

## November 5, 2006 Review

### Summary

#### Credit

- In the October survey, domestic institutions reported that credit standards on commercial and industrial (“C&I”) loans to large and middle-market firms were unchanged, on net, over the past three months. On balance, however, domestic respondents indicated that they had **further eased terms** on C&I loans to such firms over the same period. Almost one-third of respondents—a somewhat smaller net fraction than in the July survey— noted that they had trimmed spreads of loan rates over their cost of funds over the past three months, while nearly one-fifth of banks—about the same net percentage as in the previous survey—reported that they had reduced the costs of credit lines. About 15 percent of domestic respondents, on net, indicated that they had eased loan covenants. Demand for C&I loans at domestic institutions was reportedly little changed in the October survey, while **demand for commercial real estate loans at these institutions weakened** over the past three months. **Demand for residential mortgage loans weakened further** in the October survey: Sixty percent of domestic institutions—roughly the same net fraction as in the July survey—noted that demand for such loans had weakened over the previous three months.. Standards and terms on credit card and non-credit-card consumer loans were also little changed, but a considerable net fraction of domestic institutions indicated that they had experienced **weaker demand for consumer loans over the previous three months**. 10/30 Fed October survey of senior loan officers.  
<http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200610/default.htm>
- MasterCard Inc said third-quarter profit topped analyst estimates as cardholders increased spending. The amount of money charged using the company's cards increased 15 percent to \$502 billion. Consumer credit in the U.S. grew at a 2.6 percent annual rate in August, according to Federal Reserve statistics, and a drop in gasoline prices since then has spurred cardholders to spend more on clothing, furniture and computers. 11/1 Bloomberg <http://www.bloomberg.com/apps/news?pid=20601087&sid=a21ycUWwvqb8&refer=home>

#### Commodities

#### Currency

- Last week's markets unabashedly sold the US Dollar against all major currencies. The immediate reaction was so acute that major price feeds actually showed the Euro gap over 70 pips in less than 3 minutes. This is almost unheard of in one of the most liquid markets in the world. The result clearly showed that risks continued to remain to the upside for the EUR/USD, as previously hesitant traders sought reasons to sell the greenback off its recent highs. An unfavorable FMOC report coupled with the lower than expected durable goods report helped put a large dent in US Dollar. (10/30) Expresstrade free daily email. <http://view.exacttarget.com/?ffcb10-fe8413797c62067f7d-fdf5157374610d7b73167373-eff1670706306>

- SAFE, the China government unit that has holdings of U.S. dollar based assets exceeds \$1 TRILLION, or 40% of the GDP. (10/30) DR

## Derivatives

- The independent research and advisory firm focused on the impact of technology and regulation on the financial industry for its report: 'Trends in OTC Equity Derivatives.' According to the report, the extended length of time required to confirm OTC equity derivatives transactions is causing concerns among market participants and regulators in many countries. And many of the delays, which can last for weeks and even months, largely stem from the very complex legal documentation required. The Aite Group study is one of the first to analyze trends shaping the OTC equity derivatives market and the challenges it faces in bringing greater efficiency to the market place. **High Error Rates** Increased attention from regulators such as the Federal Reserve Bank of NY and the Financial Services Authority (FSA) and the findings of this report could bring greater focus among market participants to improve their operational practices. The current manually based, paper-intensive environment is fraught with excess operational risk for market participants, the Aite report noted. **Other observations are that: about one trade in five is subject to some type of processing or trade capture error**, based on figures provided by ISDA; because of these error rates, a large number of trades have to be rebooked. The need to rebook stems from improperly entered trades in a bank's or client's system. **Rebooking is quite an issue, as it means incorrect data has been entered into trading, risk and accounting systems, and it has yielded inaccurate risk and exposure profiles; as a conservative estimate, approximately USD 400 billion in notional trade amounts initiated between June 2005 and June 2006 had some type of error or was rebooked** Thu, 02 Nov 2006 *Rapid growth in the global over-the-counter (OTC) equity derivatives market is being constrained by absence of adequate infrastructure and automation, according to a report released by the Aite Group.*  
[http://www.hedgeweek.com/articles/detail.jsp?content\\_id=37839](http://www.hedgeweek.com/articles/detail.jsp?content_id=37839)
- SAN FRANCISCO (MarketWatch) -- **Hedge funds that don't have much experience in the field may be using credit derivatives "inappropriately,"** industry advisory firm Hennessee Group LLC said on Monday. Credit-default swaps, or CDS, are derivatives that provide insurance against a company going bankrupt. Investors pay an annual spread, or premium, in return for the promise of a payment in the event of bankruptcy or a similar credit event. **As the creditworthiness of companies change, the cost of this insurance fluctuates.** CDS are a common investment and trading tool of credit hedge funds, which have used the derivatives effectively over the past five years, Hennessee, which tracks manager performance, said. However, equity hedge funds have begun trading CDS more during the past year too, making Hennessee concerned **that managers who are inexperienced in derivatives markets may be using them in inappropriate ways**, the firm explained. Equity funds have been using CDS in several ways. Instead of being used as a speculative investment, CDS have often been purchased to hedge portfolios of other securities that funds currently own, Hennessee said. Some managers purchase CDS on corporate bonds designed to profit from a widening in corporate credit spreads. Others buy CDS on sub-prime, mortgage-backed, fixed-income securities and indexes as a way to profit from deterioration in credit quality among mortgage borrowers. "While there doesn't appear to be any imminent risks to the credit markets caused by hedge funds, **we are concerned about the use of these instruments by funds that are not well-versed**

**in how these markets trade and the dynamics of counter-party risk,"** Charles Gradante, managing principal of Hennessee, said in a statement. Hedge funds' use of credit derivatives a concern Inexperienced managers may be using CDS 'inappropriately,' Hennessee says *By Alistair Barr, MarketWatch Last Update: 3:40 PM ET Oct 30, 2006*  
<http://www.marketwatch.com/News/Story/Story.aspx?guid=%7B00A24926%2DB281%2D4B50%2DB257%2DF8AE13DFAA5D%7D&dist=rss&siteid=mktw>

## Housing

- But while analysts and economic eminences see a trough, data reports point to more gloom ahead. In the third quarter, the biggest drop in homebuilding investment since 1991 slowed economic growth to its worst pace in more than three years, an Oct. 27 report showed. New home sales rose in September, but the median price of a new home fell by nearly 10% in the biggest one-year drop since 1970, according to the Census Bureau on Oct. 26 Real-estate softness could have potentially wide-ranging effects on the economy. **"A seemingly minor dislocation originating in the housing sector, such as a higher rate of foreclosures, might cascade through the rest of the economy in unforeseen ways—for example, in a collapse in bank earnings or a hiccup in the huge market for securities that back residential mortgages,"** observes Jeffrey Knight, chief investment officer of global asset allocation at Putnam Investments (MMC), in his most recent market outlook. **The Economy's Housing Problem Weak third-quarter GDP numbers came courtesy of the housing slump. Is a real estate-led recession far behind? By Marc Hogan (10/30)**  
[http://www.businessweek.com/investing/content/oct2006/pi20061030\\_077497.htm?chan=investing\\_investing+main](http://www.businessweek.com/investing/content/oct2006/pi20061030_077497.htm?chan=investing_investing+main)

## Housing Finance

- **U.S. homeowners took cash out of their homes in Q3 at the highest rate in 16 years,** spurred by high costs on other types of loans, according to FREDDIE MAC. **In the quarter, 89% of Freddie Mac-owned loans that refinanced got mortgages that were at least 5% higher than the original balances.** The share was up from 88% in the prior quarter and the highest since 91% in Q2 of 1990. "High demand for cash extraction through refinance is being driven by the high cost of home improvement loans and home-equity lines of credit -- that is, the cost of alternative financing -- and still-strong demand for home improvements," Amy Crews Cutts, Freddie Mac deputy chief economist, said in a release. Also, a huge wave of adjustable-rate mortgages (ARMs) created in the past few years are facing their first reset, giving borrowers an incentive to refinance and take added cash, Freddie Mac said. (Reuters 10:32 AM ET 11/01/2006)  
<http://q1.schwab.com/s/r?l=248&a=1280495&m=1006245492fb405007393a&s=r b061101>
- "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. That means loan and title documents aren't scrutinized as carefully as they might be, and courts - many of them so low-tech they resemble Mayberry - can't keep up with the volume of paper. "Then there's the mad rush to sell, particularly by people who paid high prices for homes and suddenly can't afford the mortgages. The Forbes article tells the story of a pair of thieves, known as the Bonnie and Clyde of mortgage fraud. The two would forge documents and steal identities in order to borrow money to buy houses - and then disappear with the cash. Why the lenders would do such a thing is a bit of a mystery. And why all the money didn't have to clear through the respective lawyers at closing is also a bit of a mystery. As near as we can tell, today, a borrower can show up at settlement, present a phony drivers license, and walk away with hundreds of thousands of dollars. "Hell, one of the owners of a bank was in my office the other day, and he told me that as long as the borrower makes his first mortgage payment and the bank sells the loan to his secondary investors before the loan goes into foreclosure, he really doesn't give a crap whether the loans contain fraudulent documents or not." (11/1) DR free daily email <http://www1.youreletters.com/t/431473/1469639/776133/0/>

- Nov. 1 (Bloomberg) -- Mortgage applications in the U.S. fell last week as home purchases dropped to the lowest level in three years, extending the real estate slump that began in late 2005. The Mortgage Bankers Association's index of applications to buy a home or refinance an existing loan declined 3 percent to 570.8 in the week ended Oct. 27 from 588.6. The group's gauge of purchases fell 1.8 percent to 375.6, the lowest since the week ended Nov. 7, 2003. Also, fewer homeowners refinanced. The report suggests few signs of an end to the malaise in housing, which left economic growth limping last quarter at its weakest pace in more than three years. Melville, New York-based American Home Mortgage Investment Corp.'s portfolio of non-performing loans doubled in the third quarter, from the second quarter, a percentage change that chief executive officer Michael Strauss called "alarming." Strauss said on an Oct. 26 conference call that "it seems likely that credit loss expense will increase due to weakness in the national housing market and seasoning of our loan portfolio." Applications for one-year adjustable rate mortgages accounted for 25.9 percent of the total demand measured last week, down from 26.1 percent and the lowest since Sept. 8. **U.S. MBA's Mortgage Applications Index Declined 3%. (11/1) Bloomberg**  
<http://www.bloomberg.com/apps/news?pid=20601068&sid=aWq71tP5PlrM&refer=economy>
- Abbey, Britain's second largest mortgage lender, has become the first major bank to lend first-time buyers five times their salary to climb onto the property ladder. Malcolm Hurlston, chief executive of the Consumer Credit Counselling Service, told the BBC today that **Abbey's announcement was risky news for borrowers.** "For some people this is going to look like an answer to their prayers but it risks taking them into dangerous territory," he said. "If their salaries do not go up in the way they think, then they are

going to be very stretched." (11/1) Abbey offers five-times salary mortgages By Miranda McLachlan <http://business.timesonline.co.uk/article/0,,9553-2432102,00.html>

- According to their 3Q 2006 U.S. Foreclosure Market Report released today, RealtyTrac reported that 318,355 properties entered some stage of foreclosure nationwide, an increase of 17 percent from the previous quarter and a 43 percent increase from the third quarter in 2005. "What our third quarter research appears to be showing is that the first wave of adjustable rate mortgages is having a negative impact on the number of homes going into foreclosure," said Saccacio chief executive officer of RealtyTrac. "With the volume of these loans--more than \$1 trillion of them due to adjust over the next 15 months--this is a trend that definitely bears watching." RealtyTrac's quarterly U.S. Foreclosure Market Report provides the total number of homes entering some stage of foreclosure nationwide and by state. The total number for each month includes properties in all three phases of foreclosure: Pre-foreclosures--Notice of Default (NOD), and Lis Pendens (LIS); Foreclosures--Notice of Trustee Sale and Notice of Foreclosure Sale (NTS and NFS); and REO properties. RealtyTrac: **Nat'l Foreclosures Up 17 Percent in 3Q** Jacqueline Gilbert | 10.30.06 [http://www.dsnews.com/view\\_story.cfm?id=571](http://www.dsnews.com/view_story.cfm?id=571)

## Macro Economic

- Just like last month, the Labor Department reported a disappointing headline non-farm payrolls number, but revised up sharply the previous month's figure. Non-farm payrolls for October rose by 92,000 jobs, below the average trade estimate of a gain of 125,000 jobs. However, September's payrolls were revised to 148,000 jobs, up sharply from the initial estimate of 51,000 jobs. August figures jumped to 230,000 from a revised 188,000 announced last month. The higher revisions helped lower the unemployment rate to 4.4% -- the lowest reading since 2001. Average hourly earnings rose 6 cents to \$16.91, or a 0.4% rise. (11/3) Xpresstrade <http://view.exacttarget.com/?ffcb10-fe8a1c70726c067a70-fdf6157374610d7b73157676-feff1670706306>
- unit labor costs -- a key gauge for measuring inflationary pressures stemming from a tight labor market -- increased at an annualized rate of 3.8%. Over the past year, productivity increased 1.3%, the slowest growth since 1997. Unit labor costs are up 5.3% in the past year, the fastest increase in 16 years. The last time unit labor costs increased faster was in 1982. (11/2) <http://www.bls.gov/lpc/>
- The print of 327,000 initial jobless claims changed the trend in claims to UP--in other words, yet another sign of economic slowdown. (11/2) Buzz and Bits <http://www.minyanville.com/articles/index.php?a=11554>
- Three major indicators with strong track records are signaling it's time to sell stocks. Here's how they work and why investors should worry. The **Dow Jones Industrial Average (\$INDU)** is setting records just about every day. The **S&P 500 Index (\$INX)** has advanced 12% in less than five months. Technology stocks are up about 14% since midsummer. The giddy stock bulls may be in for a nasty surprise. They're ignoring three trusty stock-market indicators -- with great records for predicting corrections -- that currently are saying it's time to get out of equities. The signals are closely watched by market technicians on the lookout for hints that the bull run is getting tired. **The stock-bond trade-off** Money managers chiefly put money in two assets: stocks and bonds. One way of deciding whether stocks are expensive is by comparing their performance to that of bonds. If bonds lag while stocks advance, according to some market watchers, fund

managers will be more likely to sell stocks and buy bonds. But how do you compare the prices of stocks to bonds? Jason Goepfert of [SentimenTrader.com](#) looks at the performance of the largest bond and stock indexes as they are embodied by two exchange-traded mutual funds -- the **Standard & Poor's Depository Receipts (SPY, news, msgs)**, which tracks the S&P 500 Index, and the **iShares Lehman 20+ Year Treasury Bond Fund (TLT, news, msgs)**, which tracks 20-year government bonds. (For data that predates the funds, he compares the S&P 500 with the 10-year Treasury bond.) To compare them, Goepfert contrasts the current ratio of the SPY to the TLT with the average ratio over the past three months. Since the ratio typically doesn't change much in 90 days, the two values should be about the same. Now, though, with the recent rally in stocks, there's a big gap. The current ratio has moved up to 1.58, compared with an average of 1.5 over the past 90 days. That may not sound like much. But since the ratio usually stays fairly constant in any 90-day period, this is a huge move compared with what normally happens. The difference between the current gap and the 90-day average is at a level seen only 1% of the time. (For you statistical wonks, the indexes are now more than three standard deviations away from the norm). "Stocks are rarely as overvalued to bonds as they are now," says Goepfert. In the three months after such an extreme reading, the performance of the S&P 500 has ranged from a loss of 8.7% to a gain of just 1.7%. That's a bad outlook for the bulls. It gets worse: This indicator has called two of the biggest market declines in the past decade. It flashed red just before the big correction that started in March 2000, signaling the end of the technology bubble. By the end of 2002, the S&P 500 had fallen more than 45%. (On the upside, this model said buy in mid-2002, just before the start of the current bull rally.) On July 17, 1998, the model said sell just before a dramatic crash that took the S&P 500 down 19% in the next month and a half. On Aug. 31 that year, the model said buy just before a September rally that took the market up 11% in a month. **Cash-strapped mutual funds** Mutual funds are allowed to hold cash instead of stocks or bonds. How much cash they have on hand is often a good signal of where the market is heading. If they have a lot of cash, it means there's still a lot of money left to go into stocks. When cash levels are low, it means there's less money on the sidelines to drive stocks higher. It also means that if retail investors get scared and sell their fund shares, fund managers will have to sell stock to meet redemptions, driving stock prices lower. As of the end of August, U.S. equity mutual funds had 4.4% of their assets in cash, according to the Investment Company Institute. Goepfert adjusts this number for how much cash they should have on hand given the current level of interest rates. Even though interest rates are relatively low, Goepfert figures that funds should have a 7% cash position, according to historical trends. This means funds have 2.5% less cash than they "should" have, given the level of short-term interest rates. This is another historic extreme. Since 1950, whenever cash shortfalls hit these lows, the S&P 500 has fallen 69% of the time with an average decline of 4%. Ominously, the last two times cash levels were this low, bad things happened to stocks. Cash levels hit these lows in early 2000 just ahead of the last big bear market. Cash also hit current levels in early 1981 just before a two-year market slump. **The smart money is bearish** Investors, of course, always want to know what the "smart money" is doing. To figure this out, Goepfert turns to the Commodity Futures Trading Commission. First, a primer on futures contracts. Traders who own futures contracts on a stock index like the S&P 500 have purchased the S&P 500 stocks at a price agreed upon now, for

delivery at some point in the future. Usually these contracts are settled in cash, without delivery of the underlying stocks. To keep track of the futures markets, the CFTC makes brokers report client positions. The CFTC designates the biggest traders -- those holding more than 1,000 S&P 500 futures contracts -- as "commercial" traders. They only make the grade if they hold those futures contracts as a part of a hedge to protect against losses in underlying investment positions. Goepfert considers these commercial traders to be the "smart money." (The other two categories are big speculators, who hold 1,000 or more S&P 500 futures contracts that aren't part of a hedged position, and small speculators, who hold less than 1,000 contracts.) Right now, commercial traders have a \$30 billion net short position in futures on the S&P 500, the Dow Jones Industrial Average and the **Nasdaq Composite Index (\$COMPX)**. Going short is a bet against the market. Traders go short by borrowing securities and selling them, hoping they will be able to replace them later at a cheaper price after a market decline. This is only the third time in recent history that this short position has been so large. The other two times were early 2001, just before the S&P 500 tumbled 38%, and November 2004, after which the market rose some more and then corrected in early 2005. **3 signs that a stock crash is**

**coming** Michael Brush

<http://articles.moneycentral.msn.com/Common/Contributors.aspx#Brush>

- Construction spending in September 2006 declined 0.3%, to \$1,195.9 billion, 2.9% above September 2005. (11/1) Bureau of Economic Analysis  
<http://www.economicindicators.gov>
- Walker, head of the Government Accountability Office, an investigative arm of Congress that audits and evaluates the performance of the federal government, warns that, if the United States government conducts business as usual over the next few decades, a national debt that is already \$8.5 trillion could reach \$46 trillion or more, adjusted for inflation. And every year that nothing is done about it, Walker says, the problem grows by \$2 trillion to \$3 trillion. **America's consumers have as much of a borrowing problem as their government does, so higher rates could moderate overconsumption and encourage consumer saving.** But a big jump in interest rates could cause economic catastrophe. Some economists even predict the government would resort to printing money to pay off its debt, a risky strategy that could lead to runaway inflation. **GAO chief warns economic disaster looms** By MATT CRENSON, AP National Writer Sat Oct 28, 6:54 PM ET  
[http://news.yahoo.com/s/ap/20061028/ap\\_on\\_go\\_ot/america\\_the\\_bankrupt&printer=1](http://news.yahoo.com/s/ap/20061028/ap_on_go_ot/america_the_bankrupt&printer=1)
- **WASHINGTON** — The nation's manufacturing sector expanded at its slowest clip in more than three years in October, a trade group said Wednesday. Economists said housing sector weakness is a big reason for the slowdown. The Institute for Supply Management, based in Tempe, Ariz., said its manufacturing index registered 51.2 in October, below September's reading of 52.9. It was the index's lowest level since June 2003 and reflected persistently high raw material prices and a decline in new orders, according to data provided by purchasing and supply executives. (11/1) <http://ap-261.newsvine.com/>
- Oct. 30 (Bloomberg) -- The rally that sent the Dow Jones Industrial Average to a record and the Standard & Poor's 500 Index to the highest since 2000 may end, according to some analysts who use price charts to make investment decisions. **Stocks rose too far and too fast, based on so-called relative strength indexes**, before slumping at the end

of last week. The indicators peaked at their highest readings for the Dow industrials and S&P 500 in almost a decade. Another gauge, based on comparing an index with its average close for the previous 200 trading days, showed the S&P 500 rose above a level that preceded a slump at the start of 2005. Optimism about stocks is the highest since the first quarter, according to a poll by UBS AG and the Gallup Organization released last week. "You're near the end of the move higher," said Philip Roth, chief technical market analyst at Miller Tabak & Co. in New York. **A market decline of as much as 20 percent is imminent, he said. "It could start any time."** Stocks in U.S. May Have Further to Fall, Chart Watchers Say By Nick Baker 10/30

<http://www.bloomberg.com/apps/news?pid=20601084&sid=anMfgKMHCrRU&refer=stocks>

- NEW YORK (MarketWatch) -- Nouriel Roubini might be among the most bearish economists on Wall Street this year, but as shown again on Friday with the release of much weaker-than-expected third-quarter growth numbers, he's also been among the most accurate. That fact may be chilling, given that Roubini, a professor at the Stern School of Business at New York University and chairman of Roubini Global Economics, **predicts a housing-led recession will be in place by the first quarter of 2007, or in the second quarter at the latest. Few on Wall Street dare make that prediction.** Economists employed by investment banks, of course, may have an implicit interest in being cheerleaders for economic growth. Growth implies earnings growth and stock market gains, and therefore more money for their firms. Investors won't be drawn to the stock market if they know a recession is coming. Federal Reserve officials, likewise, continue to predict a soft-landing for the economy even as they again left interest rates unchanged on Wednesday. Yet, the facts remain that **Roubini's forecasts are amongst the most accurate - and prescient -- so far.** Third-quarter gross domestic production slowed dramatically to 1.6% in the third quarter from 2.6% in the second quarter and 5.6% in the first, the Commerce Department reported Friday. **Roubini had forecast the GDP to come in at 1.5%, while the average forecast of economists polled by MarketWatch called for growth of 2%, as did most other surveys. And Roubini had been predicting this number since July, while at that time, economists on average expected third-quarter growth to come in at 3.1%.** Similarly, for the second quarter, economists on average had expected the GDP to grow at 3.2%, while growth came in at 2.6%. Roubini had forecast growth of 2.5% **Roubini's call for a recession sounds more real now** **Analysis: Slow growth could get slower** By MarketWatch Last Update: 4:43 PM ET Oct 27, 2006  
<http://www.marketwatch.com/news/story/Story.aspx?guid=%7B35B0E4D8%2D4B35%2D4764%2D8EB4%2D56C7281CC8D7%7D&siteid&print=true&dist=printTop>

## Retail

- NEW YORK (MarketWatch) -- The majority of the nation's retailers posted disappointing October sales Thursday, as a surge in shopping in September and tough year-ago comparisons more than offset cooler weather and lower gasoline prices. "October results were clearly weak," said Ken Perkins, president of research firm RetailMetrics LLC. "It looks like consumers took a bit of a breather. Given the robust sales in September, we believe that siphoned off results from October." Retailers miss the mark on October sales Wal-Mart weighs on results; department stores stage a

comeback By *Dan Burrows*, *MarketWatch* Last Update: 4:29 PM ET Nov 2, 2006  
<http://www.marketwatch.com/news/story/Story.aspx?guid=%7BEDCE8745%2DC467%2D4692%2D8604%2DDDB5D9105359A%7D&siteid=&print=true&dist=printTop>

### Savings Rate

- Personal savings - September was a negative .2% (\$15 billion) vs. negative .5% (\$49 billion) in August. Negative personal savings reflects personal outlays that exceed disposable income. Negative savings reflect outlays financed by borrowing, sales of assets or depletion of savings from prior periods. **Personal expenditures on services have increased by 14.5% from 2004 to the annualized Q3 2006 rate (4.8T to 5.5T). Personal Interest payments (nonmortgage interest paid by households) have increased by 23% from 2004 to the annualized Q3 2006 rate (186B to 230B). During that period of time, personal disposable income has increased 4.7%(8.0T to 8.4T)** Commerce Department - Bureau of Economic Analysis 10/30 release. MJK calculations from data. <http://www.economicindicators.gov>.

### Tech

- The world's top chip makers have trimmed their sales growth forecast for the global chip market for 2006 and 2007. The global semiconductor market is now expected to grow by 8.5% to \$247 billion in 2006, according to World Semiconductor Trade Statistics, which groups the world's main semiconductor manufacturers. In May it still expected growth of 10.1%. The WSTS group also trimmed its 2007 growth estimate for the worldwide semiconductor market to 8.6% from an earlier expectation of 11% growth. For 2008 it sees 12.1% growth, it added in its bi-annual market forecast. (Reuters 05:38 AM ET 10/31/2006)  
<http://q1.schwab.com/s/r?l=248&a=1279515&m=100624547de9100007285a&s=rb061031>

### Wall Street

- \*\*\* "After a short pause in May and June, **we have seen the return of aggressive risk-taking in financial markets this autumn**," Bank of England Deputy Governor John Gieve said in an October 17th speech to hedge fund managers in London. **"There must be a danger that risk models are giving too much weight to the low volatility of recent times."** Hedge funds are not doing well. They're up only 7.6% this year. When you consider that the typical hedge fund charges 2% just for managing the money, the results are not very exciting, especially when you consider you can get 5.3% risk-free. And if you'd just put your money in Morgan Stanley's world equity index tracker fund, if there is such a thing, you would be up 13% - with almost no fee. What are the poor fund managers to do? Exactly what we warned about in these pages...and exactly what Mr. Grieve is now warning about: take on extra risk. Seven percent returns are about what you should expect. There are so many hedge funds; their overall, net rate of return is bound to regress to the level of the general market - minus their high fees. But it doesn't make sense for investors to put their money in hedge funds if they only get the same thing they'd get from the market itself. So, the hedge fund manager has to increase his rate of return or he will lose his customers. What does he do? **He uses more leverage**

**and takes riskier bets. He knows that many of them will go bad...and his customers will lose money. But if he doesn't take the chance he'll lose his customers anyway! Expect more spectacular losses in the hedge fund industry.** (11/3) DR

- October 31, 2006 -- A \$5 billion New York hedge fund has found itself in hot water with its clients over charges that one of its executives engaged in questionable use of the hefty fees investors paid to it. D.B. Zwirn & Co., which makes its home on Fifth Avenue, held a series of conference calls with key investors over the past weekend to address the issue of its internal financial controls, The Post has learned. An individual familiar with the calls told The Post that Zwirn discussed how **a former finance executive with the fund inappropriately expensed 'items' " to its investors over a number of years.** He would not provide examples of what "items" investors were charged for. Another source familiar with the calls said there was a lot of discussion of "whether these internal accounting problems extended further to issues that directly affected client capital," such as valuation of its holdings and allocation of its investors' money 10/31 NYPost Hedge Loot Riddle by Roddy Boyd  
[http://www.nypost.com/php/pfriendly/print.php?url=http://www.nypost.com/seven/10312006/business/hedge\\_loot\\_riddle\\_business\\_rodny\\_boyd.htm](http://www.nypost.com/php/pfriendly/print.php?url=http://www.nypost.com/seven/10312006/business/hedge_loot_riddle_business_rodny_boyd.htm)
- In January, three private-equity firms bought Hertz from Ford, paying \$2.3 billion. They're already selling, dumping 28% of the company on the public. But... before they let the public in on the deal, they will have taken \$1.43 billion out of the company, roughly 60% of what they paid for it, less than a year ago. Guess who's selling this deal to the public? Merrill Lynch. Guess who was one of the three private-equity investors? Merrill Lynch. Guess who arranged the first billion-dollar loan? Merrill Lynch. (11/1) The S & A Digest [www.stansberryresearch.com](http://www.stansberryresearch.com)
- JPMORGAN CHASE & CO. said one of its mutual funds units had received a letter from the U.S. SEC as part of its probe whether kickbacks were paid to some fund administrators. JPMorgan is the largest yet to be contacted by the SEC as part of a probe into whether mutual fund management groups, many of them owned by banks, took improper payments from outside contractors hired to handle fund marketing and other administrative details for them. In JPMorgan's case, the markets watchdog is seeking information about services provided to funds of Bank One Corp., now part of JP Morgan, by BISYS FUND SERVICES. **A unit of Bisys in September agreed to pay \$21.4 million to settle SEC fraud charges** that it had done improper payment deals with 27 fund families from July 1999 to June 2004. (Reuters 06:48 PM ET 10/27/2006)  
<http://q1.schwab.com/s/r?l=248&a=1278662&m=1006245468dca05007379a&s=rb061027>
- Morgan Stanley has bought a stake in Avenue Capital, one of the world's biggest hedge fund groups and a specialist in distressed debt trading. The investment bank becomes the latest full-service investment bank to increase its hedge fund exposure. The deal highlights the trend of big banks buying or taking stakes in hedge fund groups **in spite of a recent run of high-profile failures and a decline in performance from the sector.** Morgan Stanley's aggressive push comes as John Mack, chief executive, seeks to address the bank's weakness in hedge funds and bolster its underperforming asset management business. Analysts say banks remain eager to get involved in hedge funds because big pension funds, endowments and other investors continue to pour money into the asset

class. In addition, hedge fund managers are able to charge fees of 1-2 per cent of assets and 20 per cent of gains, sometimes more, **offering attractive profit margins for banks.** (10/31) <http://msnbc.msn.com/id/15486509/>

- NEW YORK -(Dow Jones)- A senior Republican legislator said Monday that minimum investment requirements in hedge fund of funds should be raised to protect unsophisticated investors. "**When the sharks start feeding on minnows you're in trouble,**" the chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises warned. "The size of the minnow population has expanded dramatically." "How much more negligent can you be than to say, 'We put pensioners in these funds and we didn't understand what the funds were doing?' " he said after his formal talk. -By Jed Horowitz, Dow Jones Newswires; 201-938-4047  
<http://www.nasdaq.com/aspxcontent/NewsStory.aspx?cpath=20061030%5cACQDJON200610301023DOWJONESDJONLINE000431.htm&>

## History, Profit Outlook Threaten to End U.S. Stocks Bull Market

By Daniel Hauck

Nov. 1 (Bloomberg) -- The four-year bull market that pushed the Dow Jones Industrial Average to a record last month may be near its end, if history and profit estimates are any guide.

The rally that began in October 2002 is now the second- longest since World War II and has lasted 89 percent longer than average, according to Ned Davis Research Inc. A streak of quarterly earnings growth above 10 percent for Standard & Poor's 500 Index companies that has supported the gains may end in 2007, analyst estimates from Thomson Financial show.

"The market is too complacent," said Abhijit Chakraborti, global equity strategist at JPMorgan in New York. "As you start getting into the deceleration in earnings growth, our view is that the market is going to give back some of its gains." The S&P 500 will drop 7.1 percent by year-end, he says.

Last month the 30-stock Dow average climbed above 12,000 for the first time as earnings reports showed that analysts had cut profit estimates too much. The S&P 500 rose to a level not seen since November 2000. Stocks such as Goodyear Tire & Rubber Co. got a lift from a retreat in oil prices, which eased concern that consumer spending will slow down, and the Federal Reserve's decision to keep interest rates steady after earlier increases.

"Investors seem to be playing this as if we're on the verge of another economic and market upswing," said Brett Gallagher, co-head of global equities at Julius Baer Investment Management in New York, which oversees about \$42 billion. "I don't necessarily think that what the market is implying is the most likely outcome."

Bear-Market Low

Last month's highs for the Dow industrials and the S&P 500 occurred 1,478 days after the bear-market low set on Oct. 9, 2002. Since 1945, there have been 18 previous bull markets, lasting 781 days on average, according to Venice, Florida-based Ned Davis Research.

The firm, whose more than 1,000 clients include investment firms such as Morgan Stanley, defines a bull market as a gain of 13 percent or more in the Dow average that lasts more than 155 days, or a 30 percent rise after 50 days. A bear market consists of a 30 percent drop in 50 days, or a 13 percent drop after 145 days.

The longest bull market occurred from October 1990 to July 1998, a period of 2,836 days. Markets then plunged as Russia devalued its currency and defaulted on its debt, and hedge fund Long-Term Capital Management LP began to collapse.

Both the Dow and the S&P 500 have added 13 percent since June 13, when the S&P 500 reached its 2006 low. Those gains are consistent with what Ned Davis describes as the "blow-off" rallies that often occur in the last phase of bull markets.

#### 'Blow-off'

The median gain in 21 "blow-offs" since 1901 was 14 percent, usually over three to four months. They typically featured "divergences" such as the ratio of advancing stocks to declining shares failing to make a new high, or "excessive" optimism. Divergences exist in the current rally, while the second condition doesn't, according to Ned Davis.

"You never really know these things until after the fact," said Ed Clissold, senior global analyst at Ned Davis, referring to whether the current advance is a "blow-off" or just the latest leg in the bull market. "But it's something that we're throwing out there as a potential thing to look at."

Data from Thomson and Birinyi Associates Inc. suggests that stocks may soon find less support from corporate earnings.

Profit at S&P 500 companies will climb 8.4 percent in the first three months of 2007, according to the average analyst estimate compiled by Thomson. That would snap 14 quarters of at least 10 percent growth, the longest streak since 1950, if analyst predictions of 10.6 percent expansion in the October-to- December period hold true.

#### Earnings Estimates

Forecasts released during the third-quarter reporting season suggest the slowdown may be under way. Only 8 percent of S&P 500 companies as of Oct. 27 raised their estimates, the lowest since the start of 2005, according to Birinyi, a Westport, Connecticut-based money management and research firm.

Still, any decline may wait until the new year. The S&P 500 has posted fourth-quarter gains in 10 of the past 11 years, with the exception being 2000.

That seasonal tendency may help support stocks in the rest of 2006, according to Jeffrey Hirsch, editor in chief of the Stock Trader's Almanac.

#### 'Driving Force'

"I'm not sure that the length of this bull market is the driving force of what's going on right now," said Hirsch, president of the Hirsch Organization in Nyack, New York. "There's a decent mix of good and bad news and that's the type of thing where a market can keep moving higher."

Hirsch cited tame inflation data that encouraged the Fed to halt its series of 17 straight interest-rate increases as one positive for equities.

Bearish forecasters such as Chakrabortti also have underestimated the market's strength before. At the start of the year he predicted an almost 10 percent drop in the S&P 500. The index is up 10 percent for the year.

The end to the central bank's two-year campaign of higher borrowing costs, along with oil's slide from a July record, has spurred optimism that the economy and corporate profits will hold up even as the housing market slows.

Still, data from Ned Davis suggests that the impact of the Fed's rate increases may not yet be reflected in earnings results. In 13 instances since 1929, average profit growth for S&P 500 companies slowed to 8.9 percent six months after the last rate increase. A year after the final rate boost, earnings contracted 4.6 percent.

The economy grew at a 1.6 percent annual rate in the third quarter, the slowest in three years, while the median price of a new U.S. home fell 9.7 percent in September, the most since 1970.

"Usually, bull markets end with maybe not necessarily a recession, although often they do, but some sort of economic slowdown and then coinciding with that, a profit slowdown," Ned Davis's Clissold said.

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