

## November 12, 2006 Review

### Summary

Sorry I did not get this out Sunday. I was out of town. Perhaps the most interesting item of the week past was a Bloomberg training seminar I attended. Bloomberg is a news and data service that is the Cadillac of investment products and is used by many on the Street, particularly for fixed income. The last session I attended was a demonstration of the capabilities of the Bloomberg credit derivative products. Even I was stunned at the parsing of risk and leverage in the products themselves. The actual leverage is potentially dozens of times higher as the counterparties' leverage is not determinable. After hearing the presentation I am quite comfortable with my thoughts that a major blow up in the financial markets will be coming at some point in the next probably 12 months and could be as early as now. As always this is one person's opinion, but I do my best to make it an informed opinion.

Also a visual change. My words will be in red so there is no confusion between the reported story and my comments. I will continue to use black bold to identify those passages I believe to be of greatest importance for those skimming.

### Credit

- **DR Horton** (DHI) is up \$2 pre-open on better than expected revenues and earnings. But the why doesn't concern the buyers, only that it is. The why is that the company took nearly its entire backlog from 1Q 2007 and recognized it this quarter. For a quarter that is supposed to create the lowest leverage in the company because of strong cash flows (seasonal), the debt capitalization actually rose from 35% last year to 43% this. And this from a company that supposedly is balance sheet conscious. DHI is not the worst of the builders, but that is what is so concerning about this move. As a result of their actions, 2007 EPS most certainly will be lower. With sentiment near historic "bullish" levels we have to return to what is going on. **Credit created by central banks globally, but especially in the U.S., is by any measure at levels never seen before. This credit is seeping into everything, including sentiment. People are taking more risk than ever as evidenced by extremely tight credit spreads, very low option premiums, and seemingly endlessly rising stock prices. You can tell the sentiment has turned from "bullish" to "piggy" when every piece of bad news is construed to be a positive thing.** The bad news is ending and the good news is coming. But while easy credit is forcing them (they don't realize it) to take risk, debt grows. **Debt does not go away by itself...it must be paid back or defaulted on. With the U.S. now consuming 7% more than the income it produces (trade deficit), it won't be paid back.** John Succo 11/14 <http://www.minyanville.com/articles/index.php?a=11612>

### Commodities

- **What are the "smart guys" doing?** Since 1998, the "smart guys" have asked not how can I attack this bubble that is popping (in 1998, that financial bubble was embodied by failed hedge fund LTCM), but instead how will the "powers that be" respond to the bubble popping and what asset will benefit the most from that response? In the case of

1998, the massive amounts of liquidity that were injected into the system by the Fed to avert a financial meltdown following LTCM's collapse resulted in the tech and equity bubble of 1999-2000. So, the "smart guys" bought Internet and technology stocks in 1998. In 2000, when the tech bubble popped, it became apparent that the Fed would once again respond by printing money. What did the "smart guys" do? They bought real estate and housing stocks in anticipation that the Fed's actions would create a bubble in housing. Fast forward to today... the housing bubble has now unquestionably popped. How will the Fed respond? The answer is obvious. They will print money, just like they always do in response to problems, except this time there are no more asset bubbles left to blow. **Instead, all you are left with is an eventual collapse in the dollar.** But since the dollar is also the world's reserve currency, other paper currencies also derive their "value" from the purchasing power of the dollar. So, the dollar may not necessarily "collapse" against foreign currencies, although it will most certainly depreciate, as self-interest eventually forces foreign central banks to raise interest rates. The true "collapse" will be in the dollar's purchasing power and the purchasing power of other global currencies that hold dollars as their primary reserve asset, and the biggest collapse will likely be against a "store of value" like gold. Thus at the end of the day, a "store of value" like gold may become the chief beneficiary of the official sector's response to the housing bust. So, perhaps the "smart guys" are now buying gold? Thus far in November, the **Gold Shares** (GLD) ETF has inhaled 21 tonnes of gold, or an increase of about 5 percent in its gold holdings. **So, who are the "smart guys" this time?** One never truly knows the answer to that question until after the fact, but I think a good case can be made that the "smart" trade at this point is to be long gold. Lance Lewis 11/9  
<http://www.minyanville.com/articles/index.php?a=11586>

## Currency

- **Is China one of the "smart guys?"** Now throw in today's comments from PBOC governor Zhou, when he said that the PBOC has "had a very clear diversification plan (out of its dollar reserves) for several years," and **we can see how what was already a growing inflation problem in the US could quickly become a huge problem should China begin selling treasuries or even reducing its buying of treasuries going forward in favor of other reserve assets, like gold.** The fact that China was going to eventually be forced to diversify its forex reserves, which topped \$1 trillion in October (up \$850 billion in just the past five years), is not news, but as is often the case, the conditions may now be such that the market is going to react a little more violently to what appears to be an inevitability, even though the exact timing of that event remains somewhat elusive. But can China diversify a large portion of its \$1 trillion in forex reserves into the euro for example? Practically, no, China cannot. A massive exchange of dollars for euros would drive up the euro vs. the currencies of the rest of the world, straining trade relations and causing mass financial chaos (not to mention crush Europe's economy). The logical choice for China to diversify its dollar reserves into is the only other widely recognized reserve asset held by central banks around the world and the *only* reserve asset held in any size by the US Federal Reserve, **gold**. Lance Lewis 11/9  
<http://www.minyanville.com/articles/index.php?a=11586>
- **\$30 Million Per Hour China's foreign currency reserves have topped \$1 trillion, setting a new record for the world's largest currency reserves.** China

first became the country with the largest foreign currency reserves at the end of February when it overtook Japan. Japan had reserves of \$881.3 billion at the end of September. Ba Shusong, an expert for the State Council, China's cabinet, said he expected the reserves to grow to \$1.5 trillion in only two years while the International Monetary Fund predicted they would hit \$2 trillion by 2010, according to IndiaeNews.com. **China's currency reserves increase by nearly \$30 million per hour.** The increase is fueled primarily by China's large trade surplus, which tripled last year to \$102 billion, and surging foreign investment. It is believed that as much as 70% of China's reserves consist of U.S. dollars. **Meanwhile, Chinese economists and policymakers are calling for diversification of the country's forex reserves.** Kevin Depew 11/7  
<http://www.minyanville.com/articles/index.php?a=11573>

## Derivatives

- There has been an explosive growth in the number of corporates, investors and financial institutions turning to structured products to achieve cost savings, risk controls and yield enhancements. **However, the exact nature, risks and applications of these products and solutions can be complex, and problems arise if the fundamental building blocks and principles are not fully understood.** (11/9)  
[http://home.businesswire.com/portal/site/google/index.jsp?ndmViewId=news\\_view&newsId=20061109005391&newsLang=en](http://home.businesswire.com/portal/site/google/index.jsp?ndmViewId=news_view&newsId=20061109005391&newsLang=en)
- One of the great innovations of the lending industry during this period was that it broke the link between the person who made the loan and the person who would suffer the loss if the loan went bad. That was what made the housing bubble possible. While the marginal borrower took out I.O. low-doc ARMs, the hedge fund, pension fund and insurance fund geniuses bought MBSs - mortgage-backed securities. The securities were backed by the mortgages, which were in turn backed by the imaginary incomes of the borrowers and inflated house prices. **The credit agencies rightly judged the quality of the mortgages as less than perfect - BBB - and then with the miraculous powers of modern finance these same mortgages were put into MBSs and turned into triple-A credits!** When asked to explain, the institutional salesmen resorted to logic little different that of the ordinary homeowner. The component parts may be a little oily, they said, but put together the sliced and diced, processed mortgage packages were less risky than individual mortgages. But that insight seems to have never occurred to genius investors at hedge funds and other major investment firms. The sophisticated buyers did not merely buy the packaged mortgage debt; they ate it up. Cheap suits, expensive suits - when you got down to it, they all fell for the same line of guff. Just how bad some of this glop was became apparent only recently. As reported in Forbes: "The real estate market has never offered such opportunity for graft. Since the housing market started to soar in 2001, mortgage fraud has become the fastest-growing white-collar crime, according to the FBI. Last year crooks skimmed at least \$1 billion from the \$3 trillion U.S. mortgage market. "Now that the market is slowing, fraud is only rising. As business dries up, there's increasing pressure on lenders, brokers, title companies and appraisers to be profitable. DR 11/10
- What are credit default swaps (CDS)? Credit default swaps offer a kind of insurance against non-payment of corporate debt. It is essentially an agreement between a

protection buyer and a protection seller, whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon a credit event, such as a default) happening. When the price of CDS instruments drops, this leads to market-to-market losses for those holding the instrument who have bought protection. Why? Because they are paying a premium that is greater than the market rate. According to the Financial Times, the sharp price swings of the past week have confounded many investors who had expected to see the cost of debt insurance rise this winter, as part of a broader turn in the credit cycle. This heavy selling has driven the cost of insuring debt against default in the market for credit default swaps to record low levels, the FT said. **What this means is either investors are very, very optimistic about the outlook for corporate debt, or that prices are so distorted that they are no longer being paid for the risks they are taking on.** Kevin Depew 11/6 <http://www.minyanville.com/articles/index.php?a=11566>

## Housing

- The inventories of unsold single-family homes and condo units have edged down a bit from recent records, but inventory levels and inventory-to-sales ratios still are quite high. Furthermore, inventory overhangs undoubtedly are larger than shown by published data and vacant units now account for an unusually large share of homes for sale. The weight of the inventory situation is likely to exert downward pressure on new housing production and home price appreciation for at least a few more quarters. NAHB's housing forecast shows a trough in home sales in the first quarter of 2007, a trough in housing starts in the second quarter, and a bottoming-out of home price appreciation in the second half of 2007. The projected recovery process lifts home sales and housing production back up toward trend by the end of 2008, and national house price appreciation should be comfortably in the positive zone by then. **Seider's report** – an internal analysis done monthly by the national association of home builders [I have a subscription]
- Home buyer demand fell dramatically after mid-2005 as deteriorating affordability conditions moved many prospective homeowners to the sidelines (or into rental housing) and declining prospects for price appreciation sent many investors/speculators scurrying away from the housing sector. Home sales and house price appreciation trended downward through the third quarter of this year, despite the government's report of an increase in new-home sales in September (on the heels of large downward revisions to July and August), and cancellations of sales contract were a growing issue through the third quarter of the year. Figures 4 and 5 show recent patterns of existing home sales and home price appreciation (based on closings), and Figure 6 shows the average cancellation rate (cancellation relative to sales backlog) reported to NAHB by a panel of 30 large home builders. **Seider's report**
- Unsold inventories of new and existing single-family homes moved down a bit in August and September, coming off record highs, and the inventory of existing condo units came down a bit in September from its record high. However, inventories still are historically high and the official government numbers exclude the impact of large and rising sales cancellations in the market for new single-family homes. Furthermore, there is no measure of the unsold inventory of new condo units, and that overhang presumably is quite heavy in many areas. There's also evidence that an unusually large portion of

homes for sale are vacant, accenting the seriousness of the inventory overhang in the existing-home market. **Seider's report**

- The study of neuroeconomics has illuminated a few key concepts: Many people will pass up sure profits for illusory ones. Some will turn down profits if they believe someone else is unfairly profiting more. Some will even refuse to sell if they believe they may come to regret it, because fear of future regret can be as powerful a motivator as money in the pocket today. While little of this has been applied scientifically to real estate, it is easy to make the leap. For instance, much research has been done on the concept of "loss aversion," which shows that people tend to deny reality when something they own, such as a house, declines in value. Sellers maintain the asking price even at a level that makes no sense, economists say. Similarly, home sellers become attached to the prices their neighbors received at the top of the market rather than current prices, and they become reluctant to sell unless they get that higher price. "There seems to be a psychological resistance to taking losses on the sale of a house," says David Laibson, who teaches psychology and economics at Harvard University. "People think they'll make money on it...That logic worked for a long time, and now anyone who bet on that logic is being burned." *Source: The Washington Post, Kirstin Downey (11/04/2006)*  
<http://www.realtor.org/RMODaily.nsf/pages/News2006110602?OpenDocument>
- Toll Brothers became the latest builder to cut guidance as its founder said he sees no end of the deep slump in home building. "We continue to look for signs that a recovery is imminent but can't yet say that one is in sight," said a statement from company Chairman and CEO Robert Toll. 11/7  
[http://money.cnn.com/2006/11/07/news/companies/toll\\_brothers\\_outlook/?postversion=2006110710](http://money.cnn.com/2006/11/07/news/companies/toll_brothers_outlook/?postversion=2006110710)

### **Housing Finance**

- When the 21st century first budded out, only 5% of mortgages were of the so-called 'sub-prime' variety - that is, mortgages to marginal borrowers. Five years later, one in four were to sub-prime borrowers. Also in 2000, only 25% of these sub-prime mortgages were of the 'stated income' variety. Only 1% consisted of 'piggyback loans' - junior mortgages designed to eliminate the need for a real down payment. And none were I.O., or interest only. By September 2006, 44% of sub-prime loans had 'limited documentation,' 31% were piggyback loans, and 22% were interest only. DR 11/10

### **Macro Economic**

- VIENNA, Austria -- International Atomic Energy experts have found unexplained plutonium and highly enriched uranium traces in a nuclear waste facility in [Iran](#) and have asked Tehran for an explanation, an IAEA report said Tuesday. The report, prepared for next week's meeting of the 35-nation IAEA, also faulted Tehran for not cooperating with the agency's attempts to investigate suspicious aspects of Iran's nuclear program that have lead to fears it might be interested in developing nuclear arms.  
[http://www.washingtonpost.com/wp-dyn/content/article/2006/11/14/AR2006111400230\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2006/11/14/AR2006111400230_pf.html)

- RARELY have Wall Street's seers been so split. Not only are they divided about where the economy is headed, they even disagree about how it is faring today. Pessimists, such as Nouriel Roubini of Roubini Global Economics, reckon output is slowing from its already desultory pace of 1.6% a year in the third quarter and that recession is imminent. Optimists say GDP growth is rising after a weak summer. After analysing bond, equity and credit markets, Stephen Jen of Morgan Stanley recently argued that the risk of recession was only 13%, down from 19% a month before. How can opinion be so divided? The glib answer is that America has two economies: residential construction and car production are in a slump, but the rest is still chugging along. Such resilience is why the jobless rate fell to 4.4% in October, its lowest since 2001, and why both wages and hours worked grew smartly. But how sustainable that is depends on whether the sectoral declines worsen and spread. 11/9 the Economist  
[http://www.economist.com/finance/displaystory.cfm?story\\_id=8150206&CFID=94639276&CFTOKEN=58299fb-4d7e1156-3c8e-432b-ab78-48ce79f04c37](http://www.economist.com/finance/displaystory.cfm?story_id=8150206&CFID=94639276&CFTOKEN=58299fb-4d7e1156-3c8e-432b-ab78-48ce79f04c37)

## Retail

- **Wal-Mart is cutting prices early** over concerns that the holiday shopping season may come in much lighter than expected, Kevin Depew 11/6  
<http://www.minyanville.com/articles/index.php?a=11566>

## Savings Rate

## Tech

- Chip-Equipment Stocks: Steer Clear David Kaplan, S&P's Semiconductor Equipment analyst's fundamental outlook for the semiconductor equipment subindustry is negative. The Semiconductor Industry Association reported semiconductor factory utilization of 91.2% for the second quarter of 2006, up from 89.5% in the first quarter, and within the three-year historical range of 84.8% to 95.4%. There has been rapid growth in demand for semiconductor equipment in 2006, year-to-date, but S&P expects demand to decline from current levels over the next few quarters. Kaplan bases his outlook, in part, on rising inventories, what he views as unsustainable levels of capital spending by chipmakers in recent quarters, and a slowing global economy. The analyst sees industry sales growth of 25% for 2006 and expects 2007 sales to be flat. **Kaplan also points to comments from leading manufacturers, chipmakers, and industry research firms noting weaker outlooks for the near term.** He sees the softening extending through the first half of 2007, as chipmakers digest recent capacity additions. Kaplan thinks recent investment in capital equipment by chipmakers will add substantial capacity, and he sees current oil prices, rising global interest rates, and declining housing values in the U.S. as potential threats to consumer spending and demand for semiconductor chips. 11/7  
[http://www.businessweek.com/print/investor/content/nov2006/pi20061107\\_541871.htm](http://www.businessweek.com/print/investor/content/nov2006/pi20061107_541871.htm)

## Wall Street

- It's that time of year again, as the holiday season will soon be under way and that means hedge funds and other money managers go on a shopping spree of their own as they hunt for bargains with which to stuff their clients' stockings to help boost year-end returns.

**What we are seeing is a flight to risk**, economist **Stephanie Pomboy** of New York-based **MacMavens** explained to *Reuters*. There's only about a month worth of trading days left to 2006, she said, and with the rush to generate double-digit returns begun, **the appetite for risk-taking is not surprising**. Actually, investors appear to be ravenous as they gobble up in large quantities margin-market debt, small cap stocks and especially high-yield junk bonds **not a particularly healthful financial diet**. A lot of investors are chasing yield and a lot will regret what they've bought when all is said and done, portfolio manager **Bob MacIntosh** at Boston-based **Eaton Vance Management** said in a *Reuters* interview. **Macintosh said junk bonds especially are priced too low for both economic and geopolitical risks**. Hedge funds have an especial urgency to make up for hedge fund deficiencies, notes *Reuters*, pointing to the 7.64% year-to-date returns of the *Credit Suisse/Tremont Hedge Fund Index* which is about half the performance of the Dow Jones Industrial Average and about 3.5% percentage points behind mutual funds. (11/14/06) [if this does not frighten you, it should – this is how your money is “invested” – i.e. without any regard for the long term or for risk so long as the Street gets their huge year end bonuses]

<http://www.dailyii.com/article.asp?PositionID=2597&ArticleID=1084365&LS=EMS112016>

- **How wall street works** - And so it is. Another day, another record. We asked several questions this morning, including openly pondering how many “buy stops” were sitting on the other side of S&P 1390. The answer, as we learned, was to the tune of 120,000 S&P e-minis, or \$8 billion of notional value. That's a whole lotta meat, Minyans, and it's why the tape sprung to life late this afternoon. I'm being told, for what it's worth, that much of this order was to close (covering shorts). 11/14  
<http://www.minyanville.com/articles/index.php?a=11612>
- A lavish bonus season looks set to favour only the star performers in investment banks, who will expect their year-end pay packages to be up to 30 per cent higher than last year, buoyed by record mergers and acquisitions activity, strong debt trading and rebounding stock markets. 11/15 financial times  
<https://registration.ft.com/registration/barrier?referer=&location=http%3A//www.ft.com/cms/s/d45331d4-744e-11db-8dd7-0000779e2340.html> SEE also  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=atEk12XYMerk&refer=home>
- Are they worried now? Not so's you'd notice. Volatility is again near record lows. Put options (which protect investors from the downside by allowing them to sell - to 'put' - the stocks to a buyer at a previously-agreed price) are extremely cheap. And the news is almost all positive - little inflation, high earnings, record employment figures. The IHT even tells us that consumers are still spending money like water - despite the fact that the housing bubble tap has been turned off. "Holiday sales marginally higher," adds Reuters. Where are they getting the money? We don't know. But the papers tell us that the economy is strong, with plenty of liquidity. We'll have to wait for a detailed plumbing analysis to find out for sure. There are three possibilities...either the impact of the housing slump hasn't hit the householders yet...or it's not really as bad as we think it would be...or the economy is somehow providing consumers with new sources of spending money.  
DR 11/14

- **How wall street works part II** - The first is the "other people's money" syndrome. You worked for Delta for thirty years and your retirement money was all in the company's pension plan. It turns out that the pension plan had most of your money tied up in Delta stock. If you had been making that decision yourself you probably would not have risked your retirement on the performance of Delta stock, but the pension manager and the company had ulterior motives for risking your retirement on the performance of the company's stock. They perhaps knew that it was too risky, but they were willing to take that risk with your money given the high reward to the *company* as a result (higher corporate profits). **This occurs throughout the financial system: pension managers making credit decisions, analysts making stock recommendations, financial planners investing your money, bankers making loans, etc. They tend to skew more toward return (pressure to perform) than toward taking less risk and protecting your capital.** These forces over time cause risk to be underestimated and they work cumulatively. **I view higher stock prices, low credit spreads, low volatility, extremely high debt, and very high liquidity as high risk because the probability is that they will be reversed first by the smart parts of the crowd and then the whole crowd itself.** John Stucco 10/27 <http://www.minyanville.com/articles/index.php?a=11513>
- **How wall street works part III** - Comparing two snapshots of the entire I/B/E/S analyst stock recommendations database, taken in 2002 and 2004 but each covering the same time period 1993-2002, we identify nearly twenty thousand changes of an unusual nature: the selective removal of analyst names from historic recommendations ("anonymizations"). This practice turns out to be pervasive and non-random: Bolder recommendations are more likely to be anonymized, as are recommendations from more senior analysts, Institutional Investor "all-stars," and those who remain in the industry beyond 2002. Abnormal stock returns following subsequently anonymized buy recommendations are significantly lower (by up to 11.0% p.a.) than those following buy recommendations that remain untouched, **suggesting that particularly embarrassing recommendations are most likely to be anonymized. Analysts whose track records appear brighter due to anonymizations experience more favorable career outcomes over the 2003-2005 period than their track records and abilities would otherwise warrant** [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=889322](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=889322)
- THE THEORY OF EFFICIENT MARKETS is based on the assumption that investors know all there is to know about every single security. Moreover, they coolly and rationally analyze all that information to make dispassionate investment decisions. Sound like the real world? Not exactly, and therein lies opportunity. **"The world has gone to 'index-hugging' or 'I-want-to-shoot-the-lights-out- by-Dec. 31' mentality,"** says David Winters, manager of the Wintergreen Fund. Either portfolio managers are too timid to stray from their benchmarks or they demand instant gratification, risk be damned. <http://users2.barrons.com/lmda/do/checkLogin?mg=barrons-users2&url=http%3A%2F%2Fonline.barrons.com%2Farticle%2FSB116247091504511300.html%3Fmod%3DjemBF> With stocks still near their recent highs, I think it's useful to remember the tendency of bull markets to surrender large portions of their gains over the full market cycle. **Without that understanding, investors are vulnerable to the temptation to "chase" returns in what is already a richly valued, aged bull market**

**advance, where recession risks continue to gradually increase.**

<http://hussmanfunds.com/wmc/wmc061106.htm>

SUICIDAL TRADE DEFICIT  
by Dr. Kurt Richebacher

On the surface, it seems that there are diametrically different views at work in the markets. While the rising bond prices and the falling commodity prices apparently suggest underlying distinct economic bearishness, the sudden surge in stock prices and persistent record-low credit spreads appear to reflect very optimistic expectations about the economy.

The turn in the bond market started in June with yields of 10-year Treasury notes at 5.25%. A decline to 4.7% generated a 5% return for investors within just three months. Annualized, this comes to a return of 20%. Take further into account that there is generally heavy leverage involved, multiplying this return between 10-20 times.

Considering further that this rate of decline of long-term rates has occurred against the backdrop of a firmly inverted yield curve, implying that expenses of carry trade exceed current yields, the strength of this move seems a bit surprising. The quick capital gains, though, have richly offset these interest expenses - for the time being. But to maintain these highly leveraged positions, it will need at least one of two things: either a further sharp fall in long-term rates providing new capital gains or rate cuts by the Fed reducing the costs of carry trade.

More surprising is the new bull run of the stock market in the face of an economic slowdown. Approaching recessions have always tended to depress stock markets in expectation of falling profits. Well, there is a tremendous difference between past and present experience.

Past recessions were all triggered by true monetary tightening, hitting both the economy and the markets. The current economic downturn is unfolding against the backdrop of unmitigated monetary looseness. While the Fed has raised credit costs from unusually low levels, it has done nothing to tighten credit. Its expansion has kept accelerating.

Credit demand has been running wild for consumption, housing and financial speculation. There is just one striking and ominous exception: Corporate credit demand for fixed investment remains zero. Corporations, too, have been borrowing heavily, but for mergers, acquisitions and stock buybacks, not for productive investment.

In 2005, nonfinancial corporations spent \$136.8 billion less than their cash flow from retained profits and depreciations on capital expenditures. Simultaneously, they spent \$363.6 billion on mergers, acquisitions and stock buybacks. Given their moderate cash surplus, one has to assume that the stock purchases were generally financed with borrowed money.

It is certainly reasonable to regard the strong trend of corporate stock purchases as an early negative indicator of investment intentions. Principally, there are two different ways for corporations to expand and to raise profits. One is the old-fashioned way of organic growth through creating new plant and equipment. The other is to purchase economic growth

and higher earnings through mergers and acquisitions by going more deeply into debt.

What, then, has been happening more lately to mergers and acquisitions? In short, they have gone crazy. During the first quarter of 2006, they hit an amount of \$558 billion at annual rate, and in the second quarter another \$554.8 billion.

This compares with continuously weak capital investment. In the first quarter, it was \$2.7 billion below cash flow, and in the second quarter, \$43.2 billion above cash flow. There is an interesting comparison with the year 2000. Then, capital expenditures of nonfinancial corporations exceeded their cash flow by \$310.8 billion, compared with net stock purchases of \$118.2 billion.

We would say that these figures indicate a continuous, rather dramatic change in corporate policies of expansion away from new capital investment and toward "purchasing" growth and earnings. It started in the 1980s. It strongly intensified during the 1990s, and during the last few years has gone to extremes.

Stating this, we primarily have the long-term development in mind. But in the same vein, we are pondering what is going to happen to business investment in the short run, when consumer spending slows, or even slumps, in the wake of the bursting housing bubble. The generally highly optimistic expectations and forecasts about investment spending taking over from consumption as the driver of the economy greatly puzzle us.

To stress one important point, which appears to be generally overlooked: Some rise in capital spending is not enough. Given its much smaller share of GDP than consumer spending, it needs a very strong rise to offset even a minor decline in consumer spending.

While the markets seem to reflect highly conflicting views about the U.S. economy's outlook, we nevertheless presume one underlying common view, and that is the perception of very little risk of a possible recession because the Fed would, in any case, swiftly act to head off any gathering weakness. What matters from this perspective both in the bond and stock markets are impending rate cuts.

In essence, this is in line with the conventional thinking that the U.S. Great Depression of the 1930s, as well as Japan's prolonged malaise since the early 1990s, could have been avoided by prompter monetary easing. Whoever believes in this is entitled to be bullish both on stocks and bonds.

U.S. stock prices received their lift since June/July mainly from lower oil prices and lower long-term interest rates. To keep heading higher, it will now need sufficient earnings growth. After an unusually steep rise in profits during 2005, analysts are predicting more of the same. Our focus is on aggregate profits, as calculated and reported by the Bureau of Economic Analysis within the National Income and Product Accounts (NIPA).

The customary way of making forecasts of economic developments is to extrapolate the recent past. Profit growth in the United States during the last two years has been at its best for the whole postwar period. Profits of the nonfinancial sector in 2005 have jumped to \$900.1 billion, from

\$584 billion in 2004 and \$411.8 billion in 2003. These figures compare with a profit peak of \$508.4 billion for the sector in 1997 and a profit low of \$322.0 billion in 2001.

If you look at the profit development of U.S. corporations over the last 10 years, you will see that it is an awkward picture. Profits fared very poorly during the "New Paradigm" years of the late 1990s, presumably a time of excellent economic performance. No less astounding is their sudden steep rise in the course of 2005, from \$624.2 billion in the fourth quarter of 2004 to \$1,027.7 billion in the first quarter of 2006, happening while the economy distinctly slowed.

The irony is that after a strong rise during the first half of the 1990s, profits abruptly turned down during the "New Paradigm" years of the late 1990s. For six years, from the recession year 1991-97, the nonfinancial sector's profits had soared from \$227.3 billion to \$508.4 billion. As a percentage of GDP, these profits had risen from 3.8% to 4.9%.

While "New Paradigm" ballyhoo and stock prices flourished after 1997, business profits, as officially measured, suddenly slumped. As a percentage of GDP, they were a little higher at the height of the dot-com bubble than in the recession year 1991.

Coming to the recent recovery years, we must point to some irritating observations. On the surface, it looks like a fabulous profit development. From recession year 2001 to 2005, profits of businesses in the nonfinancial sector have more than tripled, from \$322 billion to almost \$1,100 billion. It was the best profit performance of all time.

However, this good-looking total consisted of two extremely different parts. It was in the first quarter of 2004 that profits exceeded their peak of 1997 for the first time. From there, they shot up almost vertically. Typically, it has been inverse that the very first years of recovery were best for profits.

Regards,

Dr. Kurt Richebacher  
for The Daily Reckoning

Editor's Note: Dr. Richebacher has found the best investments to protect your portfolio, no matter what lies ahead for us in 2007. See his full report here:

Wealth Insurance

<http://www1.youreletters.com/t/438508/1469639/792691/578/>

Dr. Kurt Richebacher is the editor of The Richebacher Letter. Former Fed Chairman Paul Volcker once said: "Sometimes I think that the job of central bankers is to prove Kurt Richebacher wrong." A regular contributor to The Wall Street Journal, Strategic Investment and several other respected financial publications, Dr. Richebacher's insightful analysis stems from the Austrian School of economics. France's Le Figaro magazine has done a feature story on him as "the man who predicted the Asian crisis."