WHY THE CHICKENS HAVE COME HOME
WHERE TO FROM HERE?

December 15, 2008 Frank J. Andress

On April 30th 2007 I received an e-mail from my daughter Kim, a very successful businesswoman, saying, my husband and I are very bearish and have reduced our stock positions significantly, for these reasons: Mortgage defaults are making it hard for buyers with poor credit. CDO funds are investing in bad credits and selling these to pension funds all over the country. Major defaults are certain. Consumers have been using rising home prices like piggy-banks for years. Home prices will drop slowing housing starts and consumer spending. Subsidized bio-fuels production is driving up corn prices and related food products.

The e-mail concluded, "The fundamentals have changed drastically. I can't remember being so pessimistic".

At the time the DJIA was at 13,000 and seemed to be heading higher. My two investment advisors predicted further gains and they were right for awhile, the averages went up to 14,100 in the next five months. But my curiosity was aroused. I'd never heard of CDO's in spite of an adult lifetime in corporate finance and banking. What's a CDO? A CDO is a consolidated debt obligation the assets of which are millions of dollars of first mortgages and the liabilities are securities generally sold to investors.

In June of 07 I went to a 55th reunion at Harvard Business School. And to my surprise, the primary topic for the Finance Seminar I attended was CDO's. The two-hour seminar was conducted by a distinguished professor who was the head of the Finance Dep't. And what an earful I received...Mortgage brokers were making mortgages to totally unqualified buyers, selling them to investment bankers who were securitizing them in packages of $100 million and more and selling them to unsuspecting investors. One example was a Mexican fruit picker in S. California with an income of $14,000 per year who bought a $720,000 home with nothing down and no payments the first year. The mortgage broker marked the mortgage up to $750,000 and without any further liability for this junk mortgage he originated, sold it to an investment banking firm who packaged it with similar mortgages and took another fee of $50,000 a total markup of $80,000 on this one mortgage. The total package, known as a CDO, was broken into tranches and then shopped to the rating agencies where they were able to buy a AAA rating for the top tranch, representing about 70% of the total offering. The AAA rated tranch was sold to pension funds and other institutions.

Rating agencies are supposed to be financial auditors, providing an arms-length evaluation of a credit and establishing a proper rating. AAA is their highest rating, reserved only for the bluest of the blue chip companies. Except, it turns out that if you paid them enough money you could buy a AAA rating for your CDO! And they made a fortune, especially Moody's, selling these ratings at a big profit. Eventually, Moody's cleaned house and fired their CEO but by then the damage was done!

The professor referred to the mortgages as garbage and the resultant senior paper as toxic waste. A mortgage to a Mexican fruit picker for 51 times his annual income became AAA rated paper with a price tag of $800,000. The mortgage broker and investment banker made $80,000 and walked away without further liability. The rating agency, usually Moody's, sold their rating for an inflated price and everyone was happy except the ultimate buyer, who was left holding the bag!

The writeoffs of these CDO's were in the trillions. Even the investment bankers selling them took enormous writeoffs on the CDO's they were eventually stuck with as investors became aware of what was going on and refused to buy them.

My biggest concern is the fact that the originators of this toxic waste had no liability for what they created. One of the worst offenders was Countrywide Mortgage who pushed their brokers to make loans at any price so they could get their fat fee, and Mazillo, the CEO could walk away with millions. He later sold Countrywide to Bank of America for $4 Billion.

Mark to Market Accounting and Predatory Short Selling

At the same time as the bad CDO's began to rock the market, the FASB, which is the nation's arbiter of what constitutes generally accepted accounting principles (GAAP) determined that public companies had to mark financial-type assets to market in their published reports, rather than historical cost. This controversial decision forced huge writedowns of CDO's and other securities by companies like Citicorp, Bear Stems and Lehman Bros. It greatly aggravated an already bad situation. Financial companies reported losses of 20 and 30 billion that would otherwise have not appeared. Under prior rules, these losses would have been amortized over many years and might even have come back in value thus eliminating the writedown. Now enter the hedge funds and their predatory short selling. Hedge funds charge clients enormous fees and take enormous risks in highly leveraged transactions. If they win their casino-type bets, they get 20% of the gain and the managers become billionaires. If they lose they close the fund and return the investor's remaining funds, after taking huge losses, and then start a new fund. It can be a license to steal. In June of '07 the SEC eliminated restrictions on short selling which had been in place since the 1930's. Hedge funds had a field day. They could engage in predatory short sales without the usual restrictions. For over 75 years, a short sale could only be made if the prior price change had been positive and if the seller was able to borrow the shares he was selling prior to the sale. Chris Cox, SEC chairman, in his wisdom eliminated this requirement in June of 07 and permitted naked short sales. A hedge fund could now drive down the price by relentless short selling of shares they did not own, even tho the prior price movement had been down and he had not yet borrowed the stock.

As the hedge funds drove down the price, it attracted attention and other investors became concerned and also started to sell.

Poor Lehman Bros. was like a wounded gazelle in the jungle of Africa being chased by a pride of lions!.! say wounded because they had made some bad investments and had a 30 to 1 debt ratio! .Not only did Lehman now have to report huge losses on their CDO's and other securities, under the new FASB mark-to-market accounting rules. They were also prey to hedge fund rumors, which are very prevalent in Wall St. and often self-serving, and hedge fund's relentless short selling under the new permissive SEC rules. They further undermined confidence in Lehman's credit by manipulating the new credit default swaps insuring Lehman's debt. By bidding up the price of these publicly-traded credit default swaps, a new form of credit insurance that traded daily, they gave the impression to other investor's that Lehman's credit was simultaneously deteriorating. The poor gazelle finally collapsed and was devoured by the lions! A 148 year old icon of Wall St. bit the dust and filed bankruptcy.

There was an ironic twist to all this, however.

When Lehman filed for bankruptcy they had a lot of hedged derivatives where the counterparties were hedge funds. Under bankruptcy law these third party liabilities were abrogated and hedge funds suffered losses in the billions. So, the pride of lions got bad indigestion on their kill!

Hedge Funds First Hand

Last summer I decided to look closer at a specific hedge fund. Their leverage was about 6 to 1. Instead of being hedged they were primarily long with their positions. I concluded that a 10% market drop could cause a 60% drop in my funds or a 60% increase if the market was up 10%.Too much risk for me. At one point I called the manager who selected the funds. When he answered, I asked where he was. He said he was anchored in Portofino harbor on his yacht and conducted his investments from there. In winter he lives on his yacht in Florida or the Carribean.

Role of Professional Advisors

Throughout this period the market continued its steep decline and I did nothing. I spoke periodically to two investment advisors. They remained positive that this was only a correction. Ken Fisher, who advertises heavily in the WSJ, predicted prices would rise 10-20% in 2008.1 discussed this with friends of mine and without exception they were receiving similar advice- STAY invested in equities said their advisors.

I can sympathize with investment advisors, they are between a rock and a hard spot. If they advocate their clients sell and invest in cash and treasury bills they may lose their client. Few investors want to pay an advisor to manage their cash and money market funds. If they advise selling and the market goes up, they may also lose their client. Furthermore, they have to make a second correct decision on when to reinvest. Better to stay put, hopefully keep their clients in spite of market losses, and hope for a recovery. And that policy has worked for decades.

I went back to my daughter who had sent me the e-mail warning in April of '07. She and her husband were now even more concerned. So, after a long conversation with them in November of 07,1 terminated one advisor and put all the funds in Treasury Bills. That proved to be very timely as the market was still up around 13,000. In July of 08 I terminated the one predicting a 10-20% rise in 08 and put the proceeds in FDIC insured deposits and MMF.I should have done this back when my daughter advised me to but I procrastinated as the market was already down. I suffered considerable loss in the meantime and I must make a second decision on when to reinvest.

My experience with investment advisors is that if you want to get out of the market, you have to make that decision yourself!

Security analysts have also remained very optimistic. They rarely recommend selling. Buy recommendations outnumber sell recommendations by 10 to 1. Sell recommendations are usually greeted with outrage by corporate CEO's and some analysts have lost their jobs because of their sell recommendations! Their views should make any observer question whether they view their true constituency as investors or the companies they serve. Fortunately, there are totally independent analysts, who represent investors.

WHY THE CHICKENS HAVE COME HOME

I've tried to go back and reconstruct related events.

By far, the biggest chicken was the enormous rise in all forms of indebtedness-unsound mortgage loans sold as AAA rated paper to trusting investors, banks' aggressive promotion of home equity loans, auto loans, credit card availability to everyone, highly leveraged hedge funds and private equity funds, and prominent investment bankers with 30 to 1 debt/equity ratios, all clamoring to borrow as though there was no tomorrow. A 30 to 1 debt/equity ratio means if your asset value declines 3.5% your equity is wiped out! With mark to market accounting that can happen very quickly in a falling market. I'm sure many Wall St. CEO's were completely blindsided by this.

Alan Greenspan publicly admits his failure in this period. He testified to Congress in '05 that "there is no evidence home prices will collapse and the worse may be over". He contributed greatly to today's problem although at the time I thought he was on target. He lowered fed fund rates to only 1% in the early part of this decade. This put the banks under pressure to put out lots of cheap money. Housing was the quickest way to do this. He also bailed out Long Term Capital Management which came to be called the Greenspan "put", meaning you couldn't fail as the Fed would always be there to bail you out. This may have caused Wall St. to feel they couldn't fail even if they did bizarre things like CDO's, credit default swaps in amounts that greatly exceed the underlying debt outstanding, 30 to 1 debt ratios, and other derivatives. And never forget the profit motive and those million dollar bonuses!

The current Fed Chairman, Bernanke, may have contributed greatly to the current liquidity crisis. As rates were cut as much as 300 basis points below the European CB rates, those petro dollars we created by our huge trade deficit in recent years fled the country. They sought higher rates elsewhere. This contributed to the decline in the dollar, and rising oil prices, which further encouraged the exodus and a liquidity crisis occurred here in the US. Bernanke is making the same mistake right now as our key rate is still 1.5% below the ECB, even after the ECB cut rates on Dec. 5 . That means a mid-eastern sovereign fund will earn $15,000,000 more for each billion they invest in Europe. No wonder their funds fled the US and we had a liquidity crisis and a falling dollar. And Bernanke plans to cut rates again as I speak!

Foreclosures are now at an all-time high. This may be due to all the politicians advocating mortgage bailouts. Why payoff my mortgage when the Fed or Uncle Sam is going to bail me out?
We can't ignore Jimmy Carter's Community Reinvestment Act of 1977 mandating that banks loan to borrowers in risky areas and a similar one under Bill Clinton.

Do you see parallels with today? The Fed has again lowered rates, coincidentally, to the same level and again we have a bailout. But what's the alternative? Probably to let some companies fail as we have done with Lehman and perhaps the Big Three auto makers.

Glass-Steagall was passed in the 30's after the crash of'29 to separate commercial and investment banking. It was a sound move. But under pressure from Wall St. this law was rescinded under Clinton, I believe. We can primarily thank Sen. Phil Gramm, Texas Republican for this change as he led the charge. Now, the investment banking arm may be able to originate offerings and if they can't sell them elsewhere, they can sell them indirectly to their commercial banking arm, in a less than arms-length transaction. Also, the so-called Chinese wall separating confidential information obtained by investment bankers in their corporate contacts can be easily breached in off-hand comments to traders, although they will deny this. I would favor another Glass-Steagall act. The SEC contributed to the current chaos. Rescinding short trading restrictions and allowing naked short sales was a bonanza for hedge funds. The SEC has since reversed themselves, at least temporarily. Their failure to gain better control over hedge funds must also be recognized.

WHERE TO FROM HERE?

Making predictions is the hardest part of this paper .As Yogi Berra said, "It's tough to make predictions, especially about the future"

Who Gets Bailed Out?

So far we've restricted this to banks. But now American Express has converted to a bank holding co. and seeks $3.5 B. Insurance companies and real estate companies are reportedly buying small banks so they can qualify. The auto industry was turned down but will be back as this was being written. The auto parts suppliers have indicated they need help if the Big Three gets bailed out. State Governors are now clamoring for help as their tax revenues drop. California says its bankruptcy is imminent. The pricetag for AIG has risen from $85 B. to almost $200B. And the list grows daily! One of my biggest concerns is the likely decline in the police force as municipalities respond to falling tax revenues, and release of overcrowded prisoners at a time when unemployment is rising sharply. This is already occurring in some areas and may result in a sharp rise in crime rates.

Detroit's bailout request is now on the table. Bankruptcy is a viable solution. It would permit immediate relief from onerous labor contracts which cost Detroit $29 per hour more than non- Detroit auto makers. They could still produce cars just like Delta kept flying throughout their bankruptcy. They could get debtor-in-possession financing to meet funding needs. And very important, car buyers warranties would be protected by bankruptcy financing. Do you want to buy a car if the company can't meet its warrantee obligation?
Robert Nardelli is the CEO of Chrysler. He previously ran Home Depot down the hill and was fired but walked away with a $220 million golden parachute. Aren't we entitled to know how much of that Nardelli has put into Chrysler before we bail out Chrysler with the public's money? And how much has Wagoner put into GM? If we bailout Detroit without first resolving the labor problems especially, I fear we are in for a long, long recession! These huge demands could be a gigantic political problem for a new administration if it has to repay special constituencies that just elected them!

Magnitude of Federal Borrowing

I've estimated the Federal deficit for this fiscal year may exceed $2 Trillion! This is made up of last year's deficit of 475 B. plus the 700B bailout, plus $150 Billion for AIG bailout, plus $29 B. for the Bear-Steams bailout, plus about 500B for the money market fund financing facility the Fed has announced and an unknown amount for the mortgage giants we have taken over. If their mortgages are only worth the 22 cents on the dollar that Men-ill Lynch sold theirs for, the amount could be several trillion. Federal accounting overlooks the fact that we will acquire some real assets for these outlays and overstates the deficit. Military outlays should decline under the new Administration. But tax revenues will decline and a new stimulus is under consideration.
And on November 25th, we have the second bailout of Citicorp. With 20 B. of fresh capital plus another $270 B. of gov't guarantees of their MBS but no change in Directors who have been there for years. Robert Rubin has been a Director for a decade and paid $115 million. Citi advertises "Citi Never Sleeps" but apparently their Director's do.

My greatest concern is our bailouts will exhaust our country's capital. Don't forget our existing unfunded liability for Social Security and Medicare.

Federal accounting is not based on GAAP like corporate accounting. All cash outlays are expensed in the year they are spent even though they may be for a new granite office building that has a life of 50 years.

Therefore, the $700 Billion bailout for banks will be expensed even tho the Gov't. acquires some very real stakes in these banks which should produce future gains. However, the cash impact is right now while the return is off in the future.

How Will We Finance This Huge Bailout?

In the short run this is not as difficult as I first thought. Congress approved expenditures like the $700 Billion bailout will require the Treasury to sell bonds.

Fortunately, this is a very good time to borrow such huge sums. Competing demands from private industry will be down sharply. Deflation, which we are currently experiencing, should reduce rates further. I do not foresee large increases in interest rates now in spite of heavy new borrowing. But most important of all, in the short run much of the funding will come from the Federal Reserve which has the legal power to create money!! Yes, I mean cash or other means of payment. And it doesn't show up as government expense and has no effect on the deficit. But it does cause the assets and liabilities of the Fed to increase and money supply to rise. Fed assets and liabilities have risen from $800 B. to $2.2 Trillion recently. Estimates are they will exceed $4 Trillion in '09.
But in the long run it is very inflationary as the Fed creates money. Money supply for the most recent three months was up 36% versus normal increases of 5-6%.

While the current interest rate outlook is benign, I could be wrong! If rates do begin to rise sharply as the public fears inflation, they could offset the benefits of the bailout and any new stimulus!! Keep a sharp eye on interest rates!

GOOD THINGS STILL HAPPEN!

Yes, there is some good news out there-lower oil prices! The drop in oil has given American consumers a "tax cut" equivalent to about $250 Billion. And this tax cut doesn't come out of the US Treasury. Instead it comes from the pockets of the middle eastern oil barons! This exceeds the last stimulus and should be given a lot of recognition. It may account for the recent rise in consumer confidence. It should help Detroit.

OTHER LIKELY EVENTS

-Suspension of corporate stock buy-back programs and lower dividends in order to pay off debt
-Corporate goodwill writeoffs could skyrocket. GAAP accounting requires companies to evaluate goodwill periodically. Some blue-chip companies have goodwill almost equal to their entire net worth as a result of prior acquisitions. Under GAAP the difference between purchase price paid and value of assets acquired is goodwill,

unless it is a merger and qualifies for pooling of interest accounting. The combination with mark-to-market accounting could generate big writeoffs, especially if management takes the likely position that this is a terrible year so let's get all this behind us and writeoff goodwill now. It will make future years look better

-Lower commodity prices. In fact, we are now experiencing deflation and fed rates are already at 1%. How can you go much lower? Japan has had a ten year recession in spite of almost zero rates.

-Excess capacity and no need for further capital investment. This provides an opportunity for the Gov't. to pursue its infrastructure investments. Personally, I like this idea as we do get something tangible for our expenditures, much of which is sorely needed.

Conclusion

I've tried to set forth the most serious factors in our near-term future.

Bailout demands grow daily and are already in the trillions. How can a politically driven forum with conflicting constituencies discriminate between what's wanted and what's needed?

What is the long term impact of the Federal Reserve's expansion of the money supply? It could mean inflation bigtime. Inflation is the easiest way for the Government to service it's debt.I estimate that interest alone is now costing more than $300 B. per year.

We are currently experiencing deflation. The last time this happened it took us 7 years and a war to overcome it. A blizzard of new government programs like the 30's could delay recovery. This keeps business decision-making off balance. We come to think that government, rather than the private sector will solve our problems.

My greatest hope is that our new President has the leadership to deal with these problems for the nation's best interest rather than political expediency.

Good things are happening in the short run. Lower oil prices are a major break. This is a good environment for financing the bailout as private credit demands are declining and the Federal Reserve can provide major funding by printing money rather than by issuing new bonds which drives up interest rates.

In the long run, keep your eye on inflation and interest rates. MEANWHILE, STAY POSTED !!