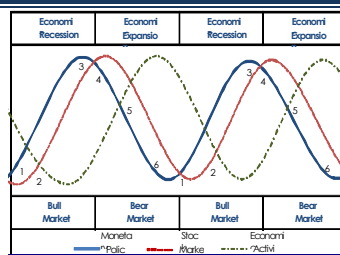


# The Financial Commentator

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A GUIDE TO  
FEDERAL RESERVE  
MONETARY POLICY,  
THE ECONOMY, AND  
FINANCIAL MARKETS  
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## **FEDERAL RESERVE**

As I have noted often since last summer, the majority of analysts and economists have underestimated the magnitude and scope of the contraction in credit, and its impact on the economy. They expected the usual prescription of lower rates and fiscal stimulus to save us from a recession in the first half of 2008, and then lead us into the promised land of a second half recovery. Alas, neither the Federal Reserve nor Congress is equipped to play the role of Moses.

In September 2007, the Federal Reserve had 90% of its \$900 billion balance sheet invested in Treasury paper. In order to back stop the ailing banking system, the Federal Reserve has reduced its holdings of Treasuries to 55%. In exchange for supposed AAA mortgage backed securities, AAA credit card and auto loan securities from banks and investment banks, the Fed has moved almost \$400 billion of Treasury paper from its balance sheet to the balance sheets of struggling banks and investment banks. This has never been done before. The Federal Reserve would not have taken this unprecedented action, unless they felt it was absolutely necessary to bolster these banks balance sheets in the short run, and ***shield them from additional losses in coming months.***

Banks are required to maintain specific levels of reserves based on their loan volume, relative to their assets. The quality of each asset is rated according to international banking rules, with assets like mortgage backed bonds, auto and credit card debt valued lower than Treasury bonds. A greater proportion of reserves from Treasury bonds make it easier for a bank to meet the minimum reserve requirements, as established by the Bank of International Settlement. By adding \$400 billion to bank balance sheets, the Fed has likely helped some banks avoid falling beneath the minimum requirements, which in the current environment could undermine confidence in the entire banking system.

As we have painfully learned, the rating agencies are fallible, and securities that were thought to be AAA have suddenly become junk. During a period of economic weakness, the credit quality of mortgage backed securities, credit card and auto loans deteriorate, which results in these securities being downgraded from to AAA to AA or worse. Banks holding securities that are downgraded are then forced to take a haircut on their reserve assets, and potentially add to their loss reserves, which reduces their capital. This weakens a bank's balance sheet and limits future lending, unless the bank raises capital. By swapping \$400 billion of Treasuries for supposed AAA bank loans, the Fed is shielding the banking system from the impact of quality downgrades

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in coming months that ***always occur in a period of economic weakness***. The Fed is effectively hiding \$400 billion of potentially questionable loans from scrutiny.

As I wrote in March, “*Small community banks and regional banks have avoided the sub-prime mess that has ensnared so many large banks and security firms. But, not wanting to miss out on all the real estate bubble fun, many of these banks have extended loans to local developers that are now in trouble. At the end of 2006, community banks had made commercial loans that represent 285% of their capital. Regional banks, with assets between \$1 billion and \$20 billion, have commercial real estate loans amounting to 272% of their capital.*” In recent weeks, a number of regional banks have been forced to raise capital and slash their dividend. On June 18, Fifth Third Banks’ stock fell 27%, when it announced it was cutting its dividend and hoping to raise \$2 billion in capital. Over the last year regional bank stocks have been slaughtered, with much of the damage occurring since March. Here’s a quick run down: Zions Bancorp -60%, Regions Financial -67%, Keycorp -70%, Fifth Third -78%, First Horizon National -80%, National City -86%.

In the March letter I asked some basic questions. “*Does anyone know, with any degree of certainty, what losses are likely from home equity loans, auto loans, and credit cards, if the economy grows just enough to avoid an official recession? With commercial real estate just beginning to soften, can anyone accurately assess what the losses will be a year from now? Let’s not forget that less than a year ago, the best estimate for sub-prime losses was \$50-\$100 billion, which has now grown to \$400 billion. The one thing we do know is that, as all these losses are taken, banks are going to reduce lending, raise capital to shore up their balance sheets, and cut their dividends.*” And it’s likely to get worse.

A bank classifies a mortgage loan as non-performing when the homeowner is more than 90 days past due on their mortgage payment. Once a loan is classified as non-performing, the bank has to increase its loan loss reserves. In recent weeks, ***a number of banks have simply changed the rules***. Rather than using a 90 day window, they have extended it to 180 days. This accounting change has enabled these banks to move hundreds of millions of dollars from the non-performing category to performing status. With foreclosures climbing, should we be surprised, if some banks decide to increase the grace period from 180 days to 365 days about 3 months from now?

In April and May, a growing number of economists and financial analysts presumed that with the rescue of Bear Stearns, the worst of the credit crisis was behind us. And, coupled with the \$168 billion fiscal stimulus plan, the consensus expected a second half rebound. I disagreed. Although the fiscal stimulus plan could be expected to give the economy a lift, it wasn’t going to be enough to launch a ***self-sustaining expansion***.

I pointed out that when the economy slows substantially, there is always a natural increase in defaults on home equity loans, auto loans, credit cards, corporate debt, and commercial real

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estate. Last fall, I forecast a slowdown in the first half of 2008, and noted that a slowdown would result in more loan losses for banks. In the February letter, I reviewed various default rates. *“At the end of 2007, the percent of home equity loans that were delinquent or in default has increased to 5.7% from 4.5% at the end of 2006. In the last year, the percent of auto loans past due or in default increased to 7.1% from 6.1%. According to Fitch Ratings, credit card companies wrote off 5.4% of their prime card balances in January, up from 4.3% a year before. It must be noted that the default rates for prime mortgages, home equity loans, auto loans and credit cards all increased, **even as the economy was growing faster than it will in the first half of 2008.**”*

On May 30, the Federal Deposit Insurance Corp (FDIC) reported on the health of the banking industry as of March 31, 2008. FDIC Chairman Sheila Bair said, “To sum up, while we may be past the worst of the turmoil in financial markets, we’re still in the early stages of the traditional credit stress you typically see during an economic downturn.” As I mentioned in the February letter, the FDIC is hiring. That’s never a good sign.

When the Federal Reserve was established in 1913, it was intended to be the lender of last resort during periods of financial stress. By allowing investment banks access to the Fed through the discount window, and swapping Treasury paper for supposed AAA debt, the Fed has clearly crossed a line for the first time in its history. The Fed has now become the lender of *first resort*, at least on that \$400 billion of debt they accepted from banks. It is important to understand that the Federal Reserve would not have taken these steps, unless they felt they had no choice. Doing anything less, would have amounted to asking the last person leaving the room to turn out the lights. And that was a risk the Fed was unwilling to take.

Against this back drop, a growing number of economists and financial analysts in recent weeks have begun a new game, “Guess when the Federal Reserve will raise rates.” Not surprisingly, a good number of the early contestants have been those who expected the economy to do well in 2008, or underestimated the severity of this crisis in credit creation. If this show gets syndicated, maybe they could get Larry ‘Right on Everything’ Kudlow to be the host. He’s certainly qualified, since he thought the Fed had done enough to stem the credit crisis, after the Fed cut rates for the first time last September! Some of the more excitable analysts hope the Fed will raise rates on June 25. As I said last month, *“Falling home prices and the contraction in credit creation are strong deflationary forces. Wage growth is weak, and in a slow economy most workers will not ‘demand’ higher wages. But the inflation in energy and food prices is real, as is the inflation from rising import prices. This is causing real wages to decline, which is also deflationary. Although the Fed members won’t be comfortable doing it, I think the Fed will choose to tolerate higher inflation, since monetary policy can’t increase the supply of oil or food.”*

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## **SECULAR TRENDS** – Part II

Since 1981, as I discussed in the Secular Trends portion of my April letter, the bond market has been in a secular bull market, which has brought short-term rates down from 21%, and long-term Treasury yields from 15%. The decline in the cost of money was made possible by a secular decline in inflation, which was aided by a number of factors.

A quick review of these factors will underscore my conclusion that the secular decline in inflation ended in 2004-2005. In 1981, Americans spent 4.5% of their after-tax income on gasoline. By 1998, it dropped to 1.9%. According to *Global Insight*, it's now just over 4%. Commodity price indexes, which measure food and raw material prices, also remained remarkably tame between 1981 and 2004. After adjusting oil and a broad basket of commodities for inflation, many commodities were cheaper in 2004 than in 1981.

Productivity gains kicked into high gear in the mid 1990's, making it possible for the U.S. economy to grow faster without pushing inflation higher. As faith that gains in productivity would persist, inflation expectations eased, and credit market participants became more confident that inflation would remain low. As a result, long-term rates fell, and credit spreads narrowed as risk premiums narrowed.

Over the last 10 years, U.S. companies have shifted an increasing amount of production to China, India, Eastern Europe, and other low cost venues. Lower cost imports pressured domestic producers to keep their prices low, to maintain market share. The primary beneficiary of offshore production was U.S. consumers. A study in 2007, suggested that the 100 million shoppers, who weekly visit Wal-Mart, save more than \$2,000 a year, with most of that savings due to cheaper imports. Although the addition of millions of workers to the global labor pool produced goods that saved consumers money, U.S. wage growth was weaker during the 2003-2007 recovery, than any other recovery since World War II. I'll let others decide whether Bush's tax cuts, or globalization played the larger role in keeping wage growth weak. However, if taxes are raised based on the belief that Bush's tax cuts were responsible, advocates may be disappointed with the results, especially if globalization played a bigger role than they want to acknowledge. Raising taxes on those who have the disposable income to keep spending, while the economy is weak, may result in unintended consequences that no one will be happy about.

The last factor that contributed to the secular decline in inflation and interest rates is statistical. Inflation figures being reported by the government have understated the real inflation rate, especially in the last few years. As I noted last month, the government revised the method and composition of the Consumer Price Index in 1983, and again in 1998. If the pre-1983 version was in use today, CPI inflation would be 11.6% as of April 2008. The post 1983 composition would peg CPI inflation at 7.3%, while the 1998 revision has the rate at 4.2%, as of May 2008. Over the last year, food prices are up 6%, and gasoline prices have soared 9.3%. In the first

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quarter and last year's fourth quarter, the government said the U.S. economy grew 3.5%, and that inflation was just 2.6% in both quarters, so that real GDP was up .9% in both quarters. Of course, if inflation was higher than 2.6%, the economy might even be in an "official" recession. Lucky for us that inflation has only been 2.6% in the world of government statistics!

The substantial increase in food and energy costs is fueling a worldwide surge in inflation. In Great Britain, consumer prices are up 3.3% over the last year. In the 15 countries of the EU, inflation is running at 3.7%. In Brazil, the increase is 5.9%, 8.5% in China, 10.4% in South Africa, 10.5% in Saudi Arabia, 11% in India, with Russia posting a 13.3% increase in prices. Many poor countries like Indonesia and Thailand are particularly hurt by rising food prices, since food costs represents 30%-40% of the average citizen's income. Since 2004, rice has soared from \$6.20 to over \$20.00, soybeans are \$15.35 a bushel versus \$5.00, wheat now fetches \$9.30 a bushel, up from \$3.50, while corn has almost quadrupled, rising from \$2.00 to \$7.25 a bushel. Although food prices are likely to moderate over the next year, high food costs are going to be a heavy burden for the world's poor in coming years.

There are a number of factors behind the surge in food costs. The shifting of production from the U.S. to other countries to access cheaper labor has given birth to a growing middle class in those countries, who are now able to afford to eat meat and chicken more frequently. This represents a fundamental shift in demand that will continue for a long time, and put a floor under crop prices. A severe drought in Australia, which is the second largest exporter of wheat in the world, hasn't helped. Congress' misguided decision to substitute corn ethanol for gasoline has not only pushed corn prices higher, but wheat and soybean prices as well. With government supported prices for corn, farmers planted more corn, and less wheat and soybeans. Wheat stock piles are near a 60 year low! This year almost 35% of the corn crop will be used for corn ethanol, which generates 30% less energy than gasoline. A recent study concluded that it will be more than 150 years before CO2 emissions will be less with corn ethanol than gasoline. Too bad all those who voted for the corn ethanol program, and still support it, won't be around to celebrate that special moment. Energy problem? Don't worry, Congress is working on it.

Two years ago, import prices were falling. Over the last year, import prices have increased more than 17%, reflecting higher production costs around the world. These trends are going to persist and represent an inflection point in the secular trend in inflation. It appears the secular downtrend in inflation that began in 1981 ended in 2004 or 2005. If this assessment is correct, investors will have to alter how they invest in U.S. stocks and bonds in coming years. Investors will have to learn how to invest in emerging markets and inflation oriented assets, despite the increased volatility in those sectors. Investors who rely on buying and holding any asset class are not likely to be rewarded, as they were between 1981 and 2007, when stocks and bonds trended higher. I'll discuss in coming months how I think various markets are likely to perform in this more challenging environment.

## **CRUDE OIL AND COMMODITIES**

With crude oil trending higher almost every day, and forecasts of \$150 to \$200 a barrel taken seriously, it doesn't seem that oil prices will ever come down in our lifetime. But a number of demand factors are softening that will cause a sharp decline in oil prices sooner than expected. The U.S. Federal Highway Administration estimated in March, (latest figures available) vehicles traveled 246 billion miles, which was 4.3% less than in March 2007. It was the first time driving has fallen in a March since 1979, and the largest year-to-year driving drop in the agency's recorded history since 1942. The economic influence of the U.S. may not be what it used to be in the global economy, but large shifts in demand in the U.S. still matter. The U.S. economy is going to remain weak well into 2009, with a chance of a deep recession developing next year. If this is on target, demand isn't going to snap back anytime soon.

China represents 40% of the annual increase in world demand for oil, with demand also rising in India and other emerging countries. However, the current inflation problem is worse in the emerging countries (Brazil, Russia, India, and China). This is forcing their central banks to raise interest rates and reserve requirements. Tighter monetary policy is going to result in a slow down in these previously fast growing economies. In addition, gasoline subsidies in Indonesia, India, and China have been reduced in recent weeks. Slower growth and less generous subsidies will reduce demand for oil modestly. Once the oil market perceives that overall demand is really weakening, the upward momentum in oil prices will also weaken. Markets that rise sharply have a tendency to decline sharply, as too many players are caught leaning. Since oil has garnered so much attention and has arguably been the strongest commodity, a sharp decline in oil would undermine every other commodity. If I'm right, this is no time to buy inflation assets, and a good time to lighten up if you own them.

## **DECOUPLING**

Last October and November, investors were told to buy stocks with overseas exposure, or invest in international mutual funds, since global growth was going to be so much stronger than in the U.S. I noted in my October and November letters that as the U.S. economy slowed we would be buying less from China, which depends on exports for almost 20% of its GDP growth. I also pointed out, "*The European Central Bank reported that in their quarterly survey of lending standards, 31% of banks tightened lending standards in the third quarter. That was up from 3% in the second quarter. Just as the tightening of credit standards in January 2007 in the U.S. signaled a sea change in the growth of credit here, the third quarter survey by the ECB signals that credit growth has already slowed in Europe. This will translate into slower economic growth in Europe. This is a crack in the global growth story not yet recognized.*" When the October letter was published on October 25, the Exchange Trade Funds for Brazil, Russia, India, China, and the Emerging Markets were priced as follows: Brazil \$79.74, Russia \$48.14, India \$77.80, China \$207.60, and Emerging Markets \$158.51. Here are the current values: Brazil

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\$89.10 +11.7%, Russia \$54.50 +13.1%, India \$57.60 -25.9%, China \$133.50 -35.6%, Emerging Markets \$137.50 -13.2%. If an investor had placed 20% in each of these ETFs to benefit from the global growth story, their overall portfolio would be down -10.0%. And if oil prices fall in coming months, there is a good chance Russia and Brazil will experience declines.

Investors must invest in these emerging countries, since growth in these countries will be greater than in the U.S and in the developed countries in general. However, the greater volatility that is inherent in emerging economies, as we have seen since last October, underscores my belief that investors can't just buy and hold these investments. Over the last 18 months, I have developed a Sector model that combines the fundamental analysis I do on global economic trends, with a disciplined technical approach. The Sector model ranks dozens of sectors according to their performance, thus identifying the best sectors, and which sectors to be avoided. It also provides signals when the top rated sectors should be bought and sold, so the large declines experienced by China, India, and the Emerging Markets aren't tolerated, as they would be in traditional asset allocation models.

## **BONDS**

In May 2003, the 10-year Treasury yield bottomed at 3.25%. Despite a 4.25% increase in the Federal funds rate between June 2003 and June 2006, the 10-year yield only advanced to 5.25%. This modest increase in the 10-year yield reflected a global savings glut, and the belief that inflation would remain under 2%. As the credit crisis gathered steam from last summer until March, the 10-year Treasury yield fell to 3.28%, and reversed. Technically, it appears that the 10-year Treasury yield has made a double bottom, which also means bond prices may have made a double top. The chart pattern in the bond market provides additional evidence from a technical perspective that the secular down trend in inflation from 1981 is over. This suggests that the yield on the 10-year Treasury bond could fluctuate between 3.65% and 5.5% for many years. If the U.S. economy remains as weak as I expect, bond yields should come down one more time, but not fall below 3.25% on the 10-year Treasury bond.

In the March letter, I thought yields would drift higher as investors lowered expectations for further rate cuts, and factored in strength from the rebate checks. In April, I thought the 10-year Treasury bond yield would be a buy if it reached 4.1%. As jabber about the Fed raising rates escalated, the yield spiked up to 4.32% on June 13. If the economy proves as weak as I expect, the debate could shift again, with the topic of conversation being whether the Fed will lower rates. I would sell half, if the yield drops below 3.8%.

## **DOLLAR**

If the European Central Bank follows through on its threats to raise rates in July to fight inflation in the EU, and the U.S. economy weakens enough to restart debate about additional rate cuts by

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the Fed, the Dollar could drop below the low of March. The rally off that low has not been very dynamic, which suggests another drop is possible. Although the non oil trade deficit has improved significantly over the last 2 years, the improvement has been overwhelmed by the cost of importing 12 million barrels of oil every day at ever higher prices. If oil does fall back to \$100.00-\$110.00a barrel for a period of months, the U.S trade deficit will show a dramatic improvement that would likely give the Dollar a real boost. Buy the Dollar, if its drops below the March low.

## **GOLD**

Every recession in the U.S. has caused inflation to drop. A global slowdown should cause the inflation rate to recede in the emerging countries as well. But if the secular downtrend in inflation since 1981 is over, worldwide inflation will trough at a higher level than it did in the 2003-2005 period. As the emerging economies begin to recover from the coming slowdown, commodities should begin the next phase of their bull market. I suspect that could happen sometime before mid-2009. In the short term, as long as Gold remains below \$962.00, the odds favor that a drop below \$840.00 is coming. If oil corrects in coming months, additional selling pressure will hit Gold as well. A trading low between \$800.00 and \$825.00 is coming. If a deep recession unfolds in the U.S., deflation could take hold for a period of time, which could cause a deeper decline in global inflation. I don't think that would be good for Gold. The next significant support area for Gold is \$700.00-\$750.00.

## **STOCKS**

I expected the market to rally after the March low, and thought the S&P could reach 1420-1440. This was achieved on May 19, when the S&P topped at 1440.24. It was my advice that investors should use this 'opportunity to lower exposure.' The U.S stock market remains in a cyclical bear market that has further to go. It is likely that the S&P will fall below the March low at 1257 in coming months. The fact that the market was not able to hold support at the 1360 level I mentioned last month is not a good sign. Short term, the market is modestly oversold, and is trying to hold the secondary low near 1310 from March 31. I don't think the Fed will raise rates, and that may be the spark the market needs to start a short covering rally. If it develops, it could carry to 1360-1375 by the first half of July. Conversely, if the market perceives a more hawkish tone in the Fed's statement, or oil spikes even higher, the S&P could spike down to the next area of support, a short-term low on March 20 between 1290-1300. At that point, the market would be oversold enough to launch a sharp rebound to 1315-1330.

A decline in oil prices would probably help the market, since it would ease some of the pressure on consumer incomes. But the overriding issue is that the economy is going to remain weak for an extended period. This means corporate earnings are not likely to rebound as much as Wall Street has forecast by the end of this year. Banks are going to have more losses to book in

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coming quarters from mortgage loans, home equity loans, auto and credit card loans. Later this year, losses from commercial real estate are going to become far more prominent, and, if all that wasn't enough, there will be a pick up in corporate debt defaults too. It is *possible* that the dislocation in March was just the first act of this crisis in credit creation. I certainly hope not.

Since July 1, 2007, the S&P is down about -12.0%. I am happy to say that my managed accounts are up almost 14% net of all fees, despite this very challenging environment.

## **Fourth of July**

Our economy is going through a rough patch, which could get tougher. The Fourth of July has reminded us of our blessings for 231 years. There may be fewer fireworks this year, but our faith in the future and each other will pull us through this trying time.

E. James Welsh