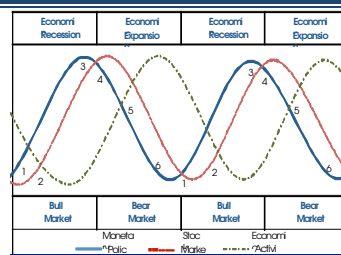


The Financial Commentator

Written by E. James Welsh, **Registered Investment Advisor**
Published by Welsh Money Management LLC
3578 Camino Arena, Carlsbad, CA 92009
Voice: 760.436.3574 • Fax: 760.436.6574
jwelsh@welshmoneymanagement.com



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

Newsletter – April 23, 2009

ECONOMY

Perspective – A way of regarding facts and judging their relative importance.

There are a number of data series that evaluate economic conditions using a diffusion index. A diffusion index will have a value above 50, when a plurality of respondents are positive, and below 50 when a majority are negative. If a diffusion index increases from 35 to 38, it represents a gain of 8.6%, while a rise to 46 from 45 is only a gain of 2.2%. It is natural to think of the larger percentage gain to be more noteworthy. However, the smaller gain is actually more significant, since it will only require a small further improvement, before **actual economic growth is achieved**. In recent weeks, many economists and market strategists have heralded the end of the recession and the arrival of spring, after spotting a few ‘green shoots’ of improvement. In most cases, the ‘green shoot’ was a modest up tick, **from a multi-decade low!** For instance, the *Conference Board's Consumer Confidence Index* edged up to 26.0 in March, from 25.3 in February, the lowest reading since records began in 1967.

In February, new home sales were up 4.7% to 337,000, and after that robust increase, were only down 75.7% from their July 2005 peak. In the last three years, housing starts have plunged from 1,823,000 to 358,000, or 80.4%. At the February sales rate, it will take 12.2 months to clear the inventory of new homes for sale, versus 5 months in a healthy market. In the past year, the median price of a new home has fallen from \$251,000 to \$200,900, a drop of 20%. After retail sales collapsed in the fourth quarter, the inventory-to-sales ratio soared from 1.25 to 1.45, or 16%. Companies were forced to cut production drastically in the first quarter, so bloated inventories could be whittled down. Although the ratio dipped to 1.43 in February, production levels will remain low, until the ratio falls further. The large decline in production will contribute to a fairly weak first quarter, and depress second quarter GDP too.

As noted last month, there is a good chance that GDP will post a positive print in the fourth quarter of this year, and maybe in the third quarter. Most of the ‘gain’ will be statistical nonsense, but that won’t deter most economists from getting excited. In the last 2 years, the 80% plunge in housing starts has subtracted about .9% from GDP each quarter. If housing starts stabilize near February’s level in coming months, the .9% hit to GDP will become 0%. If inventories are brought down by the fourth quarter and are in line with sales, the decline of 1% to 2% to GDP from production cuts in the first and second quarter could also improve to 0%. In the fourth quarter last year, personal consumption fell an extraordinary -2.99%, as consumers turned into Grinches. But consumer

The Financial Commentator

Newsletter – April 23, 2009

spending improved in the first quarter, as government income transfers of \$127 billion offset the decline in wages and salaries of \$89 billion. In the second quarter, social security recipients will receive a onetime \$250 payment in May. Tax refunds are up 11% from last year, and the decline in gasoline prices is also providing a boost to incomes. Consumers will use the extra disposable income to pay down debt, and increase savings and spending. All of these factors should help swing personal consumption to a positive for GDP in coming quarters.

In the second quarter of 2008, GDP grew 2.8%, which is a respectable number. Despite this growth, job losses continued each month, and a *self sustaining* economic expansion failed to take hold. ***The most important issue in the next 12 to 15 months is whether the rebound in the second half of 2009 and first half of 2010 will gain enough traction to launch a self sustaining economic recovery.*** There are many reasons why I remain skeptical.

In the first three months of 2009, more than 2 million jobs were lost, causing the unemployment rate to jump from 7.6% to 8.5%, the highest since November 1983. The unemployment rate increased in March in 46 states, with California, the world's eighth largest economy, hitting 11.2%, the highest since January 1941. Underemployment, which combines the unemployed, with involuntary part time workers and discouraged workers, reached 15.6%. As noted in recent months, post World War II recessions have on average caused personal income to fall between 4% and 7%, and this one has further to go. Wages and salaries shrank at a 4% annual rate in the first quarter, and according to *Deutsche Bank*, payroll-tax withholding receipts collected by the Treasury Department are down 8.2% from a year ago. This suggests that personal income growth will remain weak in coming months, and shave more than \$250 billion from total income and future demand. Changes in temporary jobs lead reversals in the overall labor market by 6 to 10 months. In 2007, a continuous decline in temporary jobs and hours worked led me to forecast a decline in jobs in 2008. When non-farm jobs fell in January 2008, most economists were shocked, and the stock market sold off sharply. In March, employers cut 71,700 temporary workers, so any real improvement in job growth is many months away.

Most economists are quick to note that unemployment is a lagging indicator, and they're right. But the magnitude of the job losses shouldn't be dismissed so glibly, given the impact they are having on the banking system. The *American Bankers Association* reported that 3.22% of consumer loans were delinquent at the end of 2008. That is the highest level since the ABA began tracking overall loan delinquency rates in the mid 1970's. ***And that was before 2 million jobs were lost in the first quarter.***

An average of 5,945 bankruptcy petitions were filed each day in March, up 9% from February and 38% from a year ago. The soaring job losses since last September are certainly behind the increase in bankruptcies.

The surge in job losses are working their way up the income ladder, with an increasing number of middle income and upper middle income workers being affected. This is pushing many of those who previously were considered prime credit risks over the edge. Two-thirds of mortgages in the U.S. are

The Financial Commentator

Newsletter – April 23, 2009

held by the best credit risk, *prime borrowers*. According to the *American Bankers Association*, 5.06% of prime borrowers have missed at least one mortgage payment. Since prime borrowers are such a large group, this represents 1.8 million mortgages. Although the delinquency rate for sub prime mortgages is up to 21.9%, it only accounts for 1.2 million mortgages.

In the fourth quarter, a number of states mandated a freeze on foreclosures, and a number of banks, not wanting to be a modern day Mr. Potter during the holidays, voluntarily suspended foreclosures. According to *RealtyTrac*, foreclosure filings increased to 341,180 in March, up 17% from February, and up 46% from a year ago. After the foreclosure moratorium expired in California, notices of trustee sales, which precede foreclosure sales, climbed more than 80% to 33,178 in March from February. *Moody's Economy.com* estimates more than 2.1 million homes will be lost this year, up from 1.7 in 2008.

Existing home sales have declined 33.3% since peaking in September 2005. The median price has dropped 28.7%, after peaking in July 2006 at \$230,900. In February, existing homes sales increased 4.4%, and the median home price advanced 2.4%. The ratio of monthly sales to the inventory of homes for sale was 9.5 months, versus 5 months in a healthy market. However, 45% of the sales in February were foreclosures, and that proportion will remain high in coming months. Since foreclosed sales represent forced selling, the persistently high level of foreclosures will continue to push home prices lower. As home prices fall another 5% to 10% or more, more home owners will realize that their mortgage exceeds the value of their home. An increasing number are simply choosing to walk away, since they have nothing to lose.

According to *RealtyTrac*, job losses result in a home foreclosure 10% to 15% of the time. If job losses narrow from the monthly average of 670,000 in the first quarter to 325,000, almost 3 million more jobs will be lost before year end. That will translate into another 300,000-450,000 foreclosures, and an unemployment rate of almost 11%. But what if that estimate of job losses is too optimistic?

New research by the Federal Reserve and Boston University of credit spreads of 900 non-financial companies from 1990-2008 predicted changes in the economy '*phenomenally*' well. Based on their initial research on low to medium risk corporate bonds with more than 15 years to maturity, the researchers went back to 1973 and found the analysis still worked well. With the massive widening of corporate bond spreads last fall, the researcher's model predicts the economy will lose another 7.8 million jobs by the end of 2009, and industrial production will fall another 17%. In the spirit of optimism, let's assume this 'phenomenal' model is off by 35%, due to the extreme nature of this credit crisis. That still results in another 5.1 million lost jobs, and an 11% drop in industrial production. In that scenario, the unemployment rate climbs to near 12.5%, the underemployment rate breaches 20%, and another 500,000-750,000 foreclosures result.

The *International Monetary Fund* (IMF) now estimates the U.S., European, and Japanese financial sectors face losses of \$4.1 trillion. Banks are confronting losses of \$2.5 trillion, insurers \$300 billion, and other financial institutions \$1.3 trillion. To date, the banking sector has written down \$1 trillion

The Financial Commentator

Newsletter – April 23, 2009

of expected losses. *The IMF estimates that U.S. and European banks need to raise \$875 billion in equity by next year to return to pre-crisis levels.*

Over the last week a number of banks have reported first quarter *earnings*, which was a pleasant surprise. Citigroup said it made \$1.6 billion. One of the ways Citigroup achieved this gain was booking a profit of \$2.7 billion on the decline in Citi's own debt. Say what? Under accounting rules, Citi was allowed to book a one-time gain equivalent to the decline in its bonds because, in theory, it *could* buy back its debt cheaply and save \$2.7 billion over time. Of course, Citi didn't actually do that. Even though more consumer loans went bad in the first quarter, Citi reduced its loan loss reserve from \$3.4 billion in the fourth quarter to \$2.1 billion in the first quarter, thereby picking up another \$1.3 billion of 'earnings'. And the recent change in mark to market accounting enabled Citi to book an additional \$413 million in 'profit' on impaired assets. Without these one-time adjustments, Citi's \$1.6 billion in first quarter profit becomes a \$2.8 billion loss.

According to a *Wall Street Journal* analysis of Treasury Department data, the 19 banks that received tax payer funds made or refinanced 23% less in new loans in February versus last October. Why lend money when all you've got to do is make a few adjustments and make even more money.

Between 2000 and 2008, the major credit card companies increased the number of credit cards issued to small businesses from 5 million to 29 million. During that period, many small business owners increasingly relied on their cards to provide short term financing for their business. Spending on small business credit cards increased from \$70.4 billion in 2000, to \$296.3 billion, according to the *Nilson Report*. Over the last 15 months, business bankruptcy filings have risen faster than consumer bankruptcies, with the average charge-off rising to \$11,000 from \$7,000, according to *Equifax, Inc.* In response, the card issuers have been aggressively scaling back, and have reduced available credit lines by almost \$500 billion. Just another example of how the availability of credit to the economy is evaporating, despite all the Fed's efforts.

Industrial production fell 1.5% in March, and is down 12.8% from a year ago. Capacity utilization fell to 69.3%, the lowest since records began in 1967. As I discussed in detail in January, excess capacity is a powerful dynamic. Companies are forced to reduce or eliminate budgeted investments in new equipment, compete for every dollar of revenue, even if it means accepting thinner profit margins, and reduce costs through job cuts. *The amount of excess capacity that has been created by the depth of this economic contraction is unprecedented.* What most inflation bugs and investors fail to understand is how long it will take to work off the current over hang of excess capacity. If the output gap grows from the current 7% to 10% next year, Goldman Sachs estimates it could be 2015 before all the excess capacity is used up, *and that's if GDP grows 4.75% per year!* Ironically, one of the reasons the economy is not likely to grow that fast is that business investment will be weaker than in prior business cycles. With so much excess capacity, businesses won't need to materially increase business investment for the next 2 or 3 years.

The economy needs to create 125,000 jobs each month, just to absorb the number of new entrants into the labor market. If job growth were to average 325,000 per month in coming years, it would

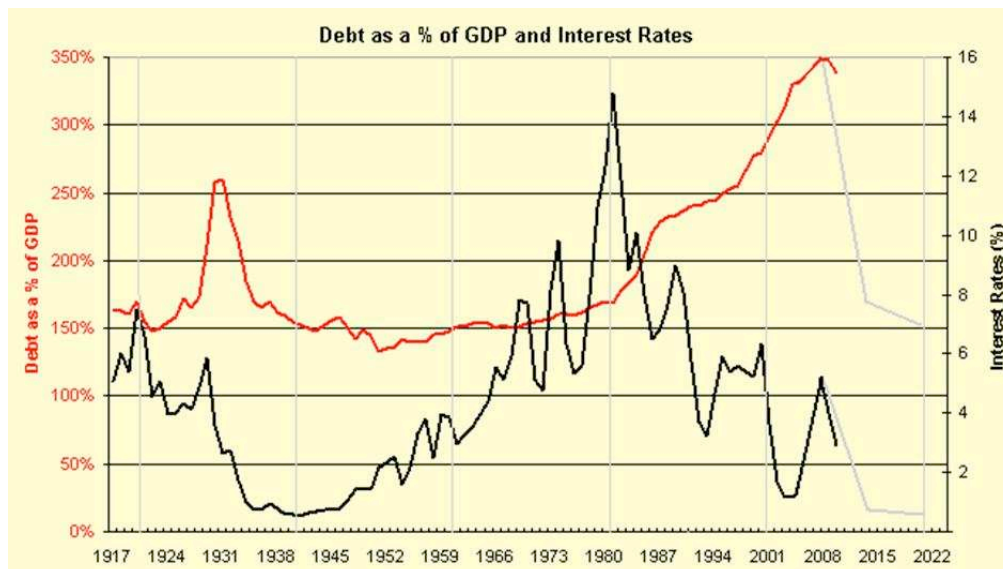
The Financial Commentator

Newsletter – April 23, 2009

still take four years to replace all the jobs lost in this recession. With so much excess labor capacity, wage growth will be weak for the next few years, which will make it harder for consumers to increase savings *and* spending. The combination of less credit availability, weaker business investment and consumer spending will be headwinds whenever the economy emerges from this recession.

The United States is mired in the deepest *cyclical* contraction since at least World War II, and arguably the depression. Falling home prices led us into this crisis, and home prices are still falling. The financial crisis in 2008 has become the economic crisis in 2009, as more than 2 million jobs were lost in just the first quarter, with another 3 to 5 million likely before year end. With the unemployment rate headed over 10%, and maybe up to 12% next year, *the default rate on every type of consumer credit* – (prime mortgages, Alt-A mortgages, Option Arm mortgages, sub-prime mortgages, home equity lines, credit cards, auto loans, student loans) – *is headed much higher*. Commercial real estate values are plunging, and corporate default rates are set to soar. Although every bank will ‘pass’ the government’s stress test, some banks will fail the real world stress test, and need billions more in capital. Sooner or later, the Treasury Department will likely have to go hat in hand asking for more money from Congress for some of the banks. For the first time since World War II, the global economy will contract in 2009, so there aren’t many places to hide. Although it is welcome to see a few ‘green shoots’, in this case, those green shoots are unlikely to yield a bountiful harvest in 2010.

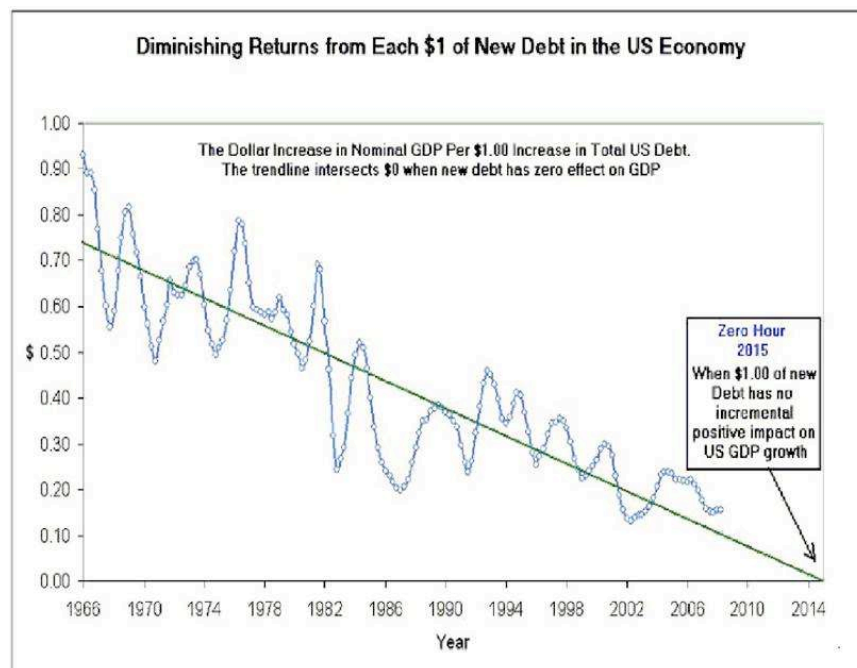
In addition to the daunting *cyclical problems* challenging the economy, there are a number of significant *secular issues* I’ve discussed before that will make it even more difficult for a *self sustaining recovery* to develop in 2010. Between 1982 and 2007, the amount of *Total debt* grew from \$1.60 to \$3.53 for each \$1.00 of GDP. This was made possible as the cost of money fell from 15% to 20% in 1982 to the generational lows of the last few years. As interest rates fell, consumers were able to take on more debt, without their monthly payments increasing very much.



The Financial Commentator

Newsletter – April 23, 2009

Household debt has increased from \$.44 in 1982 to \$.98 for each dollar of GDP in 2007. However, there is no more relief coming from lower rates, so consumers are going to have to pay for their debt from income. From the mid 1990's until 2007, most consumers had the luxury of believing that their homes and 401Ks would provide most of what they would need for their retirement. The saving rate fell from over 8% 15 years ago to near 0% in 2007. The last 18 months has convinced them they need to increase their savings. The saving rate has rebounded to near 4% in the last six months, which is one reason why the economy has been so weak. As debt levels increased over the last 25 years, GDP was boosted as consumer's bought cars, bigger homes, second homes, went on nice vacations, and basically lived the good life. However, *since 1966, each dollar of additional debt has given the economy less of a boost*. In 1966, \$1 dollar of debt boosted GDP by \$.93. But by 2007, \$1 dollar of debt lifted GDP by less than \$.20.



The message from these facts is fairly clear. Debt levels are high, and any increase in interest rates will impose a bigger burden on the economy and quickly stunt growth. Consumer debt is already so high and interest rates are so low that it will be difficult for consumers to add debt. This means economic growth will be far weaker than the debt induced growth of the last 25 years. As consumers increase their savings, GDP will be lowered by .70% for each 1% consumers increase their saving, since consumer spending represents almost 70% of GDP. In addition, the banking system remains crippled. Lending standards are high and are not coming down with the economy remaining weak. The need for additional capital will lower future lending by several trillion dollars, as banks work to repair their balance sheets and lower their leverage ratios from 30 to the low teens. The securitization markets provide more credit than the banking system, but they remain on life support. Credit availability will remain constrained well into 2010, which represents a headwind than will mute some of the lift from fiscal stimulus.

The Financial Commentator

Newsletter – April 23, 2009

The diminishing boost given to GDP from each additional \$1.00 of debt since 1966 strongly suggests that adding more debt will not return the economy to prosperity. I am reminded of a movie from the 1950's, 'The High and the Mighty'. It starred John Wayne and Robert Stack and was about an airline flight from Honolulu to San Francisco. During the flight, one of the engines fails, but they are past the point of no return, so they must try to make it to San Francisco. Over the last 60 years, the United States has used a combination of fiscal stimulus and monetary policy to soften each recession and spur the subsequent recovery, with a fair amount of apparent success. From 1982 until 2007, the U.S. only experienced two shallow recessions that each lasted just 8 months. This stretch of 25 years may be the best 25 years in our economic history. But much of this prosperity was bought with debt, as the ratio of debt to GDP rose from \$1.60 to \$3.50 for each \$1.00 of GDP. Sometime in the last 25 years, we passed the point of no return. Unfortunately, Hollywood won't get to write the script on how this ends.

STOCKS

The stock market has been rallying because investors believe there will be a recovery in the economy before the end of 2009. This leads them to ignore any bad news now, since better news is just around the corner. If I'm right, there will be GDP growth by the fourth quarter, if not in the third quarter. This suggests that the market can make further upside progress in coming months. The market fell for 17 months, between October 2007 and March 2009. This suggests the market *should* work its way higher for at least 5 months or so, maybe longer. My expectation has been that this rally should take the form of an up phase, a pullback, and then another up phase. As noted last month, I didn't expect the initial rally phase to exceed 878 on the S&P. So far, the high has been 875.63. I also expected the S&P to pullback to 760-780, which it did for literally a few minutes on March 30.

Although I think the S&P will exceed 878 in coming months, the economic fundamentals are far worse than most investors realize. Of course, this has been the case since this crisis began in August 2007. From an investment point of view it means this is no time to let one's guard down. If you buy something, use stops. If I'm right, and the rebound in the economy does not launch a self sustaining recovery, there is a moment of realization coming for most investors. That's what happened after the market rallied in April and May of last year in anticipation of a second rebound in the economy. When it failed to show up, the market reversed lower, after peaking in late May. Markets experience their largest moves when expectations are not met.

The S&P reached 845.61 on April 2 and closed at 843.55 on April 22. It's been 3 weeks, and the market hasn't made much progress, but it hasn't given any ground either. Investor's willingness to buy each dip has been in over drive, so each attempt at a sell off has lasted no more than 2 days. That's impressive, even if it's reflective of a herd mentality driven by misplaced optimism. The choppiness of the past 3 weeks is likely to continue, as sideline money uses any dip to buy. Eventually, the S&P should drop below 800, but hold above 760. Investors can buy in this range, using a decline below 740 as a stop. Conversely, investors can buy, if the S&P climbs above 872, using a decline below 825 as a stop. If the S&P closes above 878, a quick rally to 940 should follow.

The Financial Commentator

Newsletter – April 23, 2009

The high yield bond funds recommended last month (FAGIX, NNHIX, VAGIX) are up 4% to 6%. Use a trailing 1.5% stop.

BONDS

In a very real sense, the decision by the Federal Reserve to buy longer term Treasury bonds means this market will remain distorted for an extended period. My guess is that the Fed will intervene if and when the 10-year Treasury yield approaches 3.1%. But bonds will also be supported by weak economic data, and the lack of inflation.

DOLLAR

Since the bottoming last July, the Dollar cash index has made a series of higher lows and higher highs. That is the definition of an up trend. After making a new recovery high in early March, the pullback in the Dollar was given a shove, when the Federal Reserve announced its decision to employ quantitative easing on March 18. The Dollar then rebounded an almost perfect .618% of its 6.99 point decline to 86.94 on April 20. Since the rebound looks 'corrective', it implies that the dollar will fall to at least 82.50. As long as it holds above 80.30, the longer term trend is still up.

GOLD

Over time inflation has been defined as too much money chasing too few goods. Our problem now is that there is too little money chasing too many goods everywhere in the world, and that dynamic isn't likely to change anytime soon. The Federal Reserve has committed to quantitative easing and many investors have assumed the expansion of the Fed's balance sheet from \$900 billion to almost \$3.5 trillion has to be inflationary. But the massive levels of excess capacity throughout the global economy are going to keep a lid on price increases and wages for a long time. Japan is the second largest economy in the world, and their experience with quantitative easing for more than a decade has not led to inflation, as they are still battling deflation. And, if the U.S. stock market has another leg up in its bear market rally, gold will lose some of its financial instability luster.

I still think gold has the potential to drop below \$700 in coming months. Investors can short Gold in a number of ways, depending on risk tolerances. The most conservative way would be to short GLD, which is the ETF tied to gold, or by buying DZZ, which is the 2 to 1 short gold ETF, or by shorting Gold futures, which is the most aggressive. Irrespective of the route, use a print of \$1004.50 on June Gold as a stop. Short GLD above \$94.00, buy DZZ below \$20.70, and short Gold above \$960.00.

E. James Welsh