

Market Update: January 2, 2009

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- 2. If you receive this email and want to be on my list, send your email address to sandy.leeds@mcombs.utexas.edu**
- 3. This is not intended to serve as investment advice. Consult / blame someone else for losing your money.**

NOTE: I lifted many sentences directly from news sources. I do not take intellectual credit for much of this writing. I like to think of myself as the Bernie Madoff of business writing. I take other people's ideas and give you back a little less.

This week's update covers the following topics:

- 1. Economic News**
- 2. Real Estate News**
- 3. Industry News**
- 4. Credit Markets**
- 5. GMAC**
- 6. M&A: Dow and Rohm & Haas – The DOW Disaster**
- 7. One Final Thought**

Part 1: Economic News

The Big Online Retailers Outperformed

Online sales did better during the holiday season than traditional retailers. Online spending was down just 2%, while retail as a whole was down 5.5% to 8%. The strength in the online retailers was concentrated in Amazon, Apple and Wal-Mart. This is the first holiday season where online sales have not grown. EBay's traffic decreased by 16% and Best Buy is decreased by 17%.

Consumer Confidence Hit All Time Lows

The Conference Board's Consumer Confidence index fell to an all-time low of 38 in December from 44.7 in November. This is based on a survey of 5,000 households. One year ago, the measure was at 90.6.

Consumers are more negative about the labor market, with 42% saying jobs are hard to get (37.1% in November).

A Term You Will A Lot in 2009: Quantitative Easing

Quantitative easing aims to bring down long-term interest rates and increase liquidity in the financial system. Under a quantitative monetary regime, the Fed would focus directly on the quantity of money in the system rather than on trying to influence the money supply indirectly through the price of credit—in other words, interest rates. You will hear this term as reference to the Fed buying securities (since they can't lower rates any more).

Weaker Dollar is Helpful

The dollar has been weakening against the yen and the euro. It is down 10% versus the euro and 8% versus the yen since the start of November. In times of economic weakness, all countries want to see their currency lose value so that they can export more. The exception is countries that have debt that they must pay back with dollars.

One added benefit: a weaker dollar helps protect us against deflation. (In other words, a weak dollar can be inflationary.) My personal view is that deflation could be a short-term problem, but the long-term issue will be inflation (as a result of the Fed's policies). In reality, no one knows – this is all new right now.

Part 2: Real Estate

Home Prices Have Continued to Drop

1. The S&P / Case-Shiller home price index fell 2.2% in October.
2. The index is down 18% from the prior year. This is the sharpest decline in the index's 20 year history.
3. The index peaked in mid-2006 and is down 23.4% since then. Prices are back at the March 2004 level.
4. Six of the 20 cities showed declines of more than 25%.
5. Three (Phoenix, Las Vegas and San Francisco) have dropped more than 30%.
6. Dallas (-3%) and Charlotte (-4.4%) had the best performance.

Plans to Help Homebuyers Have Not Helped

Hope for Homeowners was supposed to help 400,000 people. Only 357 have signed up. Problems: high fees and narrow eligibility requirements.

Lenders have done loan modifications on their own with poor success: 37% of mortgages modified in Q1 of 2008 were 60 days or more behind after six months.

The Future of Home Prices

A few things to worry about for the next year:

1. rising unemployment
2. prices being pushed lower by foreclosure sales
3. reluctance of banks to loan

The Good News

The Federal Reserve plans to buy half \$1 trillion of mortgage backed securities by June of 2009. Since the Fed will absorb most of the expected net supply of newly generated mortgage backed securities in 2009, there is a good chance that mortgage rates could go even lower to 4.5%. The Fed's program is in addition to the treasury's purchases of mortgage bonds, which so far have totaled \$50 billion.

The Upcoming Surge of Bankruptcies

The Democratic Congress is likely to pass a cram-down law that allows bankruptcy judges to lower principal on mortgage. I have to believe that this will increase the attractiveness of bankruptcy. I wonder how this will affect other creditors:

1. will more individuals file for bankruptcy resulting in more charge-offs; or
2. will the reduction in mortgage debt allow other lenders to recover more

Part 3: Industry News

The WSJ reported that the airline industry is raising cash. A few key points:

1. Examples of cash raising:
 - a. Delta got \$1B from Amex (they co-brand a credit card) and will get another \$1B in 2010.
 - b. SW is raising \$350MM by selling and leasing back 10 planes. It raised \$400MM by selling notes backed by other aircraft.
 - c. AMR has raised \$2B from stock sales, aircraft-backed financing, a revolving credit line and by divesting a money mgt unit. They also sold and leased back 39 turboprop planes to generate \$200MM.
2. They are paying higher interest rates:
 - a. Southwest is paying 10.5% on a 3 yr note -- it had paid 5.2% on a 12 yr note in May. They have an investment grade rating.
3. Lots of refinancing ahead:
 - a. The seven largest airlines have \$4.4 billion of debt and capital lease maturities in 2009 and \$6 billion in 2010.
4. Some airlines are losing (badly) on their oil hedges:
 - a. UAL and US Air both reported \$500MM of losses on oil hedges in Q3. Imagine Q4.
 - b. They have all had to post more collateral on their hedges: United \$900MM; American \$550MM; Delta \$1.1 billion.

Pipeline Companies

Pipeline companies are having trouble financing their growth. As an example, El Paso issued debt recently with a yield of 12%. They had issued debt in May at 7.25%. This is bad for the companies as well as consumers. Note that pipeline companies charge on volume, not commodity prices.

Part 4: News From the Credit Markets

US Treasuries: 2008's Winning Investment

US Treasuries were the best investment for the past year. A portfolio of Treasuries of more than 20 years maturity would have returned 35% from January 1. Even a broad treasury portfolio with a range of maturities returned more than 14%.

Long Term for UST?

USTs are doing well as we focus on deflation and investors want to avoid risk. With that said, I don't think you can be a buy-and-hold investor with long term Treasuries at this point. The downside is much greater than the upside. In other words, if inflation increases down the road, you will have tremendous losses (i.e., you risk not keeping up with inflation).

In addition to inflation, the US is expected to issue \$2 trillion of new debt next year. This supply will not help prices. It could also hurt the emerging markets' ability to issue debt.

Foreign Demand for Agency Debt

There is less foreign demand for Fannie and Freddie debt. Foreign central banks owned \$986B in July. They now own \$819B.

Part 5: GMAC

I'm Sure This Will End Well...

The Treasury bought \$5 billion of preferred stock from GMAC. The Treasury also loaned \$1 billion to GM with the understanding that GM would invest the money in GMAC. In sum, the Treasury put \$6 billion into GMAC.

GMAC immediately started offering 0% financing on five 2008 models. They priced loans on the remaining 2008 and 2009 models at .9% to 5.9%. In addition, they are loaning money to consumers with FICO scores of 621 or higher. The median US consumer has a score of 723.

So let me get this straight...as the economy weakens, we're loaning money to subprime borrowers who want to purchase subprime cars. This should help GM recover. I'm pretty confident that my three kids (ages 8, 6 and 4) are more fiscally responsible in a candy store than these guys are when running their business.

Interestingly, while GM has received \$13 billion from the government, Chrysler has not yet received the \$4 billion that the US Treasury promised. How much do you want to be that the money was sent and Chrysler lost it?

Part 6: The Dow Disaster

The deal that everyone is talking about (which may reflect the small amount of news over the holidays) is Dow's (DOW) purchase of Rohm & Haas (ROH). I should warn you that I know nothing about the chemical industry (nor the specialty chemical industry) – I would rather watch paint dry. But, as an outsider, this looks like a disaster. I would not want to be an ROH employee right now. So here's the story:

On July 10th, DOW announced that they would buy ROH for \$78 cash plus the assumption of debt. This was a 78% premium based on where ROH had closed on the prior day. This meant they were paying approximately \$15.3 billion for the stock and assuming about \$3 billion of debt.

With respect to the \$15 billion cash payment, DOW planned to use approximately \$9 billion that they were going to receive from Kuwait's state-owned petroleum country (as part of a joint venture). Last week, Kuwait said that they wouldn't honor this deal. It's really odd...you would think that you could trust guys who attempt to manipulate the worldwide price of oil.

DOW had also arranged a \$13 billion bridge loan to finance the acquisition (plus \$4 billion in other financing – mostly preferred stock). This bridge loan is a 12-month loan! (It comes from a consortium of 19 banks.)

S&P and Moody's recently downgraded DOW's debt. It's still a couple of notches above junk status, but a journey of 1000 miles begins with a single step...

Think about this: DOW is going to effectively finance the \$18 billion cost of ROH with debt (and preferred stock) that will probably cost more than 8%. At 8%, you're talking about \$1.4 billion of interest. ROH had EBIT this past year of approximately \$900 million. In other words, this is going to significantly impact DOW's EPS. (Let's not even talk about the economy's impact on EPS.) In addition, DOW will become highly levered and will need to refinance in the next year. What are they going to have to do? CUT COSTS. Combine this debt issue and the slowing economy and I wouldn't want to be an employee of ROH. (I'd have to expect that DOW will also have significant cuts.)

When the deal with Kuwait was canceled last week, ROH's stock dropped below \$50. The market was clearly saying that they did not believe this deal would occur at \$78. The deal is supposed to close by January 10th. In the past week, ROH's stock has recovered into the mid-\$60s. Even a slightly reduced price will not solve this problem.

Personally, I'd love to see this deal fail – I think it would be better for DOW shareholders and ROH's employees (it would obviously be bad for ROH's shareholders). Apparently, the deal is somewhat unusual – there is no simple way for DOW to pay to walk away. They can only pay to walk away if they can't get regulatory approval.

A few final things to think about with respect to this deal:

1. Who is going to want to deal with Kuwait in the future?
2. If you don't believe that the chemical business is cyclical - LyondellBasell Industries, the world's third-largest independent chemical company, told lenders on Monday it is considering filing for bankruptcy protection amid plunging sales and cash crunch.
3. DOW's market cap is \$15B and they have sales of \$50+ billion. They are paying \$15.3B for ROH which has sales of approximately \$10 billion. You do the math.

Part 7: One Final Thought

I'm starting to get really irritated with all of the credit that Ponzi gets. His name has appeared in the paper thousands of times in the past month because of Bernie Madoff. I personally believe that it is just as likely that Madoff came up with his idea by looking at the Social Security system. From now on, I encourage you to refer to Madoff's Social Security scheme.

Happy Holidays.