

Market Update – January 11, 2009

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Part 1: The Economy

The Employment Situation is Horrible

1. the unemployment rate increased to 7.2% in December
 - a. the unemployment rate would be 13.5% if you included:
 - i. discouraged workers (who have stopped looking for jobs)
 - ii. people who have accepted part-time work but want full-time work
 - b. the 13.5% complete unemployment number was 8.7% last year
2. 524,000 jobs were lost
 - a. that was a seasonally adjusted number; the real number was closer to 775,000 job losses
 - i. it's adjusted down in months that normally have high losses and it's adjusted up in months that normally have low losses
3. we have lost 2.5 million jobs in 2008
 - a. 1.9 million of these jobs were lost in the last four months
4. 4.6 million American were receiving unemployment benefits for the week ending December 26th
 - a. this is the highest since 1982
 - b. demand crashed the online enrollment systems in NC, OH and NY
5. the average work week fell to 33.3 hours – the lowest level since the gov't began tracking the data in 1964
 - a. this is HORRIBLE news
 - i. employers cut hours before they cut jobs
 - ii. we are likely to see huge job losses in the future

The Budget Deficit is Exploding

1. The Congressional Budget Office estimated that the federal deficit will reach \$1.2 trillion in the fiscal year that ends September 30.
 - a. The prior record was \$455 billion in 2008.
 - b. The deficit would be 8.3% of GDP and would eclipse the postwar record of 6% in 1983.
2. The CBO forecasts the federal government taking on more than \$3.1 trillion in additional debt.
 - a. These assumptions are probably too low...as they are counting on President Bush's tax cuts to expire in 2010

Say it Ain't So: Household Debt is Dropping (Consumers Aren't Spending)

1. US household debt which has been growing steadily since the Federal Reserve began tracking it in 1952, declined for the first time in the third quarter of 2008.
2. In the same quarter, US consumer spending growth declined for the first time in 17 years.
3. These savings rate is expected to increase to 3% to 5%. The idea is that Americans will not spend their way out of this recession.
 - a. The savings rate was 2.8% in November.

Retail Drops Off a Cliff

1. Total specialty retail including apparel and department stores but excluding discounters dropped 18.3% in December from year earlier levels.
 - a. This compared with a 20.2% decline in November.
2. The luxury category fell 27.6% in December.
3. Many leading retailers (including Wal-Mart, Macy's, Gap and American Eagle Outfitters) forecast lower profits and reporting December sales.
 - a. It's amazing to see even Wal-Mart suffering
4. Neiman Marcus' sales dropped 28%.

This Will Already Be Remembered as a BAD Recession

1. From 1929 – 1933, we had a 43 month recession.
2. Outside of that, only two other recessions have lasted more than one year:
 - a. one that ended in 1982 and one that ended in 1975, both lasted 16 months.
3. Our current recession has lasted 13 months.
 - a. For gamblers, a reasonable under / over betting line might be 25 months.

Manufacturing is Getting Crushed and Points to an Ugly Recession

The Institute for Supply Management release their monthly Purchasing Managers Index (PMI). The numbers were dismal. Unfortunately, their numbers are not standardized, so to each mean something different. Here's a summary of the report:

1. The overall index (the PMI) was 32.4.
 - a. Below 50 implies that manufacturing is slowing
 - b. Below 41.1 implies that GDP is contracting
 - c. The index has been dropping for five months and the rate of speed is increasing
2. new orders registered 22.7.
 - a. This was the lowest reading in the 60 years of this index
3. new exports had their third consecutive month of contraction.
 - a. Prior to this, exports had grown for 70 consecutive months
4. all other parts of the index also pointed to recession:
 - a. no industries reported growth in production
 - b. the employment index registered 29.9; the all time low was 28.2 in November, 1982
 - c. supplier deliveries were quicker (indicating a slower economy)
 - d. inventories were contracting
 - e. respondents believed that their customers inventories were too high
 - f. the Price Index reflected that participants were paying lower prices; the reading of 18% was the lowest since June, 1949
 - g. the backlog of orders was very low
 - h. imports also declined

An Example of the Global Slowdown: Singapore

1. Singapore's economy contracted at a seasonally adjusted annualized pace of 12.5%.
 - a. This is the biggest drop in its GDP on record.
 - b. The rate accelerated from a 5.4% decline in the third quarter.

Interesting Survey on Consumer Spending, Technology and Entertainment

1. 51% of US consumers plan to cut back on purchases of high tech products this year.
 - a. 44% said they would spend the same amount
 - b. 5% said they would spend more
2. 66% are less likely to purchase satellite radios this year.
3. 62% said they are less likely to buy a portable global positioning system navigation device.
4. 63% said they are less likely to buy smart phone.
5. 62% said they are less likely to buy a new videogame console.
6. 45% said they had delayed plans to purchase new personal computers, but 40% said they hadn't changed their purchasing plans.
 - a. 18% said they now plan to spend less money on a new system.
7. 52% said they expect to spend less on entertainment outside the home
8. 56% said they would spend less money eating out
9. 58% said they will spend the same amount on entertainment in the home

Retirement Accounts Are in Trouble

1. approximately 50 million Americans have 401(k) plans with \$2.5 trillion of assets.
 - a. I'll save you the math...that's \$50K / account
2. approximately \$1 trillion of value has been eliminated since October 2007
 - a. a similar amount has been wiped out from IRAs
3. it's estimated that 44% of Americans are at risk of being financially unprepared for retirement (see below)
4. in 2007, the median account balance for 55-64 year old 401(k) holders was \$60,740 (per Vanguard)
 - a. on average, this is half of what people have for retirement
 - b. these accounts have decreased significantly in the last year
 - c. so how could only 44% be at risk of being unprepared?
5. unbelievable stat: only 10% of 401(k) account holders save the maximum dollar amount
 - a. this is a reflection of:
 - i. low salaries
 - ii. bad savings habits
6. more unbelievable: 20% of workers age 45 or older have stopped contributing toward 401(k), IRA or other retirement accounts during the last year (per the AARP)

Part 2: Markets

People Are Crazy...

Many investors were excited about the opening day of the year...the 3% gain on January 2nd represented the sixth best percentage gain for the first day of the year (using 113 years of data). The eighth best year was 1929. I can't remember, but I'm not sure that that year ended well. The second best opening day was in 1931. The market only dropped 52.7% a year. We're really grasping for straws when we look for indicators concerning the first day or the first week of the year. You have to ask yourself whether something makes intuitive sense.

My Views on the Market Rally

As always, I preface these comments with my normal caveat...if I knew what was going to happen, I wouldn't be a poor, poor public school teacher. Many people have asked me what I think about the market rallying from 7,800 to 9,000. I think that you have three choices as to what to think:

1. the economy will recover in the second half of the year and the market moves in anticipation of the economy (bullish recovery ahead)
2. the market dropped too far and we were getting a bounce (and we'll be in a trading range)
3. this was a bear market bounce and we're headed lower (bear market)

My belief is that we're not going to have a recovery this year...so you can pick between choices 2 and 3.

Is Credit Loosening?

1. US investment grade corporate debt issuance jumped to \$108 billion in December.
 - a. The record of \$111 billion was set in May
 - b. To get perspective... this is up from \$15 billion in September.
2. On average, the debt yielded 5.25% more than treasuries, while junk bonds yield about 15.6% points more.
3. \$750 billion in corporate debt is coming due in 2009 – so things better stay loose!

Obviously, this is crucial to a recovery in the economy and the stock market.

SEC Cuts

The number of SEC Enforcement Division personnel was cut from 1,338 (in 2005) to 1,192 in 2007. As a result, only about 10% of investment advisers can expect to be examined every three years. Fortunately, the markets have become safer...

Mary Schapiro – Next SEC Chairman

Bernie Madoff's firm was investigated at least eight times in 16 years by the SEC, FINRA and other regulators. FINRA was run by Mary Schapiro. Now, President Obama has nominated her to be SEC Chairman. I voted for Obama, but I think this is a horrible nomination. FINRA grew out of NASD Regulation and some other regulatory agencies. As a former attorney for NASDR, I can tell you that not many people feel good about their regulatory record. They were more like crime scene investigators than regulators.

Can't Go Public

1. Just 29 companies went public in the US in 2008. There were 215 IPOs in 2007.
 - a. This brought in fees of \$931 million to investment banks
 - i. This compares with \$2.69 billion of IPO fees in 2007
2. Follow-on offerings (from already listed companies) raised a record \$200 billion in the US.
 - a. Investment banks only charge about 1.5% - 3% for these deals (compared with 7% for IPOs)

Madoff Should Be Awaiting Trial in Jail

Bernie Madoff has potential information that the government needs. While the risk of flight is low, none of us know what the risk of suicide is. We're not talking about someone who has denied guilt. If he had gone into several banks with a weapon, he'd be sitting in a cell right now...I'm not sure how this is that different.

2008 Was a Great Year...

...if you were a securities lawyer on the plaintiff's side of the bar. There were 210 prospective securities class actions filed last year – a 19% increase. The suits allege more than \$800 billion in damages.

Surprise: Stock and Bond Funds are Down

1. Stock and bond funds had a total of \$5.62 trillion in assets at the end of November.
 - a. At the end of 2007, the US mutual fund industry had \$8.91 trillion in assets.
2. This 37% decline was almost entirely market related.
 - a. The \$197 outflow (redemptions) was a tiny piece.
3. Money market funds increased from \$3.11 trillion (end of 2007) to \$3.74 trillion at the end of November

Part 3: Real Estate

Trouble in the Commercial Market: Prices, Rent and Financing

1. In 2006 and 2007, nearly 60 percent of commercial property loans were turned into securities.
 - a. For all outstanding commercial mortgages, approximately 1/3 are securitized
2. Delinquencies on securitized commercial mortgages have doubled in the past three months to 1.2%.
3. The commercial mortgage market is small (\$3.4 trillion) compared to residential mortgages \$11.22 trillion.
 - a. It is likely that recovery rates will be higher on commercial property (there were fewer buyers who put up no equity).
4. Now that the market for those securities has dried up, borrowers cannot easily roll over the loans that are coming due.
5. In addition, these markets are weakening and it will be difficult to renegotiate loans (since they are part of securities).
 - a. Orange County vacancies have increased from 11% at the end of 2006 to 18%
 - b. NY is above 10%
6. Currently \$107 billion of commercial property (securitized and non-securitized) is in some form of distress (ranging from delinquency to foreclosure).
 - a. NY has 268 troubled properties worth \$12 billion.
 - b. 19 other cities have at least \$1 billion in distressed property.
7. Effective rents are expected to decline 30% from the peak.
 - a. Rents for office space dropped 1.2% in Q4 nationwide
 - i. If we're going to get to 30%, we have a long way to go
 - b. effective rents fell in 65 out of 79 markets
8. In 2008, office tenants vacated 42 million square feet of office space.
 - a. The vacancy rate increased from 12.6% to 14.4%.

Individual Homeowners Continue to Be In Trouble

1. Approximately one in ten homeowners (4.6 million people) are either delinquent in their payment or are in the process of foreclosure.
2. Nearly 37% of homeowners whose mortgages were modified in Q1 of 2008 were in default within six months.

The Gov't Push for a 4.5% Mortgage Rate

1. Fed'l Reserve is going to buy \$500 billion of Fannie Mae, Freddie Mac and Ginnie Mae mortgage backed securities over the next six months.
 - a. This is a \$5 trillion market
2. this demand should lower the risk premium on these bonds. The premium was 2.80% in November (prior to this announcement). It has to narrow to approximately 1.50% to get mortgage rates to 4.5%.

Part 4: Auto Industry

US Car Sales For the Year Were Horrible

1. US auto sales (by foreign and US producers) declined 18% to 13.24 million vehicles.
 - a. Lowest total since 1992
2. GM's sales fell 23% to 2.95 million vehicles (for the year).
 - a. Ford declined 21% to 1.98 million vehicles
 - b. Chrysler dropped 30% to 1.45 million vehicles
3. Toyota's US sales fell 15% to 2.22 million vehicles.

Japanese Car Sales Didn't Do as Poorly as the "Big" Three

1. Toyota's US sales were down 13% in the first 11 months of 2008.
2. Hondas were down 5.4%.
3. Nissans were down 9.1%.

December Car Sales Were Horrible

1. Sales of cars and light trucks fell 36% in December.
 - a. This was an improvement over October and November!
 - b. 4th month in a row that sales failed to exceed 1 million
2. Chrysler's sales fell 53% in December
 - a. Toyota's sales fell 37%
 - b. BMW's sales fell 36%
 - c. Ford's sales fell 32%
 - d. GM's fell 31%

Truck Sales Weren't Much Better

1. Navistar said that US and Canadian retail sales volume for class at 6-8 trucks and school buses totaled 244,100 vehicles in fiscal 2008.
 - a. This was near the lowest in more than 30 years.
 - b. They expect volume to be consistent in 2009
 - c. They expect a rebound in 2010...hope springs eternal. (Jenny expects me to be a better husband in 2010.)

Sales of Cars in Japan Also Dropped

1. Sales of new cars, trucks and buses fell 6.5% to 3.212 million vehicles in Japan.
2. This was the fifth straight annual decline, taking sales to their lowest level since 1974.

US Manufacturers Have Too Many Dealerships

1. There are approximately 20,700 new vehicle dealers in the United States.
 - a. Approximately 2/3 of them sell domestic makes. But those brands account for only half of sales.
2. GM has 6,426 dealers. Toyota has 1,461 US dealerships (23% of GM's number). Toyota has US sales equaling 85% of GM's sales.

Dealerships are Closing

1. Approximately 900 dealers closed in 2008
 - a. 86% of these sold domestic brands
2. There is an expectation that 1,100 more dealerships will close in 2009.

Part 5: Bailout

Cost of Running TARP

1. US Treasury said that it expects to spend \$26.55 billion through January for administrative services related to the Troubled Asset Relief Program (TARP).
2. So far, they have allocated \$354 billion from the fund, but they have only released \$257 billion.
3. Spending \$26.55 billion to allocate \$354 billion...that comes out to administrative fees of 7.5%. Of course, this isn't the total administrative fee, this is only through January. This is what happens when you combine two frugal groups – bankers and government bureaucrats.

Obama's Plan

1. Obama and Congressional Democrats are working on a \$775 billion stimulus package over two years.
 - a. Part of this will be a \$300 billion tax cut for individuals and businesses
 - b. This new plan would offer a credit to offset Social Security and Medicare payroll taxes of \$500 per individual or \$1000 per family.
 - i. This is likely to be capped – so no one making over \$200K is getting it
2. Up to now, the two largest tax cuts have been implemented in the last 8 years:
 - a. Bush had a 10 year, \$1.35 trillion tax cut
 - i. Contained \$174 billion in the first two full years
 - b. in 2003, bush had a \$350 billion package, containing \$231 billion in 2004 and 2005

Only One Person Got it Right

With the federal deficit growing and state's starting to run into huge problems (many states are required to balance their budget), only one person figured out the solution...sell government office. We're prosecuting Governor Blagojevich for his heroic effort to bring in revenue. If you were willing to chip in, you could be receiving a newsletter from Congressman Leeds. But, knowing most of you, I should probably set my sights on being Mayor of Newark.

One More Bailout

Larry Flynt (Penthouse) and Joe Francis (Girls Gone Wild) have asked for a \$5 billion bailout of the porn industry. Video sales are down 22%. Apparently, porn must be a luxury good and not a staple. Go figure.

Part 6: Industry News

Browsers

1. Microsoft's Internet Explorer saw its market share drop from 74% (in May) to 68% in December.
 - a. Firefox increased from 18% to 21%
 - b. Safari rose from 6% to 8%
2. Part of the explanation: Internet Explorer is dominant at work.

Digital Music Growth

1. Downloads of digital music rose 27% in 2008.
 - a. Growth had been 45% in prior year.

Buyer's Remorse

Dow's CEO Andrew Liveris made the following comment:

"One should assume that Rome & Haas in our future. Now having said that, we've just had a **material event** and we're in the middle of the regulatory situation, so... I don't want to make any announcement or add to any speculation on Rome & Haas."

The last time I heard someone try so gracefully to get out of a merger agreement was when Jenny woke up with a hangover and an engagement ring I had put on her finger.

Chips and Computers

1. Intel said that it expects that revenue dropped 20% from the Q3 to Q4.
 - a. In November, they had suggested a drop of 12%
 - b. In mid-October, they had projected a 3% rise
2. Q4 sales are usually the strongest.
 - a. This indicates the tremendous drop-off in computer sales.

Citigroup To Get Rid of Smith Barney

Citigroup is considering spinning off its Smith Barney brokerage unit into a joint venture with rival Morgan Stanley. My recommendation is that they call it Barney Stanley and be simply known as BS.

Part 7: Final Stat of the Week

The latest government study said that 34% of Americans are obese and another 32.7% are overweight. If those numbers are correct, the average reader consumed three Ho-Hos while reading this market update.