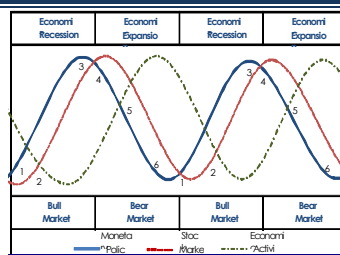


# The Financial Commentator

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A GUIDE TO  
FEDERAL RESERVE  
MONETARY POLICY,  
THE ECONOMY, AND  
FINANCIAL MARKETS  
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Newsletter – September 23, 2008

## **ECONOMY**

For the week ending September 19, the S&P finished up .26%, the DJIA ended -.29% lower, and the Nasdaq Composite closed up .55%. These modest changes in the market averages belie the extraordinary changes made necessary by an impending collapse of the global financial system. When desperate men take desperate actions, we can be certain there will be unintended consequences. Treasury Secretary Henry Paulsen and Federal Reserve Chairman Ben Bernanke have launched the largest ‘Hail Mary’ pass in our nation’s financial history. By the time this financial football finishes its flight toward the end zone, how our financial markets function will be remade, the level of government involvement will be ratcheted up, the role of individual responsibility and freedom will be diminished, and the influence of capitalism throughout our economy will be less. There appears to be bipartisan agreement that the play called by Paulsen and Bernanke wasn’t just necessary, but unavoidable. But that is why every last second, desperate Hail Mary pass is attempted.

Since March 2007, I have chronicled why I thought the brewing credit crisis was far bigger than most investment professionals realized. Whenever the stock market reversed higher after an intervention by the Fed or Treasury (August 2007, January 2008, March 2008, and July 2008) the majority of investment strategists **remained bullish**, since they haven’t understood the primary underlying problem – a progressive contraction in credit creation. In recent months, investment professionals advanced silly notions like decoupling, despite mounting evidence that a deeper slump in the U.S. was spreading to the global economy. Last spring, Wall Street strategists forecast a 73% increase in corporate earnings by the end of 2008, on the belief that the combination of Fed rate cuts and fiscal stimulus would lift the economy before year end. As the market was rallying in May, many analysts stated that the market was ‘telling’ them that the economy would be better before the end of this year, since the market is a discounting mechanism. The notion that the stock market ‘knows’ anything is an illusion that appears to have value, *only with the benefit of hindsight*. **What was the market ‘telling’ investors, when it was making all-time highs last October?** That the credit crisis was over? How could any financial professional claim in May that the market was telling only those astute to listen, that everything was getting better, when it was so wrong in October? The notion the market is a discounting mechanism is accepted as Wall Street wisdom, and treated with a reverence only due Mother Theresa, despite investors being repeatedly reminded of its true value.

I’m reviewing the quality of investment advice provided investors over the last 18 months, because we can expect a lot more of the same. The only difference this time will be the volume with which it is dispensed. We will be told that the Federal Reserve and the Treasury have finally gotten it right.

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The scope and size of the proposed program will arrest the decline in home prices, restore stability to the financial markets, enable banks to get back to the business of lending, and restore the confidence of the American consumer. While the program certainly has each of these points as a goal, the amount of time to achieve each goal is unknowable, but an important factor. Moses was told he would lead the Jews to the Promised Land. He didn't know it would take 40 years. And, in all due respect to Bernanke and Paulsen, Moses was working with God. They are working with Congress.

The success of The Plan will be determined by its impact on home prices, credit creation, and containing the economic fallout from the dislocation in the credit market.

**Will The Plan prevent home prices from falling further?** There is an eleven month supply of existing homes for sale, and a second pool of vacant and bank foreclosed homes that need to be sold. Bank foreclosed home sales increased in recent months, which caused home price deflation to accelerate. To the extent The Plan enables banks to reduce foreclosed home sales in coming months, home prices shouldn't fall as much in the short run, as they would have. But the need to sell these foreclosed properties will only have been transferred from the banks to the government. The real estate market will still have to absorb this selling pressure. The advantage is that the real estate market will have a period of years to absorb the selling pressure, rather than months. Hopefully, The Plan will mean that home prices will only fall 3% to 5%, rather than 10%, and the price decline will be stretched over 2 to 3 years rather than the next 12 months. Home prices are not likely to rebound nationwide for at least 3 to 5 years. Although The Plan will provide support for the housing market, it will not prevent home prices from falling further in most areas of the country.

**Will The Plan help banks get back to the business of lending and restore credit creation?** In the short run, no. Banks have raised lending standards for consumers and corporations to record levels on most types of loans. Irrespective of the details of The Plan, banks will have more non-mortgage loan problems to deal with in coming months. As I have noted over the last year, default rates on auto loans, credit cards, and corporate loans *always* increase whenever the economy slows. A few economists continue to tout the 3.3% gain in GDP in the second quarter, as proof the economy is fine. Even if I was willing to grant their point, and I'm not, default rates rose in the second quarter, despite the supposed 3.3% increase in GDP. With the economy clearly weaker now than in the second quarter, banks are going to be writing off more losses and building their loss reserves during the third and fourth quarters. Banks will not be lowering their lending standards anytime soon.

The goal of The Plan is to allow banks to move non-performing assets off their balance sheets and onto a new balance sheet backed by U.S. taxpayers. No matter how smoothly the political obstacles are overcome, it is still a monumental job to establish an organization capable of handling the millions of transactions required to deliver a real benefit to individual homeowners and the overall economy. As government officials and bank representatives meet to establish a 'value' for the trillions of dollars of various types of mortgages and derivatives held by banks, the negotiations may take on the appearance of a World Wide Wrestling match, than two groups of professionals working to do what's best for the American taxpayer.

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For example, banks, who have already written an asset down from \$1.00 to \$.80, want the government to buy the asset for \$.80, even if the asset is worth \$.50 now. It wasn't long ago that Merrill Lynch unloaded billions of bad assets for \$.22 on the dollar. Allegedly, the government wants warrants on the stocks of banks that sell assets, so the government can participate in a recovery in the bank stocks. While that may offer some upside, it also exposes taxpayers to greater losses if the assets are never worth \$.80. I prefer a different strategy. ***Change the accounting rules so banks can write off the losses on assets sold to the government over a period of 5 to 10 years.*** This would allow the government to buy assets for \$.50 on the dollar, lower the risk taxpayers are assuming, while still providing some upside if the assets recover. And, by paying less for the acquired assets, ***less taxpayer money may be needed.*** By acquiring the assets at a lower cost, the government would also have more flexibility through Fannie and Freddie to work out individual loans, which would help ***keep more home owners in their homes.*** Politically, this would show that The Plan will indeed help Main Street. Furthermore, by ***forcing banks to bear a greater portion of the losses,*** and allowing them to write off the losses over time from future earnings, ***bank shareholders will be assuming a greater proportion of the risk and cost of the Plan.*** We are in this mess primarily due to poor judgment by the management of these institutions.

The primary goal of taking illiquid and underwater assets off bank balance sheets is to restore capital ratios and lending capacity. Unfortunately, this is just the first step in restoring credit creation. In order for lending to increase meaningfully, banks must be able to sell loans to investment banks for securitization. As long as home values are still sinking and default rates are rising on credit card debt and auto loans, investor demand will be weak. Confidence in the rating agencies has been destroyed and will take years to restore, since so many investors were burned by supposed AAA rated debt instruments. These obstacles are beyond the reach of The Plan, and suggests it will be at least 1 to 2 years before credit creation can be rejuvenated enough to contribute to economic growth. This means any economic recovery in the second half of 2009 or the first half of 2010 will be tepid.

***During the deflation threat posed in 2001 and 2002*** by the loss of \$7 trillion in stock market wealth, ***credit creation was never impaired.*** In the wake of 9/11, the automakers could offer 0% financing, since the capability to securitize every auto loan was possible. This kept assembly lines humming, all the workers associated with the production of motor vehicles working, and current on their mortgage, credit card, and personal auto loan payments. As the Fed lowered interest rates to reduce the risk of deflation, consumers were able to refinance their existing mortgage, lowering their monthly payments and increasing their disposable income. Lower rates also made housing more affordable, so many other consumers could afford to buy their first home, which boosted construction activity and jobs. All this related housing activity was made possible because the capability to securitize every refinanced and new home loan was never impaired.

Will The Plan contain the economic fallout from the dislocation in the credit market and declining home values? The Plan will likely restore some stability to the financial markets, but falling home prices, tighter credit, and more job losses are going to translate into a weakening economy. The 3.3% increase in second quarter GDP was made possible by pegging inflation at 1.3%, even though

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consumer prices have risen 5% in the last year. Of the 3.3% gain in GDP, 3.1% came from exports. It's worth noting that exports represent just 13% of total GDP. This means that 13% of the U.S. economy was doing very well, while 87% was either struggling or doing poorly.

With economists forecasting a second half recovery, employers have let temporary workers go, and shaved hours worked in an attempt to retain their most experienced workers. As companies realize there will be no rebound before year-end and begin to formulate budgets for 2009, the number of job cuts are going to increase. By mid-2009, the unemployment rate could approach 7%.

Many consumers over the age of fifty expected their home to contribute to their retirement nest egg. In the last 18 months, their home has lost 10% to 20%, and in the last year, their 401K has shrunk by 15% to 20%, if they were invested in the stock market. With the prospect that their home value will not rise anytime soon, and an uncertain outlook for the stock market, many graying consumers are realizing they will need to save more. As I noted in my discussion of Secular Trends in the April letter, "The need for consumers to save more will also retard economic growth. Since consumers represent 70% of GDP, just a 1% increase in savings will shave .7% off of annual GDP growth."

The Plan will not keep home values from falling further, restore credit creation to foster economic growth, nor pull the economy out of the current recession in the short run. If The Plan doesn't have a good probability of achieving its primary goals, why pursue it? When time is running short and there are no viable options available, you throw a 'Hail Mary' pass. Once in awhile, they are completed.

## **BONDS**

In my April and June letter, I discussed how secular changes in our economy and global economy could impact Treasury yields in coming years. My conclusion has been that 10-year Treasury bond yields could fluctuate between 3.65% and 5.5% for many years. An extended period of economic weakness normally results in lower interest rates. But this time may be different. Economists have long argued that the numerous safety nets put in place after the Great Depression would support consumer income enough to preclude another Depression. The outcome of that benefit, however, could be an enormous budget deficit, as government spending soars and tax revenues plunge in a deep and extended economic contraction. The possibility of this outcome, while small, cannot be dismissed in the current environment.

When long-term Treasury rates failed to increase, while the Federal Reserve raised the Federal funds rate from 1.0% in 2004 to 5.25% in 2006, Fed Chairman Greenspan initially called this anomaly a 'conundrum'. He subsequently explained that a global savings glut created demand for long dated Treasury bonds that kept rates from rising. The global savings glut was certainly funded by a growing Chinese trade surplus, and revenues flowing to oil producing nations. As investors have learned in the last year, the global economy is still responsive to what happens in the U.S. **If** the U.S. experiences a protracted recession, the global economy will eventually dip into recession. The Chinese trade surplus will shrink, oil revenues will contract, and global savings will suffer from a weaker economic environment. **If** the U.S. budget deficit approaches \$800-\$1000 billion (\$1 trillion)

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in 2010, a shrinking global savings pool will translate into less demand. Over time, this would result in higher Treasury yields. I would not buy Treasury bonds, and believe a good shorting opportunity will develop in coming months.

## **GOLD**

I noted last month that *“There is a risk that deflation may cause a selling wave that hits all asset types.”* Between August 29 and September 11, the only asset class that didn’t fall was Treasury paper. It has been my view that deflation posed a far greater threat than inflation, since stocks and real estate values were falling, and credit was contracting. The Federal Reserve and other centrals will have no choice but to reflate in coming months, in an attempt to arrest asset and credit deflation. As the global economy weakens, we will see more countries use fiscal policy and deficit spending to aid in the reflation effort. All of this should be bullish for gold, silver and gold stocks. Last month, I suggested establishing a small position in the Gold stock ETF (GDX) below \$36.00. Add to this position on any decline below \$35.00. Also, establish a position in the Gold ETF (GLD) below \$85.00

## **DOLLAR**

As I noted last month, *“The rally in the Dollar was not the result of a positive change in the outlook for the U.S. economy. The declines in the euro, gold, oil and other commodities bear the characteristic of a bull market decline, while the dollar’s rally fits the bill of a bear market rally.”* Last month a small short position in the Dollar was advised above 78.00 or a long position in the Euro below 144.75. The expectation was that the Euro could rise to 148.50. The high so far has been 148.46. Use a stop of 144.50. The Dollar was expected to fall to \$75.00. Cover if the Dollar drops below 76.30, using 78.45 as a stop.

## **STOCKS**

In my January 21, 2008 letter, I forecast that the S&P could decline to 1175. As I explained then, *“This technical estimate is based on the chart of the S&P and how it has traded over the last year. In March 2007, the S&P made a low at 1364, and a low of 1370 in August 2007. The top in October was 1576. The difference between the high in October and the two lows in 2007 is 200 points. This suggests the S&P could fall as far below the 1370 area as it was above it in October 2007.”* In the February letter I noted that the 1175 level *“marks the halfway point between the low in 2002 at 775, and the October 2007 high at 1575. Bear markets frequently retrace half of the preceding bull market.”*

Now that the S&P has traded down to 1135, and we have The Plan waiting in the wings, it is worth asking if the bear market is over. Given the poor outlook for the economy and credit creation, I don’t think this cyclical bear market is over. The bear market of 2000-2003, lasted 30 months, if one marks the bottom as October 2002, or 36 months if the March 2003 low is used. This suggests the current cyclical bear market could last until March-September of 2010. In addition, there has been a 16-17

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year pattern in the stock market that dates back to 1949. Between 1949 and 1966 stocks rose in a secular bull market, fell in a bear market between 1966 and 1982 and zoomed between 1982 and early 2000. I believe a secular bear market commenced in 2000 that could last until 2016.

I recommended cutting exposure in July 2007 and October 2007, when the S&P was 1525-1550, and in May when the S&P was 1420-1440. In July, I suggested a rally to 1310-1325 would present another opportunity to sell. There is a good chance the market will rally in coming weeks. The ban of short selling on 800 stocks until October 2 will remove some selling pressure. The passage of some version of The Plan should bring in some buying and cause selling pressure to abate. My guess is that the S&P could climb to 1280-1320, and provide another opportunity to sell. I would recommend a modest short position if the S&P moves above 1313.

Last month I recommended a small trading position in the China ETF (FXI) below \$38.00, the Emerging Market ETF (EEM) below \$38.00, and the oil stock ETF (XLE) below \$69.00. Given the market environment, trading stops should be used. FXI \$34.00, EEM \$34.45, XLE \$65.50.

E. James Welsh