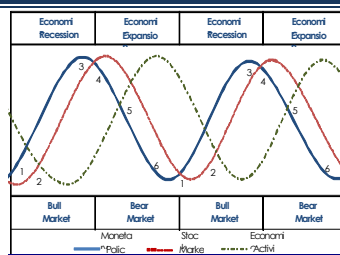


The Financial Commentator

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A GUIDE TO
FEDERAL RESERVE
MONETARY POLICY,
THE ECONOMY, AND
FINANCIAL MARKETS
ANNUAL SUBSCRIPTION: \$144.00

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HAPPY THANKSGIVING - I hope you are able to be with family and friends during Thanksgiving. Tough times remind us what we are most thankful for.

In the December 16, 2007 letter I wrote, “*Despite the rate cuts by the Federal Reserve and other attempts to contain the credit market tsunami, **the economic engine of growth, credit creation, has stalled.** In the last 25 years, banks have made a concerted effort to move as much lending as possible off their balance sheets, thus empowering the role of the market place to create credit. As the market place has supplied a greater proportion of credit creation to finance growth for our economy, the Federal Reserve’s capability to manage the credit creation engine has diminished. Although the Fed can still change bank reserve requirements and total bank reserves, the pass through effect on total credit creation is less than in the past, since the impact on the market’s capability to create credit is hardly affected. The reduced capacity to create credit by banks and the market place is going to hurt economic growth in coming quarters. Since the nature of this crisis is different, the Fed’s ability to contain it is less than it has been in prior crises. The Fed can’t improve the liquidity of the asset-backed commercial paper market by lowering the Discount or Federal Funds rate. The Fed can’t repair the collapse of the SIV business model. The Fed can’t repair the damage done to the balance sheets of the affected large banks. The Fed can and will lower interest rates further to offset the tightening of lending standards by banks. That will help, but the magnitude of this crisis is going to take a fair amount of time to workout. Unfortunately, the economy is going to weaken further, which will expose even more credit problems, adding to the stress on banks and the credit market. If the Fed’s ability to contain this crisis is less, then its capability to be the lender of last resort is also diminished. Most investors really don’t understand the credit creation process, and as a result, don’t comprehend the scope of this crisis, or the Fed’s limited ability to deal with it. **It really is different this time.**”*

Since December 2007, the Federal Reserve and most financial analysts have failed to appreciate the magnitude of the breakdown in credit creation, and the Fed’s ability to contain it, even as it unfolded right before their eyes. In recent weeks, the Fed has begun to address the dysfunctional commercial paper market and securitization markets, with new lending facilities that should help stabilize these markets. But it will take many months to restore these markets to levels of activity that revives credit creation sufficiently to support an economic recovery. A quick review of why the credit markets have become such an integral part of credit creation over the last 15 years, and where the securitization markets are today, suggests those expecting an economic recovery in mid 2009 and a stock market bottom before year end are likely to be disappointed.

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Until twenty-five years ago, our local bank would loan money to buy a home or a car, and would hold that loan until it was paid off. ***Since the bank was holding the loan, it had a keen interest that it would be paid off.*** Back then, the total amount of loans the local bank could make was dependent on the bank's capital base, total deposits, and reserves set aside for existing loans. If a bank wanted to increase its lending volume, it had to increase deposits, usually by offering higher rates on its Certificates of Deposit, or by adding to its capital base. This arrangement gave the Federal Reserve significant leverage in determining how much credit was flowing into the economy. If inflation accelerated and the Fed wanted to slow the economy, all it had to do was increase bank reserve requirements, reduce the total reserves of the banking system, or raise interest rates. By slowing credit creation, the Fed would cause the economy to slow down. To lift the economy out of recession, the Fed would accelerate the credit creation process. They did this by lowering reserve requirements and interest rates, and through an increase in total bank reserves. As credit growth grew, so did the economy.

Over the last 15 years, the business model banks used evolved. If a bank could charge fees to make a loan, ***and then sell it to someone else***, the bank could make more loans, ***without increasing its capital base or loan reserves***. Although the bank would make less money on each loan it didn't hold onto, it could increase earnings, ***by significantly increasing loan volume***. The process of moving mortgage loans off bank balance sheets was initially facilitated by Fannie Mae in the early 1980's. Fannie Mae would buy mortgages from banks all over the country and sell them to Wall Street, which would 'securitize' them, and sell them to institutional investors. This was fairly easy to do, since lending standards were fairly strict and uniform, and most mortgages were 'conventional'.

There are many advantages to the 'securitization' of mortgages. Borrowers get lower mortgage rates, due to competition. Pension funds and insurance companies are able to increase their investment returns, since mortgage backed securities offer a higher return than Treasury bonds. The success with mortgage securitization led to the securitization of car loans, credit card receivables, and numerous other assets. This increased the flow of credit into many sectors of the economy, and has kept the economy humming. Between 1982 and 2007, the economy contracted in only 16 months, which very well may be the best 25 year period in American history. ***A growing economy generates more jobs, a higher standard of living, and a tide that lifts the fortunes of most Americans.*** In the 25 years prior to 1982, there were 64 months of recession. And, when the economy slipped into recession (1954, 1958, 1970, 1974, 1982), or the markets became unsettled (1987, 1998), the Federal Reserve had the right medicine for the ailment – lower rates and lower reserve requirements.

Securitization made it possible for banks to move more loans off their balance sheets, providing more credit to spur economic growth. ***Between 1982 and 2007, nominal annual GDP growth averaged 5.9%, while credit growth increased at an annual rate of 8.9%.*** Such stability over a long time breeds complacency, and coupled with the human tendency to project the past into the future, is why most investors are bullish at market tops. And, why investors in June 2007 expected the string of stability to last longer than it did. During 2006 and the first half of 2007, investors were willing to buy securities with very low risk premiums, like junk bonds with yields less than 3% over Treasury

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bonds. *Securitization did create vulnerability.* Since it increased a banks' dependence on the credit market to move loans off their balance sheets, ***banks need to be able to securitize their lending in order to keep credit flowing into the economy.*** Even though banks and other lenders (Fannie & Freddie, GMAC, etc.) were extraordinarily dependent on the credit market to provide financing, they assumed a never ending supply of liquidity would always be available to fund their operations. This error in judgment, regarding risk and liquidity was touched on by Alan Greenspan in 2005. *“But what investors perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.”*

Over the last ten years, financial markets have become global, more liquid, and the level of financial engineering far more complex and more leveraged. In the boom years, a conventional mortgage on a home in Fargo, North Dakota could be packaged with a sub-prime mortgage on a home in Hope, Arkansas, sliced and diced into a number of pieces (tranches), and sold to an institution in China, or a hedge fund that borrowed the money from a bank in Japan. Despite the increasing complexity of these credit securities, the rating agencies – Moody's, Standard & Poors, and Fitch Ratings – continued to provide ratings that investors around the world accepted at face value. ***The cornerstone of the ratings process was based on the fact that national housing prices in the U.S. had never declined since the 1930's Depression.*** By owning a diversified portfolio of mortgages throughout the U.S., an investor could insulate themselves from the risk of regional home price declines, which did occur in the early 1990's. With the rating agencies providing the cover of an AAA rating on hundreds of billions of sliced and diced diversified mortgage pools, investors bought everything Wall Street could produce, ***without any measure of common sense.*** More than \$2 trillion of mortgage backed securities have been sold by Wall Street. No industry strives to satisfy an insatiable appetite like Wall Street. If investors are clamoring for a product, whether it is an IPO for a technology start up, or a sliced and diced mortgage pool, Wall Street will create enough product until investors choke on it.

Whenever I am asked how we got into this mess, I explain how the long term relationship between median income and median homes prices played a significant role. Between 1965 and 2000, the median home price held around 3 times median household income. When the median annual income was \$30,000, the median home sold near \$90,000. As incomes increased, home prices appreciated accordingly, which meant homeowners' ability to pay their mortgage on time was on a firm foundation and stable. In 2000, median household income was \$42,500, and the median home price was \$140,000. From 2000 until 2006, that ratio shot up to 4.7. Although median household income had grown 13% to \$48,200 in those six years, the median home price had shot up to \$240,000 by the end of 2006, an increase of more than 70%. ***With income levels lagging so far behind home prices, and the cost of financing on the rise, the risk of a nationwide decline in median home prices had also increased markedly. But the rating agencies never incorporated this dynamic into their risk evaluations.*** Fannie Mae and Freddie Mac, banks, and mortgage brokers, all kept funding mortgages, and selling them to Wall Street for securitization. Investors simply ignored the many signs of a

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housing bubble, and just kept buying. Everyone in the credit creation and securitization process made billions of dollars, until the music stopped. With many firms using leverage of 30 to 40 to 1, it didn't take much of a drop in home prices to wipe out, or seriously impair the capital base of everyone involved.

This is why the Treasury decided to shore up the capital base of banks, by pushing \$250 billion of the TARP money into banks. Unfortunately, if the estimates of total global credit losses by the International Monetary Fund, Goldman Sachs, and Bridgewater Associates are reasonably accurate (\$1.4-\$1.6 trillion), the Treasury will have to add more capital down the road, since ***only \$700 billion of losses have been written off***. Last week, the Federal Reserve, FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision issued a statement on how banks should use TARP funds. ***“Supervisors will continue to review dividend policies of individual banking organizations and will take action when dividend policies are found to be inconsistent with sound capital and lending policies.”*** In other words, the regulators will not be happy if TARP funds are used by struggling institutions to maintain dividends. I hope they follow through, since taxpayer money should ***not*** transfer to shareholders of weak banks. But this also means that a number of high profile banks will be eliminating their dividend in coming months.

Last week, the Treasury Department stated that the plan to purchase troubled assets from banks is being put on the back burner. As Paulsen said, ***“Our assessment at this time is that this is not the most effective way to use TARP funds.”*** One of the new goals will be to revive the securitization markets through the creation of a new lending facility, potentially in conjunction with the Federal Reserve. The reason the Treasury is being forced to take this new approach is because the securitization markets remain dysfunctional. According to Dealogical Data, securitization of auto loan and credit card debt at the end of October was down 79% from October 2007. As noted in September's letter, in 2002 the auto makers could offer 0% financing, since every auto loan could be securitized. This kept assembly lines humming, and all the workers associated with the production of motor vehicles working. Today, the estimated 3 million workers associated with the auto industry face an uncertain future.

In their statement regarding dividends, the four bank regulators also urged banks to lend. ***“The agencies have directed supervisory staffs to be mindful of the effects of an excessive tightening of credit availability and to encourage banking organizations to practice economically viable and appropriate lending activities.”*** Given how prudent banks have been in practicing prudent lending policies in recent years that sounds like a university president telling a rowdy fraternity on double secret probation to throw a party. I have no doubt what the fraternity will be doing on Friday night. I just don't think most banks will lower their lending standards any time soon, with more losses to book and a hostile economic environment to weather. This means the availability of credit from banks and the credit market will remain constrained well into 2009, suggesting those forecasting/hoping for a recovery in mid 2009 are overly optimistic.

DECOUPLING

Twenty to thirty years ago, an investor could achieve meaningful diversification by allocating assets to international markets. However, as globalization advanced during the last 10 years, increased trading between countries has led to greater synchronization of the business cycle and financial market trends. In this new environment, most international markets move in the same direction, with the only differentiating factor being beta levels. While this synchronization seems like a natural progression of increased world trade, most investment professionals have not yet recognized this important change. A year ago, the dominant investment strategy touted on Wall Street was to diversify overseas, by investing in foreign markets, or buying U.S. companies with significant international sales. Since the global economy was forecast to keep on *truckin'*, while the U.S. faltered, this seemed logical.

I didn't share that view. As I noted in my October and November 2007 letters, there were cracks in the global growth story that hadn't been recognized. The European Central Bank reported in October 2007 that their third quarter survey of lending standards showed an increase from 3% to 31% in the number of banks that had increased their lending standards. This meant that banks in the E.U. were reducing the availability of credit, which was going to lead to slower economic growth by mid 2008. In addition, the European Union purchasing managers index had fallen to its lowest level in two years in October, and in Great Britain, service sector growth had dropped to a four year low. And, for the first time in almost a decade, Japan's index of leading indicators pointed to a contraction, as all 10 components worsened. In my March 2008 letter, I noted, "*The United States represents more than 27% of global GDP. The combined total of the 16 countries in the European Union comprise just over 28% of global GDP. Throw in Japan and Great Britain, and all these countries represent 71% of world GDP. China and India combined are 7.5%*" It seemed fairly straight forward that if 71% of world GDP was slowing and flirting with recession, there was no way India and China would not be impacted. In addition, the central banks in both India and China had been tightening monetary policy throughout 2007, which was going to slow their domestic economies as well.

In recent weeks, it has become painfully obvious that the United States, Great Britain, Japan, and most of the countries in the E.U. are all in recession. The contraction in credit and banking problems are just as serious in Great Britain and within the European Union, as in the U.S. The ECB and the Bank of England have cut interest rates, but they are clearly behind the curve. Excluding Japan, Asia is particularly dependent on exports, with 47% of GDP in 2007 coming from exports. With every developed country in recession, Asian economies are going to feel our pain. In China, the three engines of growth – exports, investment, and domestic consumption – have all slowed down. After five years of growth over 10%, China's growth rate has slowed for five consecutive quarters. In October, power generation declined 4% from the previous year, the most severe falloff in electricity output in a decade.

The synchronized slowdown in global growth will make it difficult for individual economies to recover, especially those dependent on exports. This is another reason why those expecting a mid

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2009 recovery are too optimistic. During the last year, U.S. exports were the one area of strength, adding around 1% of growth to each quarter. Even though exports added 1.1% to third quarter GDP, export growth slowed to 5.9% from 12.3% in the second quarter. It will slow more in coming quarters, which will deepen the recession in the U.S.

STATE BUDGETS

According to the Center for Budget and Policy Priorities, a liberal think tank, states will face a total budget gap of \$100 billion by 2010, or about 15% of their budgets. California, due to falling home values, and New York, because of its reliance on financial services, are facing the largest short falls. In California, republican Governor Schwarzenegger has proposed a 1.5% increase in the sales tax. In New York, democratic Governor Patterson has proposed cuts in Medicaid and education. He has said, *“The higher we tax even the wealthy, the more we lose population and less job creation there is.”*

As states deal with their budget shortfalls, they will be forced to raise taxes and fees, which will hurt local economies. They will also be forced to cut services, which will lead to marches on state capitals in the next two years, as citizens demand government do more to help them. After almost 25 years of uninterrupted economic growth, this recession is going to feel like a depression.

DETROIT BAILOUT

A couple of years ago, I remember reading that global capacity to build cars and trucks was 80 million units, versus demand of 60 million. With China building more cars, and demand falling worldwide, there is *at least 30% excess capacity in the global auto business*. In this environment, the lowest cost producer survives, and everyone else fights for survival. This is more important than product mix, and, unfortunately, Detroit is not the lowest cost producer. And cutting costs exacts a price.

STOCK MARKET

Last month I wrote, *“My guess is that the DJIA will drop below 7,882, but hold above 7,200 in coming weeks. If this develops, a one to three month rally could follow, as analysts convince themselves that a narrowing in credit spreads and a second bigger stimulus plan will mean the economy will begin to recover by mid 2009. As more investors embrace this scenario, selling pressure will dry up, and coupled with a little buying and some short covering, the market will rally on lighter volume. This is what happened after the March low, and the market rallied for two months. If this plays out, the DJIA could rise to 9,600-10,200, and the S&P to 1000-1050. My guess is that after this rally is over, the DJIA will likely drop below 7,200 by next spring.”* So far this scenario seems on track. However, the DJIA has really been masking the weakness in the overall market. The S&P is below its October *intra day* low by -4.0%, the Russell 2000 and Nasdaq 100 are both below their October 10 lows by -11.7%, even as the DJIA holds above 7,882. This degree of weakness increases the odds that the 2002 and 2003 lows will be tested sooner, rather than later. If the DJIA

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drops below 7,882, traders should look for an entry. Needless to say, with the VIX above 70, this is not for the feint of heart.

Where ever you choose to go long, use DJIA 7,200 as a stop, and raise the stop to the DJIA low, if the DJIA climbs above 8,200.

Right after 9/11, the volatility index (VIX) got up to 43, and at the bottom in July 2002, it pushed up to 47. In recent weeks, the VIX almost got up to 90. Today it finished above 74. The S&P has swings of 3% to 5%, almost daily. Trading risk is extremely high. As noted last month, my managed accounts are up 14% since July 1, 2007, and 2% so far in 2008. We've been basically out of the market since July, waiting for a bottom that looks capable of lasting longer than a week.

GOLD

*“Although the extraordinary measures adopted by central banks may be inflationary in the long run, in the short run they have not yet stopped home and equity prices from falling, nor prevented a further contraction in credit creation. All signs of **deflation**. Gold won't move up, until **after** a period of real stability, and we aren't there yet. This suggests Gold could drop to \$660.”* These comments from last month still apply, although Gold may make a run at \$600.

BONDS

I would not buy Treasury bonds. Even though there is a mountain of supply coming, the economy is likely to remain weak enough to keep yields from climbing much above 4% on the 10-year Treasury. That means it's too early to short them either.

E. James Welsh