

The Other Side of the Street November 25, 2007

Comments

This week should have been a lay-up. Holiday weeks usually are. Further, Bloomberg touted the “Black Friday rally” as the greatest in 20 years on the highest volume since 1999 for that day. (for more on the value of headlines, see *Outside the Headlines* <http://www.kelihercapitalmanagement.com/published.html>)

However there were at least a few problems with the “all news is good news, people went shopping” scenario:

- The China Syndrome – It seems the Chinese government might be more interested in bubble bursting than Al and company were back in the day. More efforts were underway to curb the rampant speculation in all things with the word China associated with them in any fashion. On a US stock basis, a number of “China” stocks stumbled during the week breaking support and looking like a freefall is eminent. BIDU is a name to watch, but there are plenty of others that will go more quickly and with less fanfare.
- The dollar is saying goodbye to the 1.40s in Euroland and looking to go below triple figures in the land of the rising sun. Not unexpectedly gold has surged back from the 770 dip and went to near 830 – in 3 days.
- The credit problems that never were fixed are accelerating once again.
- The greatest Black Friday rally was preceded by the eclipse of the August lows and, on the week, the indices went from Dow 13,177, SP500 1,459 and Naz 2,637 to Dow 12980, SP500 1,440 and Naz 2,596. Meanwhile the non-festive Hang Seng had a very unholiday nonrally drop from 27,614 to 26,541 extending its November To Remember drop to 4,812 points (but, keep in mind, wink wink, it is ALL just a correction/buying opportunity)
- And, a possible foreshadowing headline from an Antarctica, (recall *What Boat Are You On?*) **Ship Hits Iceberg, Sinks** <http://www.abcnews.go.com/International/story?id=3905858&page=1>

It is after noon in Jellystone Park . . .

Credit

- SEPT 3 2007 [This was nearly 3 months ago and the situation now is much worse] - The problem with financials We continue to carry a very low weight in financial stocks. Though the recent weakness in these stocks has prompted a great deal of interest in “bottom fishing,” my impression is that such efforts are based on the same untempered assumptions of high and growing earnings in this sector that existed months ago. P/E ratios *ought* to be well below historical norms when those P/Es are based on record

earnings and record profit margins. **In my view, existing valuations are based on untenable assumptions of *permanently* high profit margins in this sector, with optimistic growth assumptions as well. In 2000, this was the essential problem with the technology sector. It was some time before Wall Street's expectations caught up with the reality that profit margins are cyclical and that early declines off of overvalued peaks do not constitute bargains. I expect that in the next year or two, we will observe at least one quarter, and more likely a full year, in which the entire profit of the U.S. banking sector is consumed by loan losses.** Consider, for example, the latest FDIC Banking Profile, which was published based on June 30, 2007 data (before the recent liquidity crisis emerged). **In that report, the FDIC noted that the ratio of loan loss reserves to *total* loans remains at a 32 year low. As for the portion of those loans that are in trouble, the FDIC notes “for the fifth quarter in a row, reserves failed to keep pace with the increase in non-current loans.”** The industry's “coverage ratio” of reserves to *non-current* loans fell to the lowest level since the third quarter of 2002, while non-current loans posted the largest quarterly increase since the fourth quarter of 1990. Recall that 1990 and 2002 were periods when recessions were already well underway. If we're already seeing these signs of credit stress at the peak of an economic expansion, the figures we observe in a recession are likely to be a lot worse. James Grant put it this way – “Benjamin Graham and David L. Dodd, in the 1940 edition of their seminal volume ‘Security Analysis,’ held that the acid test of a bond or a mortgage issuer is its ability to discharge its financial obligations ‘under conditions of depression rather than prosperity.’ Today's mortgage market can't seem to weather prosperity.” As of June 30, 2007, the net income of all FDIC insured banking institutions totaled \$36.8 billion. At an annual rate, that represents about 2% of all loans outstanding. Meanwhile, net charge-offs for bad loans were already running at an annual rate of about 0.50% in June. That's in a strong economy, before the recent problems, and loan loss reserves didn't even budge from a 32-year low. Net charge offs could easily quadruple in a mild recession. **Importantly, the problems go far beyond sub-prime. In its June 30 report, the FDIC noted “all of the major loan categories posted both increased net charge offs and higher net charge off rates.”** Overall, net charge-offs jumped by over 50% from year-ago levels, with a jump of over 60% for consumer loans and over 70% for industrial loans. These percentage jumps are so high because they are off of such a low base, which underscores the extent to which observed profits in the financial sector have been unhindered by loan losses in recent years. Charge-off rates have not soared as much for credit cards, but this is because the existing level of charge-offs is already high (representing over 3% of the total amount volume of credit card balances, year-to-date). In short, the problems are in all categories, and given the thin coverage of the banking system for such losses, rising charge-offs and loan loss reserves are likely to bite deeply into earnings. For some financials, relatively high dividend yields are being touted as a measure of safety and quality for investors. The difficulty is that if earnings come under pressure, a greater share of earnings will be required to cover those dividends. Of course, the long-term return is equal to the dividend yield plus the long-term growth rate of dividends. Though I don't expect forced dividend reductions for major U.S. bank stocks, I do believe that the growth rates assumed by Wall Street here are overstated. And while a *well-covered* dividend *can* produce a lower “duration” and therefore a smaller sensitivity to broad market fluctuations, it does not in itself produce an undervalued stock.

Historically, strong buying points for financial stocks have generally occurred when the group has traded at about book value. Currently, the typical multiples are two and often three times that level. That isn't to imply that financials must retreat to those lower valuations in this instance, but it's important to recognize that many financials are only "cheap" based on comparisons with very recent norms, and on the assumption that the high profitability levels of recent years will be sustained indefinitely. <http://hussmanfunds.com/wmc/wmc070903.htm>

- Nov. 23 (Bloomberg) -- MBIA Inc. and, Ambac Financial Group Inc., the world's two biggest bond insurers, jumped after the bailout of rival CIFG Guaranty signaled the industry may get the financing it needs to avoid credit-rating downgrades. MBIA, based in Armonk New York, and Ambac of New York rose more than 8 percent in New York Stock Exchange composite trading after Groupe Banque Populaire and Groupe Caisse d'Epargne agreed to take control of CIFG from their Natixis banking subsidiary and doubled the company's capital with a \$1.5 billion investment. "They'll do whatever is necessary to protect their ratings and their franchise," Fitch analyst Thomas Abruzzo said of the companies in an interview yesterday from New York. Credit ratings of at least nine bond insurers are being examined by Fitch, Moody's Investors Service and Standard & Poor's after a slide in the value of mortgage securities the companies guarantee. Fitch and Moody's have said they may need to raise capital to keep their AAA ratings. Financial Guaranty Insurance Co., the fourth-largest, is most vulnerable, Fitch said. MBIA is among the least likely to need capital, while Ambac has a "moderate" risk, Fitch said. **A downgrade would raise doubts about the safety of the \$2.4 trillion of securities they guarantee.** CIFG's rescue may set the tone for other bond insurers, also known as monolines. "The CIFG news is constructive for the monolines," said Scott MacDonald, head of research at Aladdin Capital Management LLC in Stamford, Connecticut, which has \$21.5 billion under management. **I don't believe any of the bond insurers are going to fail but they are pressed hard on the capital side.** [must be a buying opportunity] Shares Rise [I was right, it was a buying opportunity. See I can catch on and be a Wall Street maven] MBIA, the largest bond insurer, rose \$1.96, or 6.1 percent, to \$34.14 in New York Stock Exchange composite trading today, after reaching \$34.80. Trading closed at 1 p.m. New York time because of the U.S. Thanksgiving holiday weekend. The company, down 53 percent this year, is among the least likely to need capital, Moody's and Fitch said. Ambac, the second-largest, has a "moderate" risk of needing capital, the ratings companies said. Shares of Ambac, down 71 percent this year, rose \$1.41, or 5.8 percent, to \$25.55, after earlier rising as high as \$26.15. "The fact that somebody has broken ranks is significant," said Nigel Sillis, director of research at Baring Asset Management in London, which oversees 37 billion euros of fixed-income. "This might end up providing a template for other bond insurers." "A Plus" Fitch affirmed CIFG's AAA ranking after the Paris-based mutual banks took control. Moody's today said the rescue "greatly reduces the risk" that CIFG's capital will fall below the amount needed for the top rating. http://www.bloomberg.com/apps/news?pid=20601087&sid=anQ_0LVez3aE&refer=home
- Nov. 22 (Bloomberg) -- Natixis SA's bond-insurance unit, CIFG Guaranty, will be taken over by the French bank's controlling shareholders in a \$1.5 billion rescue to preserve its

top credit rating. Natixis, France's fourth-largest bank by market value, rose 16 percent in Paris trading after Groupe Banque Populaire and Groupe Caisse d'Epargne, French mutual banks that jointly control Natixis, said today they will provide the capital and assume full ownership of CIFG. They said the purchase will be completed "as quickly as possible." Fitch affirmed CIFG's AAA rating after the announcement today, providing relief to the holders of \$85 billion of bonds insured by the company. The unit of Paris-based Natixis was named by Fitch and Moody's Investors Service as among the likeliest bond insurers to face downgrades after turmoil in the fixed-income market hurt the value of the debt they insure. "It's in everybody's interest that the situation is stabilized, and the obvious way of stabilizing it is to do exactly what Natixis has done," said Karl Bergqvist, a fund manager at Gartmore Investment Management Plc in London, which manages \$28 billion of debt. "It's good news for the whole industry." Natixis shares rose 1.76 euros to 13.09 euros, valuing the bank at 16 billion euros (\$23.8 billion). Even after the gain, the shares remain 39 percent lower on the year, compared with a 21 percent decline in the 63-member Bloomberg Europe Banks and Financial Services Index. Under Review Moody's and Fitch are also examining AAA-rated insurers including MBIA Inc., Ambac Financial Group Inc. and FGIC Corp. to see if they have enough capital to warrant their top ratings. Without guarantees, \$2.4 trillion of bonds may fall in value and some issuers would get shut out of the capital markets. 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. **Natixis's Bond Insurer to Get \$1.5 Billion in Capital**

http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=a257MnaAObVA

- Nov. 20 (Bloomberg) -- They dubbed it "The Survivors' Conference." In early November, 2,000 people who handle asset-backed securities for a living crowded into a ballroom at the JW Marriott hotel in Orlando, Florida, just 3 miles from Disney World, to hear speaker after speaker explain why 2008 may be their worst year ever. The subprime crisis, which has claimed the jobs of three chief executive officers and prompted more than \$45 billion in writedowns at the world's biggest banks, may end up spilling into 2009. **"These events tend to become deeper and play out longer than most people initially expect,"** says Michael Mayo, an analyst who covers securities firms at Deutsche Bank AG in New York. **"This is one of the slowest-moving train wrecks we've seen." [keep in mind the comments from government officials in the days and weeks immediately following the September cuts that "things were returning to normal". Utter falsehoods.]** At Subprime Conference It's Too Early to Tell Who'll Survive http://www.bloomberg.com/apps/news?pid=20601109&sid=ao.pOfg_kXF8&refer=home
- LONDON, Nov 21 (Reuters) - Renewed credit turmoil and volatility led the European Covered Bond Council (ECBC) on Wednesday to suspend inter-bank market-making in covered bonds until Monday, Nov. 26. The move is a sign of the stress in the covered bond market, which is dominated by German institutions that have almost a trillion euros of covered bonds outstanding. Covered bonds -- backed by pools of assets that remain on the borrower's balance sheet -- are usually highly liquid and typically rated triple-A by

ratings agencies. The ECBC's recommendation is aimed at relieving the pressure on market makers who are forced to quote prices at a fixed bid-offer spread that can mean relatively small sales of paper by end investors ricochet around the market, depressing prices sharply. "In light of the current market situation and in order to avoid undue over-acceleration in the widening of spreads, the 8-to-8 Market-Makers & Issuers Committee recommends that inter-bank market-making be suspended," the ECBC said in a release. Market-maker obligations to investors will remain unaffected. "It's good for the market," said Christopher Anhamm, head of ABS and covered bond research at ABN AMRO in Frankfurt. "It gives the market time to think." **Interbank covered bond trading halted on volatility**

<http://www.reuters.com/article/bondsNews/idUSL2120255420071121?pageNumber=1&virtualBrandChannel=0>

- SHANGHAI -- Chinese authorities are slamming the brakes on bank lending, in their latest attempt to curb the runaway investment threatening to overheat what is soon to be the world's third-largest economy. In recent weeks, regulators have quietly ordered China's commercial banks to freeze lending through the end of the year, according to bankers in several cities. The bankers say that to comply, they are canceling loans and credit lines with businesses and individuals. **A China Banking Regulatory Commission official here confirmed that local and Chinese subsidiaries of foreign banks have been asked to ensure that loans at the end of the year don't exceed the total outstanding on Oct. 31. The official described the request as "guidance aimed at supporting the macro-control measures being implemented."** Over the past few years, Chinese authorities have repeatedly sought to rein in investment in sectors such as property development, where they deemed it was becoming excessive. But even in China a blanket edict to halt lending growth is unusual. Curbing lending by raising interest rates, as China already has done four times this year, would be more in keeping with Beijing's increasingly market-oriented approach to business. But the lending freeze shows how the slowing U.S. economy may be complicating Chinese policy making. Lower interest rates in the U.S. give Beijing less room to push up rates without creating a ripple effect. By raising rates further China could risk boosting the value of its currency, the yuan, too much for the comfort of its exporters, a critical part of the Chinese economy. A stronger yuan would make Chinese exports less competitive in world markets. Bankers say they will honor the lending edict, partly because it comes with threats of financial penalties for noncompliance. "Which commercial bank would dare not obey this?" says Liu Haibin, chairman of the supervisory committee of Shanghai Pudong Development Bank Co. A Bank of China Ltd. official in Suzhou said over the weekend his branch is pushing big corporate loans into next year. An official of the same bank in central Henan province said the new measure in effect extends existing lending controls on property developers and power producers across the board to all banking clients. The measure could pose a particular challenge for the Chinese units of foreign banks, which have less flexibility than their larger local peers. How much lasting impact the measure has could depend on whether it is extended in some form in January, bankers say. **Even a temporary lending freeze, however, could cast a chill on important segments of the Chinese economy, including the stock market, whose steep run-up over the past year has given rise to fears of a speculative bubble. Though off their highs, Chinese share prices have nearly doubled since late 2006. [the NASDAQ did likewise in 99-00 just**

before dropping 70%] The lending freeze doesn't appear directly related to concerns about a stock bubble. Still, it could weaken the earnings of banks and other listed companies and leave less cash for investors to plow into stocks. In recent weeks, stocks have tumbled 15% or so from their record highs on concern China's central bank would lift interest rates or take other steps to cool the economy. China's benchmark one-year lending rate is currently 7.02%. Less lending also could rein in China's resurgent housing market or hurt consumer confidence. Some companies operating in China, particularly smaller ones, may be hard put to find basic working capital to pay staff or buy materials at year end, bankers say. "If loan growth were to stop, that would seriously disrupt investment plans and would introduce a high degree of uncertainty regarding financing," says Stephen Green, an economist at Standard Chartered Bank in Shanghai. It has been three years since Premier Wen Jiabao pledged to deal with "severe" problems associated with rampant credit growth. But despite repeated rate increases, economic data still point to risks that haphazard investment could make the Chinese economy spin out of control and possibly lead to hyperinflation or a spate of bad loans. Just last week, the government said fixed-asset investment in factories and property expanded nearly 27% in the first 10 months of 2007 from a year earlier, one of the highest rates in recent years. Gross-domestic-product growth, at 11.5% in the first nine months of 2007, is on pace this year for its fastest rate since the blowout years of the early 1990s, when growth peaked at more than 14%. Soaring food prices and rising fuel charges are sowing concerns about consumer-price inflation -- which in October stood at a decade high of 6.5% -- and risking social discontent. It isn't easy to predict whether a pause in bank lending so late in the year might dent China's economy. Several bankers said the fourth quarter is generally quiet for lending anyway, and that many banks have already met or even exceeded year-end lending targets. In late 2005 and 2006, regulatory officials backed up rate increases by jawboning bankers to slow lending in the fourth quarter, but bankers say the end result was a rebound in lending in the first quarter of the following year. Individuals may be less affected than businesses because smaller loans may not raise eyebrows like big corporate working-capital loans. But at least one property agency in Shanghai is advising clients to delay mortgage applications until January. Meanwhile, a China Construction Bank Corp. official in Shanghai said he is for now rejecting loans for everyone but established clients. Instead of trying to target lending levels, economists say China could try to damp credit expansion by pushing up interest rates and letting the yuan appreciate against the U.S. dollar, since both adjustments would make borrowers and lenders think twice before committing to projects. U.S. officials, including Treasury Secretary Henry Paulson, regularly deliver such a message, saying a more market-oriented financial system is in Beijing's own interests. But after its four interest-rate increases this year, the People's Bank of China appeared to question that idea after the Federal Reserve cut U.S. interest rates in September to offset turmoil in the subprime-mortgage market. Beijing's concern about the stability of the yuan may be the reason, since higher interest rates tend to attract more depositors, an unwelcome prospect for Chinese policy makers keen to minimize enthusiasm for the yuan. A stronger yuan could hurt exporters by making some goods more expensive for buyers paying in dollars or euros. Beijing may still raise interest rates. It had been tolerating a moderate strengthening of the yuan for much of this year, giving the currency about a 10% gain since a revaluation in mid-2005. But bankers say in recent weeks authorities have nudged large Chinese banks to buy dollars and sell

yuan, trades that pushed the yuan down 0.2% last week in Shanghai trading. The loan freeze may have a particularly disruptive effect on foreign banks with subsidiaries incorporated in China. Foreign bankers occupy just a corner of China's financial system, and they say they are eager to remain on good terms with regulators. **China Freezes Lending to Curb Investing Frenzy**
http://online.wsj.com/article_print/SB119542008187297217.html

Commercial Real Estate

Commodities

Currency

- Nov. 23 (Bloomberg) -- China's yuan rose beyond 7.4 to the dollar for the first time since a link to the U.S. currency was scrapped in 2005 before a European delegation arrives in Beijing next week to press for faster appreciation. The People's Bank of China signaled it wanted the yuan to gain as it set the reference rate for the day's trading at 7.399 from the close of 7.4145 yesterday. Xie Fuzhan, a member of the central bank's monetary policy committee, said yesterday that China's currency is undervalued and increased flexibility is "essential" to make economic growth more stable. **China's Yuan Rises Past 7.4 Per Dollar; First Time Since Peg**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a1BeXxEPiSi0&refer=home>
- Nov. 23 (Bloomberg) -- The dollar dropped below 108 yen for the first time since 2005 and fell to a record low against the euro on speculation deepening U.S. credit-market losses will prompt the Federal Reserve to cut interest rates. The currency headed for its biggest weekly decline against the euro in a year as traders raised bets that the Fed will lower borrowing costs on Dec. 11. The yen headed for a weekly gain against the dollar as concern turmoil in credit markets will slow global growth spurred investors to sell higher-yielding assets bought with money borrowed in Japan. "Dollar weakness is going to continue," said Stephen Halmarick, co-head of economic and market analysis in Sydney at Citigroup Australia, a unit of the largest U.S. bank by assets. "The U.S. economy is going to underperform and the Fed is going to be easing." The dollar dropped to \$1.4967 per euro, the weakest since the single European currency's debut in 1999, before trading at \$1.4951 at 10:37 a.m. in Singapore from \$1.4849 in New York yesterday. It will fall to \$1.57 per euro by the end of the first quarter next year as the Fed lowers its. **Dollar Falls Below 108 Yen as Debt Losses May Spur Fed Rate Cut**
http://www.bloomberg.com/apps/news?pid=20601087&sid=a0laKyoaB_0U&refer=home

Diversification

Derivatives

- November 22 - Abbey National, the UK arm of Spain's **Santander**, became the third bank in a week to pull the sale of a mortgage-backed covered bond deal while the market-making obligations of European banks in the roughly €1,600bn market were suspended on Wednesday. Covered bonds are backed by mortgages or public sector debt and are seen as ultra-safe because they are also guaranteed by the issuing bank. However, in

September the broader credit market crisis finally spilled over into the covered bond market. Poor investor demand and higher spreads have increased volatility in the normally sedate market. Allied Irish Banks and Ahorro y Titulización, a business controlled by Spanish savings banks, have both pulled covered bond deals in the past week. The European Covered Bond Council on Wednesday announced the suspension of interbank market-making obligations until Monday in order to try to slow the fall in prices. **Abbey is latest to delay bond issue** http://www.ft.com/cms/s/0/6eb3d134-9893-11dc-8ca7-0000779fd2ac.html?nclick_check=1

Housing

- Nov 21 – London Times online email - Homeowners face a "testing time" ahead, according to the Council of Mortgage Lenders (CML). The warning came yesterday, as Paragon, Britain's third-largest buy to let lender, told shareholders that it was in danger of collapse. Michael Coogan, of the CML, said: "The next few months will be a testing time as ongoing pressures in financial markets feed through into the wider economy. Funding constraints will continue to make loans more expensive." Ray Boulger, of Charcol, meanwhile, told *The Times* that he expected price falls of between 10 and 15 per cent for flats in some regional cities over the next six months

Housing Finance

- And this from our old friend Jim Rogers: "This is worse than the S&L crisis. This is the first time – this is the worst credit bubble we've ever had in American history. No – never in American history have people been able to buy a house with no money down...never. That's never happened anytime in the world. So, we have the worst **credit bubble**. It's going to take a long time to work its way out. **You don't cure a bubble in five or six months... It takes five or six years.**" DR 11/21/07

Macro Economic

- FT: 12:47am GMT 23/11/2007 The global credit crisis has hit Asia with a vengeance for the first time, triggering a massive flight to safety as investors across the region pull out of risky assets. Yields on three-month deposits in China and Korea have plummeted to near 1pc in a spectacular fall over recent days, caused by panic withdrawals from money market funds and credit derivatives. **"This is a severe warning sign," said Hans Redeker, currency chief at BNP Paribas. "Asia ignored the credit crunch in August but now we're seeing the poison beginning to paralyse the whole global economy,"** he said. Korean and Chinese three-month yields have fallen from 4pc to 1pc in a matter of days in a eerie replay of events on Wall Street in late August when flight from banks and the US commercial paper markets caused yields on three-month Treasuries to fall at the fastest rate ever recorded. Asian investors appear to be opting for deposit accounts with government guarantees. It is unclear what prompted this latest "heart attack" in the credit system, though rumours abound that Asian banks have yet to own up to their share of the expected \$400bn to \$500bn losses from the US mortgage debacle. Stock markets were battered across the region. The Hang Seng index in Hong Kong fell 4.15pc, while

Tokyo's Nikkei slumped to the lowest level in a year and a half, dragged down by the shares of the 'Seven Samurai' exporters. Asian jitters set off fresh turmoil on Europe's credit markets. The iTraxx index measuring default insurance on bank and insurance bonds hit an all-time high of 63.5. "The whole financial market is in turmoil with Bund-Swap-Spreads going through the roof," said Andrew Guy, director of ADG Capital Management. Marcus Schuler, director of credit marketing at Deutsche Bank, said spreads on low-grade European bonds had been jumping ten basis points a day for the last week. "There's been risk aversion across the board," he said. In a rare move, the European Covered Bond Council said it was suspending trading of mortgage-linked bonds in the inter-bank-market owing to the "undue over-acceleration in the widening of spreads". Abbey National today cancelled its sale of covered bonds, the third company to withdraw an issue this week. **Charles Dumas, chief strategist for Lombard Street Research, said credit woes had led to an alarming spike in the 'Ted spread' between commercial Libor and US Treasury bills, now near 150 basis points. "Libor is at a premium to T-bills not matched the great crash in 1987," he said.** Mr. Redcker said the flight from risk has led to a sudden unwinding of the \$1,200bn yen "carry trade" as hedge funds and Japanese investors close risky positions. The yen has snapped back violently from yen118 to yen108 against the dollar since early October, with similar moves against other Anglo-Saxon currencies. **"We're seeing a liquidation of the carry trade. For years it created liquidity for global equities in an upward spiral, but this has now turned into a downward spiral. Base metal prices are falling, which that tells us that Asia may not be as strong as we thought,"** he said. Copper prices fell 6.4 percent in Shanghai today. It follows data showing China's copper imports fell 4.4pc in October, a sign that central bank moves to choke off credit is starting to slow runaway investment in heavy industry and construction. Jerry Lou, China analyst for Morgan Stanley, said the Shanghai bourse -- already down 15pc -- was now the world's "biggest valuation bubble". **"Lessons from Japan in the late 1980s show that once the stock market starts to head down, earnings and multiple contraction can together crush the market like a market rolling downhill,"** he said. **Credit 'heart attack' engulfs**

China **and** **Korea**

<http://www.telegraph.co.uk/money/main.jhtml;jsessionid=TXULD4CQHTUFDQFIQMF CFFOAVCBQYIV0?xml=/money/2007/11/21/bcnasia121.xml>

- Nov. 22 (Bloomberg) -- Royal Bank of Canada, Bank of Montreal and their four biggest domestic rivals may report debt writedowns totaling C\$1.9 billion (\$1.93 billion), contributing to the industry's first earnings drop in five years. Fourth-quarter profits at Canada's largest banks probably fell by an average 6 percent, hurt by slumps in the Canadian and U.S. fixed-income markets, according to Desjardins Securities Inc. analyst Michael Goldberg in Toronto. Royal Bank and Toronto-Dominion Bank may be the only ones to post higher operating profit for the quarter ended Oct. 31, Goldberg said in a note to clients yesterday. The results may be the industry's worst since the third quarter of 2002, Scotia Capital analyst Kevin Choquette estimates. Canadian bank shares fell by an average 11 percent in 2007, the biggest decline in five years, on concern about credit-market losses. "More writedowns are coming in 2008," said Darko Mihelic, an analyst at

CIBC World Markets, who has "sector outperform" recommendations on Bank of Montreal and Bank of Nova Scotia, and "sector perform" ratings on National Bank of Canada, Royal Bank and Toronto-Dominion. **The world's biggest financial institutions have collectively disclosed about \$66 billion of writedowns since June for assets tied to the collapse of subprime mortgages, data compiled by Bloomberg show.** "We're cautious on the sector simply because you never really know what's on the bank's balance sheet that's going to get dinged," said Stephen Carlin, who helps manage C\$3.5 billion at Toronto-based KBSH Capital Management Inc., which owns shares of four of the largest banks. Commercial Paper **Bank of Montreal, Canada's fourth-biggest bank, said last week that it expects pretax costs of about C\$320 million, primarily from trading and writedowns on commercial paper and other debt investments.** The Toronto-based company said the costs will contribute to a 50 cents-per-share reduction in earnings. Bank of Montreal will be the first of Canada's banks to report earnings when it releases results Nov. 27. Profit, excluding taxes, investment gains, credit losses, restructuring charges and other one-time items, may fall 16 percent to C\$699 million, Goldberg said. BMO Capital Markets analyst Ian de Verteuil wrote in a Nov. 7 report that the country's six biggest banks may have combined trading revenue of C\$310 million, down from C\$1.38 billion a year earlier. Banks may set aside C\$802 million in the quarter for bad loans, up from C\$626 million a year earlier, de Verteuil said. **Canadian Banks May Report First Earnings Decline in Five Years**
http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=aSGKaMevaKr
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- November 18 2007 FT It would be hard to imagine a worse moment for the Federal Reserve and the market to collide over an interest rate cut that the market wants and expects, but the US central bank is not prepared to deliver. Yet the risks of such a collision appear to be increasing by the day. Peter Hooper, chief economist at Deutsche Bank Securities, says the Fed and the markets are locked in an "increasingly rigid standoff" over the likelihood of an interest rate cut at the next Fed policy meeting in December. On Friday Randall Kroszner, the Federal Reserve governor, made clear that, in his opinion at least, the Fed was not planning to cut rates in December. He said that new information since the last meeting had not changed his view that the risks to growth and inflation were "roughly balanced". However, the market continues to price in an 80 per cent probability of a December rate cut, and more rate cuts next year. There is still ample time for data to resolve the debate before the December meeting. But if the data is ambiguous and neither side softens its position, the stage could be set for a dangerous show-down. The risk that the standoff ends unhappily is increased by the fact that the two sides appear to have drawn different conclusions from the last Fed meeting in October. **Policymakers were uncomfortable going into the October meeting under intense market pressure to cut rates and are determined not to give up their discretion in December. [this is a violation of their duty as caretakers of monetary policy. They are not under a mandate to bail out their speculative cronies on Wall, yet having done this under Easy AL and now Helicopter Ben, the piper has come calling for payment]** But market participants regard the October experience as validating their view that the Fed cannot risk upsetting market expectations at a moment such as this. "When there are some vulnerabilities, especially in financial institutions, you really do not want a

situation where the Fed is doing the unexpected, shocking or surprising the market,” says Mr. Hooper. If an expected rate cut did not materialise on the day, the market would not just have to give up that rate cut but reappraise its expectation of future rate cuts too – a jolt to a fragile financial system and a significant tightening of monetary conditions in the economy. Yet the Fed’s credibility could be at stake if it allowed itself to be bullied into a late U-turn that is not clearly justified by the data. **“No one would listen to them again – they would be like the Bank of Japan,” [a very apt analogy as it is the 20 year Japan experience we will be headed towards as a result of prior irresponsible policy making]** says a hedge fund manager. The Fed and the market seem to have a different take on the economic outlook. Fed policymakers believe they have taken pre-emptive action to address near-term weakness and see the economy as regaining strength from the second quarter of 2008 onwards. Top officials are uncomfortable with the market pricing in a lot more easing to come. But many analysts say renewed deterioration in credit markets since the Fed’s October meeting has increased the risks to growth. “The facts on the ground are changing,” says Larry Meyer, chairman of Macro-economic Advisers. He says the Fed has “put itself in a box” by emphasising that the risks to growth and inflation are “roughly balanced” when those risks are shifting. Mr. Reinhart says: “The statement, the chairman’s joint economic committee text and the Kroszner speech are all very clear that the FOMC [Federal open market committee] thinks the risks are balanced and is reluctant to ease further.” Tomorrow’s publication of the first full set of enhanced Fed forecasts offers a chance to show the market what the Fed really thinks and why. If it fails to resolve the standoff, Mr. Bernanke may have to address the market directly to soften the Fed’s stance or to make it clear to investors they must not bank on a December rate cut.

Fed and markets square up over rate cut
<http://www.ft.com/cms/s/0/8a78368a-9604-11dc-b7ec-0000779fd2ac.html>

- November 18 2007 FT When David Rubenstein, co-founder of Carlyle Group, polled his audience about their worries at a private equity conference in Hong Kong last week, many global investors identified the weak dollar as a growing concern, making them less inclined to invest in US assets today for fear that they will be worth less tomorrow. Such fears have existed for some time but have recently gained strength. Mr. Rubenstein himself characterised the ailing greenback as “a serious problem”. “The weak dollar is a significant threat and makes the US less attractive from a return point of view,” Kenneth Shen, the Qatar Investment Authority’s head of strategy and private equity, told the conference – voicing views widely echoed by other participants. Mr. Shen later said the QIA was more focused on emerging markets, particularly in Asia, and was diversifying away from the US as a result. That concern is in contrast to periods when a weak dollar was seen as a great bargain-buying opportunity for non-dollar investors. When the dollar dropped, investors would often buy more at a lower price to reduce the overall cost of an investment. This is no longer the case. Now, investors say they do not know where the bottom is, making investment in US assets particularly treacherous. “If investors don’t know how far down the dollar can go, and they buy US assets now only to see the dollar devalue more, it discourages long-term thinking,” said the head of private equity for another Gulf sovereign investment fund. “The level of the dollar is less of a problem than the trend.” For many of those at the conference, the difficulty is not just the plunging dollar. The combination of a still-expensive stock market, an uncertain outlook for the

economy, the trillions of dollars owed by the US to the rest of the world and the looming threat of financial protectionism is leading many economists and investors to question the status of the dollar as the world's reserve currency. So far, the drop in the value of the dollar has been orderly. But that too may not continue. "The risk of a disorderly correction in the dollar is growing," Stephen Roach, chairman of Morgan Stanley Asia told the conference. "We hear a lot of talk about dismantling dollar pegs as long as the subprime crisis continues to unfold." To be sure, it may be in the self-interest of the US-based titans of the private equity world to convey a dark view of the prospects for the country in the hope that global investors will not take advantage of the fact that for them US assets have suddenly become cheaper. At the same time, however, the professed interest on the part of US-based private equity powerhouses in expanding their commitment to Asia makes a lot of sense. If you believe that the dollar will continue to sag against commodity currencies like the Australian dollar or those of manufacturing powerhouses such as China or South Korea, making investments in those currencies is a natural hedge against the dollar, fuelling the eventual gains on the investment with a nice currency kicker.

Fears over value of US investments

<http://www.ft.com/cms/s/0/a8724d60-9604-11dc-b7ec-0000779fd2ac.html>

Retail

- Nov. 22 (Bloomberg) -- Wal-Mart Stores Inc. and Best Buy Co. will mark Thanksgiving today with online promotions aimed at jumpstarting the holiday sales season. The Web sites are unlikely to provide the boost they did last year. Internet sales are poised to slow with the rest of holiday spending this year as consumers suffer from higher food and fuel costs and the worst housing slump since 1991. Spending through Web sites, which makes up more than 3 percent of all retail sales, will climb 20 percent to \$29.5 billion in November and December, according to ComScore Inc., an online research firm. That's less than the 26 percent growth in online sales during last year's holiday season. The end-of-the-year selling period, which accelerates in the U.S. after Thanksgiving, is forecast by analysts to increase at the slowest pace in five years. "There's a natural terminal velocity" for online shopping, said Michael Moriarty, partner at A.T. Kearney Inc., a Chicago-based consulting firm. "People still like going into stores, they still like shopping, they still like bringing the stuff home." **Retailers' Thanksgiving Offers Won't Avert Web Sales Slowdown**
- http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=ap4QN6xuA78U

Retirement

Risk

Savings Rate

Tech

Wall Street

- Here is a comment from Charlie Gasparino, at TraderDaily.com: “The bond raters make money through one of the most flawed and conflicted business models in corporate America. The bond raters are supposed to be working for investors (hence the name Moody’s Investors Service, for example) by assigning letter grades to a bond’s ability to make principal and interest payments. The reality is much different. In rating-world lexicon, AAA means that barring nuclear war, the bonds are good. D means they’re either nearing or in default. “This conflict has posed huge problems. Municipalities have canceled contracts with rating agencies that took a negative view, and hired those who were easier graders. All that saber-rattling had an impact. I can remember how former New Jersey Governor Christine Todd Whitman attacked a particularly tough rater at Standard & Poor’s, who subsequently withdrew from the team that gave the green light to some suspect financing by the state. “Such conflicts were at the heart of the rating agencies that missed Enron and a passel of other financial catastrophes. Kenneth Lay, after all, was a valuable client.” Herewith another thought about why the credit agencies make such colossal mistakes. Credit rating agencies are really no different from house appraisers. They are called in when an independent judgment is needed. How much is that house really worth, the lenders want to know? How good are those bonds, the buyers ask? The question is essentially the same. It is the answer that varies – depending on which way the wind is blowing. **When the housing market was flying, appraisers learned that if they went along with high appraisals their phones never stopped ringing. If they refused to grease the deal through, on the other hand, spiders could build their webs over the appraisers’ doors and never be disturbed. Likewise, the rating agencies are under similar pressure.** And being human, the people who operate them yield to it whenever they can get away with it. In the great credit boom of 2001-2007, the risk of a friendly rating seemed practically non-existent. Asset prices – notably houses – were rising so fast, if the appraisal was high, they’d soon catch up! And in the corporate debt and derivative market, who could lose money when the price of money was going down? **There were plenty of bad deals financed during that period, but they couldn’t go broke – lenders wouldn’t let them. Instead, they dealmakers were offered fresh financing on even better terms. What this accomplished, of course, was merely to put off the day of reckoning. And make it worse. Instead of settling up on all those bad corporate loans, bad private equity deals, and subprime mortgages right away...billions, maybe trillions, more were added.** And now that the bills are coming due, people aren’t very happy about it. Sanctimonious members of Congress are ranting and raving at the credit-rating agencies...as if they were supposed to single-handedly dump the punch out of the bowl and turn out the lights. No, dear reader, it doesn’t work that way. When the party’s rolling, everyone wants to join in.

Rating agencies. Appraisers. Wall Street. Washington. Investors. Speculators. Fannie, Freddie and the whole host of clowns and con-men that make up our delightfully entertaining financial markets. DR 11/22

- Nov. 23 (Bloomberg) -- **Some European quantitative funds that bet on rising stock prices may have lost 15 percent this month as equity markets declined, according to strategists at JPMorgan Chase & Co.** Fund managers using mathematical formulas to pick trades helped fuel the sell-off that wiped out almost \$400 billion in value from the Dow Jones Industrial Average from July 19 to Aug. 16. It worsened as client redemptions created "magnified losses," according to Marco Dion and Matthew Burgess, JPMorgan analysts in London, in a report today. **Managers counting on rising stock prices to boost returns found the opposite this month as Europe's Dow Jones Stoxx 600 Index dropped 8.1 percent through today, headed for its biggest monthly decline since 2002.** U.S. stock declines wiped out the 2007 gain of the Standard & Poor's 500 Index as it fell 0.1 percent through Nov. 21. Asia stock indexes also have fallen. "Undoubtedly there will be some pretty horrendous numbers coming out," said Magnus Spence, chief operating officer of London-based fund manager Dalton Strategic Partnership LLP, which oversees \$3.5 billion. **"A lot of mutual funds got aggressive investing in long-only funds" after August,** when widening credit spreads and increased stock-market volatility jarred the computer models used by many quantitative funds. **Long-only managers concentrated in Asian stocks could be down 10 percent or more,** said Spence, whose firm manages eight long-only equity funds. Declines in shares of Taiwanese firms and mining stocks also will cause losses, he said. Asia Stems Slide "We haven't seen many redemptions ourselves, but I wouldn't be surprised if investors in general are starting to" put in requests, Spence said. Asian stocks advanced Nov. 22 for the first time in seven days, helped by gains in technology shares. The MSCI Asia Pacific excluding Japan Index added 0.4 percent to 507.52 at 6:03 p.m. in Hong Kong, halting an 8.3 percent drop. **Quant fund managers forced to sell securities in recent months found that many peers owned the same holdings and ran similar computer models.** "Longer term, successful quant managers will have to rely more on unique factors," New York-based Goldman Sachs Group Inc.'s fund-management division said in August after the firm's hedge funds including Global Alpha lost \$3 billion. "We expect some long-only quant managers, regardless of their strategies, to be down at least 10-15 percent for the month," Dion and Burgess of JPMorgan said in their report. Rare Event **"Movements like we've had in this month almost never happen," Dion said in a telephone interview today from London. "The previous three times they were linked to serious historical events, Long-Term Capital Management, the World Trade Center attack and Worldcom."** Long-Term Capital Management LP, the Greenwich, Connecticut-based hedge-fund manager, collapsed in 1998 amid Russia's debt crisis, prompting the New York Federal Reserve to organize a \$4 billion bailout and regulators to call for tighter risk controls for hedge funds. Compounding problems have been so-called value stocks, or shares that are inexpensive stocks relative to their earnings, have been outpaced by faster-growing stocks, Dion said. "Most of the quant funds are involved in value, not growth, creating a sort of double-whammy for long-only quants," he said. Dion declined to name funds that could be losing money and estimated long-only quants account for about 15 percent of European hedge-fund investments. European hedge funds oversee about \$538 billion in assets, according to HedgeFund Intelligence

Inc., a London-based research firm. **Europe Funds May Be Down 15% in Month, JPMorgan Says**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=afcricQ0WZWc&refer=home>

Kass: Hedge Funds Losing Their Shirts
By Doug Silver Contributor
RealMoney 9:59 AM EST
11/23/2007
URL: <http://www.thestreet.com/newsanalysis/investing/10391392.html>

This blog post originally appeared on RealMoney Silver on Nov. 23 at 7:46 a.m. EST.

"You only find out who is swimming naked when the tide goes out."
--Warren Buffett, 2001 Berkshire Hathaway Annual Report **The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money.** After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities -- that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future -- will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands. --Warren Buffett, Not only are hedge funds **closing** with regularity but a number of activist corporate raiders are in deep doo-doo. That also applies to a number of activist-oriented hedge funds, and even to many traditional hedge fund managers that traffic in concentrated investment positions. I have expected the disintermediation (outflows of funds) in the hedge fund industry for several months now, and that scenario is clearly working out. Hedge fund withdrawals and redemptions combined with eroding performance are probably the causes of the late-day swoons we have experienced in the last two weeks or so.

Don't Fight The Fed

[interesting that we don't see these stories any more isn't it?]

I Disagree . . . and why

This is so absurd that I had to set it forth by itself. I recently wrote an article about the foolishness of getting your news from headlines and lead paragraphs (http://www.kelihercapitalmanagement.com/downloads/cCents_SVMDecJan08-01LR.pdf). The following is a comical example of creating a story and headline to fill an agenda. The market went up because the movers and shakers had to pump it on a very light half day of trade so they could create headlines such as the one topping this Bloomberg "news" story.

Nov. 23 (Bloomberg) -- U.S. stocks rose the most in seven days, paring the week's loss, as shoppers packed stores on the first day of the holiday shopping season and investors speculated a weak dollar will make exports more competitive. Circuit City Stores Inc., Target Corp. and

Macy's Inc. **led a gauge of retailers to its biggest Black Friday rally since at least 1989. (the Dow rose 60 points in the final five or so minutes of trading and dropped about the same in the fifteen minutes of post close trading, i.e. the "largest rally in 20 years" was tape painting at its worst.)** Boeing Co., the world's second-largest commercial airplane maker, led an advance by exporters as the dollar traded near a record low against the euro. Citigroup Inc., Bank of America Corp. and Wells Fargo & Co. rose for the first time this week after financial shares fell to a two-year low on Nov. 21.

The Standard & Poor's 500 Index added 23.93, or 1.7 percent, to 1,440.7, reducing the week's loss to 1.2 percent. The Dow Jones Industrial Average increased 181.84, or 1.4 percent, to 12,980.88, down 1.5 percent for the week. The Nasdaq Composite Index rose 34.45, or 1.3 percent, to 2,596.6, cutting its weekly drop to 1.5 percent. About seven stocks gained for every one that fell on the New York Stock Exchange. Some 670 million shares changed hands on the Big Board by the 1 p.m. close, the busiest day after Thanksgiving since 1999.

"The fact that Black Friday is not a disaster and is off to a modest but healthy start is just a relief," said Mark Bronzo, who helps manage \$500 million at Nationwide Separate Accounts in Irvington, New York. **"The scenario we've all been operating under for the last several months is that the retail world is coming to an end. [In the "last several months" we have been inundated with stories about how the Fed would save the world and that subprime was contained. Keep in mind less than a month ago the Dow was near 14000 because it was all blue sky ahead.]** That's not the case." Yearly Gain Today's rally pushed the S&P 500 to a 1.6 percent advance for the year after a drop on Nov. 21 wiped out the benchmark's 2007 gain. Retailers in the index have fallen 17 percent as a group this year on concern that rising energy prices and slumping home values will depress spending. **"It seems like there's a lot of traffic in the stores, so that's a positive," [now there is a surprise. Quote from last weeks OSS commentary: "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."]** said Michael Nasto, senior trader at U.S. Global Investors Inc., which manages \$5 billion in San Antonio. "People might be thinking the sell-off we had the last few days was overdone."

Exporters, Banks Gain

Boeing, whose top rival is Europe's Airbus SAS, gained \$2.13 to \$89.54. General Electric Co. added 50 cents to \$37.67. Europe accounted for about one quarter of the company's net sales last year. International Business Machines Corp. rose \$1.83 to \$104.05. The world's second-biggest software maker generated more than half of its revenue outside of the Americas in 2006.

Citigroup, the biggest U.S. bank, added 97 cents, or 3.2 percent, to \$31.70. Citigroup, Bank of America Corp. and JPMorgan Chase & Co. are ready to move forward with a plan to revive credit markets with a so-called superfund to buy assets from structured investment vehicles, the Wall Street Journal reported. The three biggest U.S. banks are likely to start asking others to sign up to specific financial terms next week, the Journal reported, citing people familiar with the matter.

Bank of America, the second-largest U.S. bank, gained \$1.01 to \$43.15. JPMorgan, the third-biggest, climbed \$1.27 to \$41.95. Wells Fargo & Co., the second-largest U.S. mortgage lender, added 92 cents to \$30.84.

Super SIV

The plan is to create a fund amounting to \$75 billion to \$100 billion as a potential buyer of assets from structured investment vehicles, off-balance-sheet entities that have gotten into difficulties because of lack of liquidity in credit markets. So far, other banks have expressed informal interest, the newspaper said.

The S&P 500 Financials Index, which dropped to the lowest since 2005 on Nov. 21, rose for the first time in seven days today, adding 3.1 percent.

"The banks are coming around," said Andrew Seibert, who helps manage \$400 million at Nextier Wealth Management in Pittsburgh. "People that are buying them are saying 'There's value here and these stocks are reasonably priced at this range. I'm going to dip my foot in the water.'"

Apple, E*Trade,

E*Trade Financial Corp. gained \$1.07, or 25 percent, to \$5.33. The second-worst-performing stock in the S&P 500 this year rose on a CNBC report the online brokerage is in talks to sell itself or part of its business. Pam Erickson, an E*Trade spokeswoman, declined to comment.

MBIA Inc. and Ambac Financial Group Inc., the world's two biggest bond insurers, jumped after the bailout of rival CIFG Guaranty signaled the industry may get the financing it needs to avoid credit-rating downgrades. MBIA gained \$1.96 to \$34.14. Ambac rose \$1.41 to \$25.55.

Apple Inc. gained \$3.08 to \$171.54. The maker of the iPod music player agreed to pay \$10 million to settle a patent-infringement lawsuit by Burst.com Inc. over technology that stores audio and video files. The settlement, which isn't yet final, provides Apple with a license to Burst.com's patents, plus a pledge that Burst won't sue Apple again over future patents, Burst said.

GM, Ford Rise

Carmakers advanced on a report that Congress may adopt separate fuel-efficiency standards for cars and sport-utility vehicles in order to help pass an energy bill this year.

General Motors Corp., the largest U.S. automaker, rose 77 cents to \$27.16. Ford Motor Co., the second biggest, climbed 24 cents to \$7.19.

Democratic leaders have intensified talks with Republicans in an effort to find compromise legislation and a senior administration official said the odds that a law will be adopted have

improved significantly, the Wall Street Journal reported. Rising oil prices have increased pressure on lawmakers to speed up energy-saving legislation, the Journal reported.

Freeport-McMoRan Copper & Gold Inc., the world's second- largest producer of copper, advanced \$3.10 to \$93.16.

Copper rose the most in a week after inventories plunged in China, the world's biggest user of the metal.

Slumping Dollar

The dollar dropped as low as \$1.4967 per euro, the weakest since the single European currency's debut in 1999, on speculation deepening U.S. credit-market losses will prompt the Federal Reserve to cut interest rates.

Former Federal Reserve Chairman Alan Greenspan said policy makers may need to address the weakness of the dollar if it threatens to stoke inflation.

The decline in the subprime mortgage market "is over" because the market "went to zero and cannot go any further," Greenspan said at a conference in Oslo, Norway, today. He added that the "conventional" mortgage market is "doing reasonably well." **U.S. Stocks Advance, Led By Retailers on Holiday Sales**
http://www.bloomberg.com/apps/news?pid=20601087&sid=am3_GLuRwQWA&refer=home

In the infantile "I must be happy every instant" world that has become endemic in our culture, a couple of stories stuck out. Keep in mind the SP500 is UP for the year, markets have been UP for the past 4 calendar years, this "bull market" is the second longest in history, etc.

From the Kirk Report weekly email:

While fear won out with more losses in the stock market, it remains to be seen whether Santa Clause will make his annual visit. To be sure, you'd have to go back many years to find a market this depressed in what traditionally is the best time of the year to be holding stocks. Any good news, especially on the retail front, will likely be greeted with open arms. But, much like the past few weeks, investors will have to remain on their toes to find ways to profit from both the depressed sentiment and challenging economy.

O.K. let's reiterate – the market is "UP" this year. So I guess Mister Kirk's point is that it is not UP ENOUGH????? It is this type thinking that will have to be expunged before any "bottom" will be in. That will take years.

As for the week, the "greatest Black Friday rally" in 20 years did not get us back to anywhere near even on the week. That Friday was manipulated horrendously on a light volume day foreseeable. (See **U.S. Stocks Advance, Led by Retailers on Holiday Sales** below, excerpt:

“It seems like there's a lot of traffic in the stores, so that's a positive," [now there is a surprise. Quote from last week's OSS commentary: “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.”] said Michael Nasto, senior trader at U.S. Global Investors Inc., which manages \$5 billion in San Antonio.

[Article of the week:](#)

The Daily Reckoning PRESENTS: In the conclusion of this two-part essay, Dr. Marc Faber explains that our country's balance sheet is worse than advertised and what investors can do to protect themselves from the monetary instability. Read on...

AN EMBARRASSMENT OF RICHES, PART II **By Dr. Marc Faber**

The Goldilocks protagonists will say, “Yes, consumption is a symptom of economic strength.” Personally, I think it depends on how consumption came about. If it was achieved by the household sector selling assets and going deeper into debt, then consumption is eroding the production capacity of a country and will lead to impoverishment, as is indicated by the dollar's loss of value.

The point is simply this: in the current expansion phase, which began six years ago, the performance of the US economy and US asset markets in dollar terms looks better than is the case in reality. What kind of an adjustment we should make is debatable. It might perhaps be unfair to measure US GDP and asset markets in gold, using as a starting point a very depressed price level of gold as was the case in 2001. But even if we took a gold price of, say, US\$400 or US\$450 (in the 1980s and 1990s, it seldom traded above US\$450), the recent performance of GDP and asset markets would be dismal.

Therefore, while the Fed can lower interest rates further and see to it that asset markets stabilize — or even appreciate — in dollar terms, it is far from certain they would increase in hard currency terms. So far, strong MZM growth in the third quarter would rather seem to have boosted the performance of emerging markets and of commodities. Also, whereas major indexes have made new highs in the US, it should be noted that the majority of shares have failed to make new highs. (Among brokerage shares, only Goldman Sachs has made a new high.) As mentioned above, the strong rise in the Nasdaq 100 Index (up 20% from the August low) was driven by a handful of shares whose performance begins to resemble the performance of Chinese stocks (see Figures 30 and 31)! In my opinion, there is much to lose from buying these over-extended momentum stocks (including AAPL, GOOG, AMZN, RIMM, WYNN, etc.).

From my earlier reports and my thoughts above, one could reason that I am very negative about the US dollar. This is certainly the case from a longer-term perspective. However, we should also recognize that current sentiment towards the dollar is very negative and that the Fed has some power to force the European Central Bank (ECB) also to cut rates. Let us assume that, because of additional rate cuts in the US, the Euro strengthens further. At some point, the political pressure on the ECB will surely increase and demand rate cuts in order to weaken the currency. The

situation in Asia is more complex. So far, Asian central banks have resisted their currencies appreciating strongly against the US dollar. But with money supply growing at around 20% in China and 24% in India, and with inflation accelerating in Asia (in particular, food inflation), Asian central banks may have no other option but to tighten meaningfully and let their currencies appreciate against the US dollar.

However, as soon as their economies weakened or their over-extended stock markets collapsed, monetary conditions would be eased very quickly. If this were to occur, I suppose that the world would be left with only one currency of total integrity: gold and other precious metals.

Consequently, if one were to bet on a continuous loss of purchasing power of the US dollar and other currencies — a safe bet with respect to the US dollar in the long term — my recommendation would be to own physical gold as cash currency, which could also be bought in the form of an ETF (GLD).

I am asked constantly how gold would perform in a deflationary collapse. With the propensity of the Fed and the ECB to flood the system with liquidity and to take “extraordinary measures” whenever problems arise, deflation is a remote possibility for the foreseeable future.

So, before worrying about deflation, I would worry about inflation accelerating strongly in the years to come — especially if the US economy stagnates. But let us assume that at some point in the future deflation follows. What then? In my opinion, deflation could only be triggered by one event: a total collapse of the existing global credit bubble. And the only event I can think of that would trigger such a debt collapse would be a third world war. The failure of a large bank — say, Citigroup — wouldn’t do the trick, because the Fed would immediately bail it out (unless Ron Paul is US President).

Now, in a debt collapse, where would you rather have your money? In bank deposits, in CDs, in dubious commercial paper, in bonds, in money market funds — all of which would experience soaring default rates — or in physical gold, ideally in a safe deposit box? I think that, particularly in a debt collapse, physical gold would shine, as people the world over would become extremely concerned about, not the return on their money (interest), but the return of their money. This would be particularly true of Asian central banks, which now have less than 2% of their reserves in gold but hold massive quantities of all kinds of debt securities.

Consequently, while I find the gold price to be currently somewhat overbought, I still think that gold will be one of the best investments over the next couple of years. In particular, I would expect demand for gold from individuals around the world to increase meaningfully — especially in Asia — at a time when production is unlikely to increase. I wish to add that I am not a “gold bug”. I would much prefer to live in a world in which central banks’ top priority was to safeguard paper money’s purchasing power and its function as a “store of value”. I would also much rather live in a world in which the US dollar was a strong currency, and where America was as free as it was in the 1960s, and the economic and financial imbalances weren’t as extreme as they are today. As Steven Roach recently remarked, “no nation has ever devalued its way into prosperity”. But the fact is, the time has come when we can no longer trust central banks.

Therefore, each individual must be his own central bank and maintain adequate reserves for himself in the form of physical gold. The supply of paper money is potentially endless, whereas the supply of gold is very limited. In fact, gold production from mines is declining.

Regards,

Dr.
for *The Daily Reckoning*

Marc

Faber

Editor's note: Dr. Marc Faber is the editor of *The Gloom, Boom and Doom Report* and author of *Tomorrow's Gold*, one of the best investment books on the market.

[Tomorrow's Gold](#)

Headquartered in Hong Kong for 20 years and now based in northern Thailand, Dr. Faber has long specialized in Asian markets and advised major clients seeking bargains with hidden value, unknown to the average investing public.

Dr. Faber is also a contributor to *Strategic Investment*. For insights similar to those you've read in today's issue of *The Daily Reckoning*, see here:

[Strategic Investment](#)

UM EMBA