Market Update – March 1, 2009

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PART 1: The Economy

Things Were Worse Than Previously Reported

1. Q4 GDP dropped 6.2%.
    a. The early report (know as the Advance Report) said the drop was 3.8%.
    b. Weakest qtr since 1982 Q1 (-6.4%).
2. For entire 2008, GDP grew 1.1%.
3. Q4 consumer spending dropped 4.3%.
    a. Biggest drop since 1980.
4. Q4 business spending on software and equipment dropped at 28.8% annualized pace.

The Elderly Have it Tough

1. More elderly are in the work force:
    a. 16.8% of people 65+ are in work force
        i. Was 11.9% a decade ago
    b. Number of 75+ year olds in work force has grown 46% in YOY
        i. 7.3% of people 75+ are in work force
            1. Up from 4.7% a decade ago
        ii. Still a small number (73,000)
2. Reasons they are in work force:
    a. Losses in investment accounts
    b. Shift away from defined benefit (pensions) to defined contribution plans (401(k))
    c. Home value losses and outstanding mortgage
    d. Lack of health insurance
    e. Better health allows people to work longer
3. Unemployment among elderly is rising
    a. Jobless rate among 65+ is 5.7%
        i. Last recession it only reached 4.3%
        ii. This is probably low b/c when older workers get fired, they drop out of work force (retire)
            1. But now, many can’t retire
4. Older workers take longer to find next job
    a. 55+ took avg of 25 weeks to find new job (in December)
    b. <55 took avg of 18.7 weeks
5. Recent survey from Scottrade said only 32% think that they will someday be able to stop working completely.
    a. This is down from 39% in 2008.
    b. 2/3 said that they will not contribute to their IRA this year.
        i. Last year it was 50%.
            1. This should help matters…

Weekly Job Numbers Were Horrible

1. 5.112MM people are receiving state unemployment assistance
    a. Record high
    b. Increase of 114K (week over week)
2. Initial claims increased to 667K
    a. Highest reading since Oct. 1982 (695K)
    b. Prior week was 631K
        i. We're still seeing acceleration

California Dreamin' (of a Job)

California's unemployment rate jumped to 10.1% in January, the highest since 1983, as employers in the nation's most-populous state cut 79,000 jobs in the month.

I Rather Be Unemployed in Massachusetts?

1. States pay different amounts to unemployed people.
2. In Mass., the maximum weekly payment is $942, while NY is $405!
    a. I'm guessing that this is compensation for having to live with people who talk about the Patriots, Celtics and Red Sox.
        i. I don't think the incremental $500 / week would be worth it.

Mass Layoffs Decrease Slightly

1. There were 2,227 mass layoffs in January.
    a. Decrease of 48 from December.
2. There have been 25,712 since start of recession (14 months).
3. Mass layoff is 50 or more job cuts from single employer.

Increasing Trend: Furloughs

Anecdotally (fancy way for saying, "I ain't got no numbers"), there are more companies and governments using furloughs (where employees are being forced to take off one day per week or one week per quarter, etc.). They are paid proportionately less.

It's difficult to do this with white-collar workers. If I have to work less, my work does not go away (it's not like an assembly line). Personally, I think it's better to simply institute pay cuts. (People don't like that b/c they fear that would be more permanent than a furlough.)

Another of my personal opinions is that seeing the ramifications of unemployment, I'd be more than happy to take a pay cut in order to help the University not lay off people. I think that more people see the need to help others in today's environment.

Consumer Confidence (or lack thereof…)

1. Conference Board's Consumer Confidence Index fell to 25 in February.
    a. Lowest level since data started (1967).
    b. Index was 34.7 in January.
2. 51.1% said conditions worsened in February.
    a. Up from 47.9% in January.
3. 48% said jobs are hard to get.
    a. Largest number since Feb. 1992.
4. 47% said they expect jobs to decrease next month. You think?
    a. Highest percentage since December 1973.

Some Bad News Overseas

1. German business sentiment dropped to its lowest level in 26 years.
2. The EU's consumer confidence survey fell to -33.
    a. Lowest level since survey started in 1985.
3. Industrial orders for euro-zone dropped 5.2% in December and 22.3% YOY.
4. Rising unemployment in Germany and France.
    a. More people lost jobs in France last month (90,200) than ever before.
    b. This probably would have been worse if their workweek was longer than 6 hours…
5. Latvia is doing horribly:
    a. Latvia's credit rating was dropped from BBB- to BB+.
    b. Economy contracted 10.5% in Q4.
    c. Coalition gov't collapsed.
6. Estonia and Lithuania are on credit watch.
7. Poland, Hungary, Romania and the Czech Republic issued coordinated statements to protect currencies.
8. Ukraine's debt was downgraded further into junk status.
9. The European Bank for Reconstruction and Development warned that the economic crisis "is threatening to throw nearly two decades of economic reform into reverse" in Central and Eastern Europe.
10. The risk of credit rating downgrades for Asian companies is at 5 yr high.
    a. Exports are getting killed.
        i. Japan's exports dropped 45.7% (YOY) in January.
            1. President Obama and Japan's PM Taro Aso agreed to work together and avoid protectionism.
            2. If I had been in charge, when he was speaking Japanese, I would have translated his comments so that the closed captioning said, "Buy American." But that's me.
    b. Japan's industrial production is down 30.8%.
    c. Manufacturing output is down 10% (month over month).
    d. New job offers declined 18%.

Housing Data

1. Home prices were 18.5% lower in December (YOY).
    a. Largest YOY drop since data started 21 yrs ago.
2. Largest drops (YOY):
    a. Phoenix 34%
    b. Las Vegas 33%
    c. San Francisco 31%
3. Since peak of July 2006, index is down 26.7%.
    a. Index has fallen 29 consecutive months.
    b. In seven years before peak, index had increased 155%.
4. Karl Case (co-founder of Case / Shiller index) says home prices won't bottom until well into 2010.
5. Foreclosure filings increased 81% last year to 2.3 million.
    a. Highest on record.
6. January foreclosures increased 18% (YOY).
7. Continuing problems in housing market:
    a. Labor market
    b. Weakness in personal income
    c. Negative wealth effect from other assets
    d. Overhang of housing supply
    e. Credit availability
8. Sales of previously owned homes fell 5.3%.
    a. Nearly a 12-year low.
    b. 8.6% drop YOY
    c. Sales were flat in West
        i. Midwest and South dropped 5.7%
        ii. Northeast dropped 14.7%.
    d. Median home price dropped 14.8% (YOY).
        i. $170,300
        ii. Lowest level since March 2003
    e. Approximately 45% of sales were distressed properties.
9. New home sales dropped 10.2%.
    a. 309,000 annual pace is lowest on record (since 1963).
    b. Median price dropped 13.5% to $201,100.
        i. Largest percentage decrease since 1970.
    c. Inventory is 342,000.
        i. Good news: lowest level in five years.
10. Inventories are at 9.6 month supply.
    a. Good news: drop of 2.7%
    b. The 9.6 month supply is based on the current (low) sales pace.
        i. We don't know how many people haven't listed their house even thought they want to sell.

Home Ownership is Looking More Attractive Relative to Renting

1. Average mortgage payment was just 24% more than rent payments.
    a. Lowest gap since 2001.
    b. Near the 18 year average of 26%
    c. In 2006, this reached 66%.
2. Approximately 12% are leaving renting to buy home.
    a. This is near historical average.
    b. Had reached 25% at peak.
        i. Nonqualified buyers were entering home market.

Lets All Move to Houston

The "Credit Score Enhancement Program" will give up to $3,000 in grants to individuals who are trying to qualify for mortgages through the city's homebuyers assistance program. City officials say some applicants fall short of eligibility by only 10 or 20 points on their credit scores, and paying off some debt balances can quickly improve their numbers. These are the people we want buying homes, aren't they? It seems like these are the people who have been buying homes for the past five years.

Housing Bill in House of Representatives

1. Would allow bankruptcy judges to erase loan balance and / or lower interest rate.
2. Would lower monthly payments of borrowers who qualify for Hope for Homeowners program.
3. Mortgage service companies would get legal protection if they try to ease loan terms to preserve long term viability.
    a. Currently, contracts require them to foreclose.
4. FDIC insurance is permanently increased to $250K.

"Adverse Feedback Loop" – Recession and Financial Crisis

1. Job losses and falling corporate profits create new loan defaults.
2. New defaults hurt banks (beyond original mortgage problems).
3. Banks' falling stock prices and rising loan defaults make them less likely to lend and make it harder to raise more capital.
4. Less lending results in less spending on cars, factory, equipment, etc.
5. Less spending results in more job cuts and falling profits…

Some Assorted Bad News

1. The nation's five largest railroads have put more than 30% of their boxcars (206,000) into storage.
2. Trucking industry is also hurting.
    a. With 130% annual turnover, they are normally always looking for drivers.
        i. Turnover is down to 65% and they have more applicants than they need.
        ii. Industry employs 1.32 million people and is losing jobs.
            1. 7% of businesses (by # of trucks) closed in 2008.

        iii. Average long haul driver makes $40K - $45K.

3. The number of defaults by franchisees (on loans guaranteed by SBA) increased 52% (YOY).
    a. Loan losses jumped 167%.
    b. Franchise brands with at least 11 defaults:
        i. Aamco Transmissions, Carvel Ice Cream, CiCi's Pizza, Cold Stone Creamery, Curves for Women, Domino's Pizza, Dream Dinners, Planet Beach tanning salons, Quiznos, Subway and Taco Del Mar.
    c. Over time, the worst performing brands (on SBA loans) include:
        i. Mr. Goodcents Subs and Pastas – 55%
        ii. Philly Connection Sandwiches – 51%
        iii. Cottman Transmission – 49%
        iv. All Tune & Lube Auto Centers – 47%
        v. Cornwell Quality Tools – 42%
        vi. Carvel Ice Cream – 41%
        vii. Blimpie – 41%
4. 25% of workers expect their income to fall in next year.
5. 80% of bond ratings changes are downgrades (for past yr) in US and Europe.
    a. 74% in Asia.
6. More than 50% of the goods that are used to determine PCE (Personal Consumption Expenditures) dropped in price in December.
    a. This fuels fear of deflation.
7. The Fed said that the low savings rate that we have experienced is going to hurt our ability to retire. There's a surprise.
    a. They should have mentioned more enlightening news…our homes being down 26% and stock accounts being down 50% aren't doing that much to help us retire.
    b. Here's something that may help…
        i. The median home price in Detroit is $79,900. This might be a nice place to retire. I'm going to be too old to ski and no one is going to really want to see me in my speedo (I plan on retiring that when I'm 75) so I don't need the mountains or beach.
8. 9 out of 10 U.S. workers plan to cut personal spending this year.
    a. 47% cited food and dining as the first item to trim.
9. Durable Goods Orders Dropped 5.2% in January.
    a. Excluding aircraft, it was a 5.4% drop.
    b. The previous month's drop was revised down from 3.2% to 5.8%.

PART 2: Budget Issues

Budget Issues

1. Before Obama took office, the nonpartisan CBO projected a $1.2 trillion deficit for 2009.
    a. This does not include $787 billion stimulus bill.
        i. Not all of this will be spent in 2009.
    b. Most likely deficit will be around $1.75 trillion.
        i. 12.3% of GDP.
    c. 2008 deficit was $455 billion.
2. Obama's 2010 budget would set a goal of $533 billion deficit.
3. Our federal budget will be $3 trillion.
    a. Only three countries have GDP bigger than that:
        i. China $7.8 trillion
        ii. Japan $4.5 trillion
        iii. India $3.3 trillion
4. There is little dispute that the President is submitting a more intellectually honest budget than we saw from President Bush. (Even the nonpartisan CBO said this.) But, we are dealing with politicians, so it's not entirely honest!
    a. Bush had tax cuts during his years and his budget forecasts all said that they would go away when he was gone. In other words, they didn't count the expense of continuing these deductions / exclusions.
    b. President Obama is assuming a much stronger recovery than the Fed'l Reserve or private forecasters are predicting.
        i. Budget assumes GDP -1.2% this year.
            1. Blue chip survey projects -1.9%
        ii. Budget assumes 3.2% growth next year.
            1. Professional forecasters forecast 2.1%.
        iii. Budget assumes 2010 average annual unemployment of 7.9%
            1. Fed assumes 8.5% to 8.8% in Q4 of 2009 and 8% to 8.3% in Q4 2010
            2. Pessimistic Sandy thinks we're headed towards double digits next year.
5. Obama is going to tax higher income people at higher rates:
    a. Top tax rates will go from 33% and 35% to 36% and 39.5%.
    b. He would lower mortgage interest deductions if your taxable income is >$200K (or $250K for a couple)
        i. This will further hurt the higher end of the real estate market…
    c. Top capital gains rates would move from 15% to 20%.
    d. Personally, I think it's crazy that we don't adjust salaries by location.
        i. $250K in Austin is very different from $250K in NYC.
6. He is suggesting $630 billion to start pushing toward a national health-insurance premium.
    a. Healthcare stocks reacted poorly.
    b. Wealthier medicare recipients will have higher premiums.

7. Private equity fund managers will take a tax hit. Their "carry interest" will be taxed at normal rates, rather than capital gains rates. This is the majority of their income – it is their share of the investors' profits.
    a. The argument (and I agree with this) is that the private equity managers have not invested this capital. Rather, this is income, not capital gains. This is more of a fee for services.
8. The gov't would take over student lending.
    a. Pell grants would be expanded.
    b. Pell grants would also become more of an "entitlement."
    c. Sallie Mae and Student Loan Corp lost 31% and 22% respectively.
9. Emissions of greenhouse gases would be capped and polluters would have to purchase permits.
10. Clean energy technology would get $120 billion.
11. The estate tax will not be repealed. Bush's budget gave it to us but his fake forecasts suggested that it would be eliminated when he was gone.

High Income Voters Supported Obama

The majority of high-income voters supported Obama – even though he said that he would raise taxes on them. This reminds me of when I was dating Jenny. I told her that I was an ass, but she still wanted to marry me. Maybe this is just a reflection on McCain or the pathetic options that Jenny had.

Of course, the question is whether high-income voters still support him. Almost everyone has lost money in the market and they may feel less altruistic. My hope for the President is that his popularity doesn't decrease as much as mine did when Jenny found out that I was telling the truth.

A Few of My Views

1. The President's rosy economic assumptions violate what I like about him: I think he's generally a straight shooter. They also conflict with his "doom and gloom" announcements.
2. I am somewhat uncomfortable with the fact that I live so comfortably and some people don't have access to healthcare. If I have to pay higher taxes so that this can happen, I'm comfortable with it. (I recognize that not everyone feels this way.)
3. Even if tax rates increase, I'd still rather be in a higher bracket than a lower bracket!
4. While this isn't an apples-to-apples comparison (b/c the estate tax brings in far less money than income taxes), I find it strange to increase income tax rates and continue the estate tax exclusion. I personally feel much more desire to help people who are working as opposed to people who have wealthy parents and are inheriting. Just one man's opinion.

Tax Problems

1. Top 5% of US taxpayers paid almost 44% of all taxes.
2. We have evidence that payments from higher income taxpayers will decrease:
    a. Many states which rely on wealthier taxpayers have seen 15% to 30% drop in tax revenue.
    b. There will certainly be fewer stock gains to tax.

The Main Points on the $787 Billion Stimulus Bill

1. Main Points:
    a. $287 billion in tax breaks
    b. $500 billion in spending projects and money for social programs.
    c. New limits on bonuses and pay for top executives at banks.
    d. All of this will add to our $10.7 trillion of debt.
2. Key Spending:
    a. $95.2 billion for schools and grants for college students.
    b. $87 billion to help states pay for Medicaid.
    c. $80.5 billion to repair and improve roads, bridges, mass transit, etc.
    d. $38.4 billion to help poor and unemployed buy food, pay rent, get job training.
    e. $30 billion to invest in upgrading US energy transmission, distribution and production.
    f. $22.2 billion for science facilities and research and to expand broadband Internet to rural areas.
    g. $21 billion to lower healthcare costs by investing in IT and preventive care.
3. Distribution of Major Tax Cuts
    a. Worker tax credit of $400 for individuals and $800 for couples.
    b. Tax credit for home buyers of ~$8,000.
    c. Temporary AMT relief for 20 million taxpayers.
    d. Removal of unintended tax hit on GM’s $10 billion December bailout.
    e. Ability to deduct state sales tax from new car purchase.

PART 3: A National Citi

We Move Closer to Nationalization. Citi entered into a deal with the US government whereby the US would convert $25 billion of preferred stock into common stock. The conversion price is $3.25 per share. Converting is contingent upon private investors doing the same (with up to $27 billion of preferred stock).

Here's the Math. Citi already has 5.45 billion shares outstanding. If the government converts $25 billion at a $3.25 per share price, we will get 7.69 billion shares. If private investors convert their $27 billion of preferred stock (at $3.25 per share), they will receive 8.3 billion shares. As a result, there will be 21.44 billion shares. The US will own 7.69 out of 21.44 billion shares or 36%.

Here's How You Did. Citi's stock ended the day at $1.50. Our 7.69 billion shares are worth $11.5 billion. So yes, we have turned our $25 billion "investment" in Citi into $11.5 billion. I have often wondered if I could find someone who could lose money quicker than I can in the market. Well, I've done it. In fact, I found 300 million people who just lost $13.5 billion yesterday. Nicely done.

Goal: To Increase Tangible Common Equity. Citi did not receive any more capital. All that's happened is that preferred stock is now converted into equity. As a result, the equity base appears stronger (greater ability to absorb losses).

Why Will the (non-US gov't) Preferred Stockholders Convert? The preferred stock was trading for $7.50. They were going to be able to convert each $25 par value into shares for $3.25. That means they would get 7.7 shares ($25 / $3.25). If you could get 7.7 shares worth $1.50 each, the P/S is worth $11.55. One of the advantages of forcing the preferred shareholders to convert is that it avoids the US being the majority shareholder.

Couldn't the Preferred Stockholder Still Lose? What if you buy the preferred at $8 or $9 and the common stock goes down to $1? Then you have stock worth $7.70 (instead of $11.55). You would lose. The way you protect yourself is you buy 1 share of preferred and you short 7.7 share of Citi common stock. You lock in your profit. Now, it doesn't matter what happens to Citi's common stock. This my friend is arbitrage. In addition, this short selling is one of two factors that drove Citi's stock down on Friday. The other factor is the dilution (shareholders' interest in the company is diluted by the conversion of preferred stock to common equity).

Is This Nationalization? In effect, this is close to the nationalization we've been speaking about. The only difference is that instead of converting the subordinated debt into equity (effectively hurting the people who took the risk of loaning the money to Citi), we are converting the preferred shareholders (and effectively hurting US taxpayers). But here's the great thing…the government can say that they avoided nationalization and the general public won't understand that we just got screwed. It's as close to perfection as you can get politically. Plus, think about it, next week on the news, you may hear that a correspondent is standing outside of the Citi White House or we may have presidential debates sponsored by Citi. Of course, if this type of event leads to commercialization, I hope we nationalize Victoria's Secret.

It's Always China's Fault. There is some speculation that the reason that the government is unwilling to put banks into receivership and convert debt into equity is that it would hurt China's holdings. If we do that, they may refuse to buy our Treasuries.

I Knew Your Name Was Different, But I Had No Idea You Were From a Different Planet. Vikrim Pandit (Citi's CEO) made a very strange comment, "In many ways for those people who have a concern about nationalization, this announcement should put those concerns to rest." What is he talking about? Someone needs to break it to him that he's just been nationalized – we just hurt the wrong people.

Bernanke Calmed the Market During the Week. Bernanke said this week that he didn't see the need to nationalize any banks. Why should he if we're going to just give them money like we did with Citi? Talk about the Texas two-step…rather than just giving Citi money, we bought preferred stock and then simply converted the preferred stock at a price that was too high. I could also show you a quote from the summer of 2007 in which Bernanke said that he didn't believe subprime would affect our banks. It's your ability to see into the future that I respect so much…

Bernanke said that we don't need full control. He commented "we have very strong supervisory oversight." Now I feel better. Apparently, we never had the right to oversee Citi before? I need to thank those regulators for protecting us.

PART 4: Financials

More Criticism on TARP

Elizabeth Warren, head of the Congressional Oversight Panel for the Troubled Asset Relief Program said that the new Treasury Dep't plan "lacks crucial details," especially about how it will treat toxic securities held by banks.

Tim Geithner Criticizes Banks

Geithner said he was "deeply offended by the quality of judgments we've seen in the leadership of our nation's financial institutions." He didn't mention being offended by people who don't pay their taxes and now oversee the IRS as Treasury Secretary. I think he's okay with people like that.

Is Fed Policy Good

A recent paper suggested that Fed intervention has kept weak banks alive. The result is that these banks don't want to sell toxic assets, because this would result in losses. Strong institutions don't want to buy because they are waiting for a fire sale. I'm not quite sure why we needed a paper about this…we've all been talking about it for six months. Maybe now it's official.

Problem Bank List Increases

1. Problem banks on US watchlist increased 50%.
    a. Now, 252 on list.
2. The banks on list have $159 billion in assets.
    a. Names of banks are not released.
3. In first two months of 2009, 14 banks have been seized.
4. FDIC's insurance dropped almost 50% in Q4 to $18.9 billion.
    a. That $18.9 billion insures $4.8 trillion in deposits.
        i. Sounds like AIG…
    b. FDIC is going to start charging banks more for insurance.
        i. Raising rates just when banks need to retain capital…
    c. Banks lost $26.2 billion in Q4.

FHLB Losses

1. The Fed'l Home Loan Banks of San Francisco, Pittsburgh, Boston and Chicago reported large losses.
    a. Caused by write down of mortgage securities
2. Home loan banks:
    a. Created by Congress in 1932
    b. Cooperatives owned by more than 8,000 commercial banks, thrifts, credit unions and insurers
    c. Make loans (called Advances) to members

Stress Tests Have Started

1. Purpose: determine which of the largest U.S. banks should get bigger capital cushions in case of a deeper recession.
    a. Citi and BAC have each already received $45MM in capital and guarantees against mortgage losses
        i. This amount is larger than each company's mkt cap.
2. The stress test is examining how bank would do if:
    a. Unemployment rises above 10%; and
    b. Home prices fall by another 25%.
3. Administration will require some banks to either:
    a. Raise more private capital (good luck…); or
    b. Accept more capital from the government.
4. Stress tests will finish in April.
    a. Testing 20 US banks with over $100 billion.
    b. There will be no public disclosure of results.
    c. Banks will then have 6 months.
        i. Makes a lot of sense to give them six months, since things are changing so slowly…
5. Gov't investment would be in form of convertible preferred.
    a. But conversion option would belong to bank.
        i. Normally, convertible debt is convertible at option of bondholder, NOT the issuer.
        ii. Conversion will be at a 10% discount to Feb. 9 price.
    b. Will pay 9% dividend.
    c. After 7 years, will automatically convert to equity if not redeemed or converted earlier.
    d. Banks will be limited in:
        i. Executive compensation
        ii. No dividends to common shareholders
        iii. No stock repurchases

Regulators Missed IndyMac

1. Treasury Dep't Inspector General said that IndyMac pursued aggressive growth strategy.
    a. Failing to verify borrowers' income
    b. Relying on expensive deposits to fund operations
2. Firm was profitable, so problems and red flags were ignored.
3. But don't worry…these stress tests will identify the problems.

General Banking Industry News

1. Net interest margins are low, but have improved recently.
    a. This is the difference between interest income and interest expense.
    b. Funding is dirt-cheap right now.
        i. Fewer bad banks that offer high rates to attract capital.
    c. Banks are stringent in loans and requiring high interest rates.
2. Director and Officer insurance for banks has increased 24% (YOY).
    a. Average premium of $147K on first $5MM of coverage.
    b. ALL other industries saw decrease, including:
        i. Tech company premiums -13%
        ii. Life science -21%
3. Special Inspector General said TARP is ripe for fraud.
    a. <5% of banks have responded to questions as to what they've done w/ TARP funds
4. The Fed sent a letter to banks discouraging them from paying dividends.
    a. If a bank received gov't funding and paid a dividend, there's a problem.

Firm Specific News

1. RBS is pulling out of half of the 60 countries that it does business in.
2. JPM cut its dividend by 87%.
    a. This will save it $5 billion per year.
    b. Should be able to pay back $25 billion TARP money quicker.
3. AMBAC posted a $2.34 billion loss.
    a. AMBAC is second largest bond insurer (MBIA is first).
    b. AMBAC and MBIA are both separating their municipal bond insurance divisions.

Fannie and Freddie

1. Fannie reported a $25.2 billion loss for Q4. Freddie is expected to report a huge loss in early March.
2. Losses were caused by:
    a. Defaults
    b. Decrease in the value of interest rate derivatives
    c. Writedown of tax assets
        i. Won't have enough income in future to use them, so must write down
3. Loss for 2008 totals $58.7 billion.
    a. This exceeds net income for past 17 years.

More Merrill and BAC News

1. Q4 losses for ML were $500MM higher than the previously stated $15.31 billion. I know that I personally find it difficult to keep track of half a billion dollars.
2. Ken Lewis said he doesn't believe that BAC will need any more federal money. Of course, he believed that he got a steal on ML. Can you say "contrarian indicator?"
3. Records indicate that some of the mortgage backed securities issued by BAC are the worst performing. Interesting, some of their securities are worse than those issued by Countrywide. It's interesting to think that BAC improved their credit analysis by acquiring Countrywide. That's like improving your company's morals by hiring Elliot Spitzer.
4. BAC is considering selling First Republic Bank, a private bank that was owned by ML. BAC already owns U.S. Trust. Potential buyers are GS or MS.

We Should Have Never Gone Public. Very interesting Op-Ed piece in the WSJ suggesting that maybe the investment banks would still be safe if they were still run as partnerships. Liability flows through to partners – would they have levered up?

This Should Scare You

Several banks have recently filed their annual reports and disclosed the market value of their loans (which are on the books at book value). Some examples include:

1. Regions has $94.9 billion of loans (being held as investments) that have a fair value of $79.9 billion.
   a. Regions has $13.5 billion of equity on the balance sheet (and a market cap of $2.6 billion).
   b. If their loans were marked down to fair value, their equity book value would be negative.
2. Huntington Bancshares has $40.2 billion of loans on their balance sheet, but the loans have a fair value of $33.9 billion.
   a. Huntington has $5.3 billion of equity on the balance sheet (and a market cap of $608 million).
   b. If their loans were marked down to fair value, their equity book value would be negative.
3. Bank of America has their loans overvalued by $40 billion (almost 25% of their shareholders' equity).

Hedge Funds to Pre-empt Regulation
The Alternative Investment Management Association, a U.K. trade group (that has many US members) is proposing that hedge fund managers agree to many changes that U.S. funds have resisted. This includes registering with regulators and regular contact with regulating authorities.

Paid to Go Away
It used to be that credit-card companies lured customers with cash rewards. Now American Express Co. is paying to get rid of them. The card issuer is offering selected customers a $300 AmEx prepaid gift card if they pay off their balances and close their accounts.

This reminds me of when Jenny's father offered me money to go away. Now he realizes that he should have been willing to pay a lot more.

PART 5: Some Industry News

Newspapers Continue to Get Crushed. The publisher of Philadelphia's two major newspapers as well as the publisher of the New Haven Register all filed for bankruptcy. Since December, the publisher of the Chicago Tribune and LA Times, as well as the publisher of the Star Tribune in Minneapolis have also sought bankruptcy protection. Finally, late this week, Denver's Rocky Mountain News decided to shut down after 150 years!

Hearst said it may close the San Francisco Chronicle. Many papers are up for sale, including the Austin American-Statesman. I'm not sure who wants to buy a newspaper right now.

Advertising is dropping faster than publishers can cut costs. Think about relying on department stores and car dealers for your revenue.

Jon Stewart had an interesting suggestion for solving the newspaper problem. He said that we should put a narcotic in the newsprint so that when it gets on our hands, we'll be addicted and we won't be able to wait until we can get our hands on the next newspaper. This may be the only remedy for this industry.

Consumer Goods Companies are Watching the Paycheck Cycle. Consumers are showing a tendency to make their largest purchases when their salaries come in and make smaller purchases as their money runs out. In other words, people are spending more money at the beginning of the month and less at the end. Scary.

Home Depot Says Tough Times are Here and Will Continue. Q4 sales dropped 17.3%. Same store sales dropped 13%. HD lowered projections, saying that 2009 sales will drop 9% from 2008's crappy performance. Lowe's 2008 sales fell 7.2% and is expecting sales to drop 4 – 8% tin 2009.

Dell Hell. Dell's Q4 revenue fell 16%. Notebook sales were down 17%, desktops were down 27% and servers were down 16%. At least they were consistent. Their storage division actually had 7% sales growth. Dell will continue cutting costs…which is not a ton of fun for employees.

PART 6: Auto Industry News

GM's 2008…A Year to Forget. GM's Q4 resulted in a $9.6 billion loss, bringing the year's loss to $30.9 billion. Revenue for the year fell 17%. GM used $19 billion of cash during the year and $5.2 billion in Q4. They have $14 billion of cash now ($4 billion is from the gov't), but they need $11 - $14 for day-to-day operations. In other words, they need more cash fast. They may not meet their auditor's "going concern" requirements and this would result in violation of debt covenants. I would imagine that they need money prior to the auditor's decision.

Not surprisingly, even GM's non-US operations deteriorated. They lost $1.9 billion in Europe, $917MM in Asia and $181MM in Latin America. They're nothing if not consistent.

In the last four years, GM has lost $82 billion and cut 92,000 jobs. In effect, they have lost $56 million PER DAY since 2005.

As if things aren't bad enough, GM's pension funds are now underfunded by $12.4 billion. In early 2008, the pensions were overfunded by $18.8 billion.

Bankruptcy Attorneys…Start Your Engines. Outside advisers to the Treasury have started preliminary talks to line up $40 billion in financing for GM and Chrysler. This would be the largest bankruptcy (debtor in possession) loan ever. Previously, the all-time largest DIP financing was approximately $8 billion (to Lyondell Basell, this year). Apparently, they are talking with Citi and JPM and are trying to put together a huge syndicate of up to 70 banks – share the pain. Citi loaning money to GM, now that's rich.

DIP financing is safe – you have first priority in getting paid back. (The only time DIP financing was not repaid was Winstar Communications.) The average historical rate was ~ LIBOR + 4%. Now, it's about LIBOR + 6%. GM's should be lower if the gov't guarantees the loan. If the gov't doesn't guarantee the loan, it will be difficult to get the money.

Fed Lending Program is Not Helping Auto Industry. The Fed has a $200 billion program to help securities backed by consumer loans. This is known as the Term Asset-Backed Securities Loan Facility (TALF). The problem is that the Fed will only help finance deals with AAA ratings. Unfortunately, securities backed by loans to auto dealers are not AAA. Car manufacturers will need to refinance more than $15 billion in loans to dealers in the next year, including $6 billion in the next month. I don't want to tell anyone how to run their business, but I think if you pay S&P or Moody's a little more, you might be able to get those AAA ratings.

White House is Looking at Auto Supply Business. Lenders are refusing to extend credit to parts-makers that do significant business with Detroit's (Not So) Big 3. GM wants the government to guarantee suppliers' receivables (in other words, if a supplier is promised payment, the gov't will guarantee that payment is made). GM estimates that the insurance program would require $4.5 billion. This move would give lenders confidence to use receivables as collateral. Again, I don't want to tell anyone how to do business, but my impression was that unions had some connections with people who knew how to make people pay.

GM and Chrysler Salaried Retirees…Are You Watching? A bankruptcy court gave Delphi (GM's largest part's supplier) the right to terminate health benefits for 15,000 retired salaried employees. Salaried employees are often ending up worse-off than hourly employees.

Ford Pay Cuts. Ford's Chairman (Bill Ford) and CEO Alan Mulally will take 30% pay cuts and salaried workers will not get bonuses in 2009. Is this news? If they had paid bonuses, investors would have gone ballistic and the gov't would do the same when Ford finally comes begging for money. Bill Ford's salary will be deferred and not paid until the company returns to profitability. He hasn't taken compensation since 2005. (That is admirable.) Mulally earned $21.7 million in 2007. (That's absurd.) In 2008, Ford lost $14.6 billion and used $21 billion in cash.

Things Are Hardly Getting Better. Ford eliminated their jobs bank – a 25-year-old program that paid UAW employees their FULL salary indefinitely to go to work and not do anything. (GM and Chrysler had already eliminated this.) Now, workers with 20+ years of experience will get 70% of their pay for 52 weeks and another year at half that rate. Workers with 10+ years will get 39 weeks of each. Workers with less than 10 years experience will get 26 weeks of each supplement. This is a good change…now, if you want to get paid to do nothing, you know that your only choice is to work for the government. (I can say that…as a UT faculty member, I'm a gov't employee.)

China Seizes (Steals) The Opportunity. China is planning to build up a "Big 10" group of automakers. Many manufacturers such as VW, Hyundai and Toyota have previously invested billions of dollars in Chinese joint ventures. I will never invest in a company that has a plan like this. Why don't you just turn over all of your technology? That's all that they want. If this is a good business model, I just don't understand it.

Honda is the Only Japanese Big 3 That is Profitable. The reason for their profits…motorcycle sales to third world countries. They have great sales in Asia and South America. In addition, Honda produces motorcycle parts all around the world and the result is that they have not had to raise prices (if they produced in Japan, the stronger yen would have resulted in having to raise prices).

Motorcycle sales may slow because it is much more difficult to get credit in their target markets. In many places, you could (historically) buy a motorcycle with $50 down.

PART 7: News From the Markets

Stocks Have Lost 50% Since Peaking. When the market closed near 7,115, it was the lowest close since May 7, 1997. Think about that…if you invested in May 1997, you have made no money in the last 12 years. The S&P closed the week below the November 2008 lows. For everyone who said that was the bottom, it's time for a new guess.

The Stock Market Downturn is Widespread. Since the October 9, 2007 peak, only nine stocks in the S&P 500 are up. No sector has increased.

In 2000 – 2002, consumer staples were up 24% and healthcare declined only 7%. This time, healthcare is the best performing sector and it has lost 29%.

Something Else to Worry About…the slowdown in consumer spending only started about six months ago. That could mean that we're still not far into the recession. Consumer spending is approximately 70% of GDP.

Short Interest is Relatively Steady. Short interest in NYSE stocks rose 2.79% to 13.8 billion shares. This is the equivalent of approximately 2.5 days trading volume. Short interest in Nasdaq stocks dropped .98% to 6.89 billion shares. This is the equivalent of 3.1 days trading volume.

Nationalize the Dow
Nationalization talks swirl around 10% of the Dow: BAC, C and GM.

The Dow Effectively Has 25 Stocks, Not 30. The Dow Jones Industrial Average has 30 stocks and the importance of each stock is based on its price (not its market capitalization). Five member stocks are trading below $10 (BAC, C, Alcoa, GM and GE). This makes these stocks relatively meaningless. If all five stocks dropped to zero, the DJIA would drop 200 points.

A New Name – The Spam 500. The latest company to enter the S&P 500 is Hormel. We typically think of S&P selecting leading companies in leading industries. What does this say about what S&P thinks about our future?

Does S&P Calculate Their Earnings Wrong? S&P adds up the earnings of all the companies in the index. In 2008, this will be negative (for the first time since 1936). One commentator (Jeremy Siegel) argued this week that you should really market weight each company's earnings. In other words, rather than treating each company's earnings equally, multiply each earnings number by the weight of the stock in the index. If you did this, last year's earnings were $61.80.

Many people responded and said he was crazy (including people from S&P). But, Jeremy Siegel's comments are probably correct because of limited liability. If 499 companies made $1 trillion and 1 company lost $1 trillion, would you think that the market's earnings were zero? No, I would think that one company was going out of business (or headed for government subsidies in today's world) and the other 499 companies had earned $1 trillion.

NYSE Suspends $1 Rule. The NYSE suspended the rule that required delisting stocks that trade below $1. Approximately 56 NYSE stocks trade below $1. It also said that it would continue to relax its market capitalization rule (to $15MM from $25MM). The market cap change saves approximately 12 companies. New listings have a minimum market cap of $150MM.

Approximately 54 companies were delisted from the NYSE in 2008, most of them recently. Nasdaq delisted 85 companies.

Always Fierce Competition Between NYSE and Nasdaq. Nasdaq attracted companies with $80 billion of market cap to switch from the NYSE in 2008. The NYSE only took companies with $8 billion of market cap from Nasdaq. Nasdaq promises many things, including advertising (on their huge electronic Times Square billboard) and market intelligence (concerning who is trading the company's stock).

Listing fees on the NYSE can be significantly higher than Nasdaq. In addition, the reputational advantage (of the NYSE) has diminished. Companies that switch to Nasdaq are also being allowed to keep their three letter ticker.

Big Dividend Cut. GE cut its dividend by 2/3 (from 31 cents per share to 10 cents). It will save them $9 billion per year.

Contrary to What You May Think…Shares of dividend-paying stocks have fallen since Nov. 21, while those that don't pay dividends have risen, according to Strategas, a NY research firm. The dividend "aristocrats" (companies that have been raising dividends for 25 years) have underperformed the S&P 500. (This is particularly interesting b/c they are only measuring the surviving members – ignoring those companies that have dropped out of this elite group.)

So far this year, there have been 45 dividend increases within the S&P 500 (compared to 80 in the same period last year). With that said, 45 shocks me – I would have guessed that it would have been closer to 5.

Good Sign for the Credit Markets. On Thursday, bond investors bought approximately $10 billion of new bonds issued by investment grade companies. The majority was issued by Chevron and Abbott and had terms ranging from three to 30 years. On average, the risk premium was approximately 200 basis points (2%) above comparable US Treasuries.

Not sure this is true, but article argued that: Long Term Bonds Tend to Rally at the End of the Month. Managers who run long term bond funds often have to buy long term bonds at the end of the month in order to increase the duration of their portfolio (so that it is closer to their benchmark). With long term funds, their existing bonds mature and this creates the duration gap. (This didn't hold true in February.)

Recovery Rates on Loans are Sinking. Recovery rates on leveraged loans (think of these as high yield loans, often used during LBOs) have been less than 25%. The historical average is 80%. While these loans are often secured, many LBOs used lots of loans, meaning there are lots of claims on the collateral. Approximately 60% of companies that have rated loans do not have any debt other than loans.

We Still Have Counterparty Problems With Credit Default Swaps. We still do not have a clearinghouse set up. A clearinghouse would stand between the parties on a credit default swap trade and guarantee payments. This would help prevent the collapse of one firm causing problems at another firm – systemic risk. Without CDS, it is hard to offset credit risk.

Some Changes to Credit Default Swaps are Planned. Under existing practices, protection buyers pay sellers a regular premium based on a privately agreed assessment of the underlying risk. Under the new rules, buyers instead will be quoted an upfront price by sellers, and they also will pay a coupon. The individual swaps coupons will be fixed at 1% for contracts covering investment-grade debt and 5% for those on high yield debt.

Another change is that investors no longer will deliver bonds when credit-default swaps are settled. Already, when a default happens, traders typically settle in a cash auction, rather than handing over the physical bonds, as used to be the norm.

The new rules also will eliminate debt restructuring as a default event in the contracts, limiting them to bankruptcy and failure to pay interest payments.

Yen Has Been Weakening Lately. The yen tumbled against the dollar recently as investors have feared Japan's deep recession. Until this bad economic news, the yen had been the second best performing currency (behind the dollar) since August.

One source of strength (since August) has been the unwinding of the "carry trade." In the carry trade, speculators borrowed in Japan (at very low rates), converted the yen and invested in risky securities. As risk aversion has increased, these trades have been unwound (meaning that yen are bought back to repay the loan).

Of course, a weaker yen would be good for Japan's export led economy.

PART 8: Random

Republicans Trying to Make a Point. Mississippi Gov. Haley Barbour announced that he would join Louisiana Gov. Bobby Jindal (Louisiana) in turning down federal incentives to expand unemployment insurance coverage. These are relatively small amounts ($58MM for Mississippi and $97MM for Louisiana).

More Evidence of How Bad Things Are. Democratic Gov. Bill Ritter (Colorado) said that the number of people using Medicaid has increased 11% since last year. This is surprising because his state only has 6.1% unemployment.

Give Me That Money Back! The receiver for the assets of R. Allen Stanford sent letters to more than 50 current and former members of Congress, asking them to return any contributions from Mr. Stanford.

This is a tough issue in my mind. Imagine that he had paid me for consulting services. I wouldn't return that money – if I did, I would be the one who had been defrauded. But, I suppose that a political contribution is different and should be returned. (Realize however, that some of these politicians relied on this money and spent it and it's not much different from my consulting example.)

But here's the ALL-TIME stupid response…according to the WSJ, Senator McCain's spokeswoman said that Senator McCain and his campaign will be donating the money to charity. So let me get this right…you received this money from a fraudster, and you have it available to give back to people who have lost their life savings, but you are going to give the money to some other group of your choosing? You would have been a great president, oh wise man of genius.

One other thing about Stanford…the SEC first thought that it was a simple fraud – that Stanford represented that money was invested in a conservative fashion but that it was being put in illiquid assets. Now, they apparently believe that this was a Ponzi scheme.

Let The Ugliness Continue. Dow Chemical Co. is in talks with a group of private-equity firms about an investment in its agricultural-sciences unit, which would give it cash needed to complete the purchase of Rohm & Haas Co., people familiar with the matter said. Dow's stock is trading close to $7 and is down 80% since announcing the ROH acquisition.

Many More Frauds are Being Reported. There have been several other frauds reported in the past week. The most notable has been Westbridge Capital Management (run by Paul Greenwood and Stephen Walsh who have been arrested by the FBI). They had approximately $1.8 billion under management, including a fair amount of institutional money (such as Carnegie Mellon University and University of Pittsburg).

I have read some interesting facts about this story, including:

1. Several of the largest consulting firms (including Wilshire Associates, Cambridge Associates and Mercer Investment Consulting) recommended Westbridge Capital to their clients. Consultants advise institutional investors on investment issues such as strategies, asset allocation and manager selection.
2. The WSJ reported that a Cambridge spokeswoman said, “Westbridge was not a broadly recommended manager by Cambridge.” What the hell does this mean? We only recommended it to the clients we don’t value? We would have recommended them broadly, but we thought it was a fraud?
3. A Wilshire memo (recommending Westbridge) said that Westbridge had never had a negative alpha **month** for 12 consecutive years. In other words, on a risk-adjusted basis, they outperformed their benchmark each month for 144 consecutive months. That’s clue #1. Hellooooo….
4. In 1986, Walsh and Greenwood settled with the SEC for using $6 million in customers’ securities for some of its own bank loans. This is clue #2.
5. Greenwood used to be a professor (clue #3?) at Ohio State and currently is town supervisor (mayor) in North Salem, New York. So here’s the really shocking part…a dishonest politician. I can hardly believe it. What are you going to tell me next…that he doesn’t pay his full taxes?
6. A spokeswoman for the Iowa Employees’ Retirement System (which used Wilshire’s consulting practice) tried to diminish their own negligence and said that they “never rely on just one recommendation.” The Iowa ERS attorneys aren’t going to like that statement when they eventually sue Wilshire.

One Product Has Defied the Recession…Guns! The FBI’s National Instant Criminal Background Check System shows background checks increased 28.8% (YOY) in January. In November, the increase was 42% and in December the increase was 24%. These checks are a strong indicator of sales.

People are either afraid of their ability to buy guns in the future or they’re afraid of riots…but those are scary numbers.