

Market Update – January 18, 2009

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THIS IS NOT INVESTMENT ADVICE. Anyone who would follow my investment advice would end up being jealous of people who followed Bernie Madoff's advice.

CORRECTION FROM LAST WEEK: The government has spent \$26.55 MILLION to allocated \$354 BILLION – so this comes out to .0075% (not 7.5%).

This week's update has two parts:

Part 1: The Usual Update

- A. Financials (p. 2)
- B. Economic News (p. 5)
- C. Markets (p. 9)
- D. A Few Random Thoughts (p. 10)

Part 2: My Outline of an IMF Paper – this paper describes the issues that should be considered when developing fiscal policy to respond to this crisis. You may find this to be an interesting framework when thinking about our bailout plan. This outline is contained on pages 11 – 15.

Part A: Financials

Once again, bank stocks were the big news of the week:

1. Citigroup posted an \$8.3 billion Q4 loss. The investment banking division had huge write-downs on bad loans and securities, posting a loss of \$10.2 billion. The fourth-quarter loss would have been steeper if it wasn't for a \$3.9 billion gain from the sale of Citigroup's German retail banking business and a \$2 billion accounting benefit that resulted from the widening spreads on the company's debt.
2. Citigroup made a meaningless change to try to show investors that they had some good assets and some bad assets. While my suggestion was that they should simply change their name to Citigroups, they instead chose:
 - a. Citicorp (the core assets; approximately \$1.1 trillion of assets; 65% funded by deposits)
 - i. Global Institutional Bank
 1. The corporate and investment bank
 2. The private bank
 3. Global transaction services
 - ii. Retail Bank
 1. Branded credit card business
 2. Regional consumer and commercial banking franchises in US, Latin America, Central and Eastern Europe and middle east
 - b. Citi Holdings (non-core businesses; approximately \$8.5 billion of assets)
 - i. Brokerage and Asset Management – including the Smith Barney joint venture with Morgan Stanley
 - ii. Local consumer finance businesses including CitiFinancial and CitiMortgage and the US and consumer finance operations in Western Europe, Japan, India, Mexico, Brazil, Thailand and Hong Kong
 - iii. Special asset pool of \$301 billion which carries a guarantee and loss sharing agreement with the US government
3. Bank of America posted a \$1.79 billion loss. They set aside \$8.54 billion for bad loans in Q4 (up from \$3.31 billion last year). Loan write-offs tripled to \$5.54 billion. Losses on CDOs were \$1.7 billion and write-downs on CMBS were \$853 million. ML lost \$15.3 billion during the period and this was NOT included in BAC's report.
4. Bank of America received an additional government bailout. The government gave them \$20 billion in additional federal aid and loss protection on \$118 billion in toxic assets. BAC is blaming these toxic assets on Merrill Lynch, but 25% of the protected asset pool belongs to BAC.
5. J.P. Morgan reported a 76% drop in Q4 net income. Jamie Dimon warned that the economy could continue to weaken throughout the year.
6. Barclay's stock dropped 25% on Friday.

Ken Lewis – Pressure to Step Down From BAC Will Increase

BAC's stock has dropped from \$33 in mid-September (prior to acquiring ML) to \$7. If BAC had not acquired Countrywide or ML, BAC would likely be the largest and strongest bank in the country. Instead, they were bailed out this week. Apparently, Ken Lewis blames ML for BAC's problems and is furious at ML's lack of disclosure when BAC acquired ML in September. Things were so much worse than Ken Lewis expected that he went to Washington in mid-December to discuss backing out of the deal, but he was told that there was too much systemic risk to canceling the deal.

Lets look back as to BAC's acquisition of ML. On Friday, September 12th, BAC's stock closed just under \$33 and ML closed at \$17. Over the weekend, Lehman filed for bankruptcy and Ken Lewis agreed to buy Merrill Lynch. BAC agreed to pay .8595 shares of BAC for each share of ML. At the time, this valued ML's stock at \$29 / share (approximately \$50 billion).

This deal made absolutely no sense when it was announced. After Lehman went under, everyone knew that Merrill Lynch was going to be the next bank that everyone was going to look at. If ML hadn't been acquired over the weekend, their stock probably would have opened in the \$10 range. Paying close to \$30 made no sense.

Now, Ken Lewis is complaining about the disclosure during the transaction. Is he kidding? He did a deal for a complex investment bank in less than two days. Previously, in a "real men of genius" moment, he had purchased Countrywide Financial. BAC's stock is now worth \$7 and is being bailed out by the US government. He reminds me of a guy who goes to Vegas, meets a woman, marries her the same day and then complains that she wasn't totally honest with him.

Who Should be CEO of Citi Holdings?

Citi Holdings will stay on Citi's balance sheet, but their earnings will be broken out separately. Citi Holdings will be looking for a new CEO. The new CEO's job will be to hold a fire sale, without making it look like that's what he's doing. My suggestion would be that they hire John Thain (ML's former CEO) and maybe he can sweet talk Ken Lewis (BAC) into making one more stupid decision.

TARP Update

A few ideas about TARP:

1. we're in a huge mess with Citi and BAC. While they are too big to fail, they are not too big to be nationalized.
2. The Senate approved the release of the second half of the original \$700 billion bailout money. While the House can still vote on this, their vote is irrelevant. The law requires action by both the Senate and the House in order to block the release of the funds.
3. Talk has shifted back to the need to purchase the bad assets from the banks. The original Paulson plan will be expensive and difficult to implement. It's not that people think that this is a good idea; rather, people are unhappy that adding equity to the banks has not worked fast enough.
4. The Congressional Budget Office estimates that taxpayers could lose \$64 billion on investments made with the first \$350 of the TARP.

Think about this...if we move back to the idea of buying the risky assets from the banks (in order to allow them to invest and to raise new capital from private sources), we have two huge problems:

1. what price do we pay for these assets (same problem we've always had)
2. if banks are trying to get rid of risky assets, we now fear CDOs, CLOs, leveraged loans, credit card loans, mortgage backed securities, etc. In other words, we will have to buy a tremendous amount of assets.

Interesting Fact

When you think of banking, do you think of Minnesota? U.S. Bancorp and Wells Fargo are both based there. Their combined market value on Monday was \$138 billion. The market value of Citigroup and J.P. Morgan, the two biggest New York banks, was only 123.5 billion. Charlotte has Bank of America and used to have Wachovia. (How ironic that Charlotte's football team was a 10 point favorite last week and cratered while playing in Bank of America Stadium...)

Part B: Economic News

Recent economic data and ideas:

1. 4.2 million homes are listed for sale.
 - a. This is an 11 month inventory.
 - b. This does not include:
 - i. newly constructed homes
 - ii. most of the foreclosed homes b/c they are not on the MLS listings).
2. US foreclosure filings increased 81% in 2008.
 - a. This is an increase of 225% from 2006.
 - b. There were more than 3.1 million foreclosure filings in 2008
 - i. One in 54 families received one
 - c. 861,664 families lost their homes to foreclosure last year.
3. Producer prices fell 1.9% in December (month over month).
 - a. 5th straight monthly decline
 - i. energy prices fell 9.3%, including:
 1. 25% drop in wholesale gas prices
 - ii. food prices dropped 1.5%
 - b. core producer prices (excluding food and energy) rose .2%
 - i. 4.3% increase from prior year
 1. largest annual gain in two decades
4. Retail and food services sales fell 2.7% from December.
 - a. Sales were down 10% YOY.
 - i. Biggest yearly drop since records began in 1968.
 - b. 6th consecutive monthly decline
5. Combined exports and imports for the US dropped 18% in the four months from July to November.
 - a. We are importing much less due to recession.
 - i. The dollar value is also dropping b/c of commodity prices.
 - b. Countries like Japan are exporting much less.
 - i. So you can imagine what is happening to their economy.
6. Productivity numbers might look strong:
 - a. Hours worked are being cut even faster than the economy is shrinking.
 - i. Hours worked decreased at a 7.7% (annual) rate in Q4.

States are in Trouble

1. State sales tax revenues have dropped 6.5% in Q4 (YOY).
2. Corporate income taxes are down 22%.
3. Ten states have proposals to increase taxes on alcoholic beverages and this could increase to 30 states.
 - a. Isn't this when we need liquor the most???
4. examples of state news:
 - a. California is facing a \$42 billion budget deficit over the next 18 months
 - i. Closing state offices on 1st and 3rd Fridays of month
 1. Can you imagine how crowded their unemployment office will be on the other days of the week?
 - ii. Trying to delay tax refunds.
 - b. Arizona said it would be out of money by February.
 - c. Minnesota and Wisconsin are looking to share items such as:
 - i. Heavy equipment
 - ii. Software
 - iii. Road salt

Retail

Retail Sales fell 9.8% (YOY) in December:

1. sharpest fall since began keeping records in 1992
2. one month decline was 2.7%
 - a. 6th consecutive monthly decline
3. the high end is getting decimated
 - a. Tiffany's sales fell 21% during holiday season
 - i. same store sales down 35%

Let the retail bankruptcies begin...

1. Circuit City began liquidating 567 stores
 - a. Couldn't find a buyer or financing to help get out of bankruptcy
 - b. Since declaring bankruptcy in November, sales are down close to 50%
2. will be interesting to see how consumers respond to liquidation sales
3. unlikely to find replacement tenants in this environment

Appropriate Name...Against All Odds, a 64 store clothing chain, said it was entering Chapter 11 proceedings in hopes of selling itself or re-organizing.

Housing

J.P. Morgan said it will stop underwriting prime mortgages that are originated through third-party brokers. These mortgages turned out to be less credit-worthy. Isn't that a shock? Who would have ever thought that a broker who was being paid for originations would have done a less trustworthy job...

Interest rates on fixed rate mortgage loans for prime borrowers have fallen to below 5%, the lowest level since the 1950s. The average interest rate on new 30 year fixed-rate mortgages was 4.89%. Only about a third of US mortgage debt outstanding is likely to qualify for refinancing. You need to have a high enough credit score and sufficient home equity.

Employment

On Friday alone, the following firms announced layoffs:

1. AMD 1,100 jobs (9%)
2. Conoco Philips 1,350 (4%)
3. Pfizer 2400 (33% of sales group)
4. Hertz car rental 4000 (13%)
5. Wellpoint 1,500 (3.6%)
6. Circuit City – approximately 34,000 jobs will be lost.

Many companies are lowering salaries.

Microsoft is considering layoffs. In 1999, they had 31,000 employees. As of last June, they had 91,000 employees. My guess is that their productivity has greatly decreased as their employees spend most of their day rebooting Vista.

Assorted News

Intel's fourth-quarter profit plunged 90% and that they predicted weaker conditions ahead. They had twice (previously) lowered their fourth-quarter sales forecast. They reported quarterly sales fell 23% from a year earlier. They would not forecast sales for the first quarter, but revealed that for internal planning purposes, they estimated a 28% drop in revenue (year over year).

Nortel filed for bankruptcy (chapter 11). Motorola announced that they would cut 4,000 more jobs after their cell phone sales dropped 50% year-over-year.

Venture capital investment dropped 30% in the fourth quarter to its lowest level since 2005.

Auto Industry

Not much new here, but Chrysler can't have long to go...

1. Chrysler had \$11.7 billion of cash in June. They ended 2008 with \$2 billion of cash. In December, they were selling cars that had been on dealer lots for 142 days. (The average of all dealers was 92 days...so Chrysler was much worse.) One year ago, Chrysler was selling cars that had been on a lot for 70 days.
2. The Treasury gave \$1.5 billion in emergency loans to Chrysler's lending arm and began discussions with Ford's lending unit.
3. Honda plans to reduce its US inventory by a third over the next three months. They currently have 100 days of inventory. Their target is to have 65 – 70 days.

Debt

1. Moody's projects higher default rates for global junk rated companies.
 - a. Raised forecast default rate from 10.4% to 15.1%
 - i. It was just last month that they predicted 10.4%
 - ii. US default rates projected to hit 15.3%
 - iii. Europe expected to hit 18.3%
2. Recovery rates on senior unsecured debt may fall.
 - a. Historic average \$.40
 - i. May fall to as low as \$.15
 - b. Recovery on loans has averaged \$.87
 - i. may fall to \$.52
3. Debtor-in-possession financing is becoming more difficult to get and more expensive when you can get it
 - a. Historically, LIBOR + 5%
 - b. Now, LIBOR + 11%

Oil

Oil prices in the futures market are in a state called "contango." That means that prices several months out are much higher than near term prices. Prices for the coming month are near \$35, but you could sell oil six months out for \$55. As a result, some investors are buying oil today, selling it in the future and storing it until then. Because of a shortage of storage, investors are renting tankers and storing the oil in them.

Part C: Markets

Analyst expectations have to come down. On October 1, the Wall Street consensus was that the S&P 500 Q4 earnings would rise up 47% from 2007 Q4. Now, analysts think earnings actually fell 15% from a year ago! Analysts expect S&P 500 earnings to be roughly flat this year, but post a 33% year-over-year rebound in the fourth quarter. It's not going to happen.

Symbolism

"The Miracle on the Hudson" was truly amazing. Was it just me or did you also think that it was symbolic? I think that the plane represented the stock market and the birds represented the mortgage brokers and the investment bankers. The birds (brokers and bankers) normally just crap on us, but this time they brought the plane (market) down. As the plane (market) went down, passengers (investors) got in the fetal position. Some passengers (investors) thought that the plane (market) would bounce off the water and take off again. It didn't. Others thought that plane (market) would go to the absolute bottom – where it couldn't go any lower. It didn't. Now the government is trying to pull the plane (market) out of the water. Everyone on the plane (market) felt like they were going to die. At the end, we didn't. But we lost a lot of our luggage (money). In addition, some of us are going to be afraid to fly (invest) again.

I thought that this was a good analogy. But when I told Jenny about it, she said that the flight reminded her of being married to me. The first three minutes were fine. We all interpret things in different ways.

C and BAC are Irrelevant

Citigroup and Bank of America are two of the 30 stocks in the Dow Jones Industrial Average. The DJIA is price weighted – meaning that higher priced stocks have more impact on the index. (Most indexes are market cap weighted.) The result is that these two stocks really don't matter in the DJIA (b/c C trades for less than \$4 and BAC trades around \$7).

Part D: A Few Random Thoughts

Treasury Secretary nominee Timothy Geithner was allegedly advised in writing by the International Monetary Fund that he would be responsible for any Social Security and Medicare taxes he owed on income he earned at the IMF between 2001 and 2004. When he was audited in 2006, he corrected his tax errors for 2003 and 2004. Only when he was nominated as Treasury Secretary did he correct his 2001 and 2002 taxes. The IRS is part of the Treasury Department. I'm glad we're going to have someone in charge who understands how complicated taxes are as well as our reluctance to pay taxes...

President-Elect Obama has indicated that he is going to close the Guantánamo Bay detention center. My personal opinion is that we should keep it open and send the mortgage brokers there. Just one man's opinion.

This week, there was a salmonella scare. Investigators thought that it was related to the King Nut brand peanut butter. Upon further investigation, it turned out that all of the victims had recently received their year-end brokerage statements and that was the cause of their sickness.

Fiscal Policy for the Crisis

IMF Staff Position Note -- December 29, 2008

Antonio Spilimbergo, Steve Symansky, Olivier Blanchard and Carlo Cottarelli

I. Introduction

A. Current Crisis Requires Two Sets of Policy Measures

1. measures to repair financial system
2. measures to increase demand and restore confidence
 - a. focus of paper is on this (2nd) issue

B. Some Measures Affect Both (Financial System + Aggregate Demand)

1. recapitalization of banks
2. asset purchases
3. helping homeowners and improving housing market

C. Seven Characteristics of Optimal Fiscal Package

1. timely
 - a. need for action is immediate
2. large
 - a. expected decrease in private demand is exceptionally large
3. lasting
 - a. downturn will last for some time
4. diversified
 - a. there is unusual degree of uncertainty with any single measure
5. contingent
 - a. there must be a commitment to "do whatever is necessary"
6. collective
 - a. each country must contribute
7. sustainable
 - a. can't have gov't debt explosion that leads to fear in markets

D. Reasons for Fall in Aggregate Demand

1. decrease in real and financial wealth
2. increase in precautionary saving (by consumers)
3. wait and see attitude of consumers and firms
4. difficulties in obtaining credit

E. If Demand Falls Further, Risks Include...

1. deflation
2. rising debt
3. further injury to financial system

F. Two Strategies That May Not Work

1. export led recovery strategy
 - a. this can't work for world as whole (we can't all export more)
2. traditional monetary policy
 - a. US has already lowered rates as far as possible

G. Need All Countries to Participate, Unless Constrained by:

1. volatile capital flows
2. high public and foreign indebtedness
3. large risk premia

II. Fiscal Policy in Financial Crises -- Lessons from History

A. Severe Financial Crises

1. typically associated with severe economic downturns
2. countries have reacted quite differently (to historic crises)

B. Key Lessons from Past Crises

1. successful resolution of the crisis is a precondition for sustained growth
2. delaying intervention typically leads to a worsening of economic conditions
 - a. results in higher fiscal costs later on
3. the solution to the financial crisis always precedes the solution to the economic crisis
4. fiscal stimulus is useful (necessary) when the crisis spills over to companies and consumers
5. fiscal response will have a larger impact if its composition considers the features of the crisis

III. Composition of a Fiscal Stimulus

A. Must Consider Two Features of Current Crisis

1. the current crisis will last several more quarters
 - a. fiscal stimulus can rely on spending
 - (i) usually spending lag is too long
 - (ii) spending may also be better this time b/c:
 - (A) people may save tax cuts
 - (B) people may save increased transfer payments
2. it is impossible to estimate the multiplier effect of various stimuli
 - a. as a result, the gov't should diversify -- try various stimuli

B. Public Spending on Goods and Services

1. the tradeoff
 - a. higher multiplier effect than tax cuts or transfer pmts vs.
 - b. need to avoid waste
2. key rules for public spending stimuli
 - a. make sure existing programs are not cut
 - (i) difficult for states that must balance budget
 - (A) need money from fed'l gov't
 - b. spending programs can be restarted quickly if interrupted
 - c. avoid public sector wage increases
 - (i) difficult to target
 - (ii) hard to reverse

C. Fiscal Stimulus Aimed at Consumers

1. three specific factors affecting consumption
 - a. decreases in wealth
 - (i) housing
 - (ii) financial
 - b. tighter credit constraints
 - (i) credit lines eliminated
 - (ii) higher interest rates
 - c. high uncertainty
 - (i) leads to precautionary saving
2. must consider these factors when determining if people will consume
 - a. factors 1 and 3 imply low propensity to consume
3. target tax cuts or transfers to those who are credit constrained
 - a. these are people most likely to consume
 - b. examples:
 - (i) greater provision of unemployment benefits
 - (ii) increases in earned income tax credits
 - (iii) expansion of safety nets
 - (iv) support for homeowners facing foreclosure
 - (A) helps support aggregate demand
 - (B) helps financial sector
4. policy must have clarity and policy makers must show commitment to do whatever is necessary
 - a. will reduce uncertainty (factor 3)
 - (i) decreases precautionary saving
5. be wary of broad based tax cuts
 - a. marginal propensity to consume may be low
 - b. better off with some sort of tax cut that encourages consumption

D. Fiscal Stimulus Aimed at Firms

1. firms face several risks:
 - a. sharp fall in demand
 - b. uncertainty of how bad things could be
 - c. difficulty in financing
2. lowering cost of capital won't help these problems, so bad strategies include:
 - a. reduction in capital gains taxes
 - b. lower corporate tax rates
3. need to focus on firms that need financing to maintain operations
 - a. primarily monetary policy
 - b. gov't can help firms that could survive through restructuring...
 - (i) but they need financing
 - (A) solution: combine...
 - (1) bankruptcy
 - (2) guaranteed gov't refinancing
4. some think you should provide funding to high visibility sectors (aids confidence)
 - a. there are also problems
 - (i) arbitrariness
 - (ii) risk of political capture
 - (iii) may add uncertainty
 - (iv) may raise questions about domestic protection
 - (A) may lead to retaliation / trade wars

IV. Sustainability Concerns

A. Important Balancing Act

1. gov't must indicated financial expansion is contingent on state of economy
 - a. gov't will do more if needed
2. fiscal stimulus can't call into question medium term fiscal sustainability
 - a. questions about debt sustainability would hurt:
 - (i) financial markets
 - (ii) interest rates
 - (iii) consumer spending

B. To Avoid Questions of Sustainability

1. implement measures that are reversible or have sunset clauses
2. implement policies that eliminate distortions
 - a. e.g., fin'l transactions taxes
3. increase scope of automatic stabilizers that are countercyclical
4. precommit to specific future corrective measures
 - a. e.g., tax cuts expire
5. precommit to unwinding stimulus measures either at:
 - a. specific date
 - b. contingent basis
6. provide more robust medium-term frameworks
 - a. accurate gov't projections
 - b. give confidence that increased debt will eventually be offset
7. strengthen fiscal governance
 - a. have independent fiscal council
 - b. reduce perception of political biases
8. ensure that increased public spending will raise long term growth

C. Don't Forget the Big Problem!

1. the main threat to long term viability of public finances:
 - a. publicly funded pension and health entitlements

V. A Few Ideas to Consider

A. Greater Role of Public Sector in Financial Intermediation

1. investors:
 - a. want risk free T-bills
 - b. don't want risky private assets
2. gov't can:
 - a. issue T-bills
 - b. buy private assets
 - (i) ultimately providing financing
 - (ii) similar to quantitative easing
3. problems:
 - a. gov't doesn't have comparative advantage in:
 - (i) evaluating credit risk
 - (ii) managing diverse portfolio of assets
 - (A) can outsource this

B. Gov't Could Issue Contracts Which Derive Value from Lack of GDP Growth

1. derivative contract that guarantees growth
 - a. may encourage:
 - (i) companies to invest
 - (ii) banks to lend
 - (A) lend if company bought insurance
 - b. would show market based assessment of growth prospects
2. problem:
 - a. low growth environment would be very costly to gov't
 - (i) derivatives work against them at same time that tax revenue drops

VI. International Crisis Requires International Solution

A. Limits on Ability of Country to Act Alone

1. countries open to free trade do not have incentive to stimulate economy
 - a. result would be to import more
 - (i) benefit goes to other countries
 - b. this is why all countries need to act
2. subsidies to troubled industries may be seen as unfair practice
3. history shows that a deeper crisis is likely to lead to pressure to create trade barriers