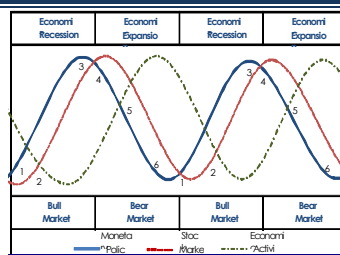


The Financial Commentator

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A GUIDE TO
FEDERAL RESERVE
MONETARY POLICY,
THE ECONOMY, AND
FINANCIAL MARKETS
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Happy Holidays - I hope this Holiday Season finds you healthy and with family and friends.

FEDERAL RESERVE

The Federal Reserve lowered the Federal funds rate to a target range of 0% to .25%, the lowest it's been since the 1940's. The Fed took this step because "*The outlook for economic activity has weakened further.*" In 2002, the Federal Reserve studied how the Bank of Japan responded to the threat of deflation it faced in the early 1990's, as real estate values plunged and their stock market declined. One of the conclusions the Fed made was that the BoJ had moved too slowly in lowering interest rates. By the time the BoJ had cut short term rates to .10%, the rate of inflation had already fallen below 0%. With prices falling 1% to 2%, even a rate of .10% meant that the real cost of money was still almost 2%. This is why the Fed lowered rates to 1% in 2003, and why they cut rates to almost 0% this week. As long as the Federal funds rate is below the inflation rate, the real cost of money is negative. Historically, this has been effective in containing deflation and boosting economic activity.

The Fed is also taking other actions, which could prove more important than traditional rate cuts alone. As I noted in the December 2007 letter, the Fed's ability to contain this credit crisis was likely to be far more limited than in the past, since credit creation had become more dependent in the credit market's ability and willingness to securitize bank lending. Global securitization of mortgage lending, auto loans, and credit card debt is down more than 75% from year ago levels. Unless the securitization markets are revived, the availability of credit from bank lending is going to remain severely constrained. The Fed has finally recognized this need. In late November, the Fed announced it would begin buying mortgage-backed securities, and they reiterated this intention in the FOMC statement. "*The Federal Reserve will purchase large quantities of agency debt (Fannie & Freddie) and mortgage backed securities to provide support to the mortgage and housing markets.*" Since the Fed's announcement, mortgage rates have dropped considerably, even though the Fed has only purchased \$8 billion of mortgage backed securities. In other words, market participants have been 'front running' the Fed, by buying the same securities the Fed intends to purchase. This was a shrewd move by the Fed, since the Fed is using other people's money to bring mortgage rates down.

Longer term, the true success of this plan will be dependent on whether mortgage rates *stay down*. In the short run, the lower cost of mortgage financing will increase housing affordability and demand. It could help lower the coming wave of foreclosures from the \$1.5 trillion of Alt-A and Option Arm mortgages that are due to reset in 2009 and 2010. By comparison, the amount of sub-prime loans totaled \$1 trillion. Unfortunately, lower mortgage rates can't help those who lose their job stay

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current on their mortgage, auto loan, or credit cards. In the last 3 months, more than 1 million workers have lost their job, and in the next six months, 1.5 million more employees will receive a pink slip. This is going to create another round of losses for the banks to absorb, which means banks will keep their lending standards high, and the availability of credit low. As I have noted many times, the availability of credit is far more important than the level of interest rates. And credit is going to remain tight well into 2009. All of these factors are going to result in lower home prices and more losses for banks.

While the recent actions by the Fed are going to help, it is important to keep the bigger picture in focus. The International Monetary Fund, Goldman Sachs, and Bridgewater Associates have estimated that total global losses could approach \$1.4 to \$1.6 trillion. To date, banks have written off less than \$800 billion. This suggests that if total losses only total \$1.2 trillion, due to central bank rate cuts and numerous government stimulus packages, there are still hundreds of billions of losses to work through. And that's if things go well! I understand wanting to see a light at the end of a tunnel, especially after such a grim year. But most financial analysts and investors have consistently underestimated the scope and magnitude of this credit crisis. I think there is a chance they will also fail to appreciate the economic fallout from the continuing contraction in credit.

STOCKS

At the lows in November, the stock market was extremely oversold, which meant the probabilities of a rally were good. This was one of the reasons I suggested that traders go long, if the DJIA dropped below the October 10 low of 7,882. I also thought investors would begin to focus on the stimulus plan President-elect Obama would present, after taking office on January 20. This positive distraction would help investors look past current weak economic reports, and lead to less selling on bad news. My expectation was that the DJIA could rally to 9,600 – 10,200, and the S&P to 1000 – 1050. While it is still possible these targets could be reached, the odds have diminished. The market has used a fair amount of energy, just to get to DJIA 9,000 and S&P 920, and it is no longer oversold.

Investment analysts are also less bearish. Some think the market is cheap, after falling more than 40%. Others note that the stock market has historically bottomed midway through a recession, or six months before a recovery. With the recession now officially a year old, they reason the recent low should mark the bottom. And, a few have said the market is undervalued, citing the 'Fed model', which compares the S&P earnings yield to the 10-year Treasury yield. While each of these points has some value, here's what I know. We are in the middle of the worst financial and economic crisis in 70 years. To confidently state that this recession will be over by mid 2009, takes more chutzpah than I have. Credit creation is still dysfunctional, despite everything the Federal Reserve and the Treasury have done. This recession could easily last into 2010. Although the Fed model indicates the stock market is undervalued, I question the validity of comparing the stock market's earnings yield to the 10-year Treasury yield in a crisis. Corporate earnings are dependent, in part, on what a company must pay to borrow money in the credit market. A solid AA investment grade company today would pay almost 8% to borrow money, which is a lot more than the 2.2% 10- yield Treasury yield. Stocks

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don't look so undervalued, when compared to an 8% cost for money, rather than 2.2%. And, as any investor who has been around for awhile knows, cheap often becomes cheaper, especially in a tough economic climate.

On December 10, I sent out a Special Update, and raised the stop to 8,600 from 8,050 on positions taken when the DJIA was below 7,882 and 8,300. The stop was triggered on December 11. A close below 8,500 would turn the short term trend negative. A close above DJIA 9,000 and S&P 920 should lead to a move up to 9,600 and 950. I would suggest doing some selling if the DJIA climbs to 9,500. Longer term, the odds still favor a decline once this rally is over, at least back to the November lows.

GOLD

Many analysts believe that inflation will become a problem sooner or later, since the Federal Reserve is flooding the economy with money. In the short run, there are problems with this analysis. The Fed has added reserves to the banking system. But banks are not lending, and are actually restricting credit availability. Although the money supply measures have been growing, the velocity of money has slowed markedly. Inflation has been defined at times, as too much money chasing too few goods. What we are experiencing could be best described as too little money not chasing enough goods. In addition, unemployment is soaring, and factory utilization rates are dropping like a stone, which means there is plenty of excess capacity in the economy. All of these factors will change some day, but not anytime soon. If the Gold market is anticipating a surge in inflation, those buying now must be using binoculars, or even a telescope. As long as February Gold does not close above \$925, a decline below \$700 is still expected in the first half of 2009.

BONDS

Last month, I wrote, "*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.*" Given that the 10-year Treasury yield has collapsed from 3.51% to 2.2% since last month's letter, I guess I could say my analysis was right on. HA! I never thought we'd see Treasury yields this low. With the Federal Reserve also '*evaluating the potential benefits of purchasing longer-term treasury securities*', anyone shorting bonds better be nimble. At some point, the 10-year Treasury will likely test 3.07%, which was the low in 2003.

E. James Welsh

THE CREDIT CRISIS

After analyzing and writing about the current financial and economic crisis since March 2007, it's a good time to reflect on how we got into this mess. Here are some ideas on what changes can be implemented to address the factors that contributed to this crisis, and how it can be prevented from

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happening again. In the second part, a number of ideas are put forward that could help stabilize the economy in the short run, and lay the groundwork for the next recovery.

A financial crisis of the magnitude we are experiencing can only come about if everyone involved contributes and plays a role. As in any Greek tragedy, there are main players and bit players in the drama unfolding right before our eyes. As with most tragedies, one can look back and see how easily all the pain and suffering, past and yet to come could have been avoided. Although we are powerless to reach back in time to alter the headlines of today, we can learn from our past avoidable mistakes. This is the nature of the human experience. It is why we know this too shall pass, why we must laugh at our folly, and why we must hold on to our faith in the future.

Part 1 COMMON SENSE

As I have noted many times over the last 18 months, maintaining a stable relationship between median incomes and median home prices is essential. Between 1965 and 2000, median home prices and median income held fairly steady, averaging about 3 to 1. This meant home prices rose based on an increase in income. For instance, if median income was \$30,000 in 1965, the median home price was \$90,000. As median income grew from \$30,000 to \$40,000, median home prices rose to \$120,000. This meant home prices were supported by a stable relationship between home prices and income, which enhanced the home owner's ability to make his monthly mortgage payment on time.

Between 1965 and 2000, the U.S. experienced five recessions, including deep recessions in 1973-74 and 1981-82. Even when the unemployment rate climbed to 9.0% as a result of the 1973-74 recession, and 10.8% in 1982, median home prices did not fall. This underscores the importance and durability of maintaining this 3 to 1 ratio between median income and median home prices. The current crisis began with the unemployment rate well below 6%. Why?

Between 2000 and 2006, median home prices rose from 3 times median income, to 4.5 times median income. In some markets – Florida, Arizona, Nevada and California, the ratio was stretched to more than 6 to 1. It is no surprise that the markets with the highest ratio of home prices to income are experiencing the largest price declines.

History suggests that mortgage lending policies should be geared to maintain a 3 to 1 relationship between median home prices and median income, nationwide and regionally.

RATING AGENCIES

Since the Great Depression, nationwide median home prices had never declined, even during the deep recessions of 1973-74 and 1981-82. Noting this record, the rating agencies (S&P, Moody's, Fitch Services) assumed nationwide home prices would never decline. Incredibly, the risk model they used to evaluate the quality of mortgages didn't even have the capability to assess loss levels, if home prices did actually fall. In the world of the rating agencies, market driven home prices could only go up!

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In the future, the rating agencies will use a risk model that does allow for home price declines. Their risk model should also incorporate the relationship between median home prices and median income, nationwide and regionally. As home prices rose from 3 to 1 times median income, to 4.5 to 1 in 2006, and to more than 6 to 1 in a number of markets, the rating agencies failed to recognize the obvious. As home prices moved 50% above their long term average of 3 to 1, the risk of a significant decline in home prices had risen substantially. And in those markets that had stretched to more than 6 to 1, a decline in home prices was virtually guaranteed. Any first year Statistics student learns about regression to the mean. The financial engineers at the rating agencies obviously flunked their introduction to Statistics class.

The other significant flaw with the rating agencies is that they were compensated by the issuers of the debt they were evaluating. No risk of conflict of interest in that relationship! Between 2002 and 2007, the ratings agencies collected billions of dollars in fees. In the future, the ratings agencies should be compensated by those who buy the securities they rate. This will eliminate the conflict of interest potential.

SECURITIZATION

The ability to securitize mortgage and auto loans, as well as credit card debt brought the cost of credit down for consumers, and provided pension funds and insurance companies the opportunity to buy securities that yielded more than Treasury securities. In other words, securitization was a clear net positive for our economy. However, there was a significant problem with the securitization process that was exposed, once lending standards evaporated between 2002 and 2007. When a bank sells 100% of a mortgage, auto loan, or credit card balance for securitization, the bank has 0% exposure to loss. If their lending standards are lax, or non existent, the bank isn't on the hook, if the borrower is unable to pay off the loan. Passing on *all* the repayment risk to an investor left holding the bag when the music stops is a form of capitalism I am not familiar with. Some have criticized those borrowers who bought homes with no money down, and no chance of making their mortgage payment. I am not defending their actions. But I see little difference between the borrower with no money down, and a bank that collects a healthy fee for making loans with lax lending standards, and has no loss exposure since it securitized 100% of the loan.

In the future, banks (or any institution that originates a loan that will be securitized) should be required to keep 10% (or some percentage) of any loan that is securitized. And, the first \$1 of loss will go to the loan originator, and not the investors who purchased the securitized loan. Banks will be far more attentive to maintaining common sense lending standards, if they are at risk of loss.

SECURITIES and EXCHANGE COMMISSION

A number of years ago, the Securities and Exchange Commission (SEC) accused Sun Trust Bank Corp of sandbagging their quarterly earnings, by using their loan loss reserve to smooth out fluctuations in their quarterly earnings. Basically, the SEC said Sun Trust was adding to their loan reserves during good quarters, and using the extra unneeded reserves, if earnings came in light in a

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subsequent quarter. In the years following the Sun Trust/SEC action, most banks chose to maintain smaller loan loss reserves, lest they too be accused of manipulating their quarterly earnings. I would not be surprised if Sun Trust was being a bit creative, but the SEC missed the more important point.

Historically, bank lending is procyclical, meaning lending is the most aggressive toward the end of an economic expansion. It's only after the economy begins to slow that banks raise their lending standards and cut back on the availability of credit. This only adds to the downward momentum in the economy, as we have seen since January 2007. If the economic slowdown is meaningful, bank loan losses rise, which forces banks to increase loan loss reserves. This only intensifies the down turn in the economy, and often leads to even more loan losses. It would be better, if banks were required by the S.E.C. to increase loan loss reserves, as loan demand rose during an economic expansion. Why wait to increase loss reserves until losses actually develop. The counter cyclical management of loan loss reserves would help moderate swings in the economy. Banks would be forced to be more conservative, as loan demand and the economy grew, and less restrictive during weak periods in the economy, since reserves for losses would already be in place.

The SEC should also prohibit banks from establishing any off balance sheet entities, i.e. Structured Investment Vehicles. After the credit market convulsion in August 2007, it was reported that the Federal Reserve called a meeting of large bank executives so they could explain what the S.I.V.'s were to the Fed. The Federal Reserve didn't even know they existed! These off balance sheet entities only added to the leverage banks used, since these entities were not required to maintain standard bank reserves.

In 2004, the SEC granted a request from Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns to increase their leverage from 12 to 1, to 30 to 1. For each \$1 dollar of capital, these firms could borrow up to \$30 to buy mortgage related assets. Once these mortgage related assets lost 4% of their value, the \$1 of capital was gone. After these assets had fallen 20%, another \$5 of capital disappeared. The excessive leverage piled onto mortgage related assets that were clearly overvalued is why Bear Stearns and Lehman Brothers are gone, Merrill Lynch has been absorbed by Bank of America, and why Morgan Stanley and Goldman Sachs have sought a lifeline only available to banks. In the future, the SEC should limit leverage by investment firms to the pre 2004 level.

This credit crisis has resulted in a major consolidation among our largest financial institutions. As Henry Kaufman noted in a December 6 Wall Street Journal editorial, *“Today, more than half of all non financial debt (debt held by households, non financial companies, and government) is held by the top 15 institutions. The influence of these conglomerates will be overwhelming. Through their global reach, these firms will transmit financial contagion even more quickly than it spread in the current crisis. The pricing power of these huge financial conglomerates will grow significantly, at the expense of borrowers and investors.”*

The SEC, with the aid of Congress if needed, should mandate that the top 15 to 20 largest financial institutions be broken up into smaller firms within 10 years. This will address the legitimate concerns

raised by Henry Kaufman. These institutions may not like it, but most of these firms bear some measure of responsibility for this crisis, and the need for taxpayer funds to keep them from failing.

Another major contributor to this crisis has been the lack of clarity regarding credit default swaps, collateral mortgage obligations, collateral debt obligations, and other esoteric financial instruments. The S.E.C should establish a central clearing firm, much like the Options Clearing Corporation, which is regulated by the SEC and the Commodity Futures Trading Corporation (CFTC). Standardizing these financial instruments and creating a liquid market for each will introduce the clarity needed for investors to evaluate the institutions issuing and owning them.

FEDERAL RESERVE

Some people believe the free market is always the best and only answer. I think the free market is a far better allocator of resources than any bureaucrat or group of bureaucrats. Not even a close call. But it isn't perfect. Just look at how well the market allocated resources in the dot.com bubble and housing bubble. This point has been made clear enough even to Alan Greenspan, who not long ago admitted he had placed too much faith in the market place to spread risk sufficiently to prevent the very crisis we're experiencing. In 2004 and 2005, Alan Greenspan ignored the mortgage ads touting 100%, even 125% home loans, and dismissed the concerns expressed by other Federal Reserve Governors. In early 2007, Fed Chairman Bernanke thought losses from the 'sub prime' problem would total \$100 billion, and that housing would be on the road to recovery before 2007 was over. A number of Fed Governors were so out of touch with what was happening, they voted against rate cuts in 2008, and actually supported rate increases! As noted previously, the Federal Reserve wasn't even aware that banks had increased their leverage through the use of off balance sheets entities. Clearly, the Federal Reserve failed to exercise the oversight they should have as the housing bubble was building, and failed to understand the impact on the banking system and credit creation once the housing bubble began to deflate. Going forward, the Fed needs to do a better job.

Part 2 Ideas to stabilize the economy in the short run, and lay the groundwork for the next recovery.

There are two factors that are going to extend the current recession and contribute to a weak recovery, whenever it comes. First and foremost, credit availability is likely to remain constrained well into 2009. Bank balance sheets will be forced to absorb another \$300 to \$500 billion in losses in 2009, as default rates on every type of credit rise. It is likely the Treasury will be forced to make another infusion of capital similar to the \$250 billion made in November. In response to this pressure, banks are going to maintain excessively high lending standards for a long time, and charge a bit more for the credit they do extend. Secondly, consumer spending is going to be very weak, as job losses increase in coming months. In addition, household debt has risen from 44% of GDP in 1982 to 98% in 2007. Since interest rates are already low, consumers can't expect any help with this debt burden from lower rates. With home values and 401Ks down, consumers are being forced to save more. If they increase savings just 2%, that will shave 1.4% from annual GDP going forward.

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Hopefully, the unintended consequences from whatever policies the new president chooses will be small.

The economy is suffering from a lack of demand, which means any tax increases on the federal level should be tabled. Since states are precluded from running deficits, many states will be increasing taxes and fees to balance their budgets. The federal government needs to send money to states to minimize state tax increases. Rather than additional tax cuts, ***the primary focus of any federal government program should be to spend money on projects that will have the greatest multiplier effect.*** In the second quarter, the government spent more than \$100 billion on rebate checks for individuals. It is estimated that consumers only spent \$.20 of each \$1 distributed, which meant the economy didn't get much of a boost. If spending on infrastructure projects, such as bridge and road repair, have historically generated more than \$1 of economic activity for \$1 spent, count me in. I'm sure economists will be able to provide the Obama administration specific spending ideas that have the greatest multiplier effect.

In order to stem the tide of deflation, the decline in home prices must stop. For this to happen, ***the imbalance between supply and demand in the housing market that has precipitated this crisis must be altered.*** It won't be easy. There is a 10 month supply overhang of existing homes for sale. In October, 45% of all home sales were foreclosures, which represent forced selling. At the end of September 1 in 10 mortgages had missed one payment. In September, October, and November more than 1.3 million jobs were lost. In the next six months, another 1 million or more jobs will be lost. The magnitude of these job losses are staggering, and will accelerate home foreclosures. This will cause home prices to fall further. To offset the coming forced selling from foreclosures, and their corrosive affect on home prices, a number of actions need to be taken. ***The goal of these steps is to lower the supply of homes for sale, and increase demand for housing.***

Offering a 4.5% fixed rate mortgage to every existing home owner is a good idea. This will help more home owners stay in their homes, which will lower foreclosures a little. A 4.5% fixed rate mortgage will also spur some demand from first-time home buyers.

The Treasury should announce plans to lower every homeowner's mortgage balance by 10%, based on the maximum allowed by Fannie Mae and Freddie Mac for a conventional loan in each real estate market. This would offer a real incentive to homeowners to stay in their homes, and, according to a recent study by Credit Suisse, lowering a home owners mortgage balance has been more effective than simply modifying the terms of a homeowners' mortgage. Since home prices are likely to fall another 10% anyway, why not try to turn a negative into a positive. When and if the homeowner sells the home for more than the mortgage, the homeowner would split the gain with the government. If the mortgage balance reduction was \$50,000 (10% \times \$500,000 mortgage), the government would receive \$25,000, if the home sold for more than \$50,000 above the mortgage value.

Demand for housing would also be increased by offering investors accelerated depreciation or tax credits for buying foreclosed homes. This would entice wealthy investors to buy multiple properties,

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and help clear the over supply of homes for sale, and help absorb the coming glut of foreclosed home sales. This would help moderate the home price declines that are coming.

Many companies are experiencing an outright decline in revenue and sales. In November, retail sales fell, and were the weakest in at least 35 years, according to the International Council of Shopping Centers. This is forcing companies to cut costs any way they can. Since labor costs make up 65% of the cost of goods sold, cutting jobs is high on the list. If our government wants to help business cut costs, and potentially save some jobs, it should eliminate corporate taxes. I understand that politically this may be tough, but taxes are a cost of business, just as labor and material costs are included in the cost of goods. Isn't it time for politicians to learn for themselves (since most don't), and then explain to their constituents, that taxes are part of the cost of everything we buy. In other words, *we* are paying the taxes collected by the government from corporations. Eliminating corporate taxes will save jobs in the short run, and speed up job growth, once the economy firms.

Law of Unintended Consequences

One thing is for certain. Given the nature of this crisis and the response it has demanded from the Federal Reserve, Treasury Department, Congress, and the new administration, there will be unintended consequences. Some of them might even be positive. More likely, they will not. Hopefully, we will avoid the urge to move away from free trade, and resist the temptation to overly regulate our financial institutions and financial markets. Despite all of its faults, capitalism is still the best economic engine to improve the standard of living of most Americans. But it is not perfect, and the very vibrancy that allows and encourages technological innovation and discovery, also allows for imbalances that are painful to correct. Too much regulation and the creativity that has enabled the United States to be the envy of the world will be stifled. Too little regulation, and the self interest of a few override the broader needs of our society. No one ever said it would be easy.

E. James Welsh