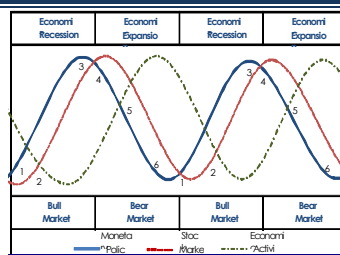


# The Financial Commentator

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

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## Managed Accounts:

My managed accounts gained 14.96% between July 1, 2007 and June 30, 2008. We were invested less than 20% of the time, and our largest drawdown was -2.56%. During the same period the S&P lost -12.0%.

## FEDERAL RESERVE

In my September 2007 letter I used the metaphor of a tsunami to describe the convulsion that swept through the credit markets in August 2007. Seismologists usually know within hours whether a 100 foot tsunami traveling 500 miles per hour, or a 2 foot wading wave was created by an underwater earthquake. I noted that we wouldn't know for a number of months the full economic impact, but the displacement, which occurred last August in the financial markets, left no doubt that a significant seismic event had occurred. There is the perception that a tsunami is a single giant wave of water that sweeps away everything in its path once it reaches land. As financial market participants have painfully learned over the past year, a tsunami is actually a series of giant waves, each one causing more destruction. After the first wave hits, survivors feel a sense of relief, as the sea water retreats into the ocean. But that respite is brief, as the second, third and fourth tsunami waves crash onshore. They seem to arrive without warning.

What most financial experts have failed to appreciate is that the current credit crisis has been building for 25 years. The last 25 years have been a glorious period of economic growth in the United States. There have only been two shallow recessions, each lasting 8 months. As I have noted many times over the last year, this remarkable period of growth was facilitated by credit creation. Between 1975 and 2000, credit grew 2.4% faster than GDP growth, and 3.7% faster from 2000 to 2007. In the process, debt as a percent of GDP ballooned from 165% to 353%. The enormous expansion in debt was made possible by a decline in inflation, a fall in short term interest rates from 21% in 1981 to 2% today, and a fall from 15% to 4% on longer term Treasury bonds. The decline in the cost of money launched a secular bull market in the stock market, with the DJIA rising from 780 in 1982 to 14,200 in 2007. Since monthly payments are determined by the cost of credit, lower interest rates made it possible for consumers to carry an ever increasing amount of debt. Consumer debt as a percent of GDP has soared from 44% in 1982 to over 100% today.

In 1982, home equity amounted to 75% of the average homeowner's home value. In March, I noted that home equity had fallen to 47% at the end of 2007, which meant the home debt ratio had increased to 53% from 25% in 1982. *As consumers pulled more money from their rising home values, the*

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*economy received a big lift as consumers spent more and borrowed more.* There was an economic benefit as the home debt ratio rose from 25% in 1982 to 53% in 2007. But home values have been falling since the end of 2007, and are likely to fall another 10%. Since the home debt ratio increases as the value of homes decline, the home debt ratio could climb to 58%, and the percent of home equity would fall to 42%. The key point, however, is that ***the economy will not have received any lift from this increase in the home debt ratio.*** In fact, the fall in home values and rise in debt ratios is contributing to economic weakness. This underscores the vicious impact of deflation, and why it is imperative for the decline in home prices to be arrested.

As the credit crisis gathered steam leading up to the initial shake out in August 2007, the consensus opinion was that the problem was confined to sub-prime mortgages. I never agreed with that assessment. When the largest increase in lending standards since 1991 was reported by the Fed in February 2007, I stated in my March 2007 letter that lending standards would be raised beyond sub-prime loans. I expected this tightening of monetary policy by banks to cause the economy to slow, and force the Federal Reserve to lower rates. I noted that banks would not lower lending standards in the face of a weak economy, which would offset the benefit of lower interest rates. As it turns out, banks have been forced to tighten standards aggressively. On August 12, the Federal Reserve released the results of its second quarter 2008 survey of bank lending standards. ***For most types of consumer and commercial loans, banks raised their lending standards to the highest level in history.*** Banks are severely limiting the availability of credit. Effectively, the only consumers and companies that can get a loan are those who don't need the money.

Option adjustable rate mortgages typically carry a low introductory rate, with an increase in the interest rate after five years, sometimes increasing the monthly payment by 60% or more. Although these loans were made to people with good credit, a large number of these loans are due to reset in early 2009. The value of option ARM mortgages resetting will rise from \$5 billion in the first quarter of 2009, to more than \$20 billion in the fourth quarter. In 2010 and 2011, quarterly resets will average more than \$25 billion. According to estimates by Barclays Capital and UBS AG, 45% to 48% of option ARMS originated in 2006 and 2007 will default.

The combination of tight credit and higher mortgage rates is causing higher default rates on Alt-A mortgages, which are one rung above sub-prime mortgages, and also prime mortgages. In the 12 months ending April, the percent of delinquent Alt-A loans soared from 3% to 12%. Prime mortgage delinquencies almost doubled to 2.7%. According to the FDIC, .91% of prime mortgages that were originated in the first half of 2007 were seriously delinquent after just 12 months, compared to .33% for mortgages originated in 2006. Freddie Mac reported on August 6, that 1.38% of the loans it purchased in 2007 were seriously delinquent, compared to .38% of loans purchased in 2006. The increase in prime mortgages is particularly disturbing, since prime mortgages are the largest category of the \$12 trillion mortgage market. The combination of a weak economy and tight credit is also causing a surge in bankruptcies. Over the last year, consumer bankruptcies jumped 48%, and corporate filings surged 57%. According to S&P, its corporate debt ratio hit a 5 year high in July, nearly doubling

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from July 2007. The increase suggests there will be a substantial increase in corporate bankruptcies over the next few years.

In July, there were 272,171 foreclosures, an increase of 55% from July 2007, and bank seizures of properties almost tripled to 77,295. Although home sales have increased, most of the increase is from the sale of foreclosed properties, with foreclosures accounting for 35% to 40% in some states. Although banks have stepped up their sales of bank owned homes, foreclosures are increasing at a faster rate, so inventories of bank foreclosed properties held by banks are still rising. The large volume of foreclosed home sales is causing home prices to fall. According to the S&P/Case Shiller home price index, home prices fell 17% between May 2006 and May 2007. As home prices fall, more homeowners are upside down. They owe more than their home is worth, which makes it easier to simply walk away. It is estimated that 20% of homeowners – basically anyone who bought after 2003 - are now upside down.

Over the last year, the Federal Reserve has used conventional monetary tools and unconventional steps never used before to slow, and ideally succeed in halting the decline in home prices. They've cut interest rates from 5.25% to 2.0%. Instead of bringing mortgage rates down, as one would expect, mortgage rates are slightly higher for conventional mortgages, and 1.5% higher for jumbo loans. The higher cost of financing is lowering affordability and demand, which means it's going to take longer to work off the 11.2 month supply of existing homes for sale. In the meantime, the accelerating pace of foreclosed home sales by banks is going to continue to put downward pressure on home prices. Since default rates on all types of mortgages are still climbing, the pipeline for increases in foreclosures is still building, which means ***the supply of foreclosed home sales has not peaked***. The only conclusion that can be drawn is that *home prices will continue to decline, even if the speed of the descent slows*. This means there are more losses for banks to absorb, bank dividends to be cut, and more capital raising ahead. All of which will keep the availability of money extremely tight in the short run, and the level of future lending weak.

Thirty years ago, a bank with a billion dollars in capital could generate \$8 to \$12 billion in loans. With the introduction and evolution of securitization, banks could sell their mortgage and auto loans, and credit card debt to Wall Street investment banks, which packaged each into securities, and then sold them to insurance companies, mutual funds, and investors around the world. Securitization did for credit creation, what Henry Ford's assembly line did for car production – it increased volume and lowered the cost of borrowing for consumers. Banks could originate more mortgage and auto loans and credit card debt, since they could readily move these loans off their balance sheet. As noted last month, *the global volume of securitized loans over the last year is down 80%*. If Wall Street can't securitize and sell mortgage, auto, and credit card debt, banks can't increase their loan volume. Banks have reduced their lending in part because they don't have room on their balance sheets.

The far bigger problem is bank loan losses. Over the last year, banks have lost \$480 billion and have raised \$345 billion, according to Bianco Research. This means total bank capital to support future lending has shrunk by \$135 billion. Since banks are allowed to lend \$8 to \$12 for every dollar of

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capital, the \$135 billion in less capital means future lending will be less, anywhere from \$1.1 trillion to \$1.6 trillion. The squeeze on bank balance sheets and future lending is going to intensify as banks write off more bad loans in every loan category over the next year. A few weeks ago, Merrill Lynch sold \$30.6 billion of Collateralized Debt Obligations for just \$.22 on the dollar. Since most banks currently value their holding of CDO's at \$.50 to \$.60 on the dollar, Merrill's sale will force other banks to mark down the value of their CDO holdings. According to Egan Jones Ratings Company, this could force world wide banks to take hundreds of billions of further write downs.

Total losses that banks will incur during this credit crisis range from the IMF's estimate of \$950 billion, to Investment Strategy's \$1.2 trillion, \$1.6 trillion by Bridgewater Associates, and \$2 trillion by Nouriel Roubini, who was one of the first economists to sound the housing and credit crisis alarm.

To date, the banks have raised about \$.72 for each dollar of write offs (\$345B/\$480B). If losses total \$1 trillion, and banks are able to raise new capital at the same \$.72 rate, total bank capital would shrink by \$280 billion. This would reduce future lending by \$2.24 trillion to \$3.36 trillion. If total losses are \$1.5 trillion, future lending would be reduced by \$3.36 trillion to \$5.0 trillion. Most likely, banks will not be able to raise new capital at the same \$.72 rate. As the cost of new capital increases, future lending will be weaker than these estimates. The economic implications are scary, even if total losses come in near \$1 trillion. Optimistically, we will be able to work through this challenge, but the economic cost will mean far weaker growth for a long time, especially when compared to the record of the last 25 years.

For the first time in its history, the Federal Reserve has allowed investment banks access to the discount window. It has also created so many auction facilities for U.S. banks and foreign banks; it has become an auction facility alphabet soup. The Fed has also taken the unprecedented step of transferring to banks almost half (\$400 billion) of its balance sheet holdings of Treasury bonds, in exchange for supposed AAA mortgage, auto, and credit card paper. I believe they did this to hide the losses banks would be forced to write off from this supposed pristine AAA paper. Who's kidding who?

Despite all these extraordinary steps to inject money into the banking system, money is not flowing into the economy. As noted last month, bank credit declined -1.9% in the second quarter, the largest three-month contraction since 1948. M2 money supply has decelerated from a 14% growth rate at the end of March, to near 0% now. Goldman Sachs estimates that commercial bank lending declined 9% in the year ending June 30, 2008. According to data compiled by Lombard Street Research, M3 money supply contracted by \$50 billion in July 2008, the largest one month decline since 1959.

Velocity is a monetary topic that gets very little discussion, even though it is integral to a healthy economy. Gross Domestic Product equals money supply times velocity, which measures how fast money is turning over. If money supply was unchanged, economic growth would speed up if velocity increased, and slow if velocity decelerated. I don't have 'official' numbers to cite, but common sense tells me velocity is slowing, as consumers cut back on driving and spending. The dramatic slowdown in M2 and M3 money supply growth, coupled with a likely slowing of money velocity, means we are in a recession that is going to last for awhile.

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One of the most dangerous experiences a pilot can face is if his airplane rolls into a spiral decline. As the plane falls and begins to spin, the pilot loses orientation, which makes it difficult to regain control. As the plane falls, it gains air speed, making it even more difficult to pull out of the spiral. The pilot usually has less than 30 seconds to make all the correct decisions. If he doesn't, the airplane gains so much downward momentum, it becomes impossible to pull out of the spiral. Pilots refer to this as a 'death spiral'.

The Federal Reserve has done everything it can to reflate the deflating credit bubble, and I'm sure they will be forced to do even more in coming months, since the plane they are piloting is still spinning and falling.

## **FDIC**

Last February, I noted that the FDIC was hiring, which is never a good sign for the economy. Of course, it is a sign that the banking system is ailing. The FDIC insures \$4.5 trillion of deposits and it has \$53 billion in assets. The ratio of assets to insured deposits on March 31, 2008 was 1.19%. The FDIC's takeover of IndyMac will shrink FDIC assets by \$4 to \$8 billion. In the next few years, it is likely somewhere between 100-300 banks will fail, with a large regional bank failure likely, and a big bank failure a distinct possibility. The FDIC charges healthy banks \$.05 for every \$100 in deposits, and up to \$.43 for weak banks. In order to increase its assets, the FDIC will increase the cost of its insurance. An increase of \$.10 per \$100 in deposit will yield an additional \$7 billion a year. Any increase in bank costs will strain the banking system further, but the FDIC really doesn't have a choice. The FDIC has a \$30 billion credit line from the Treasury that it has never used. I will be surprised if they aren't forced to draw on it in coming years.

If you have more than \$100,000 in a CD or on deposit with a bank, you can use the Certificate of Deposit Account Registry Service that can offer FDIC insurance on deposits of \$50 million, by spreading the money through the 2,274 participating banks.

## **COMMERCIAL REAL ESTATE**

It has been my expectation that commercial real estate would weaken in the second half of 2008 and into 2009. There are signs it is arriving on schedule. According to the Mortgage Bankers Association, commercial and multi-family lending activity fell 63% from Q2 2007 to the end of Q2 2008. The National Association of Realtors forward looking index is down -2.1% over the past year, and they are expecting "the weakest commercial brokerage activity in nearly 3 years." In July, the Architecture Billing Index held below 50 for the sixth consecutive month. The Index is designed to forecast actual construction spending 9 to 12 months in advance, and any reading below 50 indicates contraction. Commercial real estate values are going to fall, as more retail stores are shuttered and office vacancy rates increase. This is going to result in another wave of write downs and write offs for banks that will add up to many billions. There is never just one wave in a tsunami, and this is the biggest credit crisis since the 1930's.

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## **ECONOMY**

Economists who still proclaim that the U.S. economy is not or will not experience a recession should go into hiding, unless they desire to make an even bigger fool of themselves. Let's look at how the Commerce Department determined the economy grew 1.9% in the second quarter. Overall growth was 3.0%, and after subtracting the impact of inflation, real GDP grew 1.9%. But was inflation in the real world just 1.1% in the second quarter? At the end of June, Consumer Price Inflation was 5.0% higher than in June 2007. In other words, any reasonable inflation estimate would have pegged real GDP as negative.

A weak economy means job losses are going to continue, and the unemployment rate will climb to 6%, and probably higher in 2009. More job losses means more defaults on mortgage and home equity loans, auto loans, credit cards, and corporate loans. There is never one wave in a tsunami.

In the second quarter, exports added 2.4% to GDP. I expected global growth to show more signs of slowing by the third quarter, and the signs are everywhere. Last week, Japan, the second largest economy in the world, reported its worst quarter in seven years, as GDP contracted at an annual rate of -2.4%. On August 14, the European Union said its gross domestic product contracted -0.8%. In Great Britain, retail sales have fallen -0.9% over the last year, manufacturing output is down -1.3%, and home prices are 9% lower. I noted in my March letter that the U.S., Japan, E.U., and Britain represented 71% of world GDP, which made it nearly impossible for China and India to decouple, since they are export dependent and their combined GDP is just 7.5% of world GDP. Therefore, it shouldn't be a surprise that China and India are now slowing.

The U.S. economy is in recession, and the contraction in credit creation and future lending is going to keep the economy weak well into 2009.

## **STOCKS**

If there is one thing Wall Street loves, its investment themes. I try to discern whether a theme has merit by looking at monetary policy, overall monetary conditions, and the technical action in the market. When the first signs of the brewing credit crisis emerged in the spring of 2007, the consensus was that it would be manageable and limited to just sub-prime loans. Even the Federal Reserve expected the economy to improve in the second half of 2007, as the drag from housing waned. As a result, when the first tsunami appeared last August, few saw it coming. In my June 24, 2007 letter, I suggested selling in July when the S&P was above 1525, because the technical condition of the market had weakened. After the market bottomed in August and the Fed cut rates, most thought the housing problem had been resolved. Last October and November, investors were strongly advised 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. The favorite picks were to buy the BRICS – Brazil, Russia, India, China – and emerging markets. I noted in my October 25, 2007 letter and November letter that monetary conditions were getting worse in the U.S and European Union, which would result in a slowdown in the U.S. and Europe that would hurt China, India, and other emerging countries. On October 25, the Brazilian ETF

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was \$79.74, Russia \$48.14, India \$77.80, China \$69.20, and the Emerging Markets ETF \$52.84. The values as of August 22 – Brazil \$73.66, Russia \$39.47, India \$57.18, China \$41.38, Emerging Markets \$40.17. If an investor had placed 20% in each of these ETFs to benefit from the global growth story, their overall portfolio would be down -23.2%.

The March low was heralded as the bottom because the market was technically oversold, the Fed had slashed rates further, the \$160 billion fiscal stimulus plan would surely lift the economy in the second half of 2008, earnings were forecast to be up 73% year over year, and the demise of Bear Stearns marked the end of the credit crisis, since every previous crisis had ended with the failure of a large financial institution. I thought the March low marked a temporary low, since the current credit crisis appeared to be worsening, and the fiscal stimulus plan was not going to ignite a *self sustaining economic expansion*.

Since the July 15 low in the stock market, Wall Street has a new investment theme, which is to avoid international stocks, since the global economy is slowing. Their belief is that since the U.S. was the first one into this slowdown, we'll be the first one out, especially since the Fed has cut rates so much and the other central banks haven't even started cutting. The best thinkers on Wall Street believe the best way to cash in on this new theme is to buy small cap stocks, since they aren't dependent on international sales. There are several problems with this advice. Small cap stocks may not be dependent on international sales for growth, but they are dependent on the economic environment in the U.S., which is likely to be hostile. Even strong small companies need bank financing to finance their growth. As noted, bank lending standards are at record high levels for small companies, so getting financing is going to remain difficult for some time. Last week, the National Federation of Independent Business reported that the percent of small companies that plan to increase capital expenditures was the lowest since 1975. Small cap stocks have maybe 5% upside potential, but they could fall more than 20% from current levels.

The stock market is in a cyclical bear market that did not end on July 15. I recommended cutting exposure in July 2007 and October 2007, when the S&P was 1525-1550, and in May when the S&P was 1420-1440. Last month, I suggested a rally to 1310-1325 would present another opportunity to sell. So far the high is 1313. Sooner or later, the Treasury is going to nationalize Fannie Mae and Freddie Mac. Some will proclaim that this signals the end to the housing crisis. Stabilizing the mortgage market, and ideally, bringing mortgage rates down will help. In the short run, this news could help push the S&P up to 1325-1350. If it does, it will provide another selling opportunity. Nationalizing the GSE's will not reflate the credit bubble, or prevent housing prices from falling further.

Now that Wall Street has abandoned the global growth story theme it might be time to take a closer look. A small trading position in the China ETF (FXI) below \$38.00 could catch a bounce in the Chinese market, and would be 46.5% from its high. The Emerging Market ETF (EEM) is also worth a small trading position under \$38.00, or 28.1% from its high. The Oil stocks ETF (XLE) is attractive under \$69.00, 24.5% below its May high of \$91.42.

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## **BONDS**

Last month, I wrote, *“Although the economy is going to remain weak, and the Federal Reserve is not likely to raise rates, the problem facing the Treasury bond market is supply. The budget deficit is going to rise, as the economy generates less tax revenue and spending increases.”* The fiscal deficit for the budget year beginning October 1, 2008 is likely to be \$550 - \$600 billion. That’s a lot of money and supply for the bond market to absorb, even if the economy remains weak. I think the 10-year Treasury bond could fluctuate between 3.65% and 5.5% for many years. In April, I suggested buying the 10-year Treasury bond when the yields exceeded 4.1%. In June, I suggested to sell half when the yield dipped below 3.8%, which it did on July 10 and July 15. Last month, I suggested selling the other half on any 10 basis point reversal higher, which was triggered at 4.02% on August 6.

## **DOLLAR**

In March and April, I thought the Dollar was near a low, as sentiment was almost universally negative, and the global economy was likely to slow and lead the ECB to cut rates. I was wrong about the ECB, but the global economy has slowed. I recommended buying the Dollar on any dip below the March 17 low of 70.70. On April 22, the low was 71.19, and on July 14 the Dollar dipped to 71.31. Close, but no cigar. Last month, I suggested shorting the Euro on any new high. I thought it could drop to 1.5300, with the potential to decline to 1.4900. Never got the new high, but the Euro did fall from 157.29 on July 28 to 146.09 on August 19. Since the low on July 14 at 71.31, the Dollar has recovered to 77.41. These are enormous moves in just 3 weeks.

From a long term perspective, the Dollar made a low in February 1991 at 80.34, September 1992 at 78.19, April 1995 at 80.22, and December 2004 at 80.39. This means there is a wall of overhead supply between 78.19 and 80.39, which is not much higher from current levels. *The rally in the Dollar was not the result of a positive change in the outlook for the U.S. economy.* It was the result of a perception change regarding the economies of Great Britain, Japan, and the EU for the worse. Sentiment toward the Dollar has improved noticeably with the rally. Declines in bull markets are often violent, as longs late to the party are washed out, while rallies in bear markets are intense due to short covering. The declines in the Euro, gold, oil, and other commodities bear the characteristic of a bull market decline, while the Dollar’s rally fits the bill of a bear market rally. If the U.S. remains as weak as I expect, another period of Dollar weakness is likely. Establishing a small short position in the Dollar on any move above 78.00, or long position in the Euro under 144.75 makes sense in expectation of a rebound in the Euro to 148.50, and fall in the Dollar to under 75.00.

## **GOLD**

Last month I wrote, *“A trading low between \$800 and \$825 is coming. As oil declines and the global economy slows, inflation will come down. If gold drops below \$840, it will be time to stay on our toes, since this bottom could be significant.”* The decline in Gold proved more violent than I expected, falling to \$780. Before year-end, I expect a number of central banks to begin cutting rates to offset growing weakness in their economies. This should be bullish for Gold, just as Fed easing was in

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August 2007. The short term could prove tricky though, since the Dollar *may* have one more push above last week's high. If this develops, I would expect the Euro, Gold, and oil to make one more new low beneath their lows last week, before a solid rebound begins. The charts would look better with another drop, but it is *possible* that a trading low is in for Gold, Gold stocks, and oil. I try to be as specific as possible in my monthly letter, but this is one of those times I simply do not have a high level of conviction. There is also the risk that deflation may cause a selling wave that hits *all* asset types. Since the low may be in, establishing a small position in Gold stocks makes sense, especially since Gold stocks are historically very cheap relative to Gold. The easiest way is to buy the Gold stock ETF, (GDX) under \$36.00. If Gold drops below \$780, I'd add to the position.

E. James Welsh