

**Market Update: December 28, 2008**

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  - 2. If you receive this email and want to be on my list, send your email address to [sandy.leeds@mcombs.utexas.edu](mailto:sandy.leeds@mcombs.utexas.edu)**
  - 3. This is not intended to serve as investment advice. Consult / blame someone else for losing your money.**
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## Part I: The Economy

### A. We're in Recession

1. Q3 GDP dropped .5%. Estimates for Q4 are a drop of 4- 6%.
2. The Chicago Fed national activity index captures 85 economic indicators and measures the degree to which today's economy deviates from its long-term trend. November's reading was -2.49. This was the steepest decline since 1981. Any sustained reading below -.7 indicates recession. The index has sustained a recessionary reading since December of 2007.

### B. We're All Poorer

The Fed estimates that consumers have lost \$7.1 trillion of net worth since the third quarter of 2007. With real estate down ~20% and stocks down ~40%, this is no surprise. **Don't worry:** the government spending ("investments") is in the trillions. So while American's have lost trillions, we'll have the opportunity to pay it back in the form of higher taxes.

### C. People are Losing Jobs

1. An initial unemployment claims increased 30,000 to 586,000 this past week.
2. They are at their highest level since November 1982.
3. Continuing claims for unemployment compensation decreased to 4.37 million, but remained historically high.

Unemployment peaks after the economy bottoms. Since the economy is probably headed for further weakness, unemployment can still increase significantly.

### D. Consumer Sentiment is Low (even though it increased slightly)

1. Univ. of Michigan consumer sentiment increased from 55.3 to 60.1 because of expectations of lower prices (energy costs and retailers).
2. While this shows improvement, last December the index was at 75.5. The cyclical peak was January, 2007 when the index reached 96.9.
3. Confidence will remain low due to job issues and stock prices. Sixty percent of respondents specifically mentioned hearing news of job losses.
4. One in four consumers expect deflation (the most since the 1950s).

### E. Consumer Spending is Falling

1. Third-quarter consumer spending fell 3.7%, the biggest drop in 25 years.
2. Consumption fell .6% in November from a month earlier – the 5<sup>th</sup> straight decline.
3. One positive: spending adjusted for inflation rose .6% in November – the first gain since May. The discrepancy between consumption falling .6% but real consumption increasing is caused by falling energy prices.

### F. Christmas Sales Were Horrible

1. Retail sales dropped 5.5% to 8% during the holiday season.
2. The strongest performers were general merchandisers, food retailers and restaurants.
3. Notable drops included:
  - a. e-commerce -2.3% (although Amazon reported a record year)
  - b. footwear -13.5%
  - c. men's apparel -14.3%
  - d. luxury sales (excluding jewelry) -21%
  - e. women's apparel -22%
  - f. electronics -26%
  - g. luxury sales (including jewelry) -34%

People were clearly not buying anything extravagant. This has been a major difference from past economic slowdowns – the wealthy are getting hurt.

### G. Individuals are Saving More (rather than spending)

The nation's personal savings rate increased to 2.8% in November (from 2.4% in October). We finally know what it takes to make people save more - an economic disaster.

#### H. Inflation is Falling

1. The personal consumption expenditure inflation gauge fell 1.1% in November.
2. The year-over-year increase was 1.4%.
3. The core measure was unchanged for the month and was 1.9% higher from a year earlier.

There is fear that we could have deflation. Deflation causes a series of problems, such as:

1. choppy consumption – why buy today if something will be cheaper tomorrow
2. paying back debt with more valuable dollars – e.g., there has been deflation in home prices – you still owe the same amount to the bank

One possibility is that we will have deflation in the short term and inflation in the long term (due to the liquidity that that the Fed has added).

#### I. The Fed's Response: Zero Interest

The Fed has lowered interest rates to a target of 0% to .25%. The result is that the Fed's interest rate tool is done. Their next move will be to buy asset backed securities and Treasuries. We're moving into uncharted territories. This is like when you get in trouble at home. At first, you try talking your way out of trouble. Then, you have to start buying things. (That's not just me, is it?)

#### J. Lottery Sales are Down

1. Lottery sales nationwide fell \$215 million, or nearly 2% from July through September compared to the same period in 2007.
2. National lottery sales are \$52.7 billion per year.
3. Lottery ticket sales are down 10% in California and 4% in Texas.

For many states, this money is earmarked for education. Fortunately, our education system is already good enough... (I don't understand why all these people care about educating their kids. It's not as if there are jobs for them.)

#### K. Lower Gas Prices Will Help Consumers

1. Gas has averaged about \$3.50 a gallon in 2008.
2. Gas is expected to average 1.50 per gallon in 2009.
3. Moody's estimates that each penny decline in the cost of gas saves consumers \$1 billion over the following year. Therefore, the \$2 drop would save consumers \$200 billion.
4. Excluding vehicle sales and gas stations sales, November retail sales increased .5%. This was helped by the fact that gas prices dropped significantly.

#### L. Natural Gas Prices are Low

1. Even though we have had a harsh early winter, natural gas prices have fallen 9% this month.
2. Gas prices are down 16% from last year.
3. Storage levels are 3.4% higher than normal.
4. One of the biggest reasons for this drop is that manufacturers' demand is low.

## Part II: Real Estate

### A. The Real Estate Market is Not Improving

1. Existing home sales continue to fall.
  - A. existing home sales fell 8.6% in November (vs October) to an annual rate of 4.49 million
  - B. the median price of existing homes dropped 13.2% YOY (to \$181,300) – this is the largest drop in 40 years of survey
  - C. it is estimated that 45% of existing home sales are linked to foreclosures
  - D. there are 4.2 million unsold existing homes in inventory (11.2 month supply)
  
2. New home sales are also falling.
  - A. new home sales fell 2.9% (to annual rate of 407,000 units)
  - B. median price of a new home is \$220,400 in November, down 11.5% YOY
  - C. there is an 11.5 month supply of new homes in inventory

I would expect new home sales numbers to improve before existing home sales numbers. New homes will not continue to be built.

### B. Mortgage Rates are Decreasing

1. The 30 year fixed rate mortgage averaged 5.14% for the week ended December 24. The average 30 year fixed mortgage required .8 point.
2. One year ago, the 30 year fixed rate was 6.17%.
3. Fifteen year mortgages averaged 4.91%.

### C. The Next Potential Disaster: The FHA is Greatly Expanding Its Role

1. The FHA insures lenders against defaults on home mortgages that meet the agency's standards. They insure loans of up to \$729,000 in the most expensive areas. FHA loans are available with down payments as low as 3%. Private insurers require 10-15% down at minimum.
2. The FHA is processing 40,000 loans per month.
3. Last year, they processed 12,250 per month.
4. The FHA's share of new mortgages increased to 26% in this year's third quarter, up from 3% for 2007.
5. The FHA doesn't set a minimum for the borrowers credit score. The riskiest loans may be flowing to the FHA. (On the good side, the FHA does require proof of income and assets. In addition total mortgage payments including taxes and insurance can't exceed 31% of gross income.)

### D. REITs Have Been Volatile

1. In 57% of the trading day since September 30, the Dow Jones REIT index rose or fell 5% or more.
2. The moves were 10% or greater on 15 of those days.

## Part III: Financials

### A. The GMAC Bank

1. The Federal Reserve has recognized GMAC as a bank holding company.
2. GMAC supplies 70% to 80% of GM's dealers with fleet financing. It made \$50.8 billion in loans for new and used vehicles last year.
3. This is a company that has moved from financing car purchases and car dealers into subprime mortgage lending.
4. As part of the deal, GM and Cerberus will have to reduce their stakes in the company and GMAC will have to increase their capital levels.
5. GMAC has been undercapitalized (and probably will continue to be). At the end of the third quarter, they had \$9.2 billion in equity capital and \$211.3 billion in total assets.

The public markets won't finance GMAC...so the government is doing it.

### B. How is the Bailout Money Being Used?

1. J.P. Morgan received \$25 billion from the US government. This week, they bought the Canadian energy operations and global agricultural business of UBS. The government's money is going to good use.
2. The US treasury will invest \$6 billion in credit card giant American Express and consumer lender CIT group.
  - a. American Express will receive \$3.39 billion in return for warrants and preferred stock.
  - b. CIT will receive \$2.33 billion.
  - c. Both have become bank holding companies. This allows them to borrow at the discount window, paying .5% for 90 day loans.
  - d. American Express has also raised \$5.5 billion in debt backed by the FDIC.

### C. Banks Aren't Lending

1. So far this year, 25 banks have failed and regulators are worried that at least another 200 banks may be at risk of collapse.
2. Government officials have been reluctant to approve TARP infusions unless banks agreed to bring their Tier 1 ratios up to 8%.
3. The result is that banks are hoarding.

#### D. A Changing of the Guard?

1. For the past seven years, Goldman Sachs has led all investment banks in the dollar value of mergers and acquisitions.
2. This year, they are second in Dealogic's table – behind J.P. Morgan.
3. J.P. Morgan advised on 350 deals announced in 2000 and valued at \$818.2 billion. This compares with 295 deals valued at \$755.6 billion for Goldman.
4. Goldman remains on top of similar tables compiled by Thomson Reuters. (JPM is second in this table.) The discrepancy between the tables is based on whether warrants and options are included in deal values and when spinoffs are counted.

It's hard to argue with the fact that JPM has improved its relative strength in the banking world as a result of this crisis.

#### E. Community Banks are Important to our Future

3. Community banks are doing better than the larger banks.
4. Most did not own toxic securities.
5. In addition, their loans are doing better.
  - a. Community Banks account for 13% of loans, but more than one-third of the loans that are less than \$1 million.
  - b. The percentage of loans that are 90 days or more behind was 1.9% for community banks versus 2.4% for larger banks.

Who would have ever figured that knowing borrowers would pay off?

## **Part IV: International**

### *A. International Exposure Has Hurt*

1. The stocks of companies that book more than 50% of their revenues overseas are down 46% this year.
2. Companies with no international revenues are down 38%.
3. Sectors such as utilities, consumer discretionary and healthcare get less than 30% of their revenue overseas. The tech sector has an average of 50% of company revenue coming from outside North America.
4. The rise in the dollar has had a huge impact on this performance. In addition, slowing international growth has also had an impact.

### *B. Japan is Getting Crushed*

1. Japan's industrial output posted its biggest drop on record in November – down 8.1% from October.
2. Japan depends upon exports. Their problems reflect the global economic downturn.
3. Inventory-to-shipments jumped to a record 12.4% in November from October. This implies that companies may have to further cut production.
4. Everyone fears deflation. Japan's core consumer prices rose at their slowest rate in November since spring 1981.
5. The jobless rate rose to 3.9% in November from 3.7% in October.

### C. The Auto Industry is Shrinking Worldwide

While we hear news about the Big Three and the US, the auto industry is getting killed worldwide. Of course, the fact that we produce some of the crappiest cars doesn't help.

1. Auto Sales are Dropping Worldwide
  - A. car sales in China have fallen
  - B. Russian car sales fell 15% last month
  - C. Brazilian auto sales dropped 25% in November YOY
  - D. South Korea's Hyundai and Kia cut their 2008 sales forecast by 12.5%
  
2. Japanese car sales (and production) are also dropping.
  - A. Toyota's domestic (Japanese) production dropped 27.2% YOY – the largest drop in 30 years of data. Sales dropped 27.6% for month. Exports dropped 23.9% for month. Toyota forecast its first-ever operating loss. Toyota is being hurt by falling demand and yen's strength.
  - B. Honda's domestic production only dropped 3.9% for month (b/c of Life mini car). Honda is the second biggest Japanese car producer.
  - C. Nissan (3<sup>rd</sup> biggest) dropped production by 35.6%.

### D. Iceland Turned Into a Banking Giant and then Collapsed

1. Iceland has approximately 300,000 citizens.
2. In 2000, their biggest bank had approximately \$1.71 billion of assets.
3. By June 30 of this year, their assets had increased to more than \$50 billion. They were able to attract deposits by paying high interest rates.
4. By earlier this year, the three main banks accounted for 75% of Iceland's stock market value. Their loans and other assets totaled about 10 times Iceland's GDP.
5. Iceland's GDP is now forecast to shrink 8% next year. Inflation is 18% and expected to rise.
6. This is the same story as we've seen countless times before: small countries which rely on foreign capital have booms and then it is all destroyed when capital flees.

## Part V: Markets

### A. Corporate Yields are High (Pricing in Increase in Defaults)

1. There has been a .3% default rate in corporate bonds.
2. Some argue that the market is pricing in a 5% default rate. Corporate bonds rated BBB or better yield 6.8% more than UST.
3. Bonds rated A or higher have a 5.51% premium (above UST).

### B. Bond Investors are Increasing Allocation to Risky Corporate Bonds (not Munis)

Yields on risky bonds are much higher than Treasuries (showing fear). Bond investors are starting to increase their risky allocation:

1. Bond fund managers have increased their allocation of non-government bonds to 74%. This is the highest reading since the second quarter of 2003. Treasury allocations fell to the lowest reading since spring 2003.
2. High-yield muni funds (on the other hand) have reported \$3.3 billion in investor net outflows since July. Overall assets for high yield muni funds are down to \$32.3 billion from \$54.5 billion at the end of 2007. Investors worry about municipalities' declining tax revenue and increased outflows (services). Maybe we'll hear about municipalities turning into banks?

### C. Of Course, Bond Investors Don't Have a Great Track Record This Year

1. Funds that invest in high yield or junk rated muni bonds are down on average 25.7% this year.
2. Corporate junk bonds are down 29.3%.
3. Leveraged loans are down 30.1%.
4. The Dow Jones industrial average is down 35.8%.

So much for the power of diversification...

### D. Hedge Fund Industry

1. Hedge funds are down less than 18% this year, while the S&P is down 41%.
2. Total assets have shrunk from \$2 trillion in June to \$1.5 trillion today.
3. Hedge fund investors cashed out more than \$100 billion from September through November, the most ever in a three-month period.

## **Part VI: Industries**

### A. Producers Are Not Growing

1. The Equipment Leasing and Financing Association represents firms that lend money or lease equipment to companies that produce and distribute goods.
2. In October, its index measuring new equipment financing activity dropped 8% from the prior year.
3. Its latest reading, November showed a slump of 33%.
4. Two thirds of those surveyed reported falling volume.

### B. Small Businesses are Having Trouble Getting Financing...and They are Important

Small businesses are those with fewer than 500 employees. They can't get financing. If you want some idea on the importance of small businesses:

1. They represent 99.7% of all firms.
2. They employ approximately 50% of all private sector employees.
3. They pay nearly 45% of US private payroll.
4. They have generated 60% to 80% of net new jobs annually over the last decade.
5. They create more than 50% of the nonfarm private GDP.
6. They hire 40% of high tech workers (scientists engineers and computer workers).
7. They made up 97.3% of all identified exporters and produced 28.9% of the known export value in 2006.

### C. Retailers Are in Trouble

1. A recent research report argued that 25.8% of retailers have a high possibility of bankruptcy. This number was 7.3% in November of 2007.
2. Several lenders such as GE Capital, CIT Group and Wachovia are slowing their lending to retailers.
3. The International Council of Shopping Centers estimates that 148,000 stores will close in 2008, the most since 2001 and it predicts that there will be an additional 73,000 closures in the first half of 2009.
4. Despite the closures, the US is still likely to see a net gain in square footage mostly due to projects underway before the credit crisis hit. Growth in retail square footage will slow to 5% in 2009 from 8% in 2008.

D. Computers: Notebooks have overtaken desktops. Size does matter – smaller is better.

1. Worldwide PC shipments rose 15% to 79 million units.
2. Notebook sales increased 40% from last year to 38.6 million units.  
Desktop cells fell 1.3% to 38.5 million units.
3. Acer was the only company to grow faster than the market.
  - a. HP shipped 14.9 million units, showing growth of 13.5%.
  - b. Dell's shipments grew 10.7%.
  - c. Lenovo's sales increased 7.3%
  - d. Acer's shipments grew 80%. This reflects their focus on laptops.
4. Apple's market share fell from 3.7% to 3.2% during the quarter. This may have been skewed by Apple customers waiting for new products in October.

## **Part VII: Assorted Stories**

### *A. Steady Returns*

We all want steady, consistent returns. The only problem is that when you see them, they're usually a lie. Between 1980 and 1990, Bernie Madoff claimed to have returned 22.6% per year. This is double the return of the stock market.

Recently, I saw an academic research paper that showed that when hedge funds trade in non-public securities, these funds show many more "barely positive" months than "barely negative" months. In other words, when I get to make up the price that I'm going to use to tell investors how we did, I'm going to use a price that makes my monthly returns look good.

### *B. Madoff's \$20 Billion Rounding Error*

1. Wealthy individuals (or better said "formerly wealthy individuals), foundations and banking giants have disclosed \$30 billion of losses at the hands of Madoff.
2. Madoff says the losses are approximately \$50 billion.
3. The cofounder of an investment firm that lost \$1.5 billion with Bernie made off committed suicide this week.

### *C. Don't Worry About Private Equity*

Cerberus owns Chrysler and 51% of GMAC. But, don't worry about them. They'll strip the good assets out of these entities before they fail...here's a good example:

1. Chrysler's headquarters has more than 5,000,000 ft. of space. It is the country's second largest office building (the Pentagon is first). I'm guessing that Chrysler built a huge headquarters because they saw the tremendous growth opportunity in US car manufacturing...
2. Cerberus bought the building for \$325 million (as part of the transaction to buy Chrysler). It was on Chrysler's books for \$800 million and they had received an offer of \$1.2 billion for the building and August of 2006. Chrysler now leases the building from Cerberus.

In other words...if Chrysler files for bankruptcy, Cerberus still has the building.

Cerberus, however, is not letting investors strip out their assets...Cerberus is only allowing 20% of year-end withdrawals. The fund lost 16% since the end of the third quarter.

D. 2008 Revisionist of the Year: Christopher Cox

SEC Chairman Christopher Cox made the following statements to The Washington Post (defending his complete lack of action during the recent crisis and the fact that his single action of banning short selling was an embarrassment to our system):

*"What we have done in this current turmoil is stay calm, which has been our greatest contribution -- not being impulsive, not changing the rules willy-nilly, but going through a very professional and orderly process that takes into account unintended consequences and gives ample notice to market participants," Cox said. This caution, he added, "has really been a signal achievement for the SEC."*

*Taking a swipe at the shifting response of the Treasury and Fed in addressing the financial crisis, he said: "When these gale-force winds hit our markets, there were panicked cries to change any and every rule of the marketplace: 'Let's try this. Let's try that.' What was needed was a steady hand."*

His last comment also results in his nomination for "Team Player of the Year." We'll have to wait to see if he beats out Terrell Owens.

E. NYT to Sell Interest in Red Sox

The New York Times is considering selling their 17.5% interest in the Boston Red Sox and Fenway Park. I'm hoping that George Steinbrenner will buy it and turn it into a urinal. (I grew up a Yankees fan in NY.) Of course, as a native New Yorker, I'm not sure that I want to see Boston improved in this way.

F. Charities and Rich Children are Getting Hurt...

Through December 22, gifts by officers, directors and large stakeholders of public companies were approximately half of typical levels.