

**Market Update – February 22, 2009**

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## **PART 1: Economic News**

### **Japan is getting crushed.**

1. GDP shrank 3.3% in Q4.
  - a. Annualized rate of 12.7%.
2. Had 14% drop in exports.
  - a. It's going to get WORSE:
    - i. In first 20 days of January, exports dropped 46% (YOY)
3. Japan has high debt – 157.5% of GDP.

### **China's economy must be getting crushed.**

1. Japan's exports to China fell 36% in December.

### **Eastern Europe is in trouble.**

1. Stocks and currencies of eastern European countries are tumbling.
  - a. Money is flowing out of these and into dollars and Treasuries.
2. Moody's and S&P said that western European banks which have east European subsidiaries are at risk of downgrade.
3. During expansion, these countries borrowed heavily.
  - a. Loans are denominated in foreign currency (especially euros).
  - b. Foreign capital pulls out during slowdown.
    - i. This decreases value of east European country currency.
  - c. Devalued currency makes it hard to pay back debt.
    - i. Also results in high inflation within country (currency worth less).
  - d. In past six months, Euro has gained:
    - i. 40% vs Polish zloty
    - ii. 30% vs Hungarian forint
  - e. Polish and Czech shares are at five year lows.
    - i. Also fears about Hungary and Romania.
4. The price of credit default swaps on sovereign debt (for the eastern European countries) has increased significantly.
5. Many traders believe that betting against east Europe is now oversubscribed (too many people have placed this bet).
  - a. Many bets were also made against western European banks with exposure to eastern Europe.
  - b. But there is still fear of contagion throughout the area.
6. Eurozone GDP contracted 1.5% in Q4.

**The Fed revealed projections that the Fed governors think that the US is in for a long, painful period.**

1. Fed Governors projected:
  - a. Economy will contract .5% to 1.3% this year.
    - i. In October, projections were for somewhere between a .2% decline and a 1.1% expansion!
  - b. Unemployment will rise to 8.5% to 8.8% this year.
  - c. Inflation will remain under greater pressure.
  - d. Any positives from stimulus will be outweighed by:
    - i. Housing
    - ii. Trade
    - iii. Industrial production
    - iv. Spending
    - v. Employment
  - e. Economy will eventually rebound and growth will resume.
    - i. 2010 - 2011 will have growth of 2.5% - 3.3%.
    - ii. BUT...even as economy heals, unemployment will remain near 8%.
      1. Earliest we can get back to current level of 7.6% will be 2011.
      2. Expect unemployment to fall back to 5% by 2012 AT THE EARLIEST.
2. Fed'l Reserve Bank of Atlanta President (Lockhart) gave speech:
  - a. Strong rebound in growth is unlikely in coming quarters, citing:
    - i. Stagnant credit markets
    - ii. Housing market hurt by excess supply
    - iii. Low business and household confidence
  - b. Modest recovery will come from:
    - i. Lower business inventories
    - ii. Reduction in mortgage rates
    - iii. Improvement in outlook for consumers
  - c. Key improvement expected later in year:
    - i. Financial institutions will find more stable footing.
  - d. Said he was watching (worried about):
    - i. Commercial real estate sector
      1. Risk of default related to refinancing (lack thereof)
      2. Project development loans which need long term financing
    - ii. Financial conditions of emerging markets
  - e. Nationalizing banks is substantially off the table, but not impossible.
3. Fed said they expect 2% inflation for long term.
  - a. Moves Fed closer to targeting a particular level.
  - b. They want market to realize that they are thinking about this.
    - i. Want people to expect 2% inflation.
  - c. Market is scared b/c monetary base has grown 80% in past six months.

- i. Monetary base = total money in circulation + reserves at central bank
- ii. \$843 billion in October; \$1.5 trillion now
- iii. Expansion of money supply is what pushed up Conference Board's Index of Leading Economic Indicators.
- d. Better to get people ready now, rather than after inflation starts.
- e. Household surveys show 3% inflation expectations over long term.
  - i. Difference in yields between TIPS and regular USTs is expanding.
- f. Fed is worried that bond yields will increase if people fear inflation.
  - i. Higher yields will hinder recovery.

**The Producer Price Index (wholesale prices) increased .8% in January – much more than expected.**

1. This was biggest gain since last July.
  - a. January's expectation was for .2% increase.
2. Acceleration caused by:
  - a. 3.7% increase in energy prices
    - i. gas prices increased 15%
      1. biggest increase in 14 months
  - b. 4.4% increase in toys and sporting goods
  - c. 1.1% increase in prescription drugs
  - d. .6% increase in tobacco
4. Wholesale food costs fell .4%.
  - a. Some attribute this to Wal-Mart's reintroduction of Great Value line.
5. Core inflation (excluding food and energy) rose .4%
  - a. This was also higher than expectations (.1%).
6. Good or bad news:
  - a. Good news argument:
    - i. Deflation is much worse than inflation.
    - ii. Inflation won't continue with high unemployment.
    - iii. Some economists think BLS isn't properly adjusting its inflation indexes for price increases enacted by many industries early in the calendar year.
      1. Since 2003, the January PPI has always been significantly higher than two months before and two months after.
  - b. Bad news argument:
    - i. People losing jobs and paying higher prices.

I don't see this as bad news.

### **Bad News...**

1. 4.99 million Americans collecting unemployment insurance.
  - a. Increase of 170,000
2. First time applications for insurance stayed at 627K.
  - a. Higher than expected.
3. Philadelphia Fed issued horrible report:
  - a. General economic index fell to -41.3
    - i. Negative number means contraction.
    - ii. Was -24.3 last month.
  - b. Philadelphia Fed said manufacturing in region shrank most since 1990.
  - c. Employment and sales measures fell to lowest levels since they began keeping records (1968).

### **Wal-Mart is doing well.**

1. Quarterly sales rose 1.7%.
  - a. Same store sales increased 2.8%.
2. Forecast annual EPS growth of 6%.
3. Pressuring competitors.
  - a. Target and Costco are not doing nearly as well.
4. Increasingly, WMT is becoming a destination for more affluent shoppers.

### **The US has a huge deficit and it is even worse than the CBO decries.**

1. A month ago, the CBO forecast a \$1.2 trillion deficit. Since then:
  - a. Congress passed a \$787 billion stimulus bill.
  - b. Obama detailed a \$275 billion mortgage initiative.
  - c. Chrysler and GM have asked for \$21.6 billion more.
2. CBO projects that the deficit will decline from 9% of GDP to 1.1% of GDP by 2019.
  - a. This is based on the false assumption that Bush's tax cuts will expire in 2010.

### **A Few Other Random Facts...**

1. Charities are getting hurt by reduced donations. Think about running a food bank: donations are decreasing and you're serving more meals.
2. Economists estimate that our economy will drop 2% this year, the biggest drop in the post-war era.
  - a. They expect a 5% (annualized) drop in Q1.
    - i. They expect a 1.7% drop in Q2.
      1. Hope springs eternal.
  - b. Economists expect unemployment to reach 8.8% this year.
3. While the gov't is flooding the system with money, the velocity of that money has fallen to its lowest level since 1991.
  - a. Velocity of money is the rate at which money is spent.
    - i. Measured by nominal economic growth / money supply
4. 30 year fixed rate mortgages averaged 5.04% (down from 5.16% last week).
  - a. 15 year fixed rate averaged 4.68% (down from 4.81%).
5. Department stores saw same store sales drop 12% in January.
6. The US Army exceeded its recruitment goals in Q4 for the first time in five years.
  - a. I have great respect for anyone who serves in our military. But, when you see people choosing to go to Afghanistan, it really gives you perspective on the economic conditions.
7. Consumer debt is 130% of income.
  - a. In 2000, it was 100%.
8. The average state and local gov't employee now makes 46% more in combined salary and benefits than their private sector counterparts.
9. Industrial production fell 10% in January – the fastest rate in 30 years.

## PART 2: Mortgage Bailout

### The Plan

1. \$275 billion
  - a. \$75 billion in gov't spending
    - i. encourage lenders to modify loans (subsidize lower rates)
      1. people at risk of foreclosure
      2. people already in foreclosure
        - a. these groups of people don't normally have access to low rates
    - ii. lenders and gov't would jointly lower payments to 31% of income
      1. gov't will pay \$1,000 for each modification; and
      2. gov't will pay \$1,000 / year to servicer if borrower stays current
      3. banks which have received TARP money must participate
        - a. bank must cut rates so that payment is 38% of income
        - b. gov't will then split the difference in getting payment down to 31%
    - iii. borrowers would receive a \$1,000 / yr principal reduction for five years if they stay current on modified loans
      1. this will encourage anyone eligible to participate (even if they don't need it)
  - b. \$200 billion in backing for Fannie Mae and Freddie Mac
2. Plan also supports cramdown legislation.
  - a. Idea is to incent lenders to modify loans, or else...

## Problems

1. Plan doesn't address the difficulty of altering loans packaged into private securities (not Fannie or Freddie).
  - a. Securitized mortgages are being foreclosed upon at much higher rate.
2. Solutions will leave out many borrowers in FL, CA and AZ. Harder for people to refinance if:
  - a. Owe more than house is worth
    - i. Can't refinance more than 105% of value.
    - ii. Plan doesn't encourage principal reduction.
  - b. Mortgage not owned by Fannie or Freddie.
3. Plan relies on lenders to rework loans.
  - a. Idea is to scare them into doing right thing...
    - i. If they don't do it, bankruptcy judge will.
4. Many uncertainties still exist – such as who will qualify.
  - a. Details will be released March 4<sup>th</sup>.
5. Plan doesn't create demand for homes.
  - a. Some people hoped for interest rate subsidy for buyers from gov't.
6. There may be backlash from people who stay current on their loans.
  - a. In effect, they are paying for those who have fallen behind.
  - b. Their reward...stable home prices.
    - i. Fewer vacant homes.
7. You won't get help if:
  - a. Your debt-to-income ratio is low.
  - b. Mortgage is securitized by party other than Fannie or Freddie (unless investor agrees).
  - c. This is investment property.
    - i. Good from political perspective, but...
      1. These cause just as many problems for housing market.
  - d. You have jumbo loan.
8. Plan doesn't reduce principal.
  - a. Loan modification often fails if principal is not reduced.
9. Plan is a bureaucratic nightmare.
10. People who are deeply underwater will walk away.
11. People who can make payments don't get help.
12. There is no protection for the gov't if home price appreciates. This would discourage people who don't need help from seeking this subsidy.

## **PART 3: More Thoughts from the Stimulus and Bailout**

### **Increasing Each Paycheck Rather Than One Lump Payment**

Americans are going to receive \$116 billion in the form of reduced tax withholding from paychecks over two years. The thought was that Americans will spend this, whereas they may save money if they received one large check. Most of you on this list don't need to worry about this...if you make over \$95K, you're not getting anything. (So go ahead and spend that.)

### **As If This Will Surprise You...**

Republicans and Democrats each went on separate trips to resorts in order to "work." This is particularly amusing given all of the grief that they have given the financial companies for their junkets. The Republican trip was paid for by the Congressional Institute, which is funded by 54 "patrons," including General Electric and the Association of Home Builders. House Republican conference spokesman Matt Lloyd said Republicans accept partial corporate funding of the retreat because "we don't believe in using taxpayer money." Yes, I feel much better knowing that you take money from corporations and their trade associations. If I could keep a straight face while saying such stupid things, I'd be king of the world.

### **Pay Caps**

Many people have argued that pay caps will drive talent away from troubled firms. Maybe that's a good thing.

### **Want a Sense for the Size of the Stimulus and Bailout?**

The Pentagon's base budget request for 2009 was \$515 billion (\$513 billion was approved). Further, a separate bridge fund of \$66 billion was approved to pay for the wars in 2009, and it has been expected that the Pentagon may offer another emergency spending bill of up to \$70 billion for this year.

### **You Know I Didn't Mean That, Eh?**

While running for office, Barack Obama said he might need to renegotiate NAFTA. He said that the pact was "not good for America." This week, he went on his first foreign trip and visited our largest trading partner - Canada. Those crazy Canucks are not too happy about our "Buy America" rhetoric. One-third of Canadian GDP comes from exporting to us. Now, the President is talking up trade and not discussing the idea of renegotiating the contract.

Trade is a brutal issue for the Democrats. The east and west coast tend to embrace trade. The Midwest tends to dislike imports because it takes away their manufacturing jobs.

### **States Are Still in Trouble**

The stimulus bill gives states more than \$150 billion over the next 2.5 years. Even with this money, states will have to cut spending or increase taxes. At least 46 states are facing budget shortfalls. It's estimated that states have a \$350 billion shortfall over three years.

A few Republican governors (including SC and TX) have said that they may turn down funds, although Texas' Governor Perry announced (on Wednesday) that he would accept them. It's hard for me to believe that any state will turn these funds down. Obviously, you have a few conservatives who want to appeal to the conservative base and establish themselves as national figures. We need to bring Governor Spitzer back. He was always in favor of stimulus.

The problem that we should all worry about (and the Republican governors have stated) is that we are ultimately creating a problem for the states. How often have you seen states successfully cut programs? In other words, the federal government will get us started and then we're going to be on the hook for these programs.

### **Steel Industry Wants Tariffs**

The American steel industry is trying to get higher tariffs imposed on imports. The accusation is that the Chinese are dumping (selling goods for lower than production costs) and that this occurs because of government subsidies. (Dumping can also be caused by eating Chinese food, but that's an entirely different issue.) Foreign competitors are going to have difficulty participating in the stimulus spending (which will account for 25% of steel demand over the next two years). This is likely to escalate trade tensions with China.

### **Green Projects**

Former President Clinton said that banks which receive money from TARP should be directed to loan money to businesses which develop environmentally sustainable projects. Former President Bush weighed in with his thoughts and said that he likes the color green.

### **The Backlash Against Bonuses...**

GE CEO (Immelt) waived his right to \$12 million of bonus.

## **PART 4: Markets**

### **New Lows for Stocks**

Stocks have broken through their November low of 7,552. Watch out below. The Dow is down approximately 50% from its high 16 months ago. In order to believe we've bottomed, some people are watching for panic selling one day and then a tremendous buying surge in following days or weeks (where up volume is 90% of total volume for a day).

### **Nasdaq Relief Index**

The Nasdaq Relief Index tracks companies that have taken government assistance and is down 50% since inception (earlier this year!). Just keep telling yourself that this is an investment by the government and we're all going to profit from it...

### **Mutual Fund Compensation**

Mutual fund managers have had a tough year, but changes in their compensation sometimes lag the market. The average US stock fund was down 39% last year, but firm revenue is based on assets under management (which dropped throughout the year). We are likely to see bigger drops in compensation in the next year, rather than the past year.

Top bond and stock managers earned between \$1 - \$3 million through early 2008. Remember, these companies are still profitable (although less so) and they don't need or take government money. (There could be some dispute about this for some companies if you think about how money market funds were bailed out.)

### **Keep Buying Our Treasury Bonds**

Foreign purchases of US securities grew to \$74 billion in December, up from \$61.3 billion in November.

The largest foreign buyers of Treasuries are:

1. China
2. Japan
3. UK
4. Caribbean banking centres
5. Middle East

The Financial Times reported that some middle east countries are starting to get concerned about Treasuries. I think a more interesting (and shorter) story would be about anyone who is not concerned about US Treasuries.

### **Freddie Mac Does Huge Debt Issue**

This week, Freddie Mac sold its largest debt issue ever: \$10 billion in three year notes. The bonds yielded 2.125%, approximately .88% higher than a comparable UST. Fannie Mae's three year debt have a .68% risk premium to UST. It's not exactly fair to compare Fannie and Freddie bonds b/c they have prepayment risk (when people refinance, investors get their money back early and have to reinvest it). On Wednesday, the US government increased their preferred stock purchase (providing capital) to \$200 billion from \$100 billion.

### **Mezzanine Debt and Commercial Real Estate**

In commercial real estate, mezzanine debt is senior to equity but below first mortgage. The idea behind investing in it is that you will receive high returns and if there is a default, you will take the property. But now, that's not working out. If the borrower defaults, there often is not enough value to pay off the first mortgage. Mezzanine funds are being wiped out. Many firms that invested in mezzanine debt were leveraged (they borrowed money using the loans as collateral) and this resulted in margin calls.

### **Clearing Credit Default Swaps**

The NY Fed released a statement saying that the US, UK and Europe are working toward information sharing and consistent standards for central clearing of credit default swaps. Centralized clearing will make it easier for regulators to ensure that there is no risk of one entity creating systemic risk.

### **Gold is Rallying**

Gold broke above \$1,000 this week. It is less than 3% below its all time high of \$1,030. It has reached new highs when priced in currencies other than the dollar. It is somewhat unusual to see gold strengthen at the same time as the dollar. This is a sign of the strength of gold right now.

Gold has been helped by many factors including:

1. poor performance of stocks
2. concern about western European banks
3. Russia's central bank's plan to increase gold holdings within its overall foreign exchange reserves

There was a 4% increase in global gold demand in 2008, driven by a 64% jump in investment. Jewelry demand fell 11% while industrial consumption dropped 7% last year. Supply was 1% lower in 2008. There was a 3% drop in mine production and 42% drop in government sales (mostly central banks). Supplies from scrap increased 17%.

Interesting Fact: Sales of South Africa's Krugerrand, the world's most popular bullion coin, are running ten times higher than this time last year.

## **Oil Fades**

Oil prices fell below \$35 during the week. The drop was caused by:

1. concerns about weak demand for energy
2. movement into gold
3. fear over the slow pace of the stimulus
4. the contraction in Japan's output
5. the possible bankruptcy of GM

## **Hedge Fund Assets**

Hedge fund assets have fallen from \$2 trillion in mid-2008 to \$1.4 trillion now. Approximately 1,300 hedge funds liquidated last year. Many hedge funds are unlikely to see profits for a long time. Brokerage firms are limiting the financing that they are willing to give to hedge funds that may not make it through the financial turmoil.

## **Hedge Fund Performance**

The Credit Suisse / Tremont Hedge Fund Index, which tracks more than 5,000 hedge funds, was up 1.09% in January, a period in which the S&P 500 and the DJIA were both down roughly 11%. This is the first time that the index finished in positive territory since May. Convertible arbitrage strategies had the best January, with a return of 5.72%. Short funds gained 3.69%. Global macro gained 2.33% and market neutral funds were up 1.14%.

## **Random**

1. Foreign direct investment in China declined for the fourth month in a row. Investment fell 32.6% to \$7.54 billion from a year earlier. There was a 5.7% decline in December.
2. According to Morningstar, in 2008, any diversified equity fund that lost less than 27% ranked in the top 5%. More than 60% of all funds did worse than the S&P 500.
3. Of 1,665 US stocks with a market value of \$500 million or more, 117 have gained 20% or more this year.
4. One of the hottest crazes in mutual funds is the target date fund. The fund is based on what your asset allocation should be if you are going to retire in a particular year. For example, if you are in a 2030 fund, you will be mostly invested in stocks right now, but that stock allocation will decrease as we get closer. I am considering investing in the "12<sup>th</sup> of never fund".

## **PART 5: Financials**

### **More on the Bailout: Lending is Slow**

A Treasury survey of the 20 largest banks that have received funds through the government's \$250 billion capital-injection program disclosed that lending in Q4 was stagnant or declined.

Reasons for this include:

1. decreasing loan demand
2. tighter underwriting standards
3. loan write-offs (which decrease the balance sheet amount)

A Fed survey of banks released this month found that approximately 2/3 of banks reported that they tightened terms for business loans over past three months.

### **The Preferred Stock Injections**

1. gave no ownership to taxpayers
2. scared common stockholders because the P/S dividends must be paid before common shareholders receive anything

If this P/S was converted into common stock (and most of it is not convertible), the gov't would be the majority owner of many of these banks. In other words, the P/S is worth more than the market capitalization of the common stock.

Apparently, Citi has been floating the idea of having the government convert their \$75 billion of preferred stock into common stock.

### **Nationalization Talk Gets Louder**

Alan Greenspan said that the government may need to nationalize the banks for a short period of time. (Of course, he also said that we shouldn't regulate credit default swaps.) The significance of this is that he was known for his laissez-faire views.

### **I believe that a nationalization would look something like this:**

1. the gov't (likely the FDIC) takes control of the bank
2. shareholders are wiped out
3. bad assets are sold
4. junior debt is converted to equity
5. the gov't is done (they do not maintain control of the bank)

Interestingly, Republicans seem to favor nationalizing the banks. Lindsey Graham from South Carolina and John McCain have both said that nationalization should be on the table.

The administration has said that it believes that banks should be privately owned. They were trying to calm the markets, which were tanking at the time. In the

future, when we actually do nationalize the banks, it will be for a very short time and the banks will be privately owned immediately thereafter. The administration will tell us that this is consistent with their view that banks should be privately owned.

### **No More “Countrywide”**

Bank of America is rebranding Countrywide as Bank of America Home Loans. Recently, Ken Lewis said that “Countrywide is on fire.” Is this a good or bad thing? One could argue that Bank of America is on fire and soon we’ll be rebranding it.

### **Hey Ken Lewis, Wanna Talk?**

NY Attorney General Andrew Cuomo issued a subpoena to Ken Lewis. Cuomo is investigating whether Bank of America withheld information from investors concerning Merrill Lynch’s losses and bonuses (prior to the shareholder vote on the acquisition). Mr. Lewis testified to Congress that he had “no authority” over bonuses given to Merrill employees.

John Thain supplied testimony last week and was asked why the merger agreement had a nonpublic attachment concerning bonuses which could be paid. (If I was taking the testimony, I would have also asked him if plaid can ever go with stripes.)

### **Citi: Don’t Ignore Us...We Need Some Bad Press This Week Too**

Citi announced that Roberto Hernandez Ramirez will leave the Board. But, he’ll keep some perks (which cost approximately \$2.5 million last year), including:

1. reimbursement for private aircraft
2. security
3. office and secretary

Citi’s explanation is that Ramirez will remain non-executive chairman of Banco Nacional de Mexico (a Citi subsidiary). I find the name of this Bank really interesting. When Citi is rebranding, maybe Citi should consider being called Banco Nacional de United States. Sort of catchy, eh?

Citi and BAC continue to trade like penny stocks.

### **MBIA**

MBIA has split its business into two subsidiaries:

1. the traditional municipal bond insurance business
2. the business which insures structured finance (e.g., subprime MBS and CDOs)

CEO Jay Brown said that “this is not a good bank / bad bank split.” I love these guys. What else is it? This reminds me of when my kids were still in diapers and you would ask the rhetorical question, “did someone do a poop in their britch?” and they would deny it. At least my kids grew up.

## **PART 6: Housing**

### **Fleeing the Cities**

People are leaving the large cities due to high unemployment and high cost of living. LA has been particularly hard hit. If you add up all of the households leaving Detroit, Miami and NY, it's still less than the net outflow of LA.

### **Housing Starts Fell**

Housing starts fell 16.8% in January (from December) to a seasonally adjusted rate of 466,000 units – the lowest level in 50 years. This is 56.2% lower YOY. Obviously, this has a negative impact on GDP and construction. At the same time, this slowdown is necessary in order to lower inventory and eventually have a recovery in housing. Housing permits (which gives some indication of future housing starts) fell 4.8% in January (50.5% YOY).

States in the West and South saw starts fall much less (6.4% and 12.8% respectively) than the Northeast (42.9%) and Midwest (23.9%). In other words, the most overheated markets will bottom first. None of this happens overnight though.

### **Homebuilder Sentiment Fell**

The index of homebuilder sentiment rose from 8 to 9 in February. The index reached a high in June 2005, when it reached 72. A reading above 50 indicates good conditions. Seeing an improvement from 8 to 9 reminds me of a student who made a 20 on his midterm, a 23 on his final and came into my office to ask if I consider improvement when assigning final grades.

Homebuilder expectations for the next six months fell to a new record low this month.

### **NVR's Founder Bails Out**

NVR's founder sold \$139 million of the company stock this month. He sold nearly every share he had. He has a record of good timing on his transactions.

### **Commercial Mortgage Backed Securities**

Delinquencies on commercial mortgage-backed securities (CMBS) could triple this year according to S&P and Fitch. Defaults on three large 2007 vintage loans led the CMBS loan delinquency rate to rise 27 basis points to 1.15% in January. CMBS delinquencies have now risen six consecutive quarters from a low of .27% in March 2007.

### **Mortgage Insurers Downgraded**

Moody's cut its rating on several mortgage insurers. They cited higher than expected mortgage losses due to the recession and a continued downturn in the housing market.

## **PART 7: Auto**

### **No Czar**

Instead of naming a car czar, the president put the Treasury Secretary and Larry Summers in charge. He also appointed Ron Bloom as an adviser. Bloom is known as a tough negotiator and is expected to be hard on everyone. The Wall Street Journal reported that in a 2006 speech, he described his approach to restructuring as “dentist chair bargaining,” in which the patient “grabs the dentist by the b---- and says, ‘now let’s not hurt each other’.” It made me wonder whether he has any of these conversations with himself.

### **Restructuring Plan**

GM and Chrysler said they may need up to \$21.6 billion more. GM, which has already received \$13.4 billion says that it needs \$16.6 billion more. They also want \$8 billion to develop fuel-efficient cars. Chrysler (soon to be known as “Fiat North America”) has already received \$4 billion and only needs a cool \$5 billion more.

### **GM**

1. GM also said that it was in talks with Germany, the UK, Sweden, Canada and Thailand to get \$6 billion more in financial support.
2. GM said it would eliminate 47,000 jobs and 26,000 of those would be outside the US.
3. They said they would close another five plants, in addition to the nine that they said they would close in December.
4. They warned of possible closure or spin-off of European plants in high cost locations.
5. They said they may need \$100 billion in financing if they go through bankruptcy. Let me get this right...it will cost \$20 billion to keep you going but \$100 billion if I let you renegotiate all of your bad contracts. I believe that. We’re putting \$20 billion down on our way to a lot more. Plus, we’re not fixing you unless you go into bankruptcy.
6. They need \$2 billion by March and \$2.6 billion in April to avoid running out of cash.
7. GM wants the gov’t to create (by next month!) a \$4.5 billion credit-insurance program to guarantee payments to the country’s parts makers.
8. GM said GMAC may also need more funding (they received \$5 billion from the government in December).
9. GM said it will phase out the Hummer and Saturn in 2011 if no alternatives arise. Personally, I would contact Ken Lewis if I were running GM.
10. GM is trying to reduce their \$27 billion in unsecured debt through a debt-for-equity swap. The government loans will more than replace all of this debt on the balance sheet. I’m not sure why anyone would want to be an equity holder.

The most disturbing headline that I saw in all of my reading this week was “Hummer Could Be History by 2011.” Is it just me or is there a bit too much government involvement here?

### **Chrysler**

1. We’re seeing the impact of private equity – no one wants to give money to Chrysler because there is a feeling that we’re subsidizing Cerberus.
2. Chrysler has said that they plan to launch 24 new vehicles in the next 48 months. That’s what we need...24 new Fiats.
3. Chrysler’s comments don’t sound sincere when you also read that engineers are leaving the company and suppliers have refused to keep working on new products.
4. Chrysler’s workforce was 87,000 at the end of 2006 and is 54,000 now.

### **Ford**

Ford may be benefiting from not being involved with the bad press. They are getting the benefit of renegotiating with the UAW and, at the same time, they seem to be starting to take market share. With that said, I am not convinced that they will be better off in the long term. If GM and Chrysler go into bankruptcy and get rid of some of their expenses, it will be much tougher to compete with them.

### **They’re Turning on Each Other**

Plants are fighting other plants as to who should be closed. Cities are terrified that they are going to lose jobs and tax revenue.

### **This Was an Awesome Investment!**

Cerberus is the 80% owner of Chrysler and 50% owner of GMAC. In December, the CEO wrote to investors that in “the case of GMAC and Chrysler, we still believe we bought well. In those cases we got caught in what we see as a perfect storm in the auto and housing sectors.” The problem is that this is what you’re hired to do...analyze industries and businesses. So yes, these were brilliant purchases. We understand you’d do it again. And we understand that Ken Lewis will eventually look like a genius for buying Countrywide and overpaying for Merrill. You guys never make mistakes. Sometimes the markets don’t understand, but you guys are freakin’ geniuses. I know what it’s like to be misunderstood.

### **We Need a Second Term President**

What we really need is a President who is not worried about getting elected a second time. We need to make the hard decisions. We have problems that don’t have easy political solutions – particularly for someone who wants to be re-elected. The banks and the automakers have to be reorganized. Now is the time to fix Social Security. Giving \$20 to a drug addict solves your problem for a few hours. But they’ll be back.

### **A Few More Auto Facts (About 2008)**

1. US drivers reduced their driving by 3.6% -- the most in 66 years.
2. 881 dealers closed – with most closing in Q4.

UAW workers can retire after 30 years. Some start at the age of 18. We're subsidizing 48 year old retirees. That's absurd.

## **PART 8: Significant Corporate News**

### **Sirius XM Avoids Bankruptcy**

Sirius XM (SIRI) avoided bankruptcy by borrowing \$530 million from John Malone's Liberty Media. The company has big problems: slowing growth, counting on the auto industry for new customers, and increasing competition from mobile radio services. The first part of Liberty's investment is a \$280 million loan. That will allow Sirius to pay the \$172 million of debt that was due. The loan carries a 15% interest rate.

The second phase is a \$150 million loan to XM. Liberty has also agreed to buy up another \$100 million of XM debt. After that second phase, Sirius will issue Liberty an aggregate 12.5 million shares of preferred stock convertible into 40% of Sirius XM's common stock.

### **NY Times Cuts Dividend**

NY Times Co. suspended their dividend. They had cut it 74% in November. They continue to be hurt by falling readership and advertising. This cuts the \$25 million dividend that the Sulzberger family receives and may make them willing to sell the company. The company is trying to sell noncore assets in order to pay \$1 billion of debt that is coming due in coming years.

### **Too Bad...We Were All Rooting For You**

Trump Entertainment has filed for Chapter 11.

### **Another Reason Businesses Close**

It's impossible to sell troubled businesses right now, so more companies are simply shutting them.

**Dow Can't Blame the Credit Market**

The huge issuance of corporate debt in recent months will make it very difficult for Dow Chemical to argue that they cannot get financing for the acquisition of Rohm & Haas.

**Some Retailers Are Seeing Online Sales Grow**

Best Buy and Macy's continue to grow their online sales despite weaker store sales. HP's sales in its computer and printing divisions plunged 19% from a year earlier. Overall revenue increased 1% (service revenue doubled because of the EDS acquisition). HP took market share from PC competitors and they benefited from their broad portfolio. They cut their 2009 outlook. They are cutting the CEO's base pay by 20%. Other employees will have cuts between 5% to 15%.

**More Bad News from Retailers**

JC Penney said it was planning for a further 12 – 15% slowdown in same store sales in 2009. Same store sales dropped 8.5% in 2008.

Lowe's said it expects same store sales to drop 4 – 8% in 2009 after a 7.2% drop in 2008.

## **PART 9: Stanford Financial**

### **Accusation**

The SEC has accused Stanford International of misrepresenting the performance and safety of its CDs by claiming that the money was invested in safe, liquid securities. The suspicion is that the money was invested in illiquid private equity and real estate. There is also a possibility that this was a Ponzi scheme.

### **Size**

Stanford International Bank has more than 30,000 investors and \$8.5 billion in assets. They claim to manage more than \$51 billion in assets. The bank reported steady returns of 6 – 10% on CDs. Some were fixed rate, but others had flexible rates or were linked to indexes. Latin Americans held many CDs in an attempt to hold savings in dollars outside of their home countries.

### **Did the SEC Stop Investigating?**

There is some belief that the SEC's investigation stopped so that it didn't interfere with a criminal investigation (potentially money laundering involving drug money). This is not unusual, as criminal investigators get search warrants and this is much more effective than the subpoenas that are used by civil investigators.

Mr. Stanford attended Baylor, as did the CFO (M. Davis).

### **A Few Oddities**

1. The bank was audited by a small accounting firm on Antigua.
2. The bank reported identical portfolio returns (15.71%) in 1995 and 1996.
3. Last year, when the S&P lost 39%, the bank said that they lost only 1.3%.

The downturn in real estate may have led to the current difficulties. The bank was highly exposed to Florida real estate.

## **PART 10: A Few Random Stories**

Japan's finance Minister resigned after appearing intoxicated at a press conference when the Group of Seven met in Rome. I'd be drinking too if my economy was contracting at a 13% annual rate. I would actually feel much better if Ken Lewis came out and said that he was blitzed when he bought Merrill Lynch.

Forrester recently surveyed 1,000 millionaires (people with more than \$1 million in investable assets) online to find out what they want from investment firm web sites.

Most — 79% — visit their investment provider's Web site at least a few times a year and 83% of those do so every month.

Internet penetration rates are 17% in Asia versus 50% in Europe and 73% in North America.

Verisign reported that the number of domain names registered in Q4 fell 17% (YOY). They didn't say whether most the names that were registered were names like [www.economysucks.com](http://www.economysucks.com). Amusingly, I typed that in (after I wrote this) to see what it pulled up. It pulled up Moody's site (economy.com). Of course, Moody's is one of the reasons that we're in this mess (and that the economy does suck).

Consumer demand for data services on mobile phones, such as accessing email or browsing the internet, is rising despite the global downturn.

UBS has agreed to pay \$780 million in fines and turn over some customer names to the US government. The Swiss bank admitted that it helped thousands of clients evade taxes. The more you read, the more it seems like politicians and the wealthiest people don't pay taxes.

Facebook now has 175 million members. It's fastest growing demographic is 30+.

In the 1970s, the FDA performed 35,000 inspections each year on 70,000 food-processing plants. Today, they conduct 7,000 inspections per year. The number of plants has grown to 150,000.

So far, records indicate that Bernie Madoff did not buy any securities on behalf of his clients in 13 years.

### **PART 11: McCombs Alumni Conference (and my blog encouraging participation)**

The McCombs School is having an alumni conference. Several faculty will speak for an hour each (I'll be speaking in the morning) and an alumni (astronaut) is our keynote speaker. Below, you will find a link to register.

<http://blogs.mcombs.utexas.edu/alumni-news/tag/mcombs-alumni-conference/>

In addition, I was asked to write a blog to encourage people to attend. You can see my blog at the following site, but I also reprinted it below.

<http://blogs.mcombs.utexas.edu/alumni-news/2009/02/19/sandy-leeds-shares-perspectives-about-economy-and-alumni-business-conference/>

Once again, my guilty conscience has gotten the best of me. I'm hoping that writing this will cleanse my soul. Several alumni have told me that they think it's really great that we're hosting the Alumni Conference in March. They generously attribute altruistic motives to our actions. I really wish that they were right.

The truth is that there are a few things that we told you when you were students that might not have been quite right. We were sort of hoping that you could come back for a day and we could clear a few things up. You see, it turns out that free markets aren't always the solution. Sorry about that. And, when we told you about diversification, I really do apologize if that led you to buy international stocks or corporate bonds. My bad. If we somehow gave you the impression that corporate boards oversee management and ensure that they are taking the appropriate amount of risk, we meant that theoretically. When we implied that the SEC detects fraud, we meant that they had *the potential* to detect fraud if they were *actually* looking.

Of course, you're not completely without fault either. There were some things that you just didn't quite understand. Some of you thought that when we spoke about

alternative assets, we were talking about assets that weren't highly correlated with the stock market. We were actually talking about alternative ways for you to lose money. When we referred to technical analysis as witchcraft, you might not have realized that we actually like witches and you should have sold when the financial stocks started breaking down. And do you remember all of those annoying questions you asked me when I derived CAPM? Well, if you hadn't slowed me down, I would have had more time to talk about the counterparty risk involved with swaps.

Before you get mad at me, I want you to realize that there were plenty of other top schools that were teaching things that were a lot more wrong than anything we taught. I can guarantee you that no one here told you to pay a 70% premium for an investment bank without doing any due diligence. I can also promise you that none of our Management faculty said that it would be a good idea to give out \$4 billion of bonuses when your company lost \$15 billion in the quarter and had recently destroyed over \$50 billion of shareholder value.

At this point, it should be obvious to you that your education is dated and you need to return for a day of reprogramming. You'll notice that we priced the conference at \$115. You might wonder how we came up with this number. Well, we're a business school and we don't do anything without market research. Our analysis shows that this is the amount that remains in the average 401(k) plan. So don't compound your errors...ignore us when we told you to save money. Cash out that retirement account and attend our conference. You live in America...you've worked hard and you deserve this gift to yourself. And if you're 401(k) has less than \$115, I'm relatively confident that the government will pay for your attendance.

Thank you for allowing me to clear my conscience. I look forward to seeing you at the Alumni Conference on March 27<sup>th</sup> (as well as the reception on March 26<sup>th</sup>) – I'm sure that there will be many other things I need to get off my conscience by then.