

**Market Update – March 15, 2009**

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## **PART 1: Economy**

The World Bank predicted that the global economy would shrink in 2009, for the first time since WWII.

The IMF managing director said that the governments are moving too slow in ridding banks of problem assets and this could jeopardize a global economic recovery in 2010. The IMF now believes the global economy will be gripped by a "Great Recession" in 2009. The IMF suggests that countries which can afford it should have a stimulus equivalent to about 2% of world GDP. Currently, we are at 1.5%.

### *Indicators*

**Stable Retail Sales.** US retail sales fell only .1% in February after a 1.8% rise in January. Consumers may be doing better this quarter...although it's hard to believe when you look at unemployment. Some analysts said that the strong numbers reflected COLA adjustments to Social Security (in January) and deep discounts by retailers. There were gains at electronics to furniture stores. But, we're also seeing an increase in sales at Wal-Mart, implying a move to low-end stores.

**Wholesale inventories** declined .7% (January vs. December), but they were up 1% YOY. Sales at the wholesale level fell 15.4% YOY and 2.9% in the month. This is deflationary, as sales are dropping faster than inventory. The inventory to sales ratio rose from 1.24 in July to 1.44 in December.

**Mortgage Rates.** US mortgage rates fell to 5.03% for the week ending March 12 (from 5.15%). The 15 year fixed rate mortgage averaged 4.64%.

**Consumer Credit.** Nonmortgage consumer credit fell at a 3.2% annual rate in Q4. (Mortgage debt is 4X as large as nonmortgage debt.) Household debt levels in Q3 were equal to 96% of GDP and 130% of disposable income. (It was 66% of GDP in 1998.)

Currently, the percentage of household income used to pay creditors is near 14%. Normally, it's closer to 12%. We need to see more deleveraging.

**Loans Aren't the Problem.** Between October 2008 and January 2009, loan volumes at commercial banks declined \$144.6 billion (2%). The bigger problem has been the securitized loan market as well as the fact that people have too much debt.

## *Employment*

**Unemployment Rises.** The number of people drawing state unemployment benefits rose by 193,000 to a record 5.32 million in the week ended February 28. New applications for jobless benefits increased to 654,000 last week from 645,000 the week before.

**Almost Every State is Weak.** Unemployment rates rose in almost every state in January. The worst unemployment rates are in manufacturing heavy states in the midwest and in states that suffered the most from the housing crisis. Between December and January, nearly half of states saw unemployment rates rise a full percentage point. The lowest unemployment rates were in Wyoming (3.7%), North Dakota, Nebraska, South Dakota and Utah. The highest were Michigan (11.6%), South Carolina, Rhode Island, California and Oregon.

**We Don't Want the Money.** Several Republican governors are saying that they are not going to accept the part of the stimulus money that is designed to increase employment benefits (b/c they don't like the conditions placed on the money). This includes the governors of SC, Mississippi, Alabama and Louisiana. In short, the real thought leaders...

**Weakness in Manufacturing.** Manufacturers have cut payrolls ~9.4% in the 14 months of recession. Production has dropped 12.8% during this period. (In 2000, production dropped 2.6% and payrolls were cut 9.5%). The sector has changed and companies rely on more equipment and fewer, more highly trained people to make more goods. There is less excess to eliminate. The manufacturing sector has lost 3.5 million jobs since 2000.

Manufacturing production workers spent an average of 39.6 hours per week working, down from 41.2 a year ago. A survey of CFOs showed that 55% of manufacturing firms said they had reduced employee hours over the past month (compared with 30% for other firms). Over the next year, 58% of manufacturing firms said they planned to cut hours (compared to 32% for other firms).

**One Good Thing.** The number of active lobbyists declined 2% in 2008 to 15,900. This was the first yearly drop in seven years. Wall Street makes up about 10% of the lobbying business. There is not much lobbying being paid for by Bear Stearns, Lehman, AIG, Wachovia, Washington Mutual, Merrill Lynch, Fannie Mae, Freddie Mac, etc.

**Long Term Problem.** One of the problems with a deep recession is that unemployed workers can stay unemployed for so long that they lose their skills and become less employable.

## *G20 Meeting in April*

**Problems.** The IMF issued a paper saying that the G20 countries will see their fiscal balances worsen by 6% of GDP. The average debt to GDP ratio will increase by 14.5%. Government debt for the average G20 country will be more than 100% by 2014, compared with 70% in 2000 and 40% in 1980. Many of the G20 countries also have aging populations and need to decrease entitlement programs.

**Focus of the Meeting.** Many of the European countries want to focus on better market regulation. The US wants to focus on encouraging stimulus.

**Hard to Deal With US.** England said that it's incredibly difficult to prepare for the upcoming G-20 meeting with the US. They said that the US government relies on appointees and that "there is nobody there." Europe was also mad at Larry Summers comments that other countries should increase their stimulus spending.

## *US Debt*

The cost of buying a credit default swap on US debt has jumped to 97 basis points. This is seven times higher than a year ago and 60% higher than the end of last year. The UK's spread is 160 bps.

Local and state governments may be in trouble when they try to float debt in the future. The debt market will be saturated from Treasury issuance. This will push up rates for everyone.

## *Europe*

Europe's **three largest economies** had some poor economic numbers:

1. German exports fell 20.7% in January (YOY), the biggest drop in 16 years.
2. England's manufacturing output declined for the 11<sup>th</sup> straight month in January, falling 12.8% (YOY). This is an acceleration from December's 9.9% decline.
3. Production at French factories fell 13.8% YOY.

**Where Will the Capital Come From?** All of the dollars flowing into US Treasuries means that there is less capital available to fund Eastern Europe as they try to refinance their debt. In the last year, the dollar has risen 13% against major foreign currencies (after adjusting for inflation).

The World Bank said 2.5 – 3 trillion in public and private debt in emerging markets needs to be rolled over in 2009. Most of this is in foreign currencies.

**Warning.** Moody's said that risks were highest in European countries that have experienced rapid domestic credit growth and may not be able to rely on external support. They specifically mentioned Romania, Bulgaria and Croatia.

**Food Prices Increasing.** Food prices in Europe's emerging markets increased. In Hungary, food inflation increased to 2.7% in January. JPM's food analyst estimates that the costs of commodities used by Europe's biggest food companies will fall as much as 20% this year. But, reductions in retail food prices are unlikely because some food producers locked in higher costs. In addition, falling currencies don't help.

### *China*

**Deflation.** China's CPI fell 1.6% in February (YOY). Last February, China's CPI was up 8.7% (YOY). The PPI fell 4.5% (YOY). Housing prices also fell.

**Less Dollars to Buy Treasuries?** A sharp decline in China's trade surplus in February may signal a shift in the nation's financial balance with the rest of the world and may reduce the speed with which it piles up foreign currency assets.

**Growth is Okay. Treasuries Aren't.** Chinese Premier Wen Jiabao said that China would meet its 8% GDP growth. If not, they would increase their stimulus spending. He also said that China had worked to diversify its \$2 trillion stockpile of foreign exchange reserves. He said he was concerned about the Treasury securities they own.

## *Airlines*

Fuel costs are coming down for airlines, but demand is dropping even quicker.

**Revenue is Down.** Airlines described the following drops in revenues:

1. Continental 9.5% to 10.5% in February
2. US Airways 9% to 11% (YOY)
3. AMR said international travel fell 13% in February, on a 6.3% reduction in seats flown.
  - a. Domestic traffic fell 13.7% on a 12.4% capacity reduction.
4. UAL said international traffic dropped 22% on an 18% reduction in seats.
  - a. UAL had a 14% drop in domestic traffic (with a 14% capacity reduction).
5. Southwest said that traffic dropped 6% in February YOY.

### **Future Reductions.**

1. Delta said it would trim international seats by 10% this year.
2. UAL said it would reduce overseas capacity by 14.5% this quarter and 5.5% for the year.
  - a. United expects its overall capacity to fall 7.5% for 2009.
3. AMR said that advance bookings over the next four months are at least 2.5% lower and international bookings are 4.5% lower.

Apparently, neither UAL nor AMR would comment on whether they expect to be profitable in 2009. My guess is that they don't understand what the word means.

## *Random Economic Stories*

**No Foreign Workers.** A provision in the stimulus package limits the hiring of foreign workers by any company that receives bailout money. It makes little sense to say that we're going to limit our talent pool.

**Surprising.** Repo men are hurting! Vehicle financing is down 32% (YOY) so there will be fewer repossessions. In addition, since credit is difficult, people really try to hide their cars (b/c they can't just go out and get a new one).

**Destruction of Wealth.** Blackstone CEO Stephen Schwarzman said that up to 45% of the world's wealth has been destroyed by the global crisis. He said it's harder to find people to screw.

The wealth of Americans fell 18% in 2008. This was the biggest loss since the Fed started tracking these numbers after WWII. US households' net worth dropped \$11 trillion. At the same time, Americans' debt remained stable. Mortgage and credit card debt now total \$13 trillion, or 123% of after-tax income. In 1995, this was 83%. Collectively, homeowners had 43% equity in their homes, the lowest level since records have been kept.

**Economists Are Not Happy With the Government.** Economists give the President and Treasury Secretary failing grades. A majority of the 49 economists who participate in the WSJ survey said they were dissatisfied with policies. On average, they gave the President a grade of 59 and Geithner received a 51.

**Some Hurting Companies.** Brown-Forman, the liquor and wine producer, reported an 11% decline in quarterly sales. They said that fewer people are drinking at restaurants and bars and people are trading down to lower priced beverages.

Tiffany said holiday sales in their primary stores were 20% lower even though it lowered prices significantly. In January, they offered voluntary retirement to 800 US employees (13% of staff). Tiffany is shutting its Iridesse pearl jewelry chain.

**Local Stimulus.** Many local governments are trying their own stimulus spending. Ideas include rewarding people for spending money with local retailers and creating jobs to do projects around town.

## **PART 2: Drug Deals**

### **Big Pharma Deals.**

1. Merck agreed to buy Schering-Plough for \$41.1 billion.
2. Roche agreed to buy the part of Genentech that it doesn't already own.
3. Earlier in the year, Pfizer bought Wyeth for \$61 billion. The value of Wyeth was biotech drugs, vaccines and consumer health products.

**Reasons for the Merck Deal.** The value of SGP is biotech, consumer health and animal health. SGP also has a promising drug in the pipeline to prevent blood clotting. In addition, they have a large presence in Brazil, China and other emerging markets. Approximately 70% of SGP's sales are outside of the US. The combined company will have sales of \$42.4 billion.

Some companies are trying to become more like JNJ and Abbott – two companies that are more diversified than pure pharmaceuticals. JNJ and Abbott's stocks have outperformed the industry recently.

The deal is supposed to result in cost cutting of \$3.5 billion. After taxes, that would have a value close to \$25 billion...if it happens.

**Potential Problem.** Potential stumbling block: SGP and JNJ share the rights to Remicade (arthritis blockbuster drug) and a new late stage arthritis drug (golimumab). The agreement terminates SGP's rights if there is a change of control. As a result, the MRK / SGP deal is being done as a reverse merger where SGP would be the surviving company, but it would be called MRK. If it is this easy to circumvent the change of control clause, I'm not sure I understand why we even bother having them.

**Deal Terms.** SGP shareholders will receive .5767 shares and \$10.50 in cash. The premium (upon announcement) was 34%. The cash is coming from:

1. \$9.8 billion that Merck had on balance sheet
2. \$8.5 billion from JPM – showing that cash is available for some deals.

**Break-up Fees:** MRK agreed to pay SGP \$2.5 billion if it can't get financing for the deal (this is not an issue). SGP would have to pay MRK \$1.25 billion if they agreed to be bought by someone else. (Rumors have included that JNJ could make a bid.) PFE agreed to a \$4.5 billion penalty if its ratings are cut and banks won't loan it money for the Wyeth deal.

**Shocking News...People Traded Ahead of the Deal Announcement.** There was a tremendous increase in activity in SGP's call options prior to the deal announcement. One observer said that activity was 6X as high. The profits were estimated at \$3.7MM to \$5MM. In addition, the stock rose 8% on the day before the deal was announced. The good news is that we're going to put our best people on this investigation. The bad news is that I'm referring to the SEC. (Actually, this type

of investigation is not that difficult. I would expect it to be successful. It's much easier to investigate a crime scene than it is to identify a crime before it is public knowledge.)

**Roche's Deal.** Roche agreed to acquire the 44% of Genentech that it doesn't already own. They are paying \$95. Genentech has biotech and cancer drugs. The biotech / cancer combination explains why Genentech trades at higher multiples. Roche has already raised \$39 billion in the bond market. As a result, the deal can get done financially.

**Industry Problems.** The industry has significant problems:

1. drug discovery has slowed
2. regulation is tougher
3. revenue has declined as patents expire
4. competition from generics
5. high development costs
6. pressure from insurers to control prices
7. recession

**M&A is Good News.** These pharma deals have been good news for the investment bankers. We all want to hear happy news for bankers, don't we?

You need to be cautious when you take mergers and acquisitions as good news. Why is a company worth more to an acquiror than it is as a stand-alone? Clearly, cost cutting can be a good thing. At the same time, there are always cultural differences and unknown problems. If you don't believe me, go ask Ken Lewis or Wachovia or Wells Fargo. Actually, don't ask Ken Lewis – all of his deals are going to work out.

**Pressure on the Wholesalers.** The consolidation in the pharmaceutical industry is putting pressure on the wholesalers (McKesson, Cardinal Health, AmerisourceBergen). The thought is that they will have less leverage when contracting. The wholesalers package and distribute the manufacturers' drugs. These companies are also under pressure because there is fear that Rite-Aid will file for bankruptcy.

## **PART 3: Financials**

**Financial Collapse Worse Than Tech.** The value of financial shares in the S&P 500 has dropped more than 83%. The sector's weight in the index is now down to 9%. Tech stocks dropped 82% from 2000 to 2002. The biggest difference is that the rest of the economy really depends on the financial sector.

**Bank Bondholders are Scared.** US bank debt lost 7.8% last month, even after huge bailouts by the government. Debtholders are worried that they will be asked to take lower interest payments or lower face values. Yields on bank bonds had an 8.21% risk premium, 3.63% more than industrial companies' debt.

**Fear in the Markets.** Many people have noted that Berkshire's credit default swaps are trading at wider spread than Vietnam's debt and GE is wider than Russia's spread. Of course, these spreads can be thinly traded and subject to exaggerated movements.

### *Crisis*

**AIG.** When AIG got into trouble last year, they had \$440 billion of credit default swaps on their books. AIG didn't have to put up collateral with the swaps because of their AA rating. When their ratings were being cut, they had to post collateral and the trouble started.

The Fed gave them an \$85 billion loan to stop them from going bankrupt. The gov't has pledged a total of \$160 billion to AIG.

At the end of 2008, AIG had \$302 billion in swaps. Approximately \$235 billion was sold to foreign banks and covers prime mortgages and corporate loans. The banks that bought this insurance were able to reduce the money that they have to set aside for regulatory capital requirements.

**Still Waiting.** In November, the Fed said that it would buy \$100 billion in Fannie, Freddie and FHLB debt plus \$500 billion in mortgage backed securities. To date, they have only bought \$107 billion of this potential \$600 billion.

**Future Regulation.** Bernanke said that we need an overarching regulatory authority so that this never happens again.

**TALF Prep.** Cayman is seeing an explosion in the number of distressed asset funds being set up. These funds will be targeting US banks' toxic assets.

**TALF Problems.** The TALF program hit a roadblock when several hedge funds refused to sign the documentation. They didn't like the fact that participation gave the government the right to look at their books. Here's the thing...it really makes no sense. If you're putting money into a deal and you don't have any future liability or commitment, why should you have to open your books? Some of the first deals

include: auto lender World Omni's \$750MM, Ford Motor Credit, Nissan Motor and CarMax.

**Bankers Quitting.** Many successful bankers are quitting large firms because of the compensation limits and other problems. In addition, with stock prices down, the don't feel like they are leaving a lot of options.

**FHLB Seattle.** The Federal Home Loan Bank of Seattle has fallen below its capital requirements because of write downs on mortgage backed securities. As a result, they are not allowed to pay dividends. The 12 home-loan banks owned \$76 billion of private-label mortgage securities as of September 30<sup>th</sup>. At that point, they had \$13.5 billion of unrealized losses on the securities. The banks have total capital of \$57 billion!

**MBIA.** Representatives of 15 financial institutions are complaining to NY's Insurance superintendant about MBIA's decision to split their bond-insurance into two. One will house their insurance on mortgage backed bonds and the other will house their municipal bond insurance. How would you like it if your insurer broke into two pieces: in one unit they put the life insurance of young, non-smokers. But your policy was covered by the other company which was insuring all of their terminally ill clients.

**Don't Worry...The Government is Here.** The new president of the NY Fed (William C. Dudley) is promising the nation's big banks that they will get as much capital as they need.

**Gifts With Strings Attached.** Banks want to avoid federal money. They have been told to modify mortgages. They must let shareholders vote on executive pay. They need to cut dividends. They have to cancel trips. They can't hire foreign workers.

**Crazy Complaints.** Congressional investigators are complaining that banks received government money and then made loans overseas. It's really scary if this is the way we're going to think – the government loaned you money so now you must become a domestic company.

**Let Them Fail.** John McCain and Richard Selby (two Republican senators) said that some of the big banks should be allowed to fail. I wonder if this would have been McCain's position if he had been elected as President.

**Don't Nationalize.** Alan Blinder, former Fed governor, wrote an editorial in the NYT saying that we shouldn't nationalize the banks. He made several arguments, including:

1. we have 8,300 banks and it will be difficult to draw the line as to where to stop
2. short sellers will start to speculate as to who is next
3. our banks are very complex and it will be difficult to find replacement management
4. confidence might be undermined
5. regulators now have great power over the banks

Goldman's CEO also said that he thinks nationalization is a bad idea.

**Glass-Steagall.** Paul Volcker said that commercial banks and investment banks should be separated. He would like to see Glass-Steagall reinstated. Commercial banks took bigger trading risk and created off-balance sheet entities to reduce the capital they needed. Investment banks became more aggressive in lending to companies. (One of the leaders in repealing Glass-Steagall was Lawrence Summers.) Volcker also mentioned that there's something wrong when bankers are receiving multi-million dollar bonuses for mergers which fail.

### *Credit Cards*

**Credit Crunch.** Meredith Whitney (who called much of this crisis as an analyst) said that a credit card crunch is coming. She said that there is roughly \$5 trillion in credit card lines outstanding and that \$800 billion has been drawn upon. The lines were reduced by \$500 billion in Q4 and she estimated that \$2 trillion will be cut by the end of 2009 and a total of \$2.7 trillion by the end of 2010.

**Zip Code Better Than FICO.** Because home price depreciation has been a better predictor of consumer behavior than FICO scores, some credit card companies are cancelling cards based on zip codes.

**Don't Be the Last Card.** People have multiple credit cards. There is risk to being the last card to cancel – so the rush is on to cancel cards first.

**Why Pay It Off?** Approximately 90% of credit card users revolve a balance (don't pay it off) at least once per year. Over 45% revolve every month.

### *Stories from BAC / ML*

**Motive?** Prosecutors are investigating whether ML paid early bonuses and then traders had an incentive to mark down their positions (so that they would be in a good position to get bonuses from BAC in 2009).

**Mea Culpa.** BAC's CFO said that he and most other financial service industry executives failed to foresee the economic meltdown because they relied on backward-looking models.

**Get Rid of Him.** Jerry Finger, a longtime BAC shareholder (who controls 1.5MM shares) is launching a campaign to have Ken Lewis stripped of his chairman position.

**Single Talking Point.** Bank of America has one common refrain: "we're not Citi."

**Wasted Money?** In the spring of 2008, Merrill Lynch hired some bankers away from UBS in Brazil. They guaranteed large bonuses and it has not worked out so far.

**Undervalued?** I read an argument that BAC is undervalued at \$30 billion:

1. 25% of Santander's Mexico unit and 8% of Brazil's Itau (plus preferred stock) = \$4.5 billion.
2. BlackRock position (from ML) = \$5.75 billion.
3. 16.7% interest in China Construction Bank = \$20 billion.
4. Rest of BAC = 0?

### *Citi*

**What's Next?** US officials are supposedly strategizing as to what are the next steps for Citi.

**Unbelievable.** Citi is paying approximately \$13 million to compensate employees for canceled trips! The company lost \$27.7 billion in the 15 months ended December 31 and received \$45 billion from the Troubled Asset Relief Program.

**You Want Advice From Citi?** Citi reached the top spot on the mergers and acquisitions league table. They advised on \$138.3 billion worth of deals so far this year. Morgan Stanley was in second place followed by JPM, GS and BAC.

**Citi Profitable.** Citi's CEO said that the bank was profitable in the first two months of the year. This helped market confidence.

## *UBS*

**I Know Nothing.** Switzerland denied US demands for UBS to turn over the names of 52,000 US clients (who evaded taxes). Swiss banks are not permitted (by law) to release names unless a Swiss criminal law has been broken. Tax evasion is not a criminal offense in Switzerland.

UBS revised their 2008 net loss up to \$18.06 billion.

## *Fannie and Freddie*

The two biggest debt deals recently were a \$13 billion offering by Freddie and \$15 billion by Fannie. Barclays, UBS and JPM received approximately \$16 million in fees.

Freddie Mac reported a \$23.9 billion Q4 loss and said that it will need \$30.8 billion from the US Treasury. For all of 2008, the company lost \$50.1 billion. In 2007, they lost \$3.1 billion. Their two year loss exceeds the \$42 billion that they earned from 1971 – 2006. Fannie lost \$25.2 billion in Q4.

Freddie Mac is paying 10% on \$45.6 billion of senior preferred stock (owned by the government). That means that they are supposed to pay \$4.6 billion in dividends annually. There's probably a better chance that I'll give my kids \$4.6 billion of allowance this year.

## *Hedge Funds and Private Equity*

Hedge funds may cut 20,000 jobs – 14% of the industry. About 920 funds (12%) closed last year.

The average fund-of-funds was -21.2% last year. Funds of funds supplied 40% of hedge fund capital last year. The top ten fund-of-funds managed 35% of the industry's assets.

Some private equity firms are doing all-equity deals – referring to them as equity buyouts. The idea is that you have to buy something very cheap in order to justify a deal without the tax benefit from debt.

## *Other*

AmEx said chairman / CEO Kenneth Chenault received \$36.3 million in 2008. Most of this was stock and options (\$34 million). Some of the options have an exercise price of \$49. Wells Fargo's CEO (John Stumpf) received \$9 million.

Jamie Dimon (JPM's CEO) said JPM was profitable in January and February. He also said that there were modest signs of a recovery.

Rumors exist that GE is the next Citi. Some people say that GE has many losses buried in GE Capital. Some analysts claim that the amount is somewhere between \$21 to \$54 billion.

## **PART 4: News From the Auto Industry**

*GM*

**House Call.** The President's auto task force visited GM to gather information. They're deciding whether to give up to \$21.6 billion to GM and Chrysler. They are trying to decide prior to March 31<sup>st</sup>.

**We Don't Need It...Yet.** GM said it has enough cash to continue past March and doesn't need the \$2 billion it requested. They have canceled a series of projects in order to save cash.

**Renegotiating.** GM also announced a new contract with the Canadian Auto Workers. Wages for active workers will be frozen as will pension payments for retirees. There will be no cost of living raises for workers and they will receive less time off. Retirees are going to have to start making co-payments for health care. Chrysler said a similar deal would not work for them – they need larger cuts.

**GM Europe.** Opel and Vauxhall dealers are going to invest \$500 million in GM Europe assuming the US government helps the parent company. You've got to love the Europeans – they bought our CDOs, now they're investing in GM. Soon, we'll be selling them tubs of warm crap.

**Speaking of Crap.** Saab said it would lay off nearly 1/5 of its workforce. The company is in bankruptcy and GM is trying to sell it.

**Bankruptcy.** Recently, US News pointed out the upside of a GM bankruptcy:

1. Bankruptcy would help GM to renegotiate its debt, cut the number of dealers and reduce healthcare benefits for workers and retirees.
2. The government could provide DIP financing.
3. It might help to reduce the moral hazard argument (that we are encouraging future bad decisions by bailing out those who have made bad decisions in the past).
4. Forcing GM into bankruptcy will avoid the problem of bailing out GM and letting Chrysler go bankrupt. Politically, no one (and I mean NO ONE) wants to bail out Cerberus.
5. A GM bankruptcy could help dispel the notion that large firms can't fail (or large failures create systemic risk). Of course, GM is not a counterparty in the credit default swap market. With that said, we could see a cascade of problems in the supplier market.

## *Ford*

**Renegotiating.** Ford has moved toward paying their unionized employees amounts closer to Toyota. Hourly pay (including benefits) will decrease from \$60 to \$55. Toyota is estimated to be around \$48. New Ford employees will be closer to \$30. I find it surprising that Ford was doing this negotiating. I would have expected GM to do it – since they have the leverage of “we’re headed to bankruptcy if you don’t negotiate.”

**The Chinese Volvo.** Ford is apparently speaking with three Chinese firms about selling Volvo. (To the Chinese, Volvo seems like quality...) There has also been talk of a Swedish consortium buying Volvo, as there is fear of the Chinese stealing intellectual property. Now isn’t that cynical – thinking that the Chinese would steal intellectual property?

## *Chrysler*

**We Already Have Great Designs.** Chrysler is relying on foreign firms to design future cars. They have greatly reduced their product development staff. In the past year, they have cut 40% of their engineering staff and delayed or canceled work on brake systems and interior design improvements. Good thinking – your cars are high quality already. If we bail out this company, it is a signal that we will give money to anyone.

## *Asia*

**Toyota Worries About US.** Toyota USA said that they are worried about 100 of their US suppliers. The Treasury Department has received requests for \$25 billion in aid for the suppliers.

**China Sales Surge.** Chinese car sales surged 25% last month as the result of a tax cut (on car purchase). In January, China surpassed the US as the largest car market.(710,000 cars vs 657,000 cars).

## *Europe*

**Loans.** The European Investment Bank (EU long term lending) is loaning \$3.85 billion to the auto industry. Loan recipients include Volvo, Scania, Ford, Peugeot, Renault, Fiat, BMW and Daimler.

**Cooperation.** Daimler and BMW are working together to purchase components for cars. They are trying to increase their size (purchasing power) to lower costs. It’s also possible that this could lead to a merger in the future.

**German Engineering = German Losses.** BMW lost \$1.24 billion in Q4. Revenue fell 18%. Volkswagen said that Q1 may result in a loss and that 2009’s earnings would be significantly lower than 2008. In the first two months of 2009, sales have dropped 15%.

## **PART 5: Housing**

**Legislation Will Solve the Problem.** Federal legislation was introduced to create a Financial Products Safety Commission. One of the Commission's jobs will be to approve mortgage products. They will also provide consumers with advice about credit cards and retirement accounts. The absurdity of this is that there is often a reason for each type of loan – but these loans were rolled out to inappropriate borrowers.

**FHA – Future Chaos.** The FHA does not lend money directly to homebuyers. It provides insurance. The FHA's share of the mortgage market was 2% three years ago. Now, it's almost a third of all mortgages. The FHA has become the only option for homebuyers who don't have a downpayment or good credit. (Of course, another option is called an apartment.)

The FHA lets lenders conduct business in their own way. The FHA does require lenders to document borrowers' income. The FHA also requires that borrowers have a downpayment and live in their homes. (Pretty stringent, eh?)

In the past two years, more than 9,200 FHA insured loans have gone into default after either no or one payment. During the past year, the number of borrowers who defaulted after one payment has tripled.

The FHA allows cash-out refinancing. The number of refinanced deals that default after zero or one payment has quadrupled. This is 40% of all instant defaults.

**Future Problem Loans.** There is speculation that Acquisition, Construction and Development (ADC) loans will be a future source of bank writedowns. They total 8.4% of all bank loans. They are used by developers to buy land and construct housing or commercial property. Nonperforming ADC loans were 3.2% in 2007 and 8.5% in 2008. These loans are concentrated in small banks. ADC loans currently account for 47% of nonperforming loans at small banks.

**Housing Finance Agencies.** State housing finance agencies are getting caught in the credit crunch. All states have these agencies and they either originate mortgage loans or guarantee loans. They finance these activities by issuing municipal bonds (\$17 billion in 2007). These agencies are hurt by:

1. rising interest rates on municipal securities
2. fewer investors who want municipal securities
3. states which need to allocate resources elsewhere

**Competition Has Changed.** Hovnanian (a home builder) said its orders declined 36% to 961 homes. The company's stock price has dropped 99% from the July 2005 peak. Homebuilders are no longer competing with each other; rather, they are competing with banks selling foreclosures.

**It Wasn't My Fault!** Alan Greenspan wrote an editorial stating that it wasn't the Fed that caused the housing bubble. Rather, low mortgage rates (NOT fed funds rates) caused problems. While I don't blame the Fed or the low rates as the primary cause of the problems, I think this argument is absurd. While there was certainly a disconnect in 2004 – 2006 (mortgage rates didn't follow Fed Funds rates higher), the Fed should have been watching the increase in securitizations and known that we had a problem.

## **PART 6: Markets**

### *Credit Markets*

**The Bottom Rung.** Moody's published a list called "The Bottom Rung" 283 of the worse credit risks. They believe that approximately 45% of companies on the list will default in the next year. The dominant industries are auto, casinos, retailers, newspapers and media. The list comprises the 20% riskiest companies that it follows. These companies have approximately \$260 billion in bonds and bank debt.

**Selling Junk.** US investors withdrew \$911MM from high yield bond funds last week.

**Munis Have Rallied.** Munis have rallied 4% this year, helped by the hope that the stimulus package will make things easier for states and cities. In addition, yields on ten year munis average .7% more than Treasuries and that is making them attractive to some investors. Muni issuance is expected to shrink 12% due to federal aid.

**Betting on Inflation.** Some of the investors that made bets against housing and financials are now investing in gold. This is a bet against governments and currencies. They are expecting the possibility of tremendous inflation.

**Small Increase in Libor.** Libor has increased from 1.1% to 1.3%, a reflection of increasing concerns about banks. While many people have noticed this, Libor was as high as 4.8% in October.

**Angry Mortgage Investors.** Mortgage investors are really angry about legislation that prevents lawsuits against mortgage servicers. Some worry that mortgage servicers may modify the first mortgage and effectively help the home equity loan or second mortgage (which they servicers may have a financial interest in). Approximately half of subprime borrowers have a second mortgage.

**GE Lowered.** S&P lowered GE's ratings from AAA to AA+. The GE Capital unit was lowered from A+ to A. They are facing write-downs from consumer and commercial loans as well as real estate assets. GE's stock reacted favorably to the downgrade – the bad news was already priced in.

## *Equities*

**Buffett Sees Opportunities.** Warren Buffett said that buying opportunities are presenting themselves in the US.

**Venture Capital Moves Into Public Equities.** Venture capital firms are increasing their investments in public companies. Many have little experience in this, but you need to understand that these guys are really smart. A lot of them used to be bankers. They know everything.

**26 Year Low.** Early in the week, the Nikkei closed at its lowest level in 26 years. Approximately 20 years ago, the Nikkei was at 38,915. Earlier this week, it closed below 7,100.

**Uptick Rule.** The SEC is considering reinstating the uptick rule.

**Welch Criticizes.** Jack Welch, regarded by some as the father of shareholder value, said that it was a dumb idea for executives to focus so much on stock price and quarterly profits. Of course, Welch is worshipped by Wall Street and investors who ignore the fact that he manipulated earnings through an insurance unit, had an affair with a Harvard Business Review writer and was receiving absurd benefits from GE in his retirement (e.g., his contract called for thousands of dollars of fresh flowers as one minor example). He's a real champion of the shareholder. I'm really confident I could trust him – and I greatly value his opinion. (I wouldn't hire him as my pool boy, but that's a whole other story...)

**Inconsistency.** We visited some money managers in Dallas this week and one of the recurring themes we heard was that if the bond market is right, stocks are overvalued. In other words, they were commenting on the large spreads in the bond market.

## **PART 7: New Meaning to Dogs of Dow**

Dow finally agreed to live up to its ill-conceived buyout of Rohm & Haas. They are paying \$78 / share. They received some help in getting the deal done:

1. ROH's two largest shareholders (the Hass family and the Paulson & Company hedge fund) agreed to buy \$2.5 billion in preferred stock in Dow;
2. The two shareholders gave Dow the option to demand that the two shareholders buy an additional \$500 million in common stock;
3. Berkshire and the Kuwaiti Investment Authority agreed (previously) to buy \$4 billion of convertible preferred stock.
4. Dow received an extra year to pay off its bridge loan (which was reduced from \$13 billion to \$12.5 billion). It has been reported that Dow will use as much as \$10 billion of this loan to pay for this deal.
5. Supposedly, Dow is hoping to sell Morton Salt (part of ROH) and other assets for as much as \$4 billion. Morton Salt is expected to be sold for at least \$1.5 billion.
6. Dow is in talks to revive the plastics venture with Kuwait.

The \$2.5 billion of preferred stock will pay 15%. That pretty much sums up the risk involved. Prior to this investment, the Haas family owned approximately \$4.86 billion of the ROH stock and Paulson owned \$1.47 billion of the stock.

Including fees for delaying this deal, Dow is paying \$16.3 billion. ROH's CEO said that "we're feeling very happy about the outcome." Of course, he made \$100 million and is retiring the day after the deal closes. It's not all that surprising that he's happy. Many of his former employees will also be retiring involuntarily as Dow has to cut costs. My guess is that they will not be as giddy.

Dow's CEO said that the deal was a "massive victory for shareholders." I assume that he was speaking about ROH's shareholders? I could be wrong about this, but I don't think that his (Dow) shareholders are lining up to thank him. When this deal was announced in July, Dow had a market cap of \$31 billion and ROH had a market cap of \$8.75 billion. Now, ROH's shareholders took away \$16.3 billion and ROH has a market cap of \$6 billion. Nice work. This was a massive wealth transfer.

Appropriately, the deal will close on April 1<sup>st</sup>. I'm going to suggest that we change April Fool's Day to April Dow Day.

## **PART 8: Madoff**

**Proceed Straight to Jail.** Madoff entered a guilty plea and his bail was revoked. He said that he knew that he was doing something wrong from the start, even from a criminal perspective. He said that he started on a small scale and hoped to remedy the situation. He insisted that his stock trading business (run by his brother and sons) was legitimate. (Some have said that he pumped money from the Ponzi scheme into that business and the business would have failed if it weren't for that.) Madoff disputed some of the government's facts and that provided clear evidence that he's not cooperating with them. He could be sentenced to 150 years in June, but people expect him to receive 20 years. He's currently 70 years old.

During the bail discussion, Madoff's lawyer, Ira Sorkin explained that Madoff's wife (Ruth) paid a security company to monitor her husband at her own expense. Apparently, the audience scoffed since they knew that she was using stolen money.

**Losses.** At the end of November, Madoff had 4,800 clients and their statements led them to believe that they had \$64.8 billion.

**Who Else Was Involved?** An aid to Bernie Madoff had two assistants generate bogus trading tickets. This serves as evidence that others knew about this scam.

Everyone is waiting to see if the government can tie Madoff's sons (Andrew and Mark) or his brother (Peter) to the scam. It seems somewhat preposterous that Madoff confessed to his sons and they ran to turn him in. Skeptics believe that the sons knew what was happening, the scam was coming undone and the father was trying to protect the sons.

The government is looking into the following people:

1. Frank DiPascali – the director of options trading who did not do a trade in 13 years.
2. Annette Bongiorno – worked with Madoff for more than 30 years and oversaw the clerks who prepared fake trade documentation.
3. Horowitz and Friehling – longtime auditor of Madoff. Horowitz is 80 and is dying. He lost most of his money to Madoff – so it's hard to believe that he knew anything. Friehling is his son-in-law.
4. Ruth Madoff – Madoff's wife.
5. Peter Madoff – Madoff's brother.
6. Andrew and Mark – Madoff's sons.

**Some Banks Take Responsibility.** Safra Banking Group is partially covering losses by private banking clients who lost money with Madoff. Previously, Spain's Banco Santander did the same thing. The amount invested by these clients was approximately \$40 million. The people will receive perpetual bonds in the amount invested and the bonds will yield 2%.

**The Government Can Bail Us Out.** Representative Gary Ackerman, a Democrat from NY, has proposed legislation that would allow Madoff's investors to recoup taxes paid on income that they never earned. They would be able to recover taxes paid in the last 15 years – normally, you can only amend your returns for three years.

**Changes in Regulation.** The SEC is going to come out with new regulations about the auditing of investment advisers and the custody of customer assets in the future.

**Clawback Suits.** People who were fortunate enough to withdraw money from Madoff prior to the scam being exposed are now preparing for the possibility of the Trustee trying to recover those assets (to split among all victims). These are being referred to as “clawback suits. In particular, they want to go after people who received more than they put in.

## **PART 9: Random**

**Presidential Popularity.** President Obama's high ratings aren't abnormally high. In fact, President Carter had higher ratings at this time in his administration. Obama's approval ratings (61%) are higher than Congress or Bush (27% when he left office). Approximately 68% of people say they feel positive about him as President. The problem is that there is dissatisfaction with some of his plans – approximately 45% said that they are somewhat or not at all confident in his goals and policies.

**Dimon's Thoughts.** JPM CEO, Jamie Dimon, encouraged Congress to back Obama and not act like a dysfunctional family. He also said that companies which securitize assets should have to hold some of the securities. Finally, he commented that he liked “mark-to-market” accounting but that it can be problematic when no market exists.

**Not So Amusing.** Six-Flags has hired bankruptcy counsel. This could wipe out the ownership stake of Daniel Snyder (Washington Redskins). The company has \$2.4 billion of debt. They have to make a \$288 million payment in August to preferred shareholders.

**We Didn't Think They'd Notice.** The owner and two other employees of a Nebraska car dealership fled town this week with 81 cars. The problem was that the cars belonged to Toyota and they were trying to sell them at auction in Utah.

**Did I Say Billion?** The SEC sued a money manager who (allegedly) advertised that she had a billion dollar client that she didn't really have.

**Treasury Still Needs to Hire.** Geithner has been slow in filling Treasury positions and this has caused problems. Some say that the White House is extremely worried

about vetting all of the candidates so that they don't find any tax problems. Of the four major departments (State, Justice, Defense and Treasury), Treasury has had the fewest nominees even though they have the largest problems.

The Treasury finally filled three top positions. Most notable, Alan Krueger was named as assistant secretary for economic policy.

Senator James Inhofe (Republican from Oklahoma) said "as these three nominees move quickly through the Senate confirmation process, we must hear from each of them on how they intend to...get us on the right track."

In less than two months, the Treasury has announced a \$2.5 trillion bank rescue, a \$275 billion mortgage bailout, a stress test for banks and restrictions on executive pay (for companies that receive federal money).

**Fixing Executive Pay.** NY Attorney General Andrew Cuomo and Rep. Barney Frank are discussing ways to link executive pay to the long-term performance of companies.