

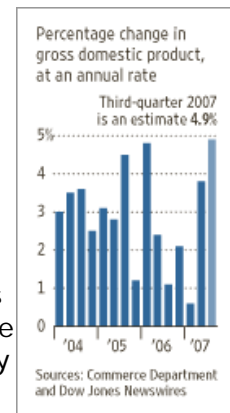
# Dow up 300 points

## Why?

The news keeps on coming. The pre primary presidential campaign trail is in full swing with little being said about the economy beyond promises of saving your home. The lack of credit is alarming. Articles in the WSJ talk of European banks hoarding cash, the US Fed opening up the vaults to ensuring enough liquidity exists through the 1<sup>st</sup> of the year, and the Bank of Canada is pumping money into its system.

Yesterday the stock market rockets up 300 points on news of a possible lowering of interest rates. This is confusing; lowering rates will lower borrowing costs but do little to ease liquidity issues. I question weather the issue is interest rates or liquidity. Yes lower interest rates will reduce consumer costs somewhat but with home heating fuel at over \$3 a gallon consumer pocket books in the Northeast and Midwest have little spare change.

Today's Wall Street Journal had an article indicating corporate profits may be softening from their high vs. GDP. GDP for the third quarter was restated at 4.9%. But output appears to have been boosted by a big increase in inventories, which basically means companies made more than they sold. As they work inventories down it will cut into growth. Economists polled by The Wall Street Journal in early November expected the GDP growth rate to slow to 1.6% in the current quarter, and many revised their estimates down since those forecasts.<sup>1</sup> This is concerning as it means smaller investment in capital expenditures, lower EBITDA, declining stock values, and oh yes less cash to cover those bonds issued for stock buy backs and dividends. The news also talked about how corporate America has been operating with lien operating costs and that they will not have an easy time cutting costs to make up for the lost margins. If they turn to head count reductions as the solution it could push the economy further into the abyss of a recession.



According to Thomson Financial, companies in the S&P 500 earned 4.4% less in the current period than a year earlier. The billion dollar write-offs financial institutions took in the third quarter won't register in GDP either. But they certainly have with investors.<sup>2</sup> The alarming part of this is that unlike past bad news on reserves the financial institutions are having trouble predicting the bottom. This indicates to me that they have not been cleaning up the balance sheets and including all contingencies so that future quarters look good. This has been especially true with the arrival of a new CEO as they want out with the old and up with EPS. The question facing many is just what is the magnitude of those losses from subprime, CDOs, and SIVs. This is the first decline in corporate profits since 2002, and there could be more to come. Strong growth overseas

<sup>1</sup> Figure This One: Hot GDP Data In Cold Quarter  
November 29, 2007; Page C1WSJ

<sup>2</sup> Figure This One: Hot GDP Data In Cold Quarter  
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could come to their rescue, but if the slowdown gets much worse, it sets the stage for a nasty drop in profit margins.<sup>3</sup>

Financial institutions are tight on cash. The private equity firms and hedge funds may have plenty of cash to invest but when they turn to the financial institutions for the leverage they may find the shelves bare.

Thursday November 29, 2007 saw a run on a state administered fund with withdrawals exceeding \$10 billion (40% of funds assets) in two weeks. Anxiety for the health of the U.S. financial system, already running high after a series of large-scale write-down's by giants such as Citigroup and Merrill Lynch, intensified today. The markets saw a spike in short-term borrowing rates and heavy buying in government debt revisited the worst days of the summer credit crunch. LIBOR rates shot up to 5.24% today. As the funds exited the commercial paper markets the demand for two year term treasury notes was strong reducing rates substantially.

The credit supply is shrinking at the most rapid rate on record with a 9% drop in commercial paper and outstanding commercial and industrial bank loans. "For now, though companies in everything from furniture to website design are tightening their belts, delaying expansion, and scrambling for other sources of cash."<sup>4</sup> At a Holiday Party last evening the discussion turned to credit markets and issues. The information provided by an insider was that senior credit officers are pouring over loan portfolios looking to weed out the weak customers. This is great news for asset based lenders further down the food chain and bad news for C & I lenders.

It could be that the banks' write-offs over the last few months are starting to shrink cash reserves and essential ratios. In the last few days HSBC made the bold move and relented to the auditors and moved \$40 billion of SIVs onto their balance sheet. Citi received a \$7.5 billion equity infusion and is publicly declining any push to move their SIVs onto their balance sheet. Was the \$7.5 billion equity infusion to cover losses announced or the first in a wave of equity infusions to prop up the reserves for more bad news to come?

Countrywide has had its hand in the Federal Bank Loans coffers for \$54 billion worth of short term loans as they are unable to sell their bonds. Fanny Mae and Freddie Mac are booking larger reserves as mortgage defaults increase and are raising equity. This weekend in Florida I saw my first outright add for a "short sale" in a desirable neighborhood. The home was priced at about 25% under previous asking price and my research leads me to believe this is 10% under the mortgage amount. The home is in a desirable development and the lowest priced home therein without an immediate buyer. It should be noted the asking price is \$100,000 below 2004 prices. A few weeks ago at the CFA conference the panel on liquidity had speakers from Standard & Poors that stressed how current losses were only 1% on mortgages foreclosures. Ops, he was off 9% and growing. An increase in loss reserves of this magnitude in the subprime arena is billions of dollars of lost liquidity.

Growth appears headed toward zero "Many economist anticipate that the U.S. economy will grow at substantially less than a 1% pace in the current quarter."<sup>5</sup>

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<sup>3</sup> Profit Margins Next Casualty of Pullback?  
*November 27, 2007; Page C1*

<sup>4</sup> Boston Globe page E4 – by Peter Goodman

<sup>5</sup> Economy Grew 4.9% in 3rd Quarter  
By JEFF BATER  
*November 29, 2007 3:17 p.m*

Unemployment is starting to grow and we have yet to see substantial layoffs from the financial service firms. Tight credit in the middle market combined with a credit squeeze on large deals with a flight to safety will only exasperate an already difficult situation.

Black Friday as they call it had an increase in revenue over 2006. Please note I said an increase in revenue. Articles in the WSJ talked about deep discounted items going unsold on Friday and Saturday. Major discount chains extending black Friday specials into Saturday to attract the revenue dollar. How about those margins I ask. My son and his new wife talked about buying a new computer at the Thanksgiving table. After dinner we reviewed the offerings and wow the deals just kept on coming. The best deal I could find was a loaded tower and 22" HP wide screen for \$600. The screen retails at \$399 alone never mind the tower with 3 gigs of ram, 360 gig hard drive etc. Profits on this item had to be razor thin. But the shock was on Friday around noon the local Office Depot that offered up this deal still had five of the six units still in stock. It is my perception that both HP and Office Depot sold this unit with zero or close to zero margin. The checkout line at Office Depot was several people deep buying free software and items that will add little to Office Depots bottom line. The Sawgrass discount Mall was busy on Sunday but we left with only a pink basketball for my grandniece. While customers were shopping the register ring was sporadic.

In summary, credit is drying up yet overall liquidity is strong with the cash moving into two and ten year treasuries. Short term LIBOR rates are higher by 2% over ten year treasuries. It appears we have an inverted yield curve based upon this criterion. Mortgage money is available but the mortgage companies must turn to quasi government agencies to borrow the funds. Holiday retail revenue is relatively strong but margins appear razor thin leading to poor profit performance.

GDP is dropping like a stone from a revised third quarter number of over 4.9% to projections of under 1% for the fourth quarter. While small we had our first run on a US institution the last few weeks. Housing inventory remains high with sales down over 25% from a year ago. So does this not beg the question what is lowering the interest rate another ¼ point going to do but shrink the margins at banks looking at hug reserve issues? I'm confused.

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