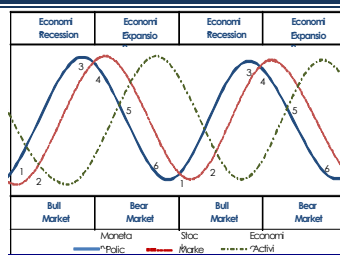


The Financial Commentator

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A GUIDE TO
FEDERAL RESERVE
MONETARY POLICY,
THE ECONOMY, AND
FINANCIAL MARKETS
ANNUAL SUBSCRIPTION: \$144.00

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2007 – A Look Back

This year was certainly an eventful year, both in the stock market and for me. On July 1, Welsh Money Management LLC was launched, with a proprietary trading model for S&P futures and S&P index ETFs. Our model was tested back to 1987 by a third party firm, and has done well. Since July 1, the S&P is down more than 2%, and our managed accounts are up 15%, before fees. Given the problems facing our economy and the Federal Reserve, 2008 is likely to be more volatile and challenging than 2007. I will do my best to help you understand and anticipate the events that will drive the markets next year.

I hope this Holiday Season finds you with family and friends, and that next year brings you good health and a measure of good fortune. Happy Holidays and Happy New Year!

Jim Welsh

FEDERAL RESERVE

Throughout the Pacific Ocean there are sounding buoys to determine if a 100 foot tsunami traveling 500 miles per hour, or a 2 foot wading wave has developed after a large earthquake. The disruption that swept through credit markets worldwide in August was equivalent to an 8.4 magnitude earthquake. While seismologists know if a tsunami was created within a couple of *hours*, we won't know for a number of *months* the full economic impact. It's been two months since I wrote those words in the September letter. Since mid-August, the Federal Reserve has cut the Discount rate four times, and lowered the Federal funds rate from 5.25% to 4.25% in three steps. Last week, the Federal Reserve announced a coordinated plan with four other central banks to improve the flow of credit between banks around the world. At the urging of Treasury Secretary Paulsen in late September, several large banks announced a plan to create a super Structured Investment Vehicle (SIV) to buy the assets of struggling SIV's set up by large banks around the world. Two weeks ago, Treasury Secretary Paulsen and the Bush administration, announced a plan to help some of 1.8 million homeowners whose adjustable rate mortgage will reset in 2008.

When an 8.4 magnitude earthquake strikes, the area surrounding the epicenter is devastated, as the ground underneath shifts violently. Within seconds, the event is over. When an earthquake

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triggers a tsunami, the damage and destruction doesn't end when the ground stops shaking. A tsunami speeds across the ocean spreading devastation to those far removed from the epicenter, oblivious that their lives were so connected to an event so far away.

Despite the rate cuts by the Federal Reserve and other attempts to contain the credit market tsunami, ***the economic engine of growth, credit creation, has stalled***. More boats are being swamped as the economy slows, which only increases the stress on the economy and banking system. After seeing how the Federal Reserve handled the 1987 stock market crash, the dot.com bust that erased \$7 trillion of equity wealth between 2001 and 2003, and the implosion of Long Term Capital Management and Russian debt default in 1998, investors have come to accept that the Federal Reserve has a market 'put option' at its disposal, that provides a safety net under the stock market. Based on the Fed's prior successes, investors believe the Fed has whatever tools it needs to manage and contain any crisis. When investors discuss the 'put option' Greenspan or Behrnanke exercise at times of market distress, they believe the Fed will make sure things never get out of hand. But each credit crisis is different in some way. So, is the Fed a fairy godfather who can wave a magical put option wand and make everything OK in the current crisis?

Until twenty-five years ago, our local bank would loan money to buy a home or a car, and would hold that loan until it was paid off. Since the bank was holding the loan, it had a keen interest that it would be paid off. Back then, the total amount of loans the local bank could make was dependent on the banks capital base, total deposits, and reserves set aside for existing loans. If a bank wanted to increase its lending volume, it had to increase deposits, usually by offering higher rates on its Certificates of Deposit, or by adding to its capital base. This arrangement gave the Federal Reserve significant leverage in determining how much credit was flowing into the economy. If inflation accelerated and the Fed wanted to slow the economy, all it had to do was increase bank reserve requirements, reduce the total reserves of the banking system, or raise interest rates. By slowing credit creation, the Fed would cause the economy to slow down. To lift the economy out of recession, the Fed would accelerate the credit creation process. They did this by lowering reserve requirements and interest rates, and through an increase in total bank reserves. As credit growth grew, so did the economy.

Twenty-five years ago, lending was largely dictated by the amount of loans a bank had on its balance sheet relative to its capital base. If a bank could make a loan, ***and then sell it to someone else***, the bank could make more loans, ***without increasing its capital base or loan reserves***. Although the bank would make less money on each loan it didn't hold onto, it could increase earnings, ***by significantly increasing loan volume***. The process of moving mortgage loans off bank the balance sheets was initially facilitated by Fannie Mae in the early 1980's. Fannie Mae would buy mortgages from banks all over the country, package them together, and sell them to Wall

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Street and institutional investors. This was fairly easy to do, since lending standards were fairly strict and uniform, and most mortgages were ‘conventional’.

There are many advantages to the ‘securitization’ of mortgages. Borrowers get lower mortgage rates, due to competition. Pension funds and insurance companies are able to increase their investment returns, since mortgage backed securities offer a higher return than Treasury bonds.

The success with mortgage securitization has led to the securitization of car loans, credit card receivables, and numerous other assets. This has increased the flow of credit into many sectors of the economy, and has kept the economy humming. ***In the last 25 years, the economy has contracted in only 16 months.*** In the 25 years prior to 1982, there were 64 months of recession. A growing economy generates more jobs, a higher standard of living, and a tide that lifts the fortunes of most Americans.

In an effort to increase loan volume further, a number of large banks set up Structured Investment Vehicles, starting with Citigroup in the early 1990’s. These SIV’s borrow short term, typically in the commercial paper market, for periods less than 270 days. They make money by investing in higher yielding instruments, like mortgage backed securities. ***Surprisingly, the SIV debt is not carried on the balance sheet of the bank that stands behind the SIV, even though the fees earned by the SIV flow back to the bank!*** I have no idea how this got past the regulators, since this was clearly an attempt by Citigroup and other large international banks to circumvent loan reserve rules. Since the debt issued in the asset backed commercial paper market by each bank’s SIV wasn’t on the bank’s balance sheet, the bank wasn’t required to set aside reserves, or count the debt against its balance sheet. Last August, it was estimated that worldwide, SIV’s had \$350-\$400 billion in debt, with Citigroup accounting for more than \$80 billion. Compare this, with the total amount of Commercial Loans on the balance sheets of the largest banks in the US. As of June 1, 2007, large banks held \$650 billion in Commercial Loans. Clearly, up until last August, international SIV’s were providing a fair amount of credit to the world economy. ***This credit creation has been beyond the reach of the Federal Reserve and other central banks.***

Securitization has made it possible for banks to move more loans off their balance sheets, and into the hands of willing global investors. And the role of global investors cannot be minimized. When the Federal Reserve was raising short term interest rates in 2004, 2005, and early 2006, the FOMC expected long term Treasury yields to rise commensurately. When they didn’t, Greenspan called it a “conundrum.” In hindsight, it is explained by saying worldwide savings exceeded investment, with investors using the surplus to buy long- term securities. As a result, a negative yield curve developed in 2005 and 2006. Some economists thought the inversion was predicting a recession, when it was merely the result of international investors chasing yield. Amazingly, investors were willing to invest in 10-year Treasury bonds that sported a yield less than what

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could be earned on a 90-day Treasury bill! Some of this 'savings surplus' undoubtedly came from China's trade surplus and OPEC's exploding oil revenues. This insatiable appetite for yield even extended to less than high quality debt. In 2003, the spread between Treasury bond yields and corporate junk bonds was 10.5%. In June 2007, the spread was down to just 2.6%. No industry strives to satisfy an insatiable appetite like Wall Street. If investors are clamoring for a product, whether it is an IPO for a technology start up, or a sliced and diced sub-prime mortgage pool, Wall Street will create enough product until investors choke on it. And now, they have.

As noted previously, in the last 25 years, there have only been 16 months when the economy didn't grow. And in the instances that markets became unsettled, the Federal Reserve had the right medicine for the ailment. Such stability over a long time breeds complacency and the tendency to project the past into the future. During 2006 and the first half of 2007, investors were willing to buy securities with very low risk premiums. SIV's and other business models were extraordinarily dependent on market provided financing, and assumed a never ending supply of liquidity would always be available to fund their operations. This error in judgment, regarding risk and liquidity was touched on by Alan Greenspan in 2005. *"But what investors perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."*

Over the last ten years, financial markets have become global, more liquid, and the level of financial engineering far more complex and more leveraged. In recent years, a conventional mortgage on a home in Fargo, North Dakota could be packaged with a sub-prime mortgage on a home in Hope, Arkansas, sliced and diced into a number of pieces (tranches), and sold to an institution in China, or a hedge fund that borrowed the money from a bank in Japan. Despite the increasing complexity of these credit securities, the rating agencies – Moody's, Standard & Poors, and Fitch Ratings – continued to provide ratings that investors around the world accepted at face value. The cornerstone of the ratings process was the fact that national housing prices in the U.S. had never declined since the Depression. By owning a diversified portfolio of mortgages throughout the U.S., an investor could insulate themselves from the risk of regional home price declines, which have occurred. With the rating agencies providing the cover of an AAA rating on hundreds of billions of sliced and diced diversified mortgage pools, investors bought everything Wall Street could produce, ***without any measure of common sense.***

Between 1978 and 2000, the median home price fluctuated between 3.2 and 3.5 times median household income. In 2000, median household income was \$42,500, and the median home price was \$140,000. From 2000 until 2006, that ratio shot up to 4.7. Although median household

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income had grown 13% to \$48,200 in those six years, the average median home price had shot up to \$245,000 by the end of 2006, an increase of more than 70%. With income levels lagging so far behind home prices, and the cost of financing on the rise, the risk of a nationwide decline in median home prices had also increased markedly. But the rating agencies never incorporated this dynamic into their evaluations, and investors simply ignored the many signs of a housing bubble, and just kept buying. In recent months, the rating agencies have changed their assessment of tens of billions of dollars of mortgage paper from AAA to junk. Overnight. This has delivered a blow to the solar plexus of investor confidence. In August, \$1.2 trillion of asset-backed commercial paper had been issued by various corporations, banks, and SIVs. A significant portion of this asset-backed commercial paper market was tied to the mortgage market. By early December, the volume of asset-backed commercial paper had shrunk to less than \$800 billion. More than \$400 billion of credit has evaporated.

In the last 25 years, banks have made a concerted effort to move as much lending as possible off their balance sheets, thus empowering the role of the market place to create credit. As the market place has supplied a greater proportion of credit creation to finance growth for our economy, the Federal Reserve's capability to manage the credit creation engine has diminished. Although the Fed could still change bank reserve requirements and total bank reserves, the pass through effect on total credit creation would be less than in the past, since the impact on the market's capability to create credit would hardly be affected. This has meant that interest rates have increasingly become the Fed's primary policy lever. During the \$7 trillion dot.com bust, the Fed could lower interest rates and provide support for the overall economy, since ***the banking and market place's capacity to create credit was fully functional***. That is not the case in the current environment, which is why ***this crisis is quite different than the other crises faced by the Fed in the last 20 years***.

In the last six months, large banks have experienced a real reversal of fortune. They have built their business model, so they would keep as few loans on their balance sheet as possible. But a significant portion of the 'temporary' loans made to private equity firms to finance takeovers, are now still sitting on their balance sheets, as private equity firms have been unable to finance the deals by selling junk bonds. The debt carried by SIVs, that previously was off their balance sheets, is now coming back on, as Citigroup last week committed to adding \$49 billion of SIV paper to its balance sheet. Although banks have increased their lending standards over the last 10 months, that doesn't apply to previously authorized lines of credit made to commercial borrowers. Since June 1, 2007, total commercial loans by large banks have soared from \$650 billion to \$744 billion, an increase of 14.4% in just 5 months! And, if all this isn't enough, banks have been and will continue to increase their loan loss reserves, by tens of billions of dollars in 2008 and 2009, as

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more homes are foreclosed. This will put a tremendous amount of stress on the balance sheets of many large banks, and it will limit their capability to lend for an extended period of time.

The reduced capacity to create credit by banks and the market place is going to hurt economic growth in coming quarters. Since the nature of this crisis is different, the Fed's ability to contain it is less than it has been in prior crises. The Fed can't improve the liquidity of the asset-backed commercial paper market by lowering the Discount or Federal funds rate. The Fed can't repair the collapse of the SIV business model. The Fed can't repair the damage done to the balance sheets of the affected large banks. The Fed can and will lower interest rates further to offset the tightening of lending standards by banks. That will help, but the magnitude of this crisis is going to take a fair amount of time to workout. Unfortunately, the economy is going to weaken further, which will expose even more credit problems, adding to the stress on banks and the credit market. If the Fed's ability to contain this crisis is less, then its capability to be the lender of last resort is also diminished. So, is the Fed a fairy godfather who can wave a magical put option wand and make everything OK in the current crisis?

ECONOMY

When we were young children, we were taught to pull our hands away from hot things, so we wouldn't get burned. As we grew up, we learned it was better to just keep our hands away from hot things. Bankers never learned this lesson. They wait until their hands are getting burned, before they pull them away. History shows that bankers typically keep lending, until the losses begin to mount, and **then** they decide to raise lending standards. The problem with this approach is that raising lending standards as the economy is weakening only makes the economy weaker, which creates more credit problems.

Most of the problem lending to private equity and SIVs was confined to large banks. Midsized and small banks, not wanting to be left behind, have also participated in the lending until it hurts process. Two weeks ago, the Federal Deposit Insurance Corporation (FDIC) reported that midsize and small banks had construction loans outstanding that **were greater than their total capital**. More than 3% of all construction loans are now non-performing, up from 1% in early 2006. This is the highest proportion in a decade, and it will likely double in 2008.

The commercial real estate market, which includes office buildings and strip malls, is also showing some strain. According to Zacks Investment Research, the number of delinquencies in the third quarter exceeded the highest the highest level reached during the 2001 recession.

At the end of September, 4.5% of auto loans made in 2006 to top rated borrowers were at least 30 days delinquent, up from 2.9% in August. According to Lehman Brothers, that is the biggest one-month jump in at least 8 years. In 2006, \$89 billion of auto loans were packaged into asset-

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backed securities, and sold to investors. With delinquencies mounting, the volume of asset-backed auto loans is down about 19% in 2007. And, surprise surprise, lending standards are being raised, which will hurt vehicle sales in 2008.

As noted in October's letter, many states are beginning to be pinched, as tax revenue from housing activity and a slower economy, result in weaker tax receipts. According to the National Association of State Budget Officers, 15 to 20 states will experience revenue short falls in the next 6 months. For fiscal 2008, which began on July 1, 2007, states have budgeted spending increases of 4.7%, down sharply from 2007's increase of 9.3%, and below the 6.4% average spending growth of the past 30 years. California, Florida, Nevada, and a number of other states, will be forced to raise taxes to maintain spending levels in their 2009 fiscal year, beginning July 1, 2008. Lower state spending and higher taxes will represent just one more drag on economic growth next year.

Economists were encouraged when the Labor Department reported that 94,000 jobs were created in November. Monthly job growth has averaged 116,000 this year, which is down from 189,000 in 2006 and 211,000 in 2005. It is going to slow further. As noted in prior letters, a decline in temporary workers, number of hours worked, and a far weaker labor market based on the household survey, all point to weaker job growth in coming months. Historically, the household survey has led the employer survey at economic turning points. The household survey showed weak job growth before the 2001 recession, and stronger job creation in 2003 before decent job growth appeared in the employer survey in 2004 and 2005. According to the employer survey, 1.2 million jobs have been created in 2007. But the household survey has only registered an increase of 200,000 new jobs.

Based on updated information drawn from unemployment tax collections, which show the number of employees **actually on payrolls**, the Labor Department now estimates that personal income from wages and salaries grew at an annual rate of 1.6% in the second quarter. This is way below their initial estimate of 4.5%, and means there were fewer people working in the second quarter than originally estimated. When the Labor Department revises their job figures for 2007 next March, they will likely revise their figures lower.

Just as a tsunami speeds across the ocean spreading suffering to those far removed from the epicenter of an earthquake, the tsunami that swept the credit markets in August will continue to work its way through the U.S. economy in 2008. In doing so, it will adversely affect more sectors, raising the unemployment rate above 5.0%.

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DOLLAR

The case for an intermediate low in the Dollar has been building over the last two months. Sentiment toward the Dollar was almost universally bearish, leading to a number of magazine covers showing the Dollar going down in flames. The reasons for all the negativity are well known. The Dollar has been declining since November 2005, so the price trend has been down and well established. Our Trade Deficit is huge, representing almost 6% of GDP. The Federal Reserve has been lowering rates, while other central banks were holding their rates steady. This caused the interest rate spread to widen in favor of the Euro, Pound, Canadian Dollar, and other currencies. A slowdown in the U.S. has been well advertised, while global growth has been strong and expected to remain healthy.

But nothing goes down forever, and after falling for two years, the Dollar was ripe for a rebound. More importantly, I felt a number of the fundamentals that had contributed to the weakness in the Dollar were about to change. The housing weakness afflicting the U.S. was also beginning to grip Britain, Ireland, Spain, Australia, and other countries in the E.U. And the dysfunction, gripping our credit market, was also plainly evident elsewhere, with LIBOR rates in many currencies actually rising.

While most market participants were fixated on the global growth story, the stage was set for a slowdown in Europe, and interest rate cuts by the Bank of England and ECB. Last week, the Bank of England and Bank of Canada lowered their rates. The ECB will likely follow in the first quarter. As these pieces have come together, the technical action in the Dollar has improved. The odds now favor that an intermediate low was established at 74.75 (cash) on November 26. Over the next few months, the Dollar (cash) should work its way up to 81.00 – 82.00. I added to the Dollar position on November 28, when the March Dollar contract was at 75.59.

BONDS

Concerns about the economy in general and banks in particular, and the expectations of additional rate cuts by the Fed, helped drive the 10-year Treasury yield down to 3.84% by November 26. At that level, bond market participants were almost pricing in 3 quarter point cuts in the Federal funds rate. As I noted last month, even “If the Fed does lower the Federal funds rate to 4.0%, as I expect in coming months, I can’t imagine that yields can fall much further in the near term. A rebound up to 4.3% is likely.” Since November 26, the 10-year Treasury yield as climbed to 4.26%.

Consumer inflation expectations have increased in the last two months, as energy and food costs pressed higher. While this will complicate the Fed’s job, at the end of the day, they will lower rates, especially if the economy continues to weaken. In addition, a rising Dollar should put

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downward pressure on oil prices, along with recognition that the global economy is slowing. A drop to \$75 - \$80 a barrel will help lower inflation expectations, as gas prices also fall. I think the Fed will lower the Fed funds rate to 3.5%, maybe less. This would lower the 'real' funds rate under 2%, which is going to be necessary to keep enough credit flowing to *hopefully* avoid a recession.

GOLD

Last month I wrote, "The fundamentals for the U.S. Dollar are going to turn more favorable in coming months, and lead to a decent rally. The recent high in Gold will hold for a number of months, as it consolidates / corrects the rally from the August low." A decline below \$775 (February) will confirm that an intermediate top is in place. This should lead to a quick drop to \$740.

STOCKS

Longer term, there have been changes in a number of sources of demand that will impact stocks in 2008 and beyond. In 2006 and 2007, the stock market received significant support from private equity buyout activity and companies buying back their own stock. In 2006, the amount of shares removed from the market through buybacks, mergers, and LBO's exceeded \$600 billion. In the first half of 2007, this activity removed another \$350 billion. Since August, private equity deal volume has virtually disappeared. In November, there was just \$5.5 billion of private equity deals, down 93% from a year ago. Although the volume of transactions will likely increase, we aren't going to see the levels of activity seen in 2006 and early 2007 anytime soon. If economic growth remains sluggish for an extended period as I expect, corporate cash flows will shrink, forcing some companies to reduce or eliminate their stock repurchase plans. Last week, Bank of America said it was suspending its stock repurchase plan until 2009. In addition, a number of very large pension funds, which control more than \$750 billion in assets, have announced plans to reduce the proportion of U.S. stocks in their portfolios. In some cases, it is to increase exposure to foreign stocks, or fund other investments. For instance, the California Public Employees Retirement System will vote soon on reducing its U.S. stock position from 40% to 24%. This reallocation process will likely be spread out over a period of years.

Profits from the financial sector now account for 31% of total corporate earnings, up from 20% in 1990. Given the problems facing many of the large banks, earnings are going to be under pressure for 12 to 18 months, which will make it difficult for total corporate earnings to show much growth. This means stocks are going to have a tough time making much headway based on earnings growth over the next year.

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The economy is going to weaken further in the first half of 2008. This will expose even more credit problems, and there will be further deterioration in the housing market, as 240,000 mortgages are reset each quarter. It is going to take a fair amount of time to work through all these problems, given the magnitude of this crisis. The market has been able to hold up, as investors have believed global growth will help the U.S. avoid a recession. Investors also want to believe that the Fed is up to the task of managing this crisis, as they have in the past. If global growth falters, or investors begin to question whether the Fed is behind the curve in forestalling a recession, the market will be vulnerable to a significant sell off.

Technically, it is very important that the market hold above the late November lows, which are 1406.00 on the S&P 500 and 12,725 on the DJIA. A break below these levels would indicate that the odds of a recession have increased, and with it, a bear market. I think 2008 is going to be very challenging for stock market investors. The odds favor a break below the lows of late November. It's just a question of when. Now, or next spring.

Since the peak in mid July, the stock market *may* be tracing out a large triangle pattern. This pattern suggests that the current decline will hold above the November lows, at least for a few more months. Triangles usually create a fair amount of negativity, as investors are buffeted by bad news and very sharp rallies and declines. The combination of bad news and this type of trading, encourages a large build up of shorts. Five point triangles are frequently followed by a thrust higher, as a piece of news causes a rush of buying and short covering.

This is certainly possible in the current environment. Most investors really don't understand the credit creation process, and as a result, don't comprehend the scope of this crisis, or the Fed's limited ability to deal with it. ***It really is different this time.*** But investors want to believe that everything will be worked out without a major dislocation. If investors begin to believe that banks might be getting a handle on their problems, and that the Fed will ease more aggressively in coming months, a blistering rally could result that would take the S&P to new highs. The first indication will be, if the S&P can climb above 1490, and then 1525. However, even if this rally does develop, it will be the last opportunity for investors to sell.

Last month, I thought the upside was fairly limited, as investors realized that the global growth story wasn't an all purpose panacea. I thought a test of 1490 was possible, due to seasonal factors. The S&P did breach 1490 briefly, but quickly fell back, after the Fed only cut the funds rate by 25 basis points.

E. James Welsh