

Market Update – March 8, 2009

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PART 1: The Economy

The key economic news from this week can be broken into five pieces:

- A. the employment market
- B. consumer spending
- C. housing
- D. manufacturing and general
- E. comments from economists and others

A. The Employment Market

1. The unemployment rate rose to 8.1% (from 7.6% in January).
 - a. There are 12.5MM unemployed people in this country.
 - b. Approximately 4.4MM jobs have been lost since December 2007.
 - i. More than half of the job losses have come in the last four months.
 - ii. There were 651,000 job losses in February.
2. Manufacturing and overtime hours slid, which is a sign of future job losses.
3. Only health services and government increased their number of jobs (and the increase was small).
4. The broadest measure of unemployment (which includes discouraged workers and people who are working part-time even though they want full-time employment) rose to 14.8%.
 - a. There are 8.6MM people who are working part-time even though they want full time work.
5. Private sector payrolls fell in February in nearly 80% of the 271 industries that the Labor Dep't tracks.
 - a. A year ago, payrolls were shrinking in only 45% of industries.

B. Consumer Spending

1. Consumer spending rose .6% in January after falling for six consecutive months (a record).
 - a. It was pushed higher by purchases of food and other nondurable goods.
 - i. There was a 1.3% increase in purchases of nondurable goods.
2. Retail sales increased .7% (stores open at least one year). But, most of this was Wal-Mart.
 - a. Without Wal-Mart's gain, this would have shown a 4.1% drop.
 - i. Other discounters also did well. BJ's posted an 11.5% same store sales gain and Costco reported a 4% gain.
 - b. Upscale chains like Nieman's and Sak's reported drops of at least 21%.
3. Consumer credit rose at an annual rate of .8% in January.
 - a. But this data is very volatile and it's hard to reach much of a conclusion from it.
4. The personal savings rate jumped to 5%.
 - a. This is great for the long term, bad for the short term.
 - b. The rate was 3.9% in December.
5. Personal bankruptcy filings increased 31% in 2008 (to 1.07MM).
 - a. The number of consumers filing for bankruptcy jumped 29% in February (YOY).
 - i. 98,344 consumers filed for bankruptcy in February.
 - b. There are expectations for 1.4MM bankruptcies this year.
6. Business filings jumped 54% (in 2008) to 43,546.
 - a. One service said that it had seen a 180% jump in bankruptcy and reorganization deals during the three month period ending February 15th.
 - b. In 2008, 136 publicly traded companies filed for bankruptcy, up 74% from the prior year.

C. Housing and Construction

1. Construction spending fell 3.3% in January.
 - a. Residential spending fell 2.9%.
 - b. Nonresidential construction spending fell 4.3% to its lowest level in more than a decade.
2. The number of people signing contracts to buy homes dropped to a new low in January.
 - a. The pending home sales index fell to 80.4 in January.
 - i. down 7.7% from a revised reading of 87.1 in December
 - ii. down 6.4% from a year ago's 85.9 reading
 - b. Of course, no one was going to buy in January, as everyone was waiting to see what type of government subsidy they would receive.
3. The Mortgage Bankers Association's survey showed that approximately 11% of mortgages were at least one month overdue or in the foreclosure process at the end of 2008.
 - a. That is up from:
 - i. 10% at the end of Q3
 - ii. 8% in 2007 Q4
 - b. The 11% rate is a combination of:
 - i. 7.9% of the loans are 30+ days delinquent; and
 - ii. 3.3% are in foreclosure.
 - c. This is based on 51MM first-lien mortgages.
 - i. 1/3 of homeowners have no mortgage
4. The Mortgage Bankers Association's application index slid by almost 13% to approximately half the level it had reached earlier this year (when rates were at 4.89%).
 - a. Last week, the average 30 year mortgage rate was 5.14%.

D. Manufacturing and Other

Beige Book. The Fed's Beige Book (a quarterly survey) found that economic activity deteriorated further in ten of the twelve Federal Reserve districts. Two districts (Philadelphia and Chicago) did not experience this deterioration – they were simply described as “remain(ing) weak.” This reminds me of a survey I did when I was single. Ten out of twelve women found me repulsive. The other two just said that I was unattractive.

The Beige Book reported that both non-financial services and manufacturing activity plummeted in the survey period across all districts. Health care providers saw patient volumes decline while demand for legal, accounting and other services continued to fall.

Businesses did not expect improvement until late this year or 2010.

Productivity. Productivity dropped .4% in Q4. Jobs were not cut as fast as production. The initial estimate (from the gov't) had been a 3.2% increase. Pretty close for government work...

ISM Indexes. The Institute for Supply Management said that the manufacturing sector contracted for the 13th straight month in February. The index rose slightly to 35.8 (from 35.6 in January). Below 50 means that the sector is contracting. The Institute said that all 18 industries it tracks reported declines last month, while employment in the industries (overall) fell to a new low.

The ISM's index of nonmanufacturing activity declined to 41.6. It has been in this range for several months (although it hit a low of 37.4 in November).

E. Comments from Economists and Others

The **chief economist of the Organization for Economic Cooperation** said that the global economic downturn will be considerably deeper than even the IMF forecast (from a month ago) predicted.

The **Dallas Fed president** said that he thinks Q1 is going to be approximately as bad as Q4 (when the economy dropped 6.2%).

The **Atlanta Fed president** said that he worries that declining commercial real estate markets could put further pressure on financial institutions and markets.

The **Kansas City Fed president** cautioned that the massive stimulus would require the Fed to tighten monetary policy well before the next economic expansion was fully underway. Otherwise, it may be too late to prevent inflation. Think about that...when the economy starts to recover, we're going to need to slow the economy!

John Bogle (Vanguard founder) said that the US recession may linger into 2011.

Some economists are already predicting that we could have a double-dip recession as companies, consumers and municipalities become addicted to bailouts. There is fear that when the bailouts stop, the economy won't be able to stand on its own.

One Last Economic Thought: Recession vs. Depression

Typically, we define a recession as two consecutive quarters of GDP contraction, although now a recession is defined by the National Bureau of Economic Research. People are unclear as to what a depression is. (It's frequently said that a recession is when your neighbor loses his job; a depression is when you lose your job.) The definitions of recession (which will become more important) are:

1. a downturn of three years or more with a 10% drop in economic output and unemployment rate > 10%; or
2. A sustained recession during which citizens have to dispose of tangible assets to pay for everyday living.

PART 2: AIG News

Huge Losses. AIG reported a **\$61.7 billion loss** on Monday, the biggest quarterly loss in history. This amounts to \$465,421 per minute. Credit ratings agencies were about to downgrade AIG (as a result of the loss) and that would have resulted in AIG needing to post more collateral for derivative contracts. This could have caused tremendous systemic problems. But not to worry. You noble reader, noble taxpayer, decided to save the day...

Fourth Bailout. The Treasury and Federal Reserve will:

1. provide \$30 billion more capital (in the form of a standby line of credit as losses mount) to AIG
2. lower the interest rate on a \$60 billion loan (from LIBOR + 3% to just LIBOR)
3. eliminate the 10% dividend on our \$40 billion preferred stock investment

The government already owns 80% of AIG and will get a large ownership in two prized holdings (AIG's Asian operations and AIG's global life insurance business).

This Wasn't Really a Bailout of AIG...this was effectively a bailout of AIG's counterparties. The bailout of AIG rescued many firms that were trading with AIG. The government eliminated the counterparty risk that existed. The bailout allowed AIG to either post more collateral or buy mortgage backed securities (that were being insured by the credit default swaps).

To some extent, you would have to be crazy to buy a credit default swap from anyone other than a large counterparty. You know that the government won't let a large counterparty fail. Thus, by dealing with large firms, you have effectively eliminated counterparty risk.

Realize that several of the firms that have effectively been bailed out are foreign firms. Think about this...we were probably bailing out UBS, the firm that helped many wealthy Americans evade taxes.

Fear of AIG Could Cause Policy Holders to Cash in Their Policies. AIG has more than 375 million life insurance policies with a face value of \$19 trillion.

AIG Pisses Off Bernanke. Bernanke, while testifying before Congress, said that if there was one firm that angered him during this whole event, it was AIG. He said that they exploited a gap in the regulatory system and that they took a great life insurance business and overlaid a hedge fund. (On a somewhat related note, the Group of Thirty (a group of former central bankers, finance ministers and academics) called for a ban preventing large banks from running hedge funds.)

You Should Also Be Pissed Off. AIG has four public relations firms on its payroll. I have some serious problems with this. First of all, you and I are paying for this. Secondly, it's not working - I couldn't think much worse of AIG.

At Least Clinton Didn't Inhale When He Smoked Dope. Edward Liddy, who has been AIG's CEO for six months emphasized that they don't need the cash (from the bailout) right now; rather this is a backstop. Now, he didn't get AIG into this mess, but is he smoking dope? If they didn't have this backstop, AIG would have been downgraded and he would need this cash right now. So I'm not sure that he's correct on that point. In further support of my dope-smoking hypothesis, he explained that the \$61 billion loss "does not reflect the fundamentals of our major businesses." It's like I explained to Jenny... the 50% drop in our stocks does not reflect the fundamentals of our major investments.

Is Being Old an Excuse? As a general rule, I don't like to promote violence against 83 year-olds. But, Hank Greenburg (former CEO of AIG) has sued AIG for "material misrepresentations and omissions" which caused him to acquire AIG shares in his deferred compensation profit participation plan at an inflated value. I would love to see some spry 75-year-old woman who lost a tremendous amount of wealth in AIG stock go and bitch-slap Hank. It's the least that should happen to him. It was under Hank's watch that the company starting writing credit default swaps.

PART 3: Bank of America (BAC)

I Hate When I Make a Tactical Mistake. Ken Lewis said that it was a “tactical mistake” to ask for \$20 billion of government money to support BAC’s acquisition of ML. He said that it made BAC appear to be as weak as Citi. In related news, the Titanic’s captain also said that he made a tactical mistake when he asked other ships to come save his passengers. He made clear, however, that hitting the iceberg would turn out to be a good move in the long run.

Are You Threatening Us? Was Ken Lewis threatening us that he would never quit and he would never pay back the government when he said, “I want to repay the TARP money before I go anywhere, and by then I think we will be seeing the success of the Merrill Lynch acquisition.”

Will BAC Need More Capital? Credit research firm Egan-Jones said that BAC will need \$100 billion of equity within the next 100 days. BAC’s spokesman rejected the idea and said that the bank is currently working on their stress test with the government. (Ken Lewis also said that he doesn’t believe that BAC will need any more equity.) The spokesman said, “we do not know what the results (of the stress test) will be, but we think the conclusion of the research report is ridiculous.” You know that I don’t want to be seen as a pessimist, but isn’t it scary that BAC doesn’t know what the stress test results will be?

Downgraded. S&P cut its credit rating on BAC from A+ to A and warned that the Merrill Lynch and Countrywide units were likely to continue to hurt the bank. I’m trying to figure out how their debt is A rated. Are ratings based on the idea that the government will bail out the debtholders (like the government seems to be doing with other financial institutions)? Certainly the rating isn’t based on BAC’s merits? Maybe this is S&P’s way of saying that the US government’s credit is only A rated now?

What Do You Give the CEO Who Has Done So Much? Have you ever wondered what you pay someone who destroys a great bank, crushing the wealth of thousands of families and employees? Apparently, they are punished by paying them a measly \$9 million. Ken Lewis received \$1.5MM in salary, \$275K in perks and \$7.2 million in stock-based compensation (but about \$3 million of that was in options with an exercise price of \$42.70). If the options have a life of 50 years, his grandkids should be okay. But, in a move of strong corporate governance that almost brings tears to my eyes, Ken Lewis did not receive a bonus.

One Other Idea of Proper Compensation. A group that advises seven union pension funds is asking Bank of America’s board to remove Ken Lewis as Chief Executive. A certain UT professor is with you on this one.

PART 4: Citi News

Citi Broke the Buck. Citi traded under a dollar this week. Every time you go to an ATM and pay a \$3 service charge, there should be a way to pay by submitting three shares. I was listening to Bloomberg on Friday and I heard the funniest thing, "Citi is trading up 1%, up from \$1.02 to \$1.03." Now that's meaningful.

What's My Total Bill? Investors are wondering how much more capital Citi would need if they wrote off all of their toxic assets. One analyst predicted Citi would lose \$4.5 billion in 2009 and would likely need more capital.

The Buffett of the Middle East? Prince Walid bin Talal, formerly Citi's largest shareholder, took a huge hit to his reputation as Citi has been crushed. He had increased his position by purchasing on the way down. He's no longer the biggest owner, you and I are. How does that feel Prince? From now on, as the largest shareholder in Citi, I believe that I will be known as Prince Sandy.

Prince Walid was known as the Warren Buffett of the Middle East, but I would suggest that he should be known as the Bill Ackman of the Middle East. (Bill Ackman started a fund that invested in stock and call options of Target and lost > 90%.)

Do I Have a Deal for You! Citigroup is trying to start joint ventures with third parties in order to shed unwanted businesses. That sounds attractive...how'd you like to start a JV with me so I can dump some of my crap?

I'm Getting So Confused. Citi is going to lower payments on mortgages of some unemployed borrowers to \$500 per month. This is all getting so confusing...is this the US mortgage bailout or is this Citi acting on their own? It is the United States Bank of Citi. It's all running together.

Oh No, We Hurt His Feelings. Sandy Weill, who built the massive Citi, is supposedly angry that he wasn't consulted during all of these problems. Many people have speculated that he has sold most of his Citi shares. I sure hope no one hurt his feelings. Someone should mention to him that the large bank that best survived this whole mess was JPM, which was run by Jamie Dimon. Dimon was Weill's protégé until Dimon felt that he was going to be passed over (to replace Weill). Maybe Citi wouldn't be in this position if Dimon was running it. So yes, I'm sure Citi should have consulted you, Mr. Weill.

PART 5: News from the Financial Sector

I'm Outta Here Freddie. David Moffett, Freddie Mac's CEO, resigned after a six month tenure. Apparently, he didn't like the combination of making a much lower salary than he made in the private sector and being told what to do by government bureaucrats. It's strange because I would have thought that this would have been attractive.

Fannie and Freddie – Never Private Again. Most people think that Freddie and Fannie will never have private features again. Fannie and Freddie are truly part of the government again, as the President's loan modification program runs straight through them. In addition, think about how long it would take Fannie and Freddie to pay the government back. Wait a second, I've got an idea...Fannie and Freddie could charge higher rates if they would start making loans to people who have no right to get a loan or buy a house...

I'm Getting Out of Here...Part 2. HSBC, Europe's biggest bank, said it would stop writing consumer loans in the U.S. It will wind down HSBC Finance (formerly known as Household International). The bank will retain its credit card business and commercial retail bank business in the US. The closings will result in 6,100 job losses.

Some people say that the 2002 agreement in which HSBC bought Household International (the largest American finance company) had huge ramifications. Household had a marginal (at best) reputation – it loaned to people who couldn't receive normal loans. They were also aggressive in collections. It is possible that this deal helped to legitimize subprime lending. One analyst commented that you have to be careful when companies use their high credit rating to do business with parties that are incompatible with that credit rating. He cited HSBC, AIG and MBIA as examples.

I'm Not Sure We Should Have Bought Wachovia. Wells Fargo cut its dividend 85% to a nickel per share. WFC is experiencing losses from its acquisition of Wachovia (which has losses from its acquisition of Golden West). This will save \$5 billion per year. Moody's had recently said that WFC's capital ratios were "comparatively low."

GE is Trying to Eliminate Some Debt. GE is trying to buy back \$1.46 billion in debt. They need to eliminate the negative pledge covenants which prevent GE from issuing debt that would undermine these bondholders' priority claim. If they can get this done, it will be easier to participate in the Fed's Term Asset-Backed Securities Loan Facility (TALF).

Derivative Profits! JP Morgan generated \$5 billion of profits in 2008, largely by trading over-the-counter fixed-income derivatives. They may have benefited from Lehman's collapse and their takeover of Bear Stearns. This left less competition in these markets. In addition, JPM was the largest underwriter of corporate bonds and this often led to interest rate swap transactions.

Salaries vs Bonus. UBS is increasing the base salary of senior investment bankers after reducing bonuses. Some base salaries are being increased from \$172K to \$429K. UBS had cut its 2008 bonus pool by 80%. Credit Suisse, UBS and Morgan Stanley added clawback provisions – allowing them to take back part of the payment from an employee who failed to meet certain targets. We’re seeing the same thing we saw with stock options – when the market went down (in 2000), everyone wanted restricted stock rather than options.

UBS Looks Bad. Documents were released this week that show that UBS sought ways to circumvent IRS rules to help wealthy Americans set up secret offshore entities and insurance plans to evade taxes on billions of dollars in assets. Apparently, they had been warned by Baker & McKenzie (a highly respected law firm...is that an oxymoron?) that they could not do this. A top Justice Department official said that there may be criminal prosecutions of top executives.

I Didn’t Know That Was Against The Law. Morgan Stanley has announced that an executive may have violated the US Foreign Corrupt Practices Act, which bars bribing foreign officials. It is alleged that he may have secured some transactions by offering cash or gifts to Chinese officials. His partners in some deals were Chinese government investment funds.

We Don’t Want the Restrictions. Northern Trust has announced that they would repay \$1.5 billion of TARP money as soon as possible. They had caught tons of flack for flying hundreds of employees and clients to the Northern Trust Open in LA, staying in luxury hotels and having Sheryl Crow, Chicago and Earth, Wind and Fire entertain them.

Credit Card Problems. American Express is suffering due to their expansion from charge cards (where they profit from vendors) into credit cards. Defaults on their securitized loans rose to 8.3% in January, up from 7% in December (and 2% in January 2006). AmEx charge cards are being hurt by reduced transactions.

Fitch estimates that overall credit card defaults will surpass the previous industry record of 7.7% (Q1 2002) and will approach 9%. Again, I’m going to take the over on this bet.

Visa and MasterCard are card processors and they don’t have credit losses.

REIT Dividends Going Away. Within the past 10 months, roughly 30% of all listed REITs have suspended, cut or switched to paying part of their dividend in company stock. Shareholders will lose out on \$4.76 billion of dividends.

What an Opportunity! Morgan Stanley told investors to expect a 60% Q4 write-down on the equity in their \$8.8 billion real estate fund. This fund had been billed as “the largest ever real estate fund” when it was started in June 2007. They projected 22% returns through leveraged transactions. The fund has now lost 2/3 of its capital in 18 months. This story is evidence of a rule that I often mention in class: when someone offers phenomenal returns, the best way to estimate your

actual returns is to multiply the promised returns by -2. This was marketed as an “Opportunity Fund” which apparently is a fancy way of saying that they will use leverage and give you the opportunity to lose your ass.

Tough Sector for Jobs. Approximately 325,000 financial services jobs have been cut worldwide since August 2007. Many of these jobs were expatriates – who then have to leave the foreign country.

Need Changes With Hedge Funds. Larry Powell, deputy chief investment officer of the Utah Retirement System (he used to run the hedge fund division of Texas Teachers Retirement System) is trying to lead an effort to get the following changes with hedge funds:

1. spread performance fees over two or three years
2. lower management and performance fees as investors increase their allocations to the fund
3. greater disclosure (by hedge funds) of individual positions and firm’s operations

Hedge Fund Withdrawals Continue. Hedge fund clients pulled out \$74 billion in January. This was second highest to December’s \$117 billion. A Morgan Stanley analyst said that he sees “no deceleration” in withdrawals. He estimates that 30% of hedge fund assets will be withdrawn this year, following a 20% decrease in the second half of last year. That will leave less than \$1 trillion in hedge funds (compared to \$1.9 trillion in mid-2008).

I Knew I Should Have Diversified! Hedge fund manager William Ackman is in talks with Target to name a potential director. His hedge fund, Pershing Square, owns approximately 8% of target. He has one fund that owns only Target shares and call options. It has lost 90% in the past year.

Mark-to-Market. A U.S. House Financial Services subcommittee plans a hearing on mark-to-market accounting rules. The hearing will be on March 12.

Trading Violations. Fourteen trading firms, including subsidiaries of some of Wall Street’s top banks agreed to pay \$70 million to settle charges of improper trading, including “trading ahead” of clients for their own benefit.

Unbelievable. Countrywide’s former president (Stanford Kurland) has started a company (PennyMac) that buys delinquent home mortgages from the government (which obtained the loans from failed banks) and gets a percentage of what they recover. The company modifies the terms. Kurland made over \$200 million putting people in crappy loans. Now he’s making money working them out. This would be like me failing students and then selling my consulting services for the make-up exam.

SWFs. Assets under management by sovereign-wealth funds rose 18% during 2008 to reach \$3.9 trillion. These assets are expected to reach \$8 trillion by 2015.

PART 6: Auto Industry

Sales Continue to Drop. US auto sales fell 41% in February to 688,000 vehicles. The company-specific decreases were:

1. GM -53%
2. Ford -48%
3. Chrysler -44%
4. Toyota - 40%
5. Honda -38%
6. Nissan -37%

Clearly, we're losing market share to the Japanese (although there are other manufacturers not listed here that are losing more share).

The "big" three had market share in February (January) of:

1. GM 18.3% (19.5%)
2. Ford 14.4% (14.2%)
3. Chrysler 12.2% (9.5%)

Don't read too much into Chrysler's gains. They offered huge incentives in order to prove their viability. Of course, their viability argument seems comical considering their submission to the Treasury said that their best hope is to merge with GM. That would be like me saying that my best chance of fixing my portfolio is to invest with Bernie Madoff.

Weak Annual Rate. The annualized sales pace for cars was 9.1 million cars. This is nowhere near the level that manufacturers need in order to break even.

The Customer Isn't Really Thriving. Consumers have:

1. seen their stock portfolio cut in half
2. lost most of the equity in their home
3. experiencing fear about keeping their jobs

Other than that, consumers are anxious to buy.

If It Wasn't For the Auditor, I Would Have Never Known. GM's auditor said that there is substantial doubt that the company can remain a going concern. This going-concern qualification requires GM to seek waivers from their lenders. These creditors had the ability to demand instant repayment in case there was a going-concern qualification. The lenders gave the waivers, but with the provision that the loans can be called if the Treasury doesn't approve the GM viability plan. This strikes me as strange...if the viability plan is denied, I would guess that a bankruptcy plan (with the gov't providing DIP financing) will be simultaneously announced. I wonder if the creditors are somehow protected.

The reason for the going-concern qualification is GM's:

1. continuing losses from operations
2. negative net worth
3. inability to generate the cash needed to run their business.

Other than that, they're fine. Next, we'll see the suppliers receive "going concern" qualifications.

Maybe Bankruptcy Is Okay. GM has apparently signaled that they are more open to bankruptcy. This has been widely reported and I think it's absurd. Who cares that they are more open to it? This is like a student not showing up for an exam and then telling me that he is open to receiving an F.

GM Repurchases Part of Delphi. GM is buying Delphi's global steering business, pending approval by the Treasury. Delphi, which was spun off from GM several years ago, is in bankruptcy. So GM is buying a quality business. Maybe they are seeking their bankruptcy experience.

We Are Accepting All Currencies. GM Europe has asked Britain to provide more than \$4 billion in aid. Senior executives said that 300,000 jobs across Europe are at risk if Opel and Vauxhall go under. GM Europe employs 50,000 but has 30% excess capacity.

Saab for Sale. Saab is trying to find a buyer. The company has said that it needs \$628.8 million in aid from the Swedish government to survive. Who wouldn't want to buy a company as fine as this? Saab's sales fell to 100,000 vehicles in 2008. The brand has three vehicles in its lineup and some of them haven't been updated in 12 years. Would the world be that much worse off if we didn't have Saab? (We're actually headed that way, as Saab only sold 712 cars in the US during February.)

Ford's Debt Reduction Plan. Ford is trying to reduce its \$25.8 billion debt load. The company and its financial arm are putting up \$2.2 billion in cash to entice holders of \$10.4 billion in debt to convert to equity. More specifically:

1. the holders of \$4.9 billion in convertible notes are being offered 108.7 shares of common stock plus \$80 (per bond). This offer is about \$297 per bond.
2. The holders of \$4.2 billion in unsecured, nonconvertible debt are being offered 30 cents on the dollar (the debt is currently selling for 20 cents on the dollar).
3. The holders of \$1.3 billion in senior secured term loans are being offered \$500 million.

Chrysler Wants to Sell Dodge Viper. Chrysler is in discussions with two or three companies to sell its high-performance Dodge Viper sports car line. Chrysler sold 1,172 of the low-volume, hand-built cars last year.

PART 7: News From the Crisis

Shadow Banking. The shadow banking system refers to the financial markets beyond traditional commercial banks that provided up to 70% of credit to borrowers before the crisis. Much of this was securitized loans. Under TALF, the Fed will loan money to institutions which buy newly issued asset backed securities. Investors are expected to earn double digit returns with little downside risk (b/c of gov't guarantees).

TALF. The Washington Post gave an example of how the private-public ~~screwing~~ partnership might work. A hedge fund would invest \$1MM and get a \$9MM loan from the Fed. The loan would be payable after three years. The \$10MM would be used to buy an asset backed security (to finance consumer loans). The hedge fund would hold the security for three years. If the security rises in value to \$11MM, the hedge fund doubles its money. The only amount that the hedge fund has at risk is the \$1MM. I wonder what the government will be charging for these loans. The government is basically providing a put (insurance) to investors and that has a cost. Personally, I think it's only right that you and I should be paying for this and not the bondholders who extended credit to the banks and have been receiving interest payments...

A Backrub is Different From a Stress Test. The government has started stress testing the large banks. Unfortunately, the stress tests probably do not apply enough stress. The government is testing the largest banks using the assumption that the economy will shrink 3.3% this year, followed by .5% growth in 2010. It also assumes unemployment will reach 8.9% in 2009 and 10.3% in 2010. These numbers are based on the assumption that the economy will bottom in Q2 of 2009. (Of course, unemployment reached 8.1% in February...you do the math.) It sounds to me like the government's adverse condition is actually a best-case scenario. If you really want to stress test the banks, use numbers that are somewhere closer to the numbers from the Depression (the economy shrunk 9%, 6% and 13% from 1930 - 1932).

Fixing the FDIC. The FDIC is trying to replenish its coffers by imposing a one-time \$15 billion increase in insurance premiums on the nation's 8,300 banks plus a longer-term fee increase. The FDIC is down to \$19 billion and is insuring several trillion dollars of deposits. So far, 16 banks have been seized in 2009.

Senator Dodd introduced a bill to allow the FDIC to temporarily borrow as much as \$500 billion from the Treasury. This is largely in response to protests from the banks concerning the higher fees that the FDIC wants to charge. When they say that the FDIC will borrow this money, do they mean borrow in the same way as "AIG is borrowing money from the government?"

Solution for the States? At least six states (including Texas) are considering gambling proposals in order to help with deficits. Proponents of the Texas bill say that they could raise \$1 billion for education and \$1 billion for transportation.

Where does this money come from? It's a way of taxing the poor and those who already are or will become addicted to gambling. Sounds like a great solution. (The Texas governor opposes this plan.)

Welcome to Houstantonio. Some municipalities are supposedly considering merging in order to cut costs. This is a great idea because we all know that mergers are always successful. And don't forget: $1 + 1$ can equal three (b/c of synergies). (A good example of this is $BAC + ML = \$3$ stock price.) In mergers, there are usually winners and losers (just ask Jenny). Municipalities have different problems, schools, home values, etc. It's one thing to consolidate a few services, but that's probably the extent of what can be done.

The New Math. The Obama Administration is saying that they will help one in nine families with the mortgage bailout. Many people have been questioning the math. The math probably doesn't make sense. It might make sense if they were using \$275 million and a lot of the money wasn't going to mortgage servicers...

If you think of the mortgage market as approximately \$10 trillion, you are trying to help homeowners with approximately \$1 trillion of debt. If you simplistically think about each one of these people being 25% underwater, you need \$250 billion. Of course, it's not that simple and there will be a lot of waste. In addition, there will be many other people who need help. Regardless, I'm not sure that the numbers are that far off if this is the way it would work.

The problem is that it looks like a lot of this money is going to end up in the hands of the servicers (up to \$3,500 per loan) and then all of these numbers break down.

I Think We Made a Small Mistake With this Proposal. The Administration's proposal to lower the charitable contribution and mortgage deduction (from 35% to 28%) for top-bracket taxpayers is never going to fly. Even the Democrats oppose this idea. The mortgage deduction is needed to support home prices and the charitable contribution deduction is needed to support charities (which are hurting right now).

A study by Bank of America suggests that 51.7% of affluent donors would not stop giving even if deductions are wiped out entirely. Of course, some percentage of giving will be reduced even with a slight reduction in deductibility and that will hurt.

PART 8: News From the Markets

That's A Lot of Trillions... Stocks have lost \$11 trillion in market value since the October 2007 peak, based on the Dow Jones Wilshire 5000 index, which includes nearly every U.S.-listed stock. Losses since the start of 2009 are \$2.6 trillion. Nearly half of all stocks in the index are now trading at less than \$5, and 37% are under \$3.

Passive Gaining on Active. Mutual fund investors made net withdrawals from actively managed funds for only the third time ever. Some of the money went into index funds. (The average actively managed fund was down 40.5% compared with the average index fund which lost 39.1%.) Index funds increased their market share from 11.8% to 13.2%. If you include ETFs, passive funds account for 21.4% of the market.

Dividend Cuts. This should be the worst year for dividend cuts since 1938. In that year, dividends were cut 36.3%. The forecast is for this year's dividends to be cut by 22.6%. The S&P 500's dividend yield is 4% higher than the 10 year Treasury – and that implies that dividends are headed lower.

Dollar Value of Dividend Cuts. In 2008, 61 companies from the S&P 500 cut their dividends. This reduced dividends by approximately \$40.6 billion. This dollar record has already been broken. With WFC's dividend cut, 2009's dividend cuts already add up to approximately \$40.8 billion.

Financials Are Less Important in Dividend Calculations Now. Half of the S&P's dividends are from 28 companies. At this point, none of them are financials. Financials had accounted for 30% of dividends in 2006. Now, they account for 11%.

See What Happens When You Cut Your Dividend? GE's CFO was on CNBC arguing that market fears about the company were overdone. Fears have intensified since they cut their dividend. There is concern that GE will need to raise more capital and will dilute shareholders or that they could lose their AAA rating.

Hope Springs Eternal. Since November 21st (the market's low until this week), several emerging markets (e.g., Brazil, Argentina, China, Indonesia, Columbia, etc.) have outperformed the US markets. One factor driving this performance is a bet that economies which rely on exports and commodities will benefit when the global economy recovers. This strikes me as early optimism, but we'll see.

Buffett's Letter. Warren Buffett released his annual letter to shareholders and reported a 62% drop in net income and a drop in the (per share) book value for only the second time since 1965. Shares have declined approximately 50%. He said that he had done "some dumb things," including a poorly timed bet on oil (he purchased COP at high levels) and the purchase of shares in two Irish banks (which lost more than 89%).

Other significant comments included:

1. A warning against “geeks bearing formulas.”
2. He analogized the tangled web of relationships (and counterparty risk) from derivatives to the desire to avoid venereal disease. He said that “it’s not just whom you are sleeping with, but also whom they are sleeping with.”
3. He also warned that the government’s remedies could cause inflation.
4. He said that some industries and municipalities are becoming dependent upon handouts.

In the past year, Buffett proved how difficult it is to time the market – he wrote an editorial on October 17th saying that it was a good time to buy stocks.

Insurance is Expensive. Option investors are paying twice this decade’s average to protect against losses in stocks through 2011. While this clearly reflects increased fears in the market, some people say it could also be impacted by the fact that fewer banks and hedge funds are selling such contracts (if fewer insurers are in the market, it’s possible that the cost of insurance will increase). Whether or not this is the case is debatable.

Increase in Credit Downgrades. S&P said that the number of companies poised for a credit downgrade in February was 977, the highest ever. This is a 40% increase from the same time last year.

Bank Debt Woes. Bank debt lost 4% in February. Since bank debt comprises approximately 20% of bond benchmarks, the average bond investor will not have done well.

We Can’t Mess With the System Now. Fitch is delaying a review of its municipal ratings program because of the economic downturn. They said that the issuers are being severely affected by deteriorating macro-economic conditions, increasing fiscal pressures and market access and liquidity constraints. In other words, the market is terrible, so lets not try to fix our rating system. That should give you confidence in our ratings.

I Was Sure China Would Protect Us. Lenders to Chinese companies are nervous as many companies are teetering on the brink of bankruptcy. Shockingly, China has very little direction concerning bankruptcy laws. It’s such a surprise. I would have really expected China to protect foreign lenders and investors...

PART 9: Private Equity

Private Equity is Getting Crushed. Examples include:

1. KKR Private Equity Investments said that its assets' value fell 32% in Q4.
2. KKR Financial Holdings, a fund that invests in corporate loans, high yield bonds and distressed debt reported a \$1.2 billion quarterly loss.
3. Stocks of Blackstone and Fortress have been decimated.
4. Blackstone wrote down to zero the value of billions of dollars of debt that it had bought from Deutsche Bank.
5. Harrah's (owned by Apollo and TPG) is looking to restructure its debt, which is trading at distressed levels.
6. Energy Future Holdings (TXU's new name) reported a Q4 loss of almost \$9 billion. EFH is owned by an investor group led by KKR. KKR wrote its investment down by 30%. The firm has \$43 billion of debt, \$32 billion of which was taken on for the acquisition.

Holders of Debt That Financed Private Equity Are Also Getting Crushed.

Moody's said that it was likely to downgrade the vast majority of non-AAA CLOs. Collateralized loan obligations bought over half of the loans used in LBOs. Moody's said that the possible downgrade was due to changes in the way that they assess the riskiness of investment vehicles. They said that they are changing default rate assumptions and that they are going to increase the correlation assumptions between different industries. (Maybe they are now going to start looking at the underlying securities, rather than the underlying check that they received to give high ratings.)

More Markdowns to Come. As equity markets continue to drop, you have to believe that private equity values will also drop. They mark their portfolio companies to market values by using either multiples of public companies or DCF. Suddenly, that absurdly academic DCF methodology is becoming more widely accepted.

Can I Jump In Front of You? TPG is trying to provide DIP financing to a company that it owned and put in bankruptcy. This would put TPG in a senior position to other debtholders. There is a fear that (if allowed) private equity firms will put portfolio companies in bankruptcy to obtain an attractive return.

PART 10: Random News

Forced Savings. The President's 2010 budget proposal includes a provision where many employers who don't offer retirement plans will be forced to enroll employees in IRAs (unless workers choose not to participate). Small business owners don't like the cost, time or paperwork issues involved with the IRA proposal.

Be Careful What You Wish For. Yahoo spent \$79 million fighting off Microsoft's \$33 bid. Fortunately, they were able to fight this off. Yahoo now trades for \$13. Money well spent.

Ponzi-Palooza. The Commodity Futures Trading Commission said that so many people are sending in tips, "there's a Ponzi-palooza out there." What he should have said was "the bitch of it is that now we actually have to investigate."

Dirtbags. I realize that this is turning into a somewhat violent issue, but there's someone else who needs to be smacked...Ruth Madoff. Bernie is trying to prevent prosecutors from seizing his NYC apartment and the \$62 million in cash and bonds that he claims belongs to his wife Ruth and "are unrelated to the alleged Madoff fraud." These dirtbags have no shame. Unless you prove to me that Ruth had some sort of relationship with Elliot Spitzer, I'm not going to believe that she made the money on her own.

Honey, You Weren't College Material Even If I Had the Money. College savings plans (529s) fell 21% last year, a loss of \$23.4 billion. Combine this with the facts that student loans are more difficult to obtain, endowments are down and states have budget problems...it's ugly.

DOW / ROH Update. Dow Chemical and Rohm & Haas announced that they are negotiating in order to avoid Monday's trial. There is some talk that the Haas family trust might finance part of the deal. ROH stock was up 18% on this news. ROH and DOW employees better get their resumes ready if this deal goes through.

Big Improvements Coming...The SEC and Finra (the securities industry's self-regulating agency) said that they are improving their operations to better respond to tips and information they receive. (This is political speak for "we're going to start answering the phone if you call between the hours of 9 and 4.) Mary Schapiro, the SEC head stated, "as we continue to reinvigorate our enforcement efforts as an agency, it's vitally important that we move aggressively to improve staff's use of tips and complaints from investors and whistle-blowers." You think?

Here's my big problem with all of this. Back when I was younger, had a good head of hair and was even dumber, I worked as a Senior Attorney at NASD Regulation. NASD Regulation was the predecessor to Finra and was headed by Mary Schapiro. The organization was impotent and much of that resulted from Mary Schapiro's desire to not ruffle feathers within the other half of the NASD. (The NASD was comprised of NASD Regulation and NASDAQ.) In other words, we were regulators who didn't want to offend the people we were regulating.

Investors were losing hundreds of millions of dollars, there were some easy solutions and no one wanted to enact them because some of the industry might disapprove. As an example, we knew the demographics of the firms that were committing IPO fraud and all we needed to do was have rotating compliance officers that were part of NASDR, rather than allowing these “firms” to hire their own compliance officers, who were part of the scams.) No, we couldn’t do this. Families lost their life savings, but it all turned out okay because Mary is now head of the SEC. So, forgive me if I vomit when someone tells me that Mary Schapiro is going to protect investors. (It’s really a shock that Bernie Madoff was on NASD’s board and the investigators never caught him, isn’t it?)