and the viability of the guarantors have caused investors to price some securities relative to the credit-default swaps of the insurers, according to David Land, a mortgage-bond fund manager at Advantus Capital Management. Advantus, based in St. Paul, Minnesota, oversees about \$18 billion. Insured securities backed by home equity-lines of credit have fallen by 15 percent, based on the rise in credit-default swap rates this year on Ambac's insurance company. If the entire insured market were to drop that far, it would reduce the value of the securities by \$150 billion. "The insurers can protect you from one unusual, idiosyncratic event, like a Hurricane Katrina," said Daniel Castro, chief credit officer of structured finance at GSC Group in New York, which oversees more than \$24 billion of debt. **"What if you had 20 Hurricane Katrinas and everything is wiped out? That's what you have right now.** 'Never Questioned' "Investors in guaranteed debt have never questioned the AAA guarantee from monolines," said Toby Nangle, who helps oversee \$37 billion at Baring Asset Management in London and avoids debt guaranteed by monolines. **Given the rise in the perception of risk, they "may start to wonder if the emperor has no clothes,"** he said. Ambac has tumbled 66 percent on the New York Stock Exchange since June 1. MBIA dropped 40 percent. New York-based ACA Capital Holdings Inc., an A rated insurer that S&P said it may cut, is down 89 percent. FGIC isn't publicly traded. Credit-default swaps on MBIA more than tripled to 410 basis points since Oct. 15, according to CMA Datavision in New York. The price suggests that investors see a 28 percent chance MBIA will default, according to JPMorgan Chase & Co. valuation models. Contracts on Ambac have climbed to 620 basis points, CMA data show. They imply a 40 percent chance of default. Credit-default swaps are a type of derivative that allows investors to speculate on a company's ability to repay debt. Derivatives are financial instruments derived from stocks, bonds, loans, currencies and commodities, or linked to specific events like changes in the weather or interest rates. A basis point on a contract protecting \$10 million of debt from default for five years is equivalent to \$1,000 a year. Pervasive Problems What has investors so concerned is the declining value of insured CDOs and mortgage securities. Bond insurers reported combined losses of \$2.9 billion last quarter after writing down the value of some of the CDOs and other securities they guarantee amid the worst housing market since 1991. **"What concerns us is the pervasiveness of the potential problems," Morgan Stanley's Peters said in an interview this week. "The bond insurers touch so many aspects of the financial system."** Losses may be so big that governments would step in to prevent losses from hurting municipal bondholders, many of them retirees, and states and municipalities, which may be prevented from selling debt, he said. Political 'Solution' "A form of bailout would probably be worked out," Charpin said in the Nov.

6 note. "A politically engineered solution will insure an acceptable way out where the innocent pensioner does not lose out and states are able to continue funding themselves and build more roads and schools. "This has implications for global financial markets," said Ackman, who has pushed for changes at companies such as McDonald's Corp., the world's biggest restaurant company, and Wendy's International Inc. He first raised questions about the bond insurance industry in a 2002 research report titled "Is MBIA Triple-A?" **MBIA, Ambac Downgrades May Cost Market \$200 Billion**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=aoiyuz8qt5I&refer=home>

Commercial Real Estate

Commodities

Currency

- Nov. 18 (Bloomberg) -- Gulf Arab heads of state, most of whose currencies are pegged to the U.S. dollar, will jointly discuss a proposal to revalue their currencies in December, the secretary general of the Gulf Cooperation Council said. "It's true," Abdul Rahman al-Attiyah told reporters in Riyadh, Saudi Arabia, today in response to a question about a Bloomberg News story that Gulf states, including Saudi Arabia and the United Arab Emirates, might revalue their currencies in a single step. A proposal to change the value of the currencies will be considered at the heads of state summit in Doha, Qatar, on Dec. 3-4, al-Attiyah said. "This case will be presented to the leaders for them to study," he said. The leaders may then pass it on to an advisory committee, al-Attiyah said. Gulf states face record inflation, caused partly by the weakening dollar that has made imports from Europe more expensive. Consumer prices rose a record 4.9 percent in Saudi Arabia in August and inflation in the United Arab Emirates accelerated to a record 9.3 percent last year. Qatar has the highest inflation rate in the region, reaching 14.8 percent in the first quarter. **Gulf States Will Discuss Revaluing Their Currencies**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aqSk2OwTKw0Y&refer=home>
- Nov. 18 (Bloomberg) -- The Group of 20 nations said some Asian countries need to allow their currencies to appreciate more after European and Canadian officials stepped up pressure on China in the past week. The G-20 agreed on the need for "greater exchange-rate flexibility in a number of surplus countries" in "emerging Asia," according to a statement released after two days of talks in Kleinmond, South Africa. The G-20 groups the largest developed countries, including the U.S., France and Canada, with emerging markets such as China and India. G-7 officials have strengthened their rhetoric on China as concern mounts the country isn't shouldering enough of the dollar's slide, garnering an unfair advantage for its exporters. French Finance Minister Christine Lagarde said today the yuan is "causing tensions" and Canada's Jim Flaherty said yesterday China and other Asian countries "need to do more." The G-20 didn't go as far as the G-7's October statement, which singled out China and the need for an "accelerated appreciation" of the yuan. Today's communiqué made no reference to the dollar's decline. The euro and the Canadian dollar have soared to records against the U.S. currency as China restrains the yuan's exchange rate. While China has allowed its currency to rise about 5 percent against the dollar this year, it has fallen against the euro by about the same amount.

'Greater Balance' The U.S. currency has dropped about 11 percent so far this year, based on the Federal Reserve's U.S. Trade-Weighted Major Currency Index. It fell this month to its weakest against the euro since the European currency's debut in 1999, to a 26-year low versus the pound and the lowest against Canada's dollar since it was floated in 1950. "Greater balance in exchange rates provides us with stability," South African Finance Minister Trevor Manuel said at a press conference today. Inflation Threat The G-20 also said that "rising energy and food prices will remain an important source of price pressures" and central banks "will need to assess carefully the inflation outlook in light of both tight conditions in commodity markets and the downside risks to growth." Policy makers around the world are trying to curb inflation just as fallout from the biggest U.S. housing slump in 16 years spreads through financial markets and a weaker dollar threatens to hurt growth. While the U.S. Federal Reserve has cut interest rates twice since September to shore up U.S. expansion, policy makers in India, China and the 13 euro nations say they are worried about accelerating inflation. The price of oil has surged 58 percent in the past year and wheat prices have increased 60 percent in the same period. European inflation accelerated to the fastest pace in two years last month and Chinese inflation matched the quickest pace in a decade. The statement said G-20 nations agreed that easing lopsided trade and investment flows is a "shared responsibility." While Asian nations need to make their currencies more flexible, the U.S. needs to boost saving, European governments must take measures to spur economic growth and Japan must undertake "further structural reforms." **G-20 Calls on Asia For More Currency Flexibility**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aRetMWLBy8Mw&refer=home>

- Nov. 18 (Bloomberg) -- The falling U.S. dollar's effect on oil revenues overshadowed Saudi Arabia's promises to fight global warming at this weekend's OPEC summit in Riyadh. Saudi Arabia, considering a revaluation of the riyal against the dollar, had to fight off an attempt by Iran and Venezuela to get the group to discuss pricing oil in different currencies. Hosting the summit, King Abdullah committed \$300 million to research climate change, while OPEC leaders pledged to cut emissions from oil and gas production. The dollar's 10 percent decline this year has cut the buying power of revenue from record oil prices above \$90 a barrel. A further drop may harden OPEC's reluctance to raise supply in a bid to ease prices. Ministers at the summit said the oil market was well-supplied and recent gains were due to speculation and beyond the group's control. **"OPEC is in a price paralysis conundrum," said John Sfakianakis, chief economist at Saudi British Bank, a unit of HSBC Bank Plc. "They do care about the dollar, but if they say publicly they worry it will show they care even more."** Gulf Arab countries, most of whose currencies are pegged to the U.S. dollar, will jointly consider a revaluation in December in a bid to combat inflation, Abdul Rahman al-Attiyah, the secretary general of the Gulf Cooperation Council said in Riyadh today. The council includes OPEC members Saudi Arabia, Kuwait, the United Arab Emirates and Oman. "Everyone wants to discuss the dollar, but we don't know in what form to put it on the agenda," Algerian Oil Minister Chakib Khelil said in an interview yesterday. "It is a very complex issue - it impacts economic growth, purchasing power." Final Declaration The final declaration from OPEC's third heads of state summit reiterated the group's commitment to ensuring stable energy supplies and promise to reduce carbon emissions

from oil and gas production, according to a draft of the statement. "The stability of the oil market is essential," said the statement issued at the end of a summit read by the group's secretary general, Abdalla el-Badri. OPEC energy ministers have their next meeting to discuss oil production in Abu Dhabi on Dec. 5. The producers' club, which supplies more than 40 percent of the world's oil, is gaining influence on the back of high prices. Importing nations have transferred \$3 trillion more to OPEC than they would have since 2001 had oil prices stayed near \$20 a barrel, according to Goldman Sachs Group Inc. **OPEC's Dollar Concerns Overshadow Environmental Push**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aDYk2EV7L.Vk&refer=home>

- **The Canadian dollar (aka the "loonie") is now worth US\$1.10 – a price not seen since the 1870s.**
- Nov. 16 (Bloomberg) -- Bank of England Governor Mervyn King is joining Jean-Claude Trichet and Henry Paulson to demand that China allow the yuan to strengthen at a faster pace. King, usually reluctant to address exchange rates, used his quarterly press conference to warn that China is stoking "great currency tensions." He said the issue will be discussed at this weekend's meeting of officials from the Group of 20 nations near Cape Town. Trichet, head of the European Central Bank, insisted last week that China meet its "global responsibilities," and Treasury Secretary Paulson called Beijing "out of step with the rest of the world." King's remarks reinforce a shift in rhetoric from officials of the largest economies as concern mounts that China isn't shouldering enough of the dollar's slide, garnering an unfair advantage for its exporters. While the yuan has risen about 5 percent against the dollar this year, it has dropped by the same amount against the euro. "It's a pretty hot topic for all of them now," said Dominic White, an economist at ABN Amro Holding NV in London. "Policy makers were hoping that the currency shifts needed for the rebalancing of the global economy would happen more gradually and over a longer period." The dollar has slumped 11 percent against the euro this year, falling to a record of \$1.4752 on Nov. 9. It also fell last week to its weakest versus Canada's dollar since that currency was floated in 1950 and declined to a 26-year low against the British pound. 'Correct Direction' For now, China is signaling little willingness to bow to pressure. Central bank Deputy Governor Wu Xiaoling said Oct. 19 China won't hurry to alter its exchange-rate system, saying the country is already "moving in a correct direction and in a smooth manner." European officials may nevertheless up the ante when they travel to China later this month. They will tell their counterparts to allow faster appreciation of the yuan or risk "triggering protectionist tendencies," according to the draft of a confidential briefing document. Trichet, Luxembourg Prime Minister Jean-Claude Juncker and European Union Commissioner Joaquin Almunia arrive in Beijing on Nov. 27 for two days of talks. **In the absence of assistance from the Chinese, some G-20 officials may ask Paulson to step up his defense of the dollar. Like his four predecessors, Paulson has stuck with former Treasury chief Robert E. Rubin's phrase that a "strong dollar" is in the U.S. interest. The language has been repeated whether the dollar is rising or falling. [I guarantee you that is no chance the Fed will raise rates or drastically decrease money supply either or which would have to happen to strengthen the dollar. Thus Paulsen as usual is simply full of hot air.]** "Ups and Downs" Paulson may be willing to say more now. He told reporters yesterday that "our economy,

like any other, goes through ups and downs," after last week expressing confidence in the dollar's status as a reserve currency. **The six-year expansion will continue, he said yesterday, and growth will ultimately be reflected in the dollar's exchange rate.** [Based on what data?????] The dollar nevertheless remains close to a record low and was worth \$1.4621 today. "The political establishment in Europe and Canada are flagging unhappiness with dollar weakness and we could get more comments like that," said Adam Cole, senior currency strategist at RBC Capital Markets Ltd. in London. G-20 officials will probably also say they're concerned about increasing inflation pressures, which may make it harder for them to end any dollar rout. European consumer prices rose the most in two years last month, Chinese inflation matched the fastest pace in a decade in October and Australia's central bank on Nov. 12 raised its price forecasts and expects inflation to exceed its target until June. "Inflation is a concern for policy makers outside of the U.S. and that colors their attitudes to currencies generally," said Cole. "Intervention really only works when it pushes the same way as domestic policy, which it doesn't at the moment." **King Joins Trichet, Paulson, Puts Pressure on China** <http://www.bloomberg.com/apps/news?pid=20601109&sid=aZANBIkhwcvI&refer=home>

- Nov. 16 (Bloomberg) -- Treasury Secretary Henry Paulson signaled to U.S. trading partners that the dollar will rebound from a record low, predicting it will reflect "long-term strength" in the American economy. **"He's trying to instill a bit of confidence in the market, in the dollar,"** said Jens Nordvig, senior global markets economist at Goldman Sachs Group Inc. in New York. **"That's the purpose of this. This is what European policy makers want to hear, Canadians as well."** [notice there is no reference to action, see prior as to fact no action to strengthen the dollar is forthcoming] `Strong Dollar' Mantra Paulson's efforts to strengthen his rhetoric began Nov. 8, when he said "the U.S. has a very competitive, strong economy that's proven itself over many years." The next day, he told reporters in Washington "the dollar has been the world's reserve currency since World War II and there's a reason." "The long-term strength of the U.S. economy will be reflected in the currency," Paulson said in an interview with Johannesburg's 702 Radio today. "Hank Paulson knows the markets pay very close attention to everything he says," said Callum Henderson, head of global currency strategy at Standard Chartered Bank in Singapore. **"Washington is getting the message it has to change its rhetoric."** [What an absurd comment. The "strong dollar rhetoric has been unchanged for a decade as the euro has gone from 87 cents to a buck forty-five and the looney from 67 cents to a buck ten.] Before the dollar's decline accelerated a month ago, Paulson and Bush repeatedly hailed record U.S. exports as a bright spot in a slowing economy. American shipments abroad, fueled partly by a weaker currency, climbed 14 percent to a record \$140.1 billion in September, narrowing the trade deficit to the smallest gap since May 2005. `Brutal' Moves The shift in trade patterns threatened to slow growth in Europe, Canada and Japan, and their governments responded. Fukuda said the yen's gains aren't desirable and warned against speculative currency bets in an interview with the Financial Times published three days ago. European Central Bank President Jean-Claude Trichet last week said "brutal" currency moves are "never welcome," reprising language he last used when the euro climbed in 2004. French President Nicolas Sarkozy told American lawmakers Nov. 7 that the U.S. must support the dollar or risk triggering a trade war. In Canada, where a drop in exports caused the

nation's trade surplus to dwindle to its smallest since 1998 in September, Finance Minister Jim Flaherty said last week that he was "concerned" about the soaring Canadian dollar. Bank of Canada Senior Deputy Governor Paul Jenkins said Nov. 14 that the U.S. currency's drop threatens "rising protectionist sentiment." Shifts in Language **Still, analysts said shifts in language aren't likely to cause lasting movements in the \$3.2 trillion a day foreign- exchange market.** Bush's previous Treasury secretaries, veteran chief executive officers of industrial companies, were sometimes associated with weaker endorsements of the "strong" dollar policy **Paulson Signals He Expects U.S. Dollar to Rebound**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aMO6lggH80tg&refer=home>

- Nov. 16 (Bloomberg) -- China's growth in factory and property spending accelerated, making the central bank more likely to raise interest rates for a sixth time this year. Fixed-asset investment in urban areas rose 26.9 percent to 8.9 trillion yuan (\$1.2 trillion) in the first 10 months of 2007 from a year earlier, the statistics bureau said today. That beat the 26.2 percent median estimate of 21 economists surveyed by Bloomberg News. The pace was 26.4 percent through September. Today's number is the last in October data that showed inflation matching a decade high and the trade surplus widening to a record. Surging factory spending raises the risk that China, the biggest contributor to global growth, will be left with idle factories, lost jobs and a supply glut if export demand slows. "Macro controls will strengthen because the government wants slower investment," said Liao Qun, chief economist at Citic Ka Wah Bank in Hong Kong. **"Add the high inflation number and the chance of an interest-rate increase today or this weekend has got much bigger."** He expects borrowing costs to rise as many as two times before year's end. China's "Turning Point" **China's economy may face "a turning point" if exports drop abruptly as a result of cooling overseas demand, Sheng Baofu, a Ministry of Commerce researcher, wrote in a Nov. 13 article posted on the ministry's Web site. Exporters mainly targeting the U.S. risk "continuously shrinking" orders,** Sheng wrote. That contrasts with current government efforts to tame the flood of cash from a trade surplus that reached \$27 billion last month, stoking inflation, asset prices and investment. Money supply grew 18.5 percent from a year earlier, exceeding the central bank's annual target of 16 percent for a ninth straight month. Consumer prices rose 6.5 percent on surging food costs. China should raise interest rates and allow more currency appreciation, the World Bank said yesterday. Bigger yuan gains would staunch money inflows by pushing up export prices. The currency has climbed 11 percent versus the dollar since a fixed exchange rate ended in July 2007. China is the biggest contributor to global growth this year, the International Monetary Fund said last month. **China Factory Spending Quickens, Adds Rate Pressure**
http://www.bloomberg.com/apps/news?pid=20601087&sid=a_XvxDGUyR7g&refer=home

Diversification

Derivatives

Housing

- Absent a substantial drop in mortgage rates the Bear Stearns analysts estimate home prices would have to fall 15-20% to bring affordability back into its historical averages. Barrons 11/17 p. 8
- **"We have not seen a nationwide decline in housing like this since the Great Depression,"** said Wells Fargo chief executive John Stumpf. "I don't think we're in the ninth inning of unwinding this. If we are, it's going to be an extra-inning game." Stumpf told reporters that the housing slump would continue well into 2008, and that (of course) Wells Fargo was well positioned to weather the storm. WFC shareholders nodded and grinned as they discreetly slammed the "sell" buttons... the stock fell nearly 4%.

Housing Finance

- "The mortgage black hole is, I think, worse than anyone saw," said Tony James, president of Blackstone, the big private equity firm. "Deeper, darker, scarier. [The banks] are now looking at new reserves and my sense...is they don't have a clear picture of how this will play out and confidence is low." DR 11/15
- **Foreclosure filings, for example, were up a staggering 30% in the third quarter of '07 compared to the previous three months.** California, Ohio and Florida are still leading the charge, says RealtyTrac. Of the nation's 100 largest metropolitan areas, 77 saw a rise in delinquencies in the third quarter. The worst city in the third quarter proved to be Stockton, Calif., where one in 31 households was delinquent. Close behind was Detroit -- 1 in 33. Agora 11/14
- **Countrywide announced yesterday that its mortgage loan origination fell 48% in October year over year.** The company drafted \$20 billion less in loans last month than in October 2006. GodMozilo and company originated \$42 million in subprime mortgages last month -- down 99% from the \$3.2 billion they drafted in October 2006.

Macro Economic

- Nov. 16 (Bloomberg) -- Bank of Japan Deputy Governor Toshiro Muto said the U.S. housing recession and financial- market turmoil could hurt Japan's economy, making it "difficult" to decide when to raise interest rates. **The central bank expects the economy to keep growing with stable prices, though "we must examine both upside and downside risks carefully," Muto, 64, said in an interview yesterday in Tokyo. "This is quite a difficult situation."** Governor Toshihiko Fukui, whom Muto is favored to replace in March, this week also said the U.S. housing slump and market rout could become worse than expected, threatening global growth. Lehman Brothers Holdings Inc. today pushed back its forecast for the next increase in Japan's key rate, the lowest among major economies, from the first quarter of 2008 to the third. "The economic views of the Bank of Japan and financial markets are converging somewhat, though the bank hasn't lowered its rate-hike flag just yet," said Hiroshi Shiraiishi, an economist at Lehman in Tokyo. "There won't be any major changes in the bank's policy stance should Muto

become governor." `Fully Aware' **Muto said policy makers ``are fully aware' growth in Japan would be threatened should the U.S. slowdown infect the rest of the world. The housing crisis and banks' reluctance to lend have yet to damp spending by U.S. consumers and companies, he added.** His comments ``reveal the Bank of Japan's true feelings," said Yasuhiro Onakado, chief economist at Daiwa SB Investments Ltd. in Tokyo. ``Japan's economy will continue to lose steam." The bank this week held the key overnight lending rate at 0.5 percent. ``Unstable" global financial markets could derail economic growth, board members said in October, according to minutes released today. Muto said expectations that borrowing costs will stay low for a long time could cause swings in growth and prices and encourage inefficient investment. Fukui has also said rates need to rise to deter companies and traders from making risky investments, even as barriers mount against an increase. **Fallout from the U.S. subprime-mortgage collapse has wiped \$1.8 trillion from world stock markets since Oct. 31 [and trillions more to go I am afraid]** and the yen has gained more than 4 percent, hurting Japanese exporters. Waning Exports **Shipments to the U.S., Japan's biggest market, fell at the fastest pace in almost four years in September.** At home, consumer prices have yet to rise this year and household spending is being curtailed by falling wages and a deteriorating job market. **BOJ's Muto Says Japan May Suffer From U.S. Woes**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=acz06IMbTzDI&refer=home>

- Americans are the world's biggest spenders – with a 20% share of total global consumption. They are the world's biggest users of oil. They are also the most indebted people in the world. And now, Americans are running out of money. Their houses are sinking in value. Their wages are stagnant or falling. Their dollar is so depressed it can't get out of bed in the morning. DR 11/15
- Nov. 16 (Bloomberg) -- Dexia SA, Belgium's third-largest financial-services company, reported a 28 percent decline in third-quarter profit following losses at its U.S. bond insurer. Dexia, which provides loans to municipalities, banking services to Belgians and bond insurance in the U.S., fell as much as 7.5 percent in Brussels trading after net income dropped to 439 million euros (\$640 million). Four analysts surveyed by Bloomberg estimated Dexia would earn closer to 468 million euros. ``Dexia came up with a clear miss," Simon Chiavarini, a UBS AG analyst who has a ``sell" rating on the stock, wrote in a note to clients today. ``Dexia argues this is accounting noise. We are more concerned." Profit declined at the Brussels and Paris-based company after unrealized investment losses at Financial Security Assurance Holdings Ltd., Dexia's U.S. bond insurance subsidiary, and writedowns at its capital markets unit. Dexia followed London-based Barclays Plc and HSBC Holdings Plc in reporting writedowns this week after record foreclosures on U.S. mortgage loans to subprime borrowers roiled credit markets. **Dexia Third-Quarter Profit Falls 28% on U.S. Unit**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a0RslIkVBVQ4&refer=home>

Retail

- YRC Worldwide said it is experiencing disappointing freight trends,

- Risk aversion doesn't just apply to bank lending and consumer discretionary spending. It applies across many different segments of the economic landscape. Take **J.C. Penney (JCP)** for example.
- J.C. Penney is an important stock in terms of consumer stress, something made clear by CFO Robert Cavanaugh in the company's conference call yesterday: "Our focus is the moderate consumer, a consumer who has always had to make serious choices about their discretionary spending."
- And J.C. Penney CEO Myron Ullman touched on what the company is seeing in terms of consumer sentiment and risk aversion: "For the first time we really saw a change in consumer sentiment reflecting the soft housing market, the subprime market and the effect of – psychological effect, at least, of fuel prices."
- But what struck us as interesting about the call is how risk aversion infects everything and applies across many different segments of the economic landscape.
- Ullman noted, "[I]t's our belief that 2008 is going to continue to be a difficult selling environment and as such **we are planning 2008 very conservatively on expenses**. We certainly need to be able to flex the business count in terms of customer staffing and selling, **but we are not going to be very aggressive in terms of spending on discretionary projects in this environment**."
- This is how risk aversion leads to yet more risk aversion, and why the Federal Reserve's battle at a point becomes a psychological battle.
- The Federal Reserve can continue to make credit available, but what matters is how willing businesses and consumers are to take it.
- Nov 16 – Schaeffer opening email - In earnings-related news, despite posting a 36% jump in quarterly profit, Starbucks (SBUX: sentiment, chart, options) shares dropped more than 9% overseas in the wake of confessing a 17% to 21% decline in its 2008 earnings growth forecast. Kohl's (KSS: sentiment, chart, options), taking a hint from fellow retailer J.C. Penney (JCP), also trimmed its fiscal outlook after revealing a 13% decline in profit.
- <http://www.minyanville.com/articles/FNM-WFC-GS-JCP/index/a/14910>

Retirement

Risk

Savings Rate

Tech

Wall Street

- “But it’s funny,” continued our friend, who is also in the financial trade, “we find that our clients have no real appreciation of what is going on. They only judge by the last few years. If a stock was trading at 100, and now it’s 95, they think it is a bargain. Same thing for houses. You get a little bit of a price decline, and people think they have a good

investment opportunity. The idea of a bear market...or a credit deflation...never enters their minds.” DR 11/14

Don't Fight The Fed

I Disagree . . . and why

[Article of the week:](#)

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