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Key Views, Overview,...

...Rescue Round One Recap, The Next Bubble, The Fiddler's Notion

Key Views

- The Senate hearings on the Paulson economic rescue plan were just the first round of the three round bout that continued today with Mr. Bernanke's testimony at the Congressional Joint Economic Committee. Needless to say, these were contentious get-togethers on a couple of different fronts. As we have noted previous, the level of economic and financial market sophistication which leading members of Congress have developed in recent years is impressive. While there was much meaningful discussion and questioning, it ended with the impasse so clearly articulated by committee Chairman Dodd that while some form of government action is indeed likely necessary, the Paulson plan as presented was not acceptable; it needs more work.
- As the hearing was a very open-ended discussion, our analysis of it is going to be more anecdotal than the relatively deductive analysis we normally attempt to provide in our topical discussions. Yet there were a couple of very pointed insights from the committee members that deserve mention here. The first is the very practical suggestion by New York Senator Charles Schumer that the necessary funds be provided in a series of tranches rather than one massive \$700 billion transfer. That is likely the way any reasonable corporate CEO would require his treasury to pursue a radical spending plan; so why not the US Treasury? The other pointed comment that was another really brilliant articulation of the problem we have highlighted all along was from Idaho Republican Mike Crapo. After discussing the problem of the rating agencies using mark-to-market re-assessment of bank portfolios based on any current fire sale prices, he noted that foreclosure prevention was going to be a key element of any solution to the illiquidity of the securities that Mr. Paulson sought to ring-fence. His bottom line for the plan's weakness was that the lack of foreclosure mitigation was a "gaping hole" at the center of the plan. We could not have said it better.
- The further influence from that foreclosure pressure on the US housing contraction that even Messrs. Paulson and Bernanke freely admit is the core of the problem was once again in evidence in recent statistical releases. While under the current fraught circumstances most economic data is less relevant, as we noted Monday this week's US housing data was obviously important ancillary information as hearings proceed. Yesterday's US OFHEO Home Price Index for July was minus 0.6% on the month (well below the -0.3% estimate) and minus 5.3% on the year. Today's US Existing Home Sales (AUG) release saw a 2.2% decline with prices down a record 9.5% on the year. That sort of weakness illustrates how a lack of foreclosure mitigation has also robbed the powers-that-be of a reasonable assessment of MBS mark-to-maturity valuation.

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- While contentious discussion was the driving influence behind the continued fall in equities that began on Monday in anticipation of just this sort of stalled effort, that still leaves all of the technical trend perspectives and key price levels very much the same as in yesterday's **TRENDVIEW GENERAL UPDATE**, with only very modest further psychological perspective necessary. The first of those is that the weakness of equities is obviously still more so directly correlated to weakness in the short money futures, commensurate with the additional strains on liquidity from nervousness about the overall fate of the markets. While it might be of some comfort that the greatest pressure was on the December (lead contract) Eurodollar future while the forwards held up better than not, the full resolution will not take place until the overall crisis atmosphere has abated. It is also of note that the last couple of days' sharp drop in equities prices has not brought any joy to the long dated government bonds. That could be the beginning of an exacerbated effect from the additional deficit spending having a negative impact above and beyond the negative real yields encouraged by the "haven" effect that we have reviewed extensively previous. We will have more to say on that below.
- Other market tendencies also remain very much the same as expressed in yesterday's **TRENDVIEW GENERAL UPDATE**. As already evidenced by the early week activity, that means the DJIA is now capable of trading both above and below the previously violated 11,100-10,975 weekly UP CPR. That leaves resistances into 11,500, 11,750-800 or 12,000 at best, and lower interim support at 11,100-10,975, with major 10,700 support now having its Tolerance to 10,500-450 reinforced by last week's activity; and others following the DJIA lead. Of course, that 10,500-450 Tolerance is the failsafe this side of a swing down to interim support at 10,150 and more major 10,000 area support. It is still in the critical nature of the 10,500-450 area therefore that any failure below that level would maintain enough trend volatility to leave in question whether the equities can indeed evolve from the vicious accelerated bear trend into a more gradual 'eroding' bear trend.
- As noted previous, the US dollar resurgence was also vulnerable to a meaningful correction in any event after the impulse wave of the overall trend reversal was priced into the market as the US Dollar Index hit the .8000-.8100 area. There is now room for a US Dollar Index reaction to .7500 or even .7200, with commensurate reactions against the other currencies as was noted in yesterday's **TRENDVIEW GENERAL UPDATE**. That was also very similar for the recent resurgence in Crude Oil, as the November contract has pushed back up toward 110-112 resistance even as it assumes a much lower value after the heavy squeeze in the expiring October contract saw it push all the way up above the 120 area resistance. Please refer to yesterday's analysis for further indications.

Overview

We will be much briefer than in last week's *magnum opus* now that the members of the Senate committee focus on including some form of foreclosure mitigation as a very rightful part of any attempt to stabilize the mortgage backed securities (MBS) market. As we have been adamant that is the only way to ultimately re-liquefy the MBS market, we will visit some of their comments in the hearing recap below.

The additional analysis that follows also revisits a previous perspective of ours from back in April that the government bond markets are the next bubble that is already bobbing around in our midst. As noted above, if the additional issuance necessary to fund major federal expenditure on MBS and other securities is the reality, that only adds further weight to the existing lack of real yield, most especially in the US.

While that removal of the "haven" status of the long dated "govvies" will only become a meaningful reality once the situation is stabilized to a degree that restores some confidence in the fungibility of lesser credits, that is the entire point of the financial system rescue exercise in process at the present time. It is of note that this will create conditions that have not been in effect for some time, even if that is significantly disturbing for the long dated government bond markets, especially in the US that has been previously (and rightfully) deemed the center of economic problems.

In that regard it is easy to imagine any restoration of true liquidity to the interbank lending market leaving short term interest rates back toward reasonable levels (i.e. far less of a premium to central base rates), while government bond yields head higher. A strongly positive yield curve to further repair banks' balance sheets? You never know; it just might happen.

Rescue Round One Recap

To the degree to which this is anecdotal as opposed to more linear deduction that we prefer to focus upon in the analysis of the overall situation, yesterday's coverage of both the Senate committee hearings as well as *ad hoc* comments from other quarters deserve a bit of an airing for those who did not have the luxury of observing the proceedings firsthand.

We began by revisiting a point that we have noted on more than a few occasions: the extent to which members of the US Congress have obviously taken great pains to educate themselves in matters that relate to the economy, markets and the financial services industry. Some of that they use in a most constructive manner; yet it also leaves even their critical observations that much more meaningful and telling.

Last but not least as we listened to the members of Congressional committees hold Mr. Paulson's feet to the fire over the nature, size and efficacy of his plan, let's not forget that there is plenty of blame to go around for this mess in the first place, and no small amount of that rests with some of the members who are currently grilling the good Treasury Secretary and the Chairman of the Fed. Yet even on that front, it is very hard to apportion blame that has anything to do with malicious intent.

While the Republicans still controlled the Senate in 2006 there was indeed a move to reform Fannie Mae and Freddie Mac that was forestalled in subcommittee by the then Democratic minority. While their motivation was charitable, as is so often the case the path to Hell is paved with the very best of intentions. As we shall review in **The Fiddler's Notion** this week there is a current topical bent to **Plenty of Blame**, that has a *de facto* 'race card' aspect.

We must admit that some of our thoughts and observations in this area amount to self-aggrandizement, as the preference of the Senators is to see some form of the foreclosure mitigation that has been a key theme of ours since the late part of 2007. However, as opposed to the suspicion that would have been so prevalent previous that this was just so much populist partisan politics playing to the Main Street gallery, in this case it does seem to make sense that the discussion of how to re-liquefy the MBS market includes that aspect. There is also the issue of meaningful and fair valuation for the currently illiquid securities that would be well-served by some sort of grassroots indications as to what the lenders and borrowers are willing to accept as a realistic adjustment to the individual home prices on a case-by-case basis.

Of course, in addition to the unnecessary and now potentially tragic sharpness of the contraction in US housing, this also relates very strongly to a good point Mr. Bernanke raised yesterday: the difference between the current fire sale mark-to-market prices that cannot reasonably be used as a basis for any government rescue plan, and valuations that it is reasonable to imagine would come from a more circumspect assessment of the mark-to-maturity value of currently illiquid MBS and other securities.

Even before yesterday's hearing began there was an interview with Michigan Governor Jennifer Granholm. As we have highlighted in previous analysis, even by comparison with California, Arizona and Florida the situation in Michigan stands out as a specially dire straits for the housing market and associated foreclosures.

For any of you who have not already seen it, we revisit the indications from a speech by Federal Reserve Bank of San Francisco President Janet Yellen that we focused upon in previous analysis. In the graphs associated with her speech it was glaringly apparent that the combined impact of heavy marketing of Hybrid Adjustable Rate Mortgages and the sharp contraction in the US domestic automakers businesses and inflicted upon Michigan a particularly pernicious form of the housing downturn.

In her CNBC interview Governor Granholm was very clear on a key point that surfaced repeatedly during the Senate committee hearings yesterday: There needs to be something in it for the folks who are paying the bill, which means a link to make sure at-risk borrowers see some form of relief. There was another indication of the trouble that Mr. Paulson and Mr. Bernanke were going to experience from CNBC financial services reporter Charlie Gasparino early in the morning. He noted that Mr. Paulson was losing the 'battle of the rhetoric' with the interests from Main Street.

The basic thought behind his suspicion was the sentiment that offsetting previous losses of the firms and now directly buying MBS raised a question: Why should Main Street bail out the guys who created the mess in the first place? While that is very possibly a misguided perspective, any insensitivity to the fact it is out there is an impediment to the rescue plan moving forward on a purely political basis, which is what it now comes down to with Congress.

Governor Granholm was very explicit on that same theme around the same time yesterday morning. She expressed the concerns of her constituents in just so many words when she inquired (verbatim), "Why am I backing the folks who built this house of cards when nobody is backing me?" However populist that may sound, we have felt for some time that in this instance it is just possible that the 'little guys' have more sensible instincts than very sophisticated Masters of the Universe. Mr. Paulson in particular seems very enamored of proving that the situation can still be put right with a top-down dynamic leadership effort from a Wall Street-style if approach.

Without in any way diminishing the major contribution some of Wall Street's creative finance has indeed provided Main Street at times, at present Wall Street's intellectual capital is as diminished as that of its financial variety. After hundreds of billions of dollars have already been splashed out in the futile attempt to restore liquidity to the interbank lending market, and massive expenditures and/or guarantees had been provided to prevent the failure of various financial services entities, the public has a reasonably well-founded suspicion that simply throwing money at the problem is not going to be any more productive. And there is that overt resentment that the \$85 billion committed to save AIG was committed with no previous or subsequent comment on the \$85,000 that might prevent a foreclosure! That's a quantum factor of 1,000,000: 1.

And that was just one instance of the major swathes of capital that have been expended or committed to guarantees. While not a gift to the financial services industry from which their executives will reap a windfall or any of the employees will derive any greater job security, it is still viewed as a 'gift' from the Main Street purse to offset a portion of the previous sins.

Expressing that sentiment is clearly a big part of the committees' agendas this week on behalf of their constituents, whether their subsequent questions and comments took the form of likely helpful suggestions or downright derisive grilling. However, it is notable that the criticism (whether constructive or condescending) was very bipartisan in nature. While the Democrats are possibly taking some election year liberties with veracity in their criticism of how the situation became so dire, there was no less pointed an assault on the efficacy of the plan and the causes of the problems from Republican members.

Senator Jim Bunning (R-KY) is always among the most irascible members of the committee on the subject of the recent effectiveness of the US Treasury and most especially on what he characterizes as the multiple sins of the Fed. In fact, in the joint hearing which occurred in mid-July on the potential to expand the current powers of the Federal Reserve, his position was (and this is an obvious paraphrase of what he actually said), "Over my dead body."

So it was not necessarily a surprise when he began his discussion with Mr. Paulson by focusing on the fact that the Treasury Secretary had spent the period between 1999 and the middle of 2006 as Chairman of Goldman Sachs. Mr. Bunning then went on to a series of quasi-rhetorical questions (of a very derisive sort) about just how could Mr. Paulson have been so very confused by complex structures of financial instruments causing the current problems?

The obvious implication was that the good Treasury Secretary either had indeed, or certainly should have, known that the "too complex to analyze" debt securities which his previous firm along with many others were creating were a problem waiting to happen, and a major contributor to the sustained generation of mortgages of a pernicious nature

Of course, Mr. Paulson responded that at his senior level he was relying upon various lieutenants and other company officials that the new hybrid loans and the derivative securities into which they were being folded were of the high quality being represented at the time. It seemed neither productive nor relevant to note that this was based upon the assessment of rating agencies that were in turn relying on the very guarantees of the Government Sponsored Enterprises that later came into question. Yet, just as Senator Dodd was very polite in mentioning that they had collaborated in the passing of the combined GSE and Hope for Homeowners Act back in mid-July without noting that administration approval was only forthcoming when the GSE failure cannon was pointed at their heads, Mr. Paulson likely saw no benefit from revisiting Congress' culpability in the bad end they are attempting to address.

Mr. Bunning's testy tone notwithstanding, he did visit another clearer and telling point for most committee members: on January 20th of next year Mr. Paulson and all of the current US Treasury team will be on their merry way to their next professional horizon while members of the committee will for the most part still be answerable to constituents on the success or failure of this plan out into 2010 when some of them, and all members of the House, will need to face the music in the next midterm elections. In US football terms, it is okay for Mr. Paulson to attempt a "Hail Mary" long pass to rescue a victory for team Bush in the game's waning minutes; for Congress it's still only half time.

There were quite a few other telling comments from both the committee and other sources yesterday. One of the questions which Mr. Bernanke quickly glossed over in his response has some implications we have explored previous on the issues surrounding the conservatorship into which Fanny Mae and Freddie Mac were recently placed. That is the degree to which some of the US regional banks had relied upon the government backing for the GSE's as they invested in the preferred stock of those organizations. While the specific plan still held out a faint possibility of that stock recovering some value, as we noted previous the conditions under which that would occur our equivalent to chances one will soon be able to drive an automobile to the moon.

Mr. Bernanke noted that there had been some discussions of finding a way to restore the asset value of that preferred stock to the affected banks. While it was enough of a minor sub-topic in the context of the primary focus of yesterday's hearings to not warrant any further exploration at that time, it was a most troubling response. Unless it was an incorrect inference that the banks had some sort of preferential status by which their interests might be made whole, it seems to indicate the standing of different holders of that preferred stock would be treated in a dissimilar manner by the Treasury and the Fed in a wholesale dismissal of the concept of a unified class of shareholders. If the banks' holdings of between \$10 billion and \$15 billion of that preferred stock are to be resurrected, what about the other folks (that include individual investors and pensioners) who also relied on the previous assertions from Treasury and the Fed that the GSEs' balance sheets were sound (which proved significantly specious) as they encouraged folks to invest in them?

And they wonder why the public is so suspicious of the current assertions from Messrs. Paulson and Bernanke.

At various points previous we questioned whether Mr. Bernanke's changes to the more directive style of his predecessor were possibly less than effective in him evolving into a prescient prime mover from his previous acclaimed academic status. Among the most telling of these were his notions on transparency and the degree to which a central bank can afford to be 'data driven.' Each of those was ineffective in cooling down the bubble mentality when the DJIA was the first equity market to push to a new high above its 11,750 Dot.Com Bubble extreme. In addition to our fear at that time Mr. Bernanke would (in words of the French fabulist Jean de La Fontaine) "...meet his fate on the very paths he chose to avoid it" (and take us all along for the ride), there was an additional point made at various times along the way that his lack of effectiveness was potentially going to diminish the Fed's standing and influence. That seems to be the unfortunate state of affairs at this time. While that encourages more intervention on the part of Congress, at least that is significantly more informed and constructive than in days of yore.

While there were many other comments and questions that deserve mention, possibly one of the most telling on the reasons the Paulson-Bernanke approach is coming under extreme scrutiny relates to the points we have just reviewed. While he was polite in his support for what he was sure was a sincere best effort, Republican Senator Bob Corker of Tennessee might have summed up a good deal of the discomfiture apparent on the rest of the committee, whether they took a cordial or aggressive approach to the rescue plan. It also relates to the 'fallen idol' figures that the previously highly esteemed Secretary and Chairman have become. Corker noted that they collectively seemed "... more of a deer in the headlights than talent." That's the real bottom line for failing to help Main Street, and then asking for a massive sum to extend a strategy that it appears has already failed for a full year.

The Next Bubble

As we noted last week in our assessment of why the Congressional plan to provide the sensible Hope for Homeowners at-risk borrower relief was more enlightened than the administration's 'just absorb the write-downs' approach, to this point the highly sophisticated powers-that-be at the Fed and Treasury have splashed out liquidity, and splashed out liquidity, and splashed out liquidity, and,... well, you get the point.

Apparently the US long-term government debt market gets the point as well. It is most telling that this previous "haven" vehicle had benefited so markedly from the flow of funds from those who were less than capable (and that might mean anything from regulatory requirements to psychological aversion) of placing their investable capital in any lesser rated form of fixed income vehicle. It has been nothing less than breathtaking in recent months for experienced portfolio managers and dealers to witness the "govvies" sustain premium pricing with such a significant level of negative "real yield."

The half-joking question has been, "So who would like to lock a major chunk of their net worth away for ten years at a percentage yield that locks in a significantly negative real return of anywhere from one half of a percent to a full percent relative to prevailing headline inflation?" Of course, that is meant as a sardonic observation on the degree to which preservation of capital has become either requirement for those with a fiduciary responsibility, or preference for those who are simply looking out for their own interest.

Yet the recent action in "govvies" is most instructive as to what is likely coming next. In the context of current extreme equities volatility it is telling that December 10-year T-note went from a bid in the continuation congestion area around the low 118-00 area to back down into its 115-00/114-16 trend support in the proverbial heartbeat.

Even more telling is the degree to which it has failed to recover very much ground back above the 115-00 area as the DJIA came plunging back down to the area of the mid-July lows at 10,828. While the initial panic drop into that area back in July only saw the lead contract T-note (September contract at the time) push up to the 116-00 area, that is still better than the level at which the December T-note is now trading. On the subsequent equity market selloff that threatened and then succeeded in violating that DJIA 10,828 previous low, the recently expired September contract pushed up above 120-00 (i.e. to the best levels since mid-March, and even discounted December contract managed to trade into low 119-00 area prior to falling back sharply on the equities recovery late last week.

The implication? That the long dated government bonds are stuck in a "good news is bad news" and "bad news is bad news" conundrum as it relates to the future path of the equities market, and attendant implications for the US economy. The first of those indications is that historically 'good news' has indeed been bad news for the long dated bonds, because of the inflation implications. Any real bottom in the equities market that is good news on the economic front certainly would indicate a potential for the basing of the economy while inflation remains at troubling levels.

However, because of massive expenditure that seems necessary to rescue the system, any near term bad news that spells trouble for the equity and credit markets points to an even more massive rescue package than the one currently under consideration. It is implicit that in a weak economy that will not come from the taxpayer's pocket. As such, it can only come from deficit spending into lowered tax revenues, and that will tip over the fiscal balance in a way last seen in the 1970s. While European long ends led the way down this spring, the US may be next.

The Fiddler on the Roof is part of eastern European folklore. His essence was beautifully captured in the late nineteenth century book by Sholem Aleichem, *Tevye the Dairyman*. Yet, the popular name taken by the musical production is based on the quasi-cubist painting by Marc Chagall. 'The Fiddler' is a metaphor for survival in an uncertain world that is very apt for capital markets participants at all times; especially during the more volatile, erratic phases. As luck would have it, about ten years ago I came across a unique, purple palette print of him. My wife was extremely hesitant to even allow the green-faced man in the house. He ended up on my office wall. I now realize this is just as it was meant to be, as he looks over my shoulder in the rear view mirror on my computer monitor. The Fiddler's Notion_{SM} is devoted to observations on risk that may not correlate with some of the typically market trend oriented factors in our other analysis. It is fitting that one involved in such a risky pursuit is looking over my shoulder. Whether or not you like to think about it, he is likely looking over yours as well. So welcome up to the rooftops, where you can share the Fiddler's perspective.

Plenty of Blame

Any meaningful review of the extensive causes of all of the aspects of the current failures of the financial services industry, the instruments they created and the travails of investors who put their stock in them would take more of a book than a reasonably brief assessment in a market report. As many of the facts surrounding this are well known, and it would be a waste of analysis powers and your time to revisit them all here.

Amongst the research departments at the securities firms who originated the concept of blended debt derivative securities, the mortgage origination companies which were more than happy to extol the benefits of the Hybrid Adjustable Rate Mortgage (HARM) to the enthusiastic borrowers, the banks and securities firms who were hungry for more of that product, to implicit guarantees from Government Sponsored Entities, to the rating agencies who were also more than happy to rely upon that implicit government guarantee, to the US central bank that failed from late 2006 to lean against what was a fairly clear bubble mentality, and SEC that did not warn securities firms about spinning specious instruments, there is certainly plenty of blame to go around.

And that should include portfolio managers and individual investors who were chasing yield in a diminished return environment, and used that as an excuse to put aside their normal due diligence on the nature of the underlying assets upon which the debt instruments they were buying were based.

Yet, all of that said, some of the folks who are questioning (even constructively so) the value or process for the current proposed rescue plan are some of the very same folks who stalled previous reforms that might have diminished if not fully eliminated the problems we are currently facing. When the Republicans still controlled the Congress in 2006 there were indeed GSE reform bills put forward. Back at that time Democratic Senators stalled that legislation in hearings by the subcommittee considering it, and it never came to a vote. And their highly politicized basis back at that time for killing that measure? The degree to which any restraint on GSE's lending would represent a drag on the otherwise enlightened goal of expanding minority and lower income home ownership. So the "race card" has not just surfaced for this election. As noted above, the path to Hell,... ..and all that...

We look forward to providing further comments as the situation warrants, and hope you have found these perspectives helpful.

-Rohr

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