

## The Other Side of The Street October 28, 2007

### Comments

I am on my way out the door on Friday. Today's action was remarkable. The Indices were up big but my screen was virtually entirely red until the last 20 minutes. Pumpers continue to get the headlines so the big boys can hand off to the little guys.

Sorry for another email to my distribution list, but I have not had time to cull. All you bulls out there can jump for joy, the bridge stood up another week. You might however wish to read below to see how the credit bridges, in particular CDOs are holding up.

### Credit

- Oct. 26 (Bloomberg) -- Moody's Investors Service cut the ratings of collateralized debt obligations tied to \$33 billion of subprime mortgage securities that were downgraded this month, a decision that may force owners to mark down the value of their holdings. **Securities with ratings as high as AAA from at least 45 CDOs were either cut or put on review for a downgrade, according to individual statements distributed today by the New York-based ratings company. Moody's didn't release a summary. [the credit markets have not stabilized]** Indexes linked to subprime mortgages tumbled after the cuts on concerns that more top-rated pieces of CDOs may be downgraded. **A ratings reduction may mean some owners of CDOs, which package pools of debt such as mortgage bonds, will either have to sell the debt or write down the value of the CDOs on their books.** "They're going down now and they're likely to go down further in the future," said Dan Ivascyn, a managing director at Pacific Investment Management Co. in Newport Beach, California, manager of the world's largest bond fund. **"This is just one step in aligning ratings with where the market is trading bonds."** Merrill Lynch & Co., the third-biggest securities firm, this week reported writedowns of \$8.4 billion, in part because of the tumbling value of CDOs and mortgages backed by loans made to borrowers with poor credit. MBIA Inc., the world's largest bond insurer, reported its first-ever quarterly loss after reducing the value of mortgage securities that it guarantees. Accelerating Reductions ABX indexes, used to bet on defaults on underlying subprime bonds, tumbled. An index linked to securities created in the second half of 2006 and rated AAA tumbled 5.1 percent to a mid-price of 82, according to Deutsche Bank AG. That suggests a similar drop in the prices of the bonds. Moody's, Standard & Poor's and Fitch Ratings accelerated the size and pace of downgrades in the past three months after record defaults on subprime home loans started to yield losses in mortgage-backed securities. **Almost 480 tranches of CDOs had been downgraded, according to an Oct. 5 report by Morgan Stanley structured credit analysts. That included 69 AAA securities and 106 with AA ratings. [this was NEVER supposed to happen]** The firms came under criticism from regulators, lawmakers and investors for giving the debt excessively high credit ratings and then waiting too long to downgrade them. Connecticut Subpoena **S&P owner McGraw-Hill Cos. and Fitch Ratings today said they had been subpoenaed by Connecticut Attorney General Richard Blumenthal. The U.S. Securities and Exchange Commission and the states of New**

**York and Ohio are also probing the ratings companies.** Moody's spokesman Anthony Miranda wouldn't say whether the company was also subpoenaed by Connecticut. Moody's doesn't plan to release a statement totaling all the ratings actions caused by the cuts to the subprime-based securities, said Thomas Lemmon, a spokesman in New York. "We're doing what we said we were going to do" and examining the impact of the mortgage-bond downgrades on CDOs and alerting investors, Lemmon said. "It's going to take us a little while to get through the whole process." Moody's lowered \$873 million of the safest types of AAA rated securities from a CDO created this year by New York-based Vertical Capital LLC to one level below investment grade. **Moody's said earlier this month that almost 40 percent of CDOs that hold asset-backed debt contain some of the \$52.7 billion in subprime bonds it downgraded or placed under review.** The company said it may cut ratings without first placing them on review, in a departure from its usual practice. **Moody's Cuts Ratings on CDOs Tied to Subprime Bonds**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aDBaFwGV784g&refer=home>

- Oct. 24 (Bloomberg) -- **Kohlberg Kravis Roberts & Co. put \$38.3 million into two of its commercial-paper funds backed by mortgage bonds to cover losses,** Standard & Poor's said today. The KKR Atlantic and KKR Pacific funds, once \$5 billion conduits rated A-1+, the top level, were downgraded to A-2 and A-1, S&P said in a release. Both are run by KKR Financial LLC, which manages publicly traded KKR Financial Holdings LLC and a private fund. The commercial paper vehicles, started in 2004, remain on watch for further downgrade. KKR spokesman Mark Semer declined to comment. The terms of investing in both programs were changed Oct. 15, S&P said, with KKR agreeing to inject cash into the funds and lengthening the maturities to Feb. 15 for half of each program's extendible notes and March 13 for the other halves. "The amendment provides additional time for an orderly portfolio liquidation," S&P analysts led by Andrew Engel said in the statement. "The amendment prevented the liquidation of the assets in the current environment, which could have resulted in an impairment to the noteholders." Credit tests were removed from the programs so that an automatic liquidation can't occur before Feb. 15. Investors were also given the option to take out mortgage-backed securities as collateral and several investors in KKR Pacific elected to do so, S&P said. KKR Atlantic had \$4.1 billion in commercial paper outstanding in June, and KKR Pacific had \$4.8 billion, S&P said. **KKR Pays Commercial Paper Investors \$38.3 Million; Ratings Cut**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=acLQRpL.nwLo&refer=home>
- Oct. 23 (Bloomberg) -- Many structured-investment vehicles may be forced to close in the next few months as defaults by SIVs run by European hedge funds make it harder for others to avoid selling off their assets, according to CreditSights Inc. Funds run by London-based Cheyne Capital Management Ltd. and IKB Deutsche Industriebank AG last week failed to repay maturing short-term debt. The defaults may lead to price and ratings cuts and force SIVs to sell assets, prolonging the "turmoil" in credit markets, CreditSights analysts led by Christian Stracke in London wrote in a report yesterday. "We continue to expect that the bulk of SIVs will manage to avoid a worst-case scenario of imminent liquidation," Stracke wrote in the report. "But the problems that the recent

defaults have underlined will make a gradual unwind of many SIVs difficult to avoid over the next several months." Widening Spreads The sale of a "significant portion" of SIV assets is "deeply problematic" and would widen spreads in other pockets of the credit market, especially for bonds backed by real estate mortgages, debt issued by financial companies and collateralized debt obligations containing asset-backed securities, Stracke wrote. CDOs are created by packaging securities such as bonds and loans and using their income to pay investors. That in turn would force ratings companies such as Standard & Poor's and Moody's Investors Service to cut rankings of top-rated securities, according to the report. Worst Ahead? "We do not mean to say that price volatility in assets at a \$1.0 billion SIV named Rhinebridge will be the straw that breaks the camel's back in global credit markets," Stracke wrote in the report. "But the experience at the defaulted SIVs should, at the very least, remind investors that the worst may not be over in terms of structured products ratings and the broader fall-out from the ABS sector." SIVs, which borrow in the commercial paper market to fund purchases of asset-backed securities, have been forced to sell about \$75 billion of assets as investors have shunned all but the safest debt. Paulson, a former chief executive officer of Goldman Sachs Group Inc., brokered talks in Washington with the biggest U.S. banks to set up a fund to buy SIV assets and avoid further forced sales. The banks announced the planned fund on Oct. 15. The agreement reached by Citigroup Inc., Bank of America Corp. and JPMorgan Chase & Co. is well-enough designed that it may help credit markets, a Federal Reserve official, who declined to be identified, said late yesterday. The plan also may help investors establish prices for complex securities that fund purchased with the proceeds of commercial-paper sales, the official said. **SIV Defaults May Prompt Others to Close Their Doors**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a6R81tWSHh9s&refer=home>

- Oct. 23 (Bloomberg) -- Former Federal Reserve Chairman Alan Greenspan said credit markets are in a "state of fear," instead of a "state of euphoria" where investors are buying. "We're now in a state of fear," Greenspan said in Chicago at the Midwest ACG Capital Connection conference, a gathering of investment bankers and private-equity companies. Greenspan was discussing commercial paper and structured investment vehicles. **Fed and U.S. Treasury officials have also said that it will take some time for confidence to return to markets for complex securities. [what a heaping pile of b.s. those officials have serially stated at every turn that "the markets have returned to normal. The abdication of neutrality in reporting is amazing to me]** Investors who depended on credit ratings companies to assess the debt now must struggle to come up with their own prices, Fed Chairman Ben S. Bernanke said Oct. 15. **Greenspan Says 'State of Fear' in Credit Markets**

[http://www.bloomberg.com/apps/news?pid=20601087&sid=aF\\_Do39KvC\\_Q&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aF_Do39KvC_Q&refer=home)
- Oct. 23 (Bloomberg) -- More companies in the Asia-Pacific region outside of Japan had their credit ratings cut in the three months to September than in the previous two quarters because of disruption in the bond markets and "stress due to refinancing risks," according to Moody's Investors Service. The ratings on eight companies were lowered by the credit assessor, compared with six in the second quarter and two in the first. More companies in the region have had their debt ratings cut than raised this year, Moody's

said today in a report. The "negative trend" will continue because the region's export-orientated companies rely on short-term debt such as commercial paper to fund operations, making them more susceptible to "credit shocks," Moody's said. Turmoil in the global credit markets froze global commercial paper markets in August, leaving sellers unable to fund themselves. "An unexpected tightening would put companies under liquidity stress and companies with weak operating performance and significant funding needs in the next six months could be especially vulnerable," Moody's said. **Asia Firms Face More Credit Rating Cuts, Moody's Says**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aMG2SUEBajS0&refer=home>

## Commercial Real Estate

## Commodities

## Currency

- Oct. 24 (Bloomberg) -- Jim Rogers, chairman of Beeland Interests Inc., said he is shifting all his assets out of the dollar and buying Chinese yuan because the Federal Reserve has eroded the value of the U.S. currency. "I'm in the process of -- I hope in the next few months -- getting all of my assets out of U.S. dollars," said Rogers, 65, who correctly predicted the commodities rally in 1999. "I'm that pessimistic about what's happening in the U.S." Rogers, delivering a presentation late yesterday at an investors' meeting organized by ABN Amro Markets in Amsterdam, said he expects the Chinese currency to quadruple in the next decade and that he is holding on to commodities such as platinum, gold, silver and palladium. **Jim Rogers Shifts Assets Out of Dollar to Buy Chinese Currency**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=amQBwDBSDvBE&refer=home>

## Diversification

## Derivatives

## Housing

- Oct. 26 (Bloomberg) -- Homeownership in the U.S. dropped for a fourth consecutive quarter, the longest decline since at least 1981, suggesting more Americans will miss their best chance of building wealth. The proportion of households that own their residences fell to 68.1 percent in the July-September period from 68.3 percent in the prior three months, according to a report today from the Census Bureau in Washington. The rate has been declining from a peak in 2004, which culminated a decade of gains fueled by easier lending standards and rising home purchases by immigrants and younger households. **[the key point here is not that it is down slightly from historical highs but that for a decade it went up due to easy financing. This ate up pent up demand. With tighter credit and demand satiated the direction will continue down]** "Owning a home in this country has been a principal source of wealth creation for low- and moderate-income

people," said Nicolas Retsinas, director of Harvard University's Joint Center for Housing Studies in Cambridge, Massachusetts. "In the absence of home equity, families will inevitably spend less." **U.S. Homeownership Falls in Longest Slide Since 1981**  
[http://www.bloomberg.com/apps/news?pid=20601087&sid=aQa\\_BmGs8VRs&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=aQa_BmGs8VRs&refer=home)

- Sales of single-family homes increased 4.8% last month to a seasonally adjusted annual rate of 770,000, the Commerce Department said Thursday. August new-home sales fell 7.9% to an annual rate of 735,000. Originally, the government had said August sales were on track to rise 795,000 for the year. This is one of the more amazing misleading government tricks. The 4.8% RISE is based on a comparison to the revise number for prior month. Comparing apples to apples – the initial 795 estimate to 770 estimate shows a 25K decrease not an increase. I have noted this before but it makes for a much less fun headline. Headline I would love to see “August initial new home sales
- Oct. 24 (Bloomberg) -- Sales of previously owned U.S. homes fell more than forecast in September, signaling no letup in the real-estate slump that threatens to hobble economic growth. Purchases declined 8 percent to an annual rate of 5.04 million, the fewest since record keeping began in 1999, from a 5.48 million August pace, the National Association of Realtors said in Washington. Sales were down 19 percent from September 2006 and the median home price dropped. **The collapse in subprime lending will limit access to credit and reduce sales even more in coming months, economists said. The drop in demand suggests home prices will keep falling, raising the risk consumer spending, which accounts for more than two-thirds of the economy, will slow.** "Housing still has a lot of weakness ahead of it," Jan Hatzius, chief U.S. economist at Goldman Sachs Group Inc. in New York, said before the report. **Existing home sales are still not particularly low by historic standards.** [correct they were abnormally high for the past five years thus using up pent up demand] Resales were forecast to fall 4.5 percent to an annual rate of 5.25 million from a previously reported 5.5 million pace in August, according to the median estimate of 76 economists in a Bloomberg News survey. Forecasts ranged from 4.95 million to 5.8 million. **The median price fell 4.2 percent to \$211,700, compared with September 2006.** Financing Difficulty Stricter lending standards and higher borrowing costs are making it more difficult to qualify for loans, causing an increase in the number of unsold properties and pulling prices down. Some economists say falling home values, by making owners feel less wealthy, may reduce consumer spending. Inventories Rise The inventory of single-family homes represented a 10.2 months' supply, the most since February 1988. Resales of single-family homes fell 8.6 percent to an annual rate of 4.38 million, the fewest since January 1998. Sales of condos and co-ops dropped 4.3 percent to a 660,000 rate. Purchases declined in all four regions, led by a 10 percent decrease in the Northeast. The volume of mortgages issued this year will fall to the lowest since 2000, the Mortgage Bankers Association forecast on Oct. 17. Foreclosures doubled in September from a year earlier as subprime borrowers struggled to make payments on adjustable-rate mortgages, RealtyTrac Inc. said Oct. 11. "We have a ways to go in the housing recession," Douglas Duncan, the Mortgage Bankers Association's chief economist, said last week. Today's report corroborates

earlier figures this month from the Realtors' association that the housing slump is worsening. More Declines Pending sales plunged 6.5 percent in August to the lowest level on record following an 11 percent plunge in July. The measure tracks contract signings, while the figures on sales of existing homes are based on closings, which usually occur a month or two later. The real-estate agents' group this month reduced its sales forecast for the 10th time this year. Federal Reserve Chairman Ben S. Bernanke last week said the drop in residential construction will be a "significant drag" on growth into 2008, though evidence of a broader impact on spending is limited. He reiterated that policy makers will "act as needed" to secure growth and contain prices. Fed funds futures trading shows the majority of investors are betting the Federal Open Market Committee will reduce the benchmark rate by a quarter percentage point on Oct. 31. Economists have lowered their outlook for economic growth this year since the August turmoil in credit markets. The economy will grow 2 percent, the least since 2002, according to the median forecast in a Bloomberg survey taken earlier this month. Economists had projected a 2.5 percent rate of expansion at the start of the year. Construction Declines Declining home construction has detracted from growth for the six quarters ended in June. D.R. Horton Inc., the second-largest U.S. homebuilder, said Oct. 16 that orders in the fiscal fourth quarter plunged to the lowest in almost six years as customers backed out of purchases and banks restricted lending. Chairman Donald Horton said in a statement that prospective buyers had more difficulty obtaining mortgages, hurting demand. "Buyers continued to approach the home-buying decision cautiously," Horton said. "We expect the housing environment to remain challenging."

#### **U.S. Existing Home Sales Fall More Than Forecast**

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### **Housing Finance**

- Oct. 23 (Bloomberg) -- Countrywide Financial Corp., the biggest U.S. mortgage lender, may change terms on \$16 billion of adjustable-rate mortgages before the end of 2008 so borrowers won't lose their homes to foreclosure. **About 52,000 customers who hold subprime loans can refinance into prime and government-backed loans, [Let's think this one through, 52,000 people who could not qualify for prime when those required much less scrutiny now are suddenly able to be prime borrowers even though they are in foreclosure proceedings? How about the truth – government to bail our lenders by paying bad debts of those who were improperly extended credit]** the Calabasas, California-based company said today in a statement. Such loans usually carry lower rates. Terms will be eased for another 30,000 who may fall behind or have already missed payments when their adjustable rates rise. Treasury Secretary Henry Paulson last week called the housing slump "the most significant current risk to our economy" and urged lenders to modify and refinance more loans. Countrywide has been the target of protests by housing advocates who say the company has done little to help homeowners with overdue payments or to halt foreclosures, which set a record in the U.S. during the second quarter. **Countrywide to Refinance Up to \$16 Billion of Loans** <http://www.bloomberg.com/apps/news?pid=20601087&sid=asrMOzvQW.Ok&refer=home>

- NEW YORK, Oct 22 (Reuters) - Countrywide Financial Corp , Washington Mutual Inc and several other finance companies were downgraded on Monday by Lehman Brothers Inc analyst Bruce Harting, who **said the U.S. credit downturn could result in \$242 billion of mortgage-related losses.** Harting estimated mortgage industry losses over the next several years at between \$40 billion and \$242 billion, including from mortgage-backed securities and financial institutions' balance sheets. He called \$174 billion the most likely scenario, assuming an estimated 6 percent decline in home prices. Under this scenario, losses could total \$12 billion this year, \$40 billion in 2008, \$45 billion in 2009, more than \$30 billion in 2010, and falling thereafter, he said. **"We cannot remember a period in recent history when financial stocks in our sectors went up in the face of rising credit losses, let alone in the early stages of rising credit losses," Harting wrote. "Only a FRACTION OF THESE LOSSES HAVE BEEN REALIZED, and each quarter the numbers will likely get larger."** Harting added: "We believe that the hefty expected losses in the mortgage sector cannot happen in a vacuum, and that **it is just a matter of time before problems spill over to other loan sectors in consumer finance, most notably credit cards, auto and other forms of credit.**" **Countrywide, WaMu, Amex, Capital One cut by Lehman [imagine how awful things must be for an analyst to say so]** <http://q1.schwab.com/content/rb/2007/10/22/1405005.html>

## Macro Economic

- Oct. 20 (Bloomberg) -- Group of Seven finance ministers and central bankers said the credit-market rout will slow economic growth and strengthened calls for China to let its currency appreciate. "Recent financial market turbulence, high oil prices and weakness in the U.S. housing sector will likely moderate" the global expansion, officials said in a statement after meeting in Washington yesterday. "Our overall economic fundamentals continue to be strong and emerging markets are providing critical impetus." Policy makers met for the first time since a collapse in demand for assets backed by U.S. subprime mortgages sparked a surge in international borrowing costs. They told investors to address "shortcomings" in risk management and called for rules to guide the international investments of government-run funds, seeking to head off a protectionist reaction. "Damage" to Markets **"It will take a little time for markets to stabilize," [noticeably different than "the markets are stabilizing" – they aren't and this is overly optimistic too]** said Japanese Finance Minister Fukushiro Nukaga. Bank of Italy Governor Mario Draghi said "there has been significant damage to the financial system and the damage will continue." **The amount of asset-backed commercial paper outstanding tumbled to \$899 billion in the week ended Oct. 10, from a high of \$1.14 trillion at the end of June, according to Fed figures.** By the middle of August central banks from Frankfurt to Oslo were channeling cash into markets and the Federal Reserve reduced its discount rate. The U.S. central bank subsequently cut its benchmark rate on Sept. 18. The G-7 praised market participants in the U.K. and U.S. for acting to relieve strains in some markets. Banks including **Citigroup Inc. this week said they'd set up an \$80 billion fund to revive demand for asset-backed commercial paper. [so assuming this scheme is successful and ALL the money is NEW money, it is about a third of the 240 billion drop. Have you seen that noted anywhere?? As previously discussed, this was yet another propaganda move and it did not work.] Paulson**

repeated that while a ``strong dollar is in our nation's interest'' he wants exchange rates to be set in free markets. **G-7 Says Global Growth Will Slow After `Market' Rout**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aPmmeretXvM0&refer=home>

**Retail**

**Retirement**

**Risk**

**Savings Rate**

**Tech**

**Wall Street**

- [Henceforth the government lackeys doing the Street's bidding will be carried in the Wall Street section. Their actions can no longer be dignified by being placed in macro economics] Oct. 23 (Bloomberg) -- The Federal Reserve indicated it supports the plan brokered by Treasury Secretary Henry Paulson to increase liquidity in the market for asset-backed commercial paper. The agreement reached by Citigroup Inc., Bank of America Corp. and JPMorgan Chase & Co. is well-enough designed that it may help credit markets, a Fed official, who declined to be identified, said late yesterday in Washington. The plan also may help investors establish prices for complex securities that funds purchased with the proceeds of commercial-paper sales, the official said. [The plan will artificially inflate prices allowing the entities involved to continue to issue false and misleading financial statements and to contravene existing securities laws. It won't work either.] The Fed's endorsement comes as some banks, analysts and international officials question whether the planned \$80 billion fund will help. Deutsche Bank AG Chief Executive Officer Josef Ackermann said Oct. 21 that it is ``premature to make a firm judgment'' because details of the plan haven't been established. Fed officials' silence since the agreement was announced Oct. 15 has been misinterpreted as criticism, the Fed official said. [I guess some people must have been thinking the government might do its job as regulators, how silly is that?] Central bank policy makers have lowered their benchmark interest rate by half a percentage point and the charge for direct loans to banks by 1 percentage point since access to credit slumped in April. The New York Fed has also injected reserves into money markets to help provide liquidity. SIV Fund The three biggest U.S. banks said last week that they would raise money for a fund that would buy assets from distressed structured-investment vehicles. Banks and hedge funds set up the SIVs to issue short-term debt and invest in longer-term assets such as bank loans and mortgage-backed securities. ``The Fed wants to see financial markets function normally, and this fund is a step in that direction,\" [the Fed actually in concert with Treasury and the Street is doing everything it can to prevent normal functioning of markets, which would entail washing out the players who acted imprudently instead of bailing them out.] said former Fed Governor Lyle Gramley, now a senior economic adviser at Stanford

Group Co. in Washington. ``The greater the success of this fund in restoring normal functioning of financial markets, the less the Fed has to reduce the funds rate to prop up the economy." **Fed Signals Support for Paulson Commercial-Paper Plan**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aHoDjZCAteAo&refer=home>

## Don't Fight The Fed

### I Disagree . . . and why

Article of the week:

#### **Kass: Blinded by the Derivatives Boom**

Permit me the opportunity to give you my perspective and to reflect on the intermediate-term prospects I see for the capital markets.

We live in a brave new investment world. With the explosion of hedge funds -- the newest and most aggressive and dominant investor -- riches beyond the highest degree of avarice can be only a year away.

Industrialization of America business icons (Ford, Carnegie, Rockefeller, etc.) are no longer the leaders, nor are the kids of the dot-com boom (Bezos, Yang, Case, etc.); today, the masters of the universe are hedge fund managers (Ed Lampert, Stevie Cohen, Paul Tudor Jones, etc.).

And there are many hedgies who are, understandably, wannabes -- and who sometimes (arguably) misuse other people's money by worshiping at the altar of momentum in the pursuit of happiness. In the process, negatives are also sometimes ignored or, even worse, dismissed.

**As such, in the pursuit of George Soros-like riches, momentum has taken a peculiarly more important role than ever. It has been almost unbridled as investors have often taken abnormal risks for normal returns in the low-interest world of 2000-07. This is true not only in the equity markets but especially true in the credit markets.**

And, as a result, over the last five to seven years, following the stock market bubble of the late 1990s and the easing in monetary policy around the world in the 2000s, we entered a period in which a surplus of cash led to a shortage of good sense in the capital markets. Investors prospered in the ensuing synchronized advance in almost every asset class -- equities, private equity, fixed-income, commodities, gold and real estate.

As a consequence of the broad-based financial and economic prosperity, another new paradigm emerged -- the notion that a long and uninterrupted economic boom was believed by many to lie ahead. That promise, abetted by the low cost of capital and interest rates, stimulated the straw that stirred the drink of growth and speculation -- namely, the financial derivatives markets.

**That market mushroomed, in an unquestioning atmosphere in which T's were not crossed and I's were not dotted, to the point where the derivative market eclipsed the actual size of the markets it served. (In a generally unregulated market, this was an easy do.)**

The appetite for derivative products creation grew almost boundlessly and was brought to us by that wonderful brokerage community that brought us the dot-com IPOs and biased research, stoking all asset classes and revving up the real estate market in particular.

Layers of different sorts of assets were securitized by the Street and packaged into one, and the generally unregulated asset-backed securities, collateralized debt obligations, special interest vehicles and so on were given their birth. The new securities gave way to their cousins; levered hedge fund pools of capital emerged to take advantage of the availability of borrowed money ("the carry trade") supporting those ABC and XYZ assets. They could, in theory, produce alpha (or excess returns).

**In time, the need for speed had as its outgrowth the loss of common sense, particularly in lending. Subprime and no-/low-documentation lending gained share of the total mortgage market, and**

**speculators/investors, drawn to those riches of flipping and daytrading homes, began to stretch home prices to levels well beyond affordability and reason.**

In time, the unintended consequence was literally a very shaky foundation to the residential real estate market and to the derivative products into which the subprime loans were dumped.

Over in equities, a new breed of stocks (energy, infrastructure, metals, emerging markets, etc.) flourished and took center stage during the synchronized worldwide economic growth boom and personal consumption binge -- and these sectors were capable of making the sort of broad and parabolic moves that rivaled the AOLs and **Amazons** (AMZN) of the last decade.

As an aside, and for good measure, we can add the anointed ones -- **Apple** (AAPL) , **Google** (GOOG) **Research In Motion** (RIMM) and **Baidu** (BIDU) -- which prospered by taking share from less innovative and less thoughtful competitors.

Meanwhile, other secondary deleterious influences were "emerging," too. Although, prima facie, these influences were positive for the markets -- that is, as investors easily marginalized the U.S.' loss of its competitive edge in producing goods for worldwide consumption -- they were destined to hold some negative consequences down the road.

The most important was the emergence of India and China as world economic powers and the concomitant dive in the U.S. economy's currency and economic standing, which buoyed the demand for basic materials as those countries' infrastructure developments began to take hold.

That rising demand served to have the adverse consequence of raising commodity prices around the world -- and with it, attendant inflation and higher costs for manufacturers. Other influences during this period, such as the U.S.' reliance on imported oil, sowed the seeds for higher noncore inflation.

In summary, the momentum of asset-price appreciation and the rewards that were a byproduct of those gains have been intoxicating and virtually unquestioned, even as headwinds mounted, in a world in which the dominant investors (hedge fund managers) get a carried participation in their growth.

And so was the cocktail of derivatives, leverage and credit creation, which buoyed consumption in both the industrialized and emerging economies. What has recently intensified the problem is recognition that the derivative markets have bypassed the traditional conduit -- namely, the commercial banking system (governed by capital and reserve requirements and audits).

**In the absence of oversight, accountability has been weakened and, at times, eliminated. And then, almost overnight, conduits worth tens of billions of dollars are revealed. And so are tens of billions of dollars of debt securities and loans the market is unable to value.**

Surprise, surprise. It was especially a surprise to the money center banks, which are in the forefront of the dance of write-offs -- a marathon, not a two-minute fast step.

The problem with the aforementioned momentum and the overexuberance that follows is that it does not last forever. Equally important (and often enigmatic) is that you never know what should end it -- nor what will end it.

Over the past several years, I have chronicled the seeds of what I believed would be the market's (self-) destruction -- in housing, in risk-taking and in the derivative markets. For a time, I am sure that many subscribers (and contributors) probably viewed my preoccupation with a housing downturn and the subprime problem with skepticism bordering on ridicule and even annoyance. I tried to demonstrate the logic of the developing contagion, but common sense was ignored.

While the market has dismissed my warnings -- most of which have come, or are coming, to pass -- I suspect that tolerance as well as the unquestioned momentum stimulated by the strength (or madness) of crowds are eroding. Today there are a number of obvious problems/casualties that suggest that a more problematic and uneven stock market might be surfacing.

Unlike Cassandra, I am not saying the end of the world is near. (Bulls tend to dismiss bears with this one phrase.) Indeed, there is no reason to believe that Friday was the Big One. (Quite frankly, it has not paid to bet on the Big One, and probably won't for a while longer.)

**It appears, however, that there are solid reasons to be increasingly concerned.**

Most of my concerns, which I shall discuss below, are fundamental, not technical. I would add, however, that **the negativity bubble you read about could not be further from the truth; just look at the *Investors Intelligence* sentiment studies, the high level of margin debt and/or the consistent raft of uninterrupted bullishness in the media.**

Can't get  
enough Kass?  
Get *RealMoney Silver*.  
» 14-day FREE trial.

Importantly, a confluence of a number of events is occurring at or near the conclusion of a mature economy in the U.S., Japan and Europe.

Without further ado, here are some (but not all) of my concerns:

- **The pile of levered pools of capital that hold the extraordinary (in size and quality) amount of derivative assets are now in disarray.** Mark-to-market issues and an acceleration in nonearning assets run deep and are endangering large bodies of market participants and their capital bases. This includes the domestic money center banks, investment brokerage firms and, importantly, the unregulated and monstrous special interests vehicles, collateralized debt obligations and levered hedge funds that play in that water.

The destabilizing effect of the impaired financial institutions cannot be understated or underestimated; just ask those investors who have overweighted financials (20% of the **S&P**) on the basis of "value," only to see the sector drop on a daily basis. Banking problems tend to have a long tail and historically are not resolved in a quarter or two (e.g., the less-developed-country debacle, the junk bond fiasco and the early 1990s housing depression, all of which crippled the banking community for years).

Arguably, the problems in housing and leveraged derivatives in 2007 run deeper than the prior adverse cyclical issues. Finally, we should not lose sight of the fact that the money center banks, which are this cycle's (and nearly every cycle's) dolt, entered 2007 ill-equipped to deal with losses. (They were at a historically low level of reserves as a percentage of earning assets.) The banks, too, were momentum players, believing in the new paradigm and believing (incorrectly) in their own credit standards and (lack of?) analysis.

Recognizing that the level of credit losses virtually hit an all-time low in 2006, only to be reversed markedly through the first three quarters of 2007, a likely mean reversion-of-loss experience augurs poorly for a capital-depleted and off-balance-sheet-dependent U.S. commercial banking system that has experienced a two-decade drop in loan-loss reserves just as the economy matures and the consumer falters.

- **To an important degree, the Fed has lost control of the capital markets.** [These are situations that cannot be arrested by somewhat lower interest rates. Many problems reside abroad outside of the Fed's influence. And much that is domestic lies in unregulated territory.](#)
- **Capital-weakened financial intermediaries spell an important retardant to the financing of growth.** The era of unbridled lending is over. Just try to get a mortgage for a second home. Just try to get a jumbo mortgage. Just try to borrow with little or nothing down -- on anything. Or just try to get a nondocumented mortgage loan, motorcycle loan, furniture loan or automobile loan today.
- **The next shoe to drop will be the failure of a public homebuilder and a private mortgage insurer.** The latter concerns me more than the former, as the markets are not aware of the economic implications of my view.
- **The domestic, nonexport economy is in recession.** If you don't believe me, read last week's conference calls at **Schlumberger (SLB)**, **Caterpillar (CAT)**, etc. The Federal Reserve gets it and will likely lower interest rates by another 50 basis points next week. But the adoption of a Japanese solution of supporting bad debts will have, as an adverse consequence, further drops in our currency and competitiveness -- and higher prices for consumer products.
- **Based on my recent trip, I can assure you all that the Western European economies are falling faster than is generally realized for many of the same influences behind the U.S. weakness.**
- **The dual impact of a higher real rate of inflation and climbing oil prices are a tax on the consumer and will weigh on corporate profit margins, which will be hurt by slowing top-line growth.** Importantly, these are occurring at a time in which the consumer's debt load has never been higher based on nearly any measure. As I mentioned earlier, with declining home

prices, the burden on maintaining financial net worth has never been more on the shoulders of stock prices, and that's a [slippery slope](#). One might prefer to listen to some of the bullish managers interviewed on *CNBC* and *Bloomberg* (and now *Fox Business News*), who repeatedly defer to dogma in their general statement that "it has never paid to underestimate the American consumer."

I prefer to look at some of the more tangible measures regarding the consumer's rocky fundamental position -- for instance, an all-time high in debt service and in the debt load of the consumer and, importantly, the message of the market from the **Retail HOLDERS'** (RTH) steady demise and the equally steady drop in bond yields -- as a precursor to the obvious slowdown.

- **The excess capacity in housing holds far-greater economic import than the excess capacity in technology six years ago.** Ben Stein wrote yesterday in *The New York Times* that "there is still a long waiting list for Bentleys in Beverly Hills."

Unfortunately, there is no waiting list for low-end Fords or Chevrolets. That's the reason the Democratic Party's message of populism struck a chord in 2006 and is likely to influence the presidential election in 2008.

Meager job and income growth and the squeeze on the lower- and middle-income classes at the tail end of a maturing economic cycle bodes especially poorly as the consumer's dependency on asset appreciation (stocks and houses) remains elevated. In the aforementioned *Times* article titled "[The Gloomayers Should Look Up](#)," my email buddy, Ben Stein, further suggests that the ursine crowd should look up to see that the sky is not falling. By contrast, bears, like myself, suggest that when we look up to the sky, we will see dark clouds and headwinds. (Memo to Ben: \$200 billion here, \$200 billion there and soon we are talking about a lot of money!)

The next five years in the capital markets seem destined to be unlike the last five years. The most significant difference is that the egregious use, generation and packaging of debt will not be repeated -- and the consequences of that leverage will be adversely seen in areas of the world economies that we had never contemplated.

From my perch, the bulls continue to think very linearly and seem to be missing how significant the role of credit was to past growth and how significant a pullback in credit will be on future growth. Significantly, the markets continue to underestimate the consequences of leverage and are overestimating the prospects for corporate profit growth.

There will always be winners in the markets, just as there are always losers in the markets, and a number of contributors have brought up some beauties over the years. The winners appear to be narrowing in scope, however, representing a classic sign of a maturing equity market. And, in more difficult markets, those babies are often taken out with the bath water.

<http://www.thestreet.com/pf/newsanalysis/investing/10385707.html>

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