

Market Update – February 8, 2009

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Part 1: The Economy

Key Economic Releases

1. Employment numbers were terrible.
 - a. Nonfarm payrolls declined 598,000
 - i. December revised down to 577K loss (from 524K)
 - ii. 1.77 million jobs lost in last 3 months
 - b. Unemployment rate increased to 7.6%
 - c. Really bad signs for the future:
 - i. Avg. workweek remained at 33.3 hours
 - ii. Hiring of temp. workers dropped 3.7%
 - d. Unemployment rate including discouraged workers and involuntarily part-time workers is 13.9%
 - i. Discouraged workers increased from 642K to 734K
 - ii. Involuntarily part-time stayed at 7.8MM
 1. but this is 3.1MM increase in last 12 months
2. Weekly initial jobless claims increased.
 - a. From 591,000 to 626,000
 - i. Worst since 1982
 - b. Four week moving average increased
 - i. From 543,250 to 582,250
 - c. Continuing claims increased 20K to 4.788 million
 - i. Each week sets new record...
3. Productivity increased 3.1% (this can be bad!)
 - a. Causes of increase:
 - i. Output decreased 5.2%
 - ii. Hours decreased 8.1%
 - b. Problem:
 - i. If we can produce more with less, we need fewer people
 1. Productivity growth is really important in long term
 - a. It allows us to increase our standard of living
 - i. Can pay people more if they produce more
 - ii. In the short-term, it can lead to a jobless recovery
 - iii. May just reflect ability to quickly cut workforce when demand drops
4. January ISM (Manufacturing) increased from 32.9% to 35.6%.
 - a. Below 50 means manufacturing is contracting
 - b. Fact that it increased means the rate of contraction is slowing
 - c. Monthly improvements in:
 - i. New orders index (23.1% / 33.2%)
 - ii. Production index (26.3% / 32.1%)
 - iii. Prices paid index (18% / 29%)
 - d. Employment index held steady (29.9%)
 - e. Inventories index dropped (39.6% / 37.5%)

5. January Services ISM increased from 40.1% to 42.9%.
 - a. Monthly improvements:
 - i. Orders index (38.9% / 41.6%)
 - ii. Prices index (36.1% / 42.5%)
 - b. Employment was steady (34.4%)
 - c. Monthly declines:
 - i. Backlogs (42.5% / 37.5%)
 - ii. Inventory index (49% / 41.5%)
6. Pending home sales rose 6.3% in December.
 - a. Down on the sides, up in the middle...
 - i. West -3.7%
 - ii. Northeast -1.7%
 - iii. South +13%
 - iv. Midwest +12.8%
 - b. Caused by:
 - i. Drop in mortgage rates
 1. Unfortunately, these are increasing again
 - ii. More affordable homes
 - c. 80% of pending home sales become existing home sales in next two months
7. A few other quick stats:
 - a. Personal income dropped .2% in December.
 - i. 3rd consecutive drop
 - ii. Savings rate increased to 3.6%
 - b. Residential spending dropped 27% for all of 2008.
 - c. Orders for manufactured goods fell 3.9% in December.
 - i. 5th consecutive monthly decline
 - d. The Fed'l Reserve said approximately 2/3 of loan officers reported tightening terms for business loans over the past three months.
 - e. Approximately 2/3 of banks reported weaker demand for business loans.
 - f. Approximately 40% of banks said demand for prime mortgages weakened during quarter.
 - g. The home vacancy rate increased from 2.8% to 2.9% in Q4. The 50 year average is 1.5%.

Some Other Things to Think About With the Economy

1. Many companies have stopped giving guidance to analysts. There is too much uncertainty. This often results in lower expectations (and lower stock prices). Microsoft recently stopped supplying guidance. If they can't see the future, I'm not sure who can.
2. Consumer spending fell 1% in December, the fifth straight monthly decline. One of the things we see in this type of environment is that EVERYONE slows their spending. I'll use myself as an example. I teach at The University of Texas and I'm in a reasonably stable job. But, this week, I told my wife that she needed to fire the pool boy that she had hired. I think that a lot of what bothers me is constantly hearing the news about the recession. I'm also bothered by the fact that we don't have a pool.
3. People reportedly waited in line for two hours for a free Grand Slam Breakfast from Denny's (advertised during a Super Bowl commercial). If they had paid, the cost would have been \$5.99. So people are valuing their time at \$3 / hour... One customer was quoted in the paper as saying "we need more offers like this to stimulate the economy." Quotes like that are constant reminders that our education system is broken. (But, my guess is that if some Congressman heard that quote, it won't be long before we hear about the "Rooty Tooty Fresh and Fruity Stimulus Bill.")
4. As of October, 31 million Americans were receiving food stamps. That's more than one in ten people. Obviously, those numbers must have become worse in the past few months (October is our latest data).

Part 2: Stimulus and Bailout

This week, we're going to see:

1. the resolution to the stimulus bill
2. the Treasury department's new bailout plan

The Stimulus Bill

1. the Senate and the House have each developed a stimulus bill. Unfortunately, they now need to be consolidated. This is going to be a difficult process.
 - a. The House bill focuses on helping states and municipalities avoid cutting services
 - b. The Senate bill focuses more on tax cuts and is less generous with health care
2. both bills are approximately \$820 billion

Here are The Problems

1. President Obama has said that spending equals stimulus. The problem is that you may not be stimulating the right things. Imagine California was in trouble and we created a bill that spent money in New York. Obviously, the impact on California would be minimal. These bills are packed with spending that will have no impact on our problems.
2. The cost is staggering. We have 300 million people in this country. That includes men, women and children. (There are only 138 million who are part of the work force.) Spending \$900 billion means we're spending \$3,000 per person. Think about this. I have three children – so the government is effectively spending \$15,000 for the five of us. We're going to have to pay for this, aren't we? When money is spread out over a bunch of crap, this is just a waste.
3. Many provisions are not going to be well thought out and will lead to fraud. Apparently, there is talk of a tax credit for home purchasers equal to the lower of \$15K or 10% of the purchase price. If this isn't tightly worded, we're going to see a ton of sham transactions. This is simply one example.

Update on the Treasury's Plans

1. Tim Geithner is going to announce his strategy on Monday. The market rallied on Friday in anticipation of this announcement.
2. The rumors are that the Treasury is going to announce a plan in which they insure toxic assets. The idea is that buyers will purchase the assets if the government is guaranteeing them.

Problems With the Insurance Plan

1. Insuring an asset is no different than buying an asset – you have to know what it's worth in order to price the policy correctly. This plan does not eliminate the problem we had with the asset purchase program.
2. Most insurance companies make money by investing the premiums until a payout is necessary. The government will not be able to do this.
3. We will hear crazy stories about the idea that the government may not lose money on this deal.
4. The government overpaid with the first \$700 billion it spent. What will be different this time...
 - a. The head of the Congressional Oversight Panel which oversees TARP said that the Treasury failed to price for risk and paid substantially more for assets purchased under the \$700 billion program. She suggested that the Treasury paid \$254 billion for preferred stock and warrants that were probably worth \$176 billion.
5. There's been much talk about the fact that banks can't sell these toxic assets. What's really going on is that they don't want to sell these assets at the current market prices.
6. Bank's slow approach to cleaning up their balance sheets has been caused by the government's different plans to buy these assets. If you bought a house for \$400,000 that was now worth \$250,000, you wouldn't sell if you thought that the gov't would pay you \$300,000 for it. This is what's happening with the banks.
7. Every time we spend another \$900 billion, it's \$3,000 more for each one of us (including our kids). Why should my family pay for these problems? The shareholders should be wiped out and the debtholders should become equityholders. They took the risk in order to get the reward. They lost and they should pay. It makes little sense to shift the loss to me and you.
8. The problem with letting the bondholders get hurt is that there are credit default swaps outstanding. When you buy insurance, you have counterparty risk. We're so busy trying to protect everyone who took risk that we're killing our future.
9. There are rumors that "mark-to-market" accounting will be eliminated. That's great...keeping assets on our books at false prices will solve our problems. I plan on telling Jenny, "Good news, honey...remember how I told you that our stocks lost 40% of their value? Well I'm marking them back up to our purchase price." Maintaining false prices on our books is not a remedy to these problems. It simply allows banks to remain undercapitalized and creates risks for all of us.

Part 3: Obama Limits Compensation

The Rules

1. President Obama established new regulations (I believe through the Treasury Department) on executive compensation.
2. If a firm receives extraordinary assistance from the gov't (such as Citi, BAC or AIG):
 - a. \$500,000 salary cap for top executives.
 - i. Any pay above this must be in restricted stock.
 1. Can only vest after gov't is paid back.
 - b. No severance packages for top 10 executives.
 - i. Next 25 executives can only receive one year severance.
 - c. Requires disclosure of luxury spending (holiday parties, corporate jets, office renovations, etc.).
 - i. Chief executives will have to certify expenditures.
3. If a firm participates in generally available rescue programs:
 - a. \$500,000 salary cap can be waived with:
 - i. Disclosure of compensation packages; and
 - ii. Nonbinding shareholder vote
 - b. Top five executives can get one year compensation upon severance.

A Few Compensation Facts

1. In 2007, total compensation of chief executives in large American corporations was 275X the salary of the average worker.
 - a. This is an estimate from a liberal think tank (Economic Policy Institute), but we can see plenty of evidence of this.
 - b. In 1970, the number was 35X.
2. An academic paper found that the excess compensation to finance employees (vs. other industries) was normally slight, but had boom years:
 - a. Late 1920's to 1930.
 - b. Mid 1990's to current.
 - i. This paper adjusted for education, skill, age, gender, etc.
3. Students are chasing money...look at Harvard undergraduates:
 - a. In 1960s, 4% entered banking and finance.
 - b. In recent years, number grew to 23%.
4. Citi had approximately 4,000 employees (out of 300,000) earn more than \$500K in 2008.
 - a. JPM had approximately 2,250 (out of 225,000) do the same.

There are a Tremendous Number of Problems / Loopholes

1. Relatively healthy banks will be reluctant to participate in programs.
2. We don't know what certain terms mean (such as senior executives).
 - a. Titles can easily be changed.
 - b. The senior executives are not always the highest paid individuals in these institutions.
3. It will be very difficult to replace top executives at troubled firms:
 - a. You will have little upside; and
 - b. You will have reputational risk on the downside (if the firm fails).
4. We may be weakening troubled firms.
 - a. Employees may leave for foreign firms or boutique firms.
5. We may be strengthening foreign firms.
 - a. We may be hurting our competitiveness in the long term.
6. We may simply see an increase in restricted stock.
7. We may see other tricks, such as repricing existing options.

Bad Facts Make Bad Law

There is a saying among lawyers that bad facts make bad laws. That's what is going on here. We have bad facts. Some banks, particularly ML, paid absurd salaries when their bank was experiencing huge losses and their shareholders had been crushed. Then, we had a knee-jerk reaction and created regulations that will have little impact (or negative impact).

What Should Be Done

Many of the problems we see are the result of our worthless corporate governance structure. Companies have a nominating committee in which they nominate friends to be on the Board. Directors run unopposed. People say that these are free elections. (They used to have similar free elections in Iraq. You could vote for Sadaam or you could not vote.) The directors are often top executives of other firms (who have an incentive to push up salaries) or retired executives or friends of the CEO.

Why can't we have free elections? Why can't the shareholders nominate directors? I know that's an odd idea...letting the owners decide who represents them. Why can't people put a one page position paper in the prospectus describing their background and their views – so that we can decide who we want to vote for?

Do you think an independent board that cared about the shareholders would have approved these bonuses for ML? We need corporate governance, not price ceilings.

Part 4: News from the Crisis

China Has Problems

1. An estimated 20 million (out of 130 million) migrant workers in China have lost their job. Since the Chinese government is incapable of telling the truth, you have to believe that the number is higher.
 - a. The gov't has ordered the military to stand ready to obey government orders at any time and under any circumstances.
 - i. In other words, Chinese citizens are welcome to protest if they would like to be shot.
2. China is going through one of its worst droughts in decades.
 - a. It is threatening to damage 1/5 of China's wheat harvest and millions of livestock.
 - b. Think about this...more expensive food, rising unemployment and an intolerant government. Sounds like a nice place to visit.

Plenty of Problems in the U.S.

1. Treasury yields increased significantly as investors feared increased supply.
 - a. In other words, we will have to issue more debt.
 - b. Fed'l Reserve may start buying bonds.
 - i. Buying pushes up price and pushes down the yield.
2. Spread between mortgage rates and Treasury yields is still wide.
 - a. Fed is purchasing MBS and agency securities.
 - i. Buying pushes up price and pushes down yield.
 - ii. They are trying to narrow the spread b/t mortgage backed securities and UST.
 - iii. REMEMBER: even IF this works and the spread narrows, it is being counteracted by the increase in UST yields (due to the fear about future UST issuance).
 - iv. They have spent \$70 billion.
 1. On way to \$500 billion.
 2. Problem is that there will be \$500 billion of refinancing with lower rates.
 - a. All Fed can do is absorb that.
 - v. This worked for a while (and narrowed spread from 2.8% to 1.8%), but we're headed back the other way now.
3. States are having problems:
 - a. S&P downgraded California's credit rating to the lowest of all states.
 - i. \$46 billion of general obligation bonds were downgraded
 1. from A+ to A
 - ii. Stop and think about this...
 1. You are lower than Louisiana, Mississippi, etc.
 - iii. The Governor and state legislature are at impasse.
 1. Need to close deficit that will be \$42 billion by mid-2010.

- iv. Controller is delaying \$3 billion in tax refunds, welfare checks and other payments.
 - v. State agencies are furloughing state employees.
 - 1. They must take every other Friday off.
 - a. Pay is decreased by 10%.
 - b. Seven states have already emptied their unemployment insurance trust funds.
 - i. Another 11 will do same by year end.
 - ii. States have borrowed \$2.3 billion from Fed'l gov't.
 - 1. They are required to pay this back.
 - iii. Nearly 4.8 million people collected unemployment insurance last week.
 - 1. Highest number in the 40 yrs data has been tracked.
 - iv. Stimulus will pump billions of dollars into this system.
4. MBS continue to have problems:
 - a. 2,446 classes of RMBS (residential MBS) were downgraded on Wednesday.
 - i. Downgrade to junk status hurts banks and insurance companies.
 - ii. Moody's is projecting that alt-A deals done in 2007 Q3 and Q4:
 - 1. Will experience 25.5% loss of original balance.
 - 2. Compare to:
 - a. 2007 Q1 and Q2: 23.9%
 - b. 2006 Q3 and Q4: 22.1%
 - c. 2006 Q1 and Q2: 17.1%
 - 3. Back in May, the assumptions were:
 - a. 2007 deals: 14.7%
 - b. 2006 deals: 11.2%
 - b. Moody's is reviewing \$302.6 billion of CMBS (commercial MBS).
 - i. AAA CMBS are now yielding 10 yr UST + 10%
 - 1. The market has already downgraded these.
 - a. One yr ago – spread was 2.2%.
5. Credit default swaps on USTs increased 759% this year.
 - a. In other words, insurance on US debt costs a lot more.
 - i. The annual cost of insurance \$10MM of five-year UST increased from \$7,680 to \$66,000.
 - b. This is a reflection of problems in US.

Academic Research on Financial Crises – Includes Developed Countries and Emerging Markets (Carmen M. Reinhart [Univ of Md]; and Kenneth S. Rogoff [Harvard])

1. Negative growth periods (recessions) typically subside in just under two years.
2. Housing typically declines 36%.
 - a. Duration of peak-to-trough is typically 5 – 6 years.
 - i. This would mean we have another 10% to go.
 - ii. This would mean we will hit bottom in ~2011.
3. Equities typically drop 55%.
 - a. Duration of drop is 3.5 years.
 - i. This would mean equities will bottom in 2010.
4. Unemployment typically rises for five years.
 - a. Average increase is 7%.
 - i. This would put us close to 12%.
5. Government debt tends to increase 85%.
 - a. This would mean debt increases \$8 - \$9 trillion.
 - i. The increase in debt is not due to bailouts.
 1. It's normally due to dropping tax revenue.
 - b. This would mean higher interest rates in future.
 - i. This could hurt future growth.

A Few More Stories From the Crisis

1. The Russian ruble is sinking.
 - a. Very sensitive issue.
 - i. People remember 1998.
 - b. Being hurt by:
 - i. Price of oil.
 - ii. Huge capital outflows.
 - c. Depleting reserves trying to defend currency:
 - i. Spent 1/3 of foreign currency reserves.
 1. Dropped reserves from \$600 billion to \$385 billion.
2. Momentum is growing for idea of setting up a commission to probe causes of fin'l crisis.
 - a. This will impact future regulation.
3. It wasn't just selling credit default swaps that got AIG in trouble.
 - a. They loaned out securities to short sellers.
 - i. Short sellers had to post collateral.
 1. AIG invested collateral in MBS.
4. US has lost ~\$10.2 trillion of wealth in this crisis:
 - a. Combination of:
 - i. \$3.3 trillion of home equity
 - ii. \$6.9 trillion of stock market losses
 - b. This is approximately 1/5 of WORLD GDP.
 - i. It's also the size of the US debt at the end of 2008.
 1. We could have paid off debt with money we lost last year.
5. Harley Davidson issued \$600MM in senior unsecured notes to Warren Buffet.
 - a. They come due in 2014 and yield 15%.
 - i. The company has a lot of other debt coming due:
 1. \$500MM credit line expires in March.
 2. \$950MM of debt comes due in July.
 - b. How risky do you think this company is compared to the banking system?
 - i. Is the gov't charging 15%?

Part 5: Financials

This week, we've seen several hints that **could indicate important trends**, including:

1. government involvement in bank's business decisions
2. growing importance of boutique investment banks
3. shakeup in the brokerage industry
4. increasing regulation

Government Involvement In Bank's Business Decisions

1. Previously, **Citigroup** entered into a \$400 MM marketing agreement with the NY Mets, which allowed Citi to name the stadium and put ATMs throughout it.
 - a. Now, they are trying to get out of this arrangement.
 - i. CEO (Vikram Pandit) is supposed to testify before the House Financial Services Committee this week.
 1. He knows he's going to be asked if this is a good use of TARP funds.
 - a. There is no way to say what money is used where.
 - b. This is going to be a constant refrain – how could they use gov't money for this?
 - c. Citi has lost \$28.5 billion since 2007.
 - d. Citi has received \$45 billion in aid and the gov't guaranteed \$301 billion of loans and assets.
 - ii. I think that they should embrace the current events and name the stadium Citi TARP Stadium. Or if any stadium was ever going to be called "National Stadium," this is it.
 - i. Order seats in the "Bailout Bleachers."
 - ii. If you spend too much money on beer at the game, the government can give you money to get home.
 - iii. The Mets should be encouraged to give bonuses to players who underperform.
 - b. A BAC spokesman said that these deals are normal banking relationships and they are profitable for the bank. (That may explain why they want to exit the contract...)
 - i. Of course, owning securities is normally profitable for a bank that hasn't turned out that well for Citi.
2. **Wells Fargo** canceled plans to host top mortgage officers in Las Vegas.
 - a. They have received \$25 billion from the Treasury (mostly b/c of problems from Wachovia)
3. **Goldman Sachs** canceled its Miami hedge fund conference (scheduled for March).

4. **Morgan Stanley** canceled plans to take top producing brokers to Monte Carlo and the Bahamas.

If all of these junkets keep getting canceled, we're going to need a bailout for hotels (and other industries...).

Boutique Investment Banks Will Grow in Importance

1. Many boutique firms are being hired for restructuring work.
 - a. Some bulge bracket firms are not allowed to do this b/c of conflict of interest laws.
 - i. Creditor banks are prohibited from advising firms that have filed for bankruptcy.
2. Boutique firms may become more attractive due to compensation limitations at other firms (see Compensation part of paper).

We've Seen Lots of Movement in Brokerage Industry

1. Morgan Stanley bought control of Citi's brokerage unit.
2. Bank of America is struggling to keep Merrill Lynch's brokers.
3. UBS has been offering large bonuses to successful private wealth management teams across the country.

The brokerage / private wealth management business tends to be a relatively steady stream of income.

More Proposed Regulation

The Hedge Fund Transparency Act would require hedge funds and private equity funds to disclose the value of their funds and the names of all investors. It's hard to see what this will do. We'll make hedge funds more regulated than mutual funds.

Don't forget... (1) hedge funds didn't cause the problems we have. Oddly enough, many of the problems were caused by the US banking industry – the MOST HIGHLY REGULATED INDUSTRY. Go figure. I really had thought that some bureaucrats could have saved us from ourselves. (2) the SEC had authority to see all of this information with Madoff. Nice work guys.

Follow-Up on BAC and ML

1. More stories have come out about BAC's dealings with the government in December:
 - a. Apparently, Ken Lewis wanted to walk away from ML.
 - b. Supposedly, Paulson and Bernanke praised BAC's earlier cooperation.
 - c. Then, they warned that walking away would be a death sentence for ML.
 - d. They also cautioned that investors would lose faith in BAC.
 - e. Two days later, Bernanke supposedly:
 - i. Told Lewis that BAC had no justification for walking away.
 - ii. Regulators would have to question the confidence they have in BAC's management.
2. Lewis asked for more capital and guarantees against losses.

If these stories are true, it sounds as if the gov't told Lewis that if he wants more money and he wants to keep his job, he would complete the deal with ML. Some commentators have said that this reduces his culpability. I don't see it that way at all. First of all, he was the one who did a deal in two days and paid an absurd premium. Second, Lewis should have walked away from the deal and worried about himself later.

A Few More Ken Lewis Stories (Can you really ever get tired of these?)

1. Ken Lewis said that he believed he was doing the right thing for the country. Unfortunately, that was at the expense of his shareholders – the people he had a duty to.
2. The other day, he said that the ML deal will still turn out to be a good deal in the long run.
 - a. Of course, it's really odd that he wanted to get out of this deal, isn't it?
 - b. I've started telling Jenny that I'm going to turn out to be a good husband in the long run.

Struggle of "Mortgage Banks"

1. Mortgage banks obtain funding from "warehouse lenders."
 - a. Mortgage banks can not take in deposits.
2. They use short-term credit to make loans to home buyers.
 - a. They sell these loans to Fannie and Freddie.
 - b. Then, they repay warehouse lender.
3. Now, the quantity of warehouse loans has dropped 90%.
 - a. If a mortgage bank can only make a few loans, they will charge higher rates.
4. It probably won't be long before the government is guaranteeing warehouse loans.

A Few More Random Ideas

1. The companies that operate the black sedans that drive investment bankers around NY are reporting a 30% drop in revenues.
 - a. I'm assuming that this is true and that it's not a reflection of hiring Tom Daschle as their tax accountant.
2. Equity mutual funds have experienced net outflows for six consecutive months through December.

Part 6: Auto Industry

Car Sales Continue to Plummet

1. January US sales crumbled (YOY – compares Jan. 09 to Jan. 08):
 - a. Chrysler's dropped 55% to 62,157
 - b. GM's dropped 49% to 128,198
 - c. Ford's dropped 40% to 93,041
2. US sales by foreign manufacturers also dropped:
 - a. Mercedes fell 43%
 - b. Toyota dropped 34%
 - c. Honda dropped 30%
3. US car sales were the lowest since December 1981.
4. For the first time ever, US car sales were lower than cars sold in China.
 - a. China – 790,000
 - b. US – 657,000 cars and light trucks

Big Three Financing Has Dried Up

1. GMAC financed \$2.7 billion of new vehicles in Q4.
 - a. This is an 80% drop (YOY).
 - b. GMAC financed 8% of new GM retail sales in Q4.
 - i. Last year, they finance 43% in Q4.
2. Anecdotal evidence: AutoNation (largest chain of US auto dealers):
 - a. Financed 9 cars from GMAC
 - i. Financed 1,527 in December 2007
 - b. Financed 22 loans from Chrysler Financial
 - i. Financed 823 in December 2007
 - c. Financed 1,235 loans from Ford Motor Credit
 - i. Financed 1,624 in December 2007

Ford Motor Credit is the only one (of the three) that is a complete subsidiary. This explains why Ford's lending has not dried up. This probably explains why Ford's sales did not drop as much as Chrysler and GM.

GMAC – Rebranding

Apparently, GMAC is considering “rebranding.” This is a fancy way of saying that they want to change their name so that people don't associate them with GM. I'm guessing that GM would also like to rebrand so that people don't associate them with GM. (And yes, my wife would also like to rebrand.)

Chrysler's Troubles

1. Chrysler has 151 days of inventory at its facilities.
 - a. This is after shutting factories down for a month.
2. Vice Chairman Jim Press said Chrysler had a pretty good month.
 - a. What does a bad month look like?

Apparently, Press had a closed door meeting with some dealers on Tuesday and he made a (reportedly) emotional plea for dealers to order more cars. One dealer quoted Press as saying, "if you don't order cars, how is the company going to make it?" This is like a restaurateur standing in the bathroom as his customers vomit from his tainted food, yelling "if you don't order more food, how will I stay in business?"

Auto Parts Suppliers Seek Bailout

An auto parts supplier group (representing 400 parts makers) asked for \$25.5 billion in aid and guarantees.

No Car Czar

We still don't have a car Czar. GM and Chrysler are supposed to submit reports to him by February 17th. This will be the excuse to give the companies more time. A suspicious person would think that this was intentional. Fortunately, I take everything at face value.

Part 7: Cramdowns

There is legislation going through Congress that would allow bankruptcy judges to modify the terms of a mortgage. In other words, the judge could reduce the amount that the borrower has to pay to the lender.

Before I get started talking about this, stop and think about this for a minute. (I've learned more in the last two years than I have in the five years before that – so maybe this crisis has been a good thing.) Two things that really surprised me to learn (in the past years) were:

1. Mortgage loans are non-recourse – if I default, the lender can't go after my other assets. This is why people mail in their keys when they default. It effectively turns the lenders into the speculators.
2. Bankruptcy judges can't modify mortgages. This is really somewhat strange to think about – the all-powerful bankruptcy judge not being able to touch this debt.

Some people believe that this cramdown law will create benefits by allowing families to stay in their home, making their mortgage affordable (hopefully amending terms so that payments are consistent with income levels) and avoiding the tremendous losses that banks experience with foreclosures. Opponents argue that lenders will have to raise mortgage rates in order to be compensated for the risk of modification. (I'm not sure that this argument is correct – the banks are already factoring in the risk of foreclosure.)

I am not sure yet where I come down on this issue. But, I have read some other issues that are not as obvious as the ones described above. Some of the other consequences that we need to investigate are:

1. Owners of second-lien portfolios (home equity line of credit, etc.) will likely be wiped out by the modification process.
2. This change in bankruptcy law would probably result in more people filing for bankruptcy. The result is that credit card issuers would have bigger losses. Apparently, credit card issuers have to write off loans immediately upon notice of bankruptcy.
3. Mortgage insurance does not protect the lender against loan modification. Mortgage backed securities that were enhanced by owning mortgages with mortgage insurance will have losses. This will mean further writedowns.
4. Most MBS have tranches and the lowest tranche (highest risk) incurs losses first. The highest tranches don't incur any losses of principal until the lower tranches are wiped out. Yet, most MBS actually have all tranches share bankruptcy losses. In other words, higher rated securities are going to share in some of these losses – and this could result in writedowns. (Of course, this could help the lower tranches.)
5. FHA insurance also does not cover bankruptcy losses. Same arguments as above.

6. Loan modification may actually be bad for homeowners. We've seen a tremendous percentage of people default a second time shortly after having their loan modified (by the lender). Some people are better off walking away and letting the lender foreclose.

Part 8: A Few Random Stories

This Week's Real Men of Genius Award

Bankruptcy Judge James M. Peck, the man overseeing the largest bankruptcy in U.S. history, was arrested following a domestic incident with his wife at their apartment. He oversees the Lehman bankruptcy. I'm really impressed with his dispute resolution skills. (With that said, I can't wait until he gets his hands on Fuld.)

Erin Burnet is Clueless

If you want to get really annoyed, go to the link below.

Erin Burnet was on Meet the Press last Sunday. Do people really want to hear her opinion? She was asked about the bonuses that were paid to bankers. She made three points:

1. if she lost \$10 billion but another employee made \$1 billion for the company, that other employee should receive a bonus;
2. these weren't really bonuses...it was compensation; and
3. the government money was not used for bonuses...this was a different pile of money.

These absurd comments were compounded by her condescending mannerisms. There is little that is more annoying than watching someone speak with affected mannerisms in order to appear intelligent. You really should watch it. It's sickening.

I have to tell you that when a company loses money, I don't really see giving \$4 billion of bonuses to employees. Would you do this if you were the owner of a company?

In addition, think about the separate pile of money analogy. Imagine I make \$100,000 per year, but I spend as if I make a lot more. (In other words, imagine I live in Dallas.) Imagine that during the year, I inherit \$75,000 that I use to buy a \$75,000 car. Jenny says, "that's so irresponsible - you spent your inheritance on a car." I explain to Jenny that she clearly was a marketing major and doesn't understand. I spent my salary on the car. The inheritance had nothing to do with it.

Whether you think about the bonuses or my car example...the question is "but for the government money (or the inheritance), could the bonuses have been paid?" Or, in the case of ML, but for the bonuses, would the government have had to provide such a large bailout to BAC?

You can also see video of Cramer (aka Mr. Ethics) defending Erin. (My guess is that he defended Erin on Monday and his opinion switched and he hit the sell button on Tuesday.) For a great article on Cramer, see this week's Barron's. You can read

about how much money you could lose by listening to him. But, as long as he makes money for himself and has fun, it's all good.

<http://www.youtube.com/watch?v=wFIPs0zEI5c>

Cost of Data Breach

1. In an annual survey, data privacy research firm Ponemon Institute found that the cost of a data breach rose to \$202 for each compromised record last year, an increase of 2.5% over 2007.
 - a. The average cost of a healthcare breach was \$282 per record, while the cost of the average retail breach was \$131.
2. The average expense to an organization was \$6.6 million in direct and indirect costs, which includes the cost of notifying victims and maintaining information hotlines as well as legal, investigative and administrative expenses.

Tom Daschle Saga Ends

Senate Democrats rallied around Tom Daschle, nominee for secretary of health and human services, despite his failure to pay more than \$100,000 in taxes. The fact that these guys don't think that tax evasion should preclude you from a cabinet position is astounding.

Of course, Daschle eventually withdrew his name from consideration. In addition Nancy Killefer also withdrew her name over tax issues. She was supposed to lead the effort to streamline government. Unfortunately, she had already proven her talent by streamlining her tax payments.

The president has introduced regulations to limit the amount that bank executives are paid. Maybe he can also require politicians to pay their freakin' taxes.

Madoff Hearings

Mr. Markopolos (who had sent the SEC a long letter describing Madoff's Social Security / Ponzi scheme several years ago, only to be ignored) had very harsh words for the SEC. He said "that the SEC securities' lawyers if only through their ineptitude and financial illiteracy colluded to maintain large frauds such as the ones to which Madoff later confessed." Don't expect it to get better with Mary Schapiro in charge.

One of the things that people don't realize is how little lawyers know about finance. Law schools hardly teach anything about this.

Dow Chemical is Spiraling

Dow reported an unexpected \$1.55 billion fourth-quarter loss on Tuesday. Sales dropped 23% in their worst financial results in more than a decade. They had already planned to close 20 plants and eliminate 5,000 jobs. On Tuesday they said there might be more closures in coming months. Dow's utilization dropped to 44% in December.

Dow had a market capitalization of \$31.7 billion when it agreed in July to buy Rohm & Haas (which then had a market cap of \$8.9 billion). Each company's market value is about \$10.5 billion now.

Dow made a big mistake when they paid a \$400 million dividend on January 30, 2009. They are making an argument that they are in a horrible financial position and they are distributing almost half a billion dollars (and the dividend is quarterly – so they pay \$1.6 billion per year).

What a Shock – Prostitutes on Wall Street (this isn't a banker joke)

Kristin Davis was laid off (no pun intended) from a hedge fund, so she started a prostitution ring. She claims that her clients came from Lehman, JPM, GS, ML and Deutsche Bank. She also claims that a partner at Cravath, Swain & Moore once spent \$20,000 with her agency. She has spent a few months in jail. (People are upset b/c some clients supposedly used corporate funds, which might be a crime in NY, and they were not prosecuted.) Shockingly, she has just written a book (who would expect someone who sold themselves or others for money to write a book to profit off of this?).

Are people really surprised about this story? Bankers and lawyers work long hours and don't get home for dinner. As a result, the company brings food in. I think we all understand the analogy.

Follow Up From Class

For those of you who took Investments with me...you might remember that we valued Dow Jones & Co. at the time Rupert Murdoch bought the company for \$5.2 billion. We showed that it was probably worth about \$20, rather than the \$60 he paid. This week, he wrote the investment down by \$2.8 billion. (Of course, when he bought the company, News Corp. immediately dropped by \$3 billion. It took 18 months for News Corp. to admit what the market had already said.)