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Overview, Markets Summary,…
…Still Not Ready, Flailing III, RTC-2008 III, Solution at Hand?

Key Views

- **To once again quote that Master of Malapropism Yogi Berra (NY Yankees player and coach), "It's like *déjà vu* all over again." The equities have recovered from a sharp decline into an FOMC decision today that is anticipated to be constructive. The Fed is expected to provide extensive accommodation even though in the short term various economic data is stronger than expected. To cut to the chase, we believe that it has learned the lesson of disappointing the equities by being too incremental at the tops of rallies in October and December: look for a 50 basis point easing today even though the Fed does not have the power to 'cure' the equities' overall weakness.**

- **Kind of ironic isn't it? The trend decision for the equities remains much the same as two weeks ago when a downbeat Beige Book in preparation for today's meeting left the DJIA (still the trend setter for others) failing from no better than 12,500-600. While that is quite a bit lower than 13,550 on the holiday rally, that area is also a major channel DOWN Break into violated major congestion and Fibonacci levels: as usual, the ultimate indication is once again not from the FOMC, but from the market response.**

- **Quite a few folks have noted that last week was a weekly UP Closing Price Reversal (CPR) in the DJIA. That was also true for the S&P 500, yet not the balance of global equity markets (including the NASDAQ 100.) That brings us to the related issues of conformation and confirmation. Considering the drop to 465 points lower early last week (actually 700 points in electronic trading Tuesday morning) and recovery to nearly 400 points higher on the week, last Friday's finish of up just 107 points was a very weak signal in spite of the huge range. That poor 'conformation' is a warning sign the market might still Negate the UP CPR by failing its 11,940 Tolerance. As to 'confirmation', that requires a push above the UP CPR range. In this case that would be a convincing surge above… 12,487; as in violating the 12,600 area resistance!**

- **In the face of a near term rangebound equity market, the fixed income has also remained rangy, with the March T-note stalling into the low-mid 117-00 area, yet finding good support back into the 116-00/upper 115-00 area; likewise, if weaker, for Europe.**

- **There is also really no surprise that foreign exchange has seen the US dollar revert to weak sister after the removal of any vestige of short term yield differential support. The US dollar Index remains vulnerable to a failure below .7560-40 leading to .7450.**

- **While energy markets finally took the prospect of a slowdown serious, March Crude Oil managed to hold 87-86, and rebound above 90-89. Resistance: 94-59 and 100.**

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Overview

This is really quite an interesting week on so many levels that the fact the FOMC decision is thrown in for good measure just happens to add to the intensity. As opposed to last week when the markets were allowed to go softly, softly into the weekend, this week the real cannon fire just begins today, and remains right through Friday.

It is very impressive (and a bit daunting from an analytic perspective) to have seen the very soft (as expected) US housing, very strong (albeit ever-volatile) US Durable Goods (DEC) in the face of very weak Consumer Confidence (JAN) along with weakish minor numbers from Europe, and still see the equity markets up near the highs into DJIA 12,500-600. And then there was the weak US GDP (Q4 Advance), with its weak Consumer Spending yet higher (some would say surprisingly so in light of the weak headline number) Core PCE.

Of course, we don't really need to illuminate our readers that the equities trend is not about rear view mirror aspects of the US economy that was, and much moreso about what shall be in the face of the continued combined housing and debt securities dilemmas, and whether that actually spills over into a more telling retrenchment by the US consumer. While last year's Christmas stocking did seem to have a hole in the bottom that allowed all of the cheer which developed into the holiday to spill out in the New Year, there is a serious debate about whether the US economy will continue to weaken due to housing pressure.

As suggested by their titles, various updates on that are included in our topical discussion. For now it is as important to review the additional information which the markets are going to need to digest between now and Friday's Close to prepare for the late- and early-month combined reporting onslaught which will be at least an influence on how last week's upside reversals in equity markets fare (with their inevitable influence on other market complexes.

There is a very welcome lack of pronouncements from financial luminaries this week, yet the reporting crunch actually intensifies after the FOMC decision today. Thursday morning sees the German CPI (JAN Preliminary), ILO Unemployment Rate (DEC) and Unemployment Rate and Unemployment Change (JAN), French Producer Prices (DEC), Italian Hourly Wages and Producer Price Index (both DEC), the Euro-Zone CPI Estimate (JAN) and Unemployment Rate (DEC), along with many survey results that include Euro-Zone Consumer Confidence, Economic Confidence, Industrial Confidence, Services Confidence, and the Business Climate Indicator (all JAN), followed by the UK GfK Consumer Confidence Survey (JAN.)

Thursday morning in the US follows with the (also typical) end of month indications for Personal Income and Consumption, with its PCE Deflator and Core PCE (all DEC), the Employment Cost Index (Q4), and usual Weekly Initial Jobless Claims (for the week ending JAN 26), followed by the Chicago Purchasing Managers Index (JAN) and the closely related NAPM-Milwaukee (JAN) as a prelude to the PMI and ISM figures on Friday.

Friday indeed begins with the Australian AiG Performance of Mfg Index (JAN), yet then sees the US and Japanese Vehicle Sales (JAN) prior to switching back to Australia for the RBA Commodity Index (JAN.) Then it's on to the pan Euro-zone and UK Manufacturing PMI's (JAN Final) and UK CIPS prior to jumping off to the US for the major Employment (JAN) report, University of Michigan Consumer Sentiment Index and ISM Manufacturing (both JAN) as well as Construction Spending (DEC.)

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What it all amounts to is likely whether any hindsight good news is sufficient to goad the equities into the stronger recovery than seen to date in the wake of last week's emergency easing by the FOMC. If the DJIA can indeed sustain enough activity above the 12,500-600 resistance to post a weekly Close back above it, the door may open to a more extensive recovery that sees at least the 13,000 area, and possibly ranges as high as the previously violated support in the 13,250-350 area. Any higher than that would require a wholly different set of economic assumptions, even in light of extensive US monetary easing, fiscal stimuli and the plan to ensure the solvency of the bond insurers.

In light of the continued deterioration of US housing and related problems in debt securities markets, it strains credulity to attempt to believe the DJIA can push through all of the heavy resistance to retest the Santa Claus rally gift (actually more of a short term loan) Christmas highs back at the 13,500-550 resistance (as noted into that period.) That is why the near term operative question remains whether it can even push above the 12,500-600 resistance to solidify the recent basing activity. If so, then at least a further rally of some sort will seem to underpin the lows for now, even if the market does likely remain in a bear trend by failing at somewhat more elevated resistance.

Yet, if it can not push above the 12,500-600 resistance in the wake of what is likely to be another 50 basis points of aggressive anticipatory accommodation from the Fed as well as all of the other stimulation efforts, then the recovery from last week's lows will soon acquire the taint of previous basing attempts. Those proved to be only very temporary way stations along the path of this forceful intermediate term bear trend.

As we noted some time ago (in extensive discussions of **Analytic Balance** which included the **Trend Deduction** section in ***Capital Markets Observer*** III-22 last May), due to being in a state of dynamic disequilibrium markets always trend. If one potential trend direction is eliminated as a possibility, then the other will be the result. As you may recall, we related that back the wonderful Sherlock Holmes crime scene analysis methodology as articulated by Arthur Conan Doyle in ***The Sign of Four***, "…when you have eliminated the impossible, whatever remains, however improbable, must be the truth." As trend psychology that tends to be very relevant during the most volatile directional activity. Unless there is a refutation of the aggressive equities down trend soon in the form of a DJIA recovery above 12,500-600, then look for violation of the 11,940 Tolerance of last week's 12,100 UP CPR; and fairly soon.

Of course, the implications for the fixed income markets from any of that are also quite critical once again as well. Inflation indications are rising to levels that bring questions of 'real yield' back into focus at current levels, and the equity markets remain a very primary influence for fixed income, and even the US dollar. There is a sense that in spite of increasing inflation pressures, any relatively sharp economic slowdown in the US will be enough to deflate future prices to acceptable levels. Yet, also as noted previous, the indications for everything from the influence of subsidized ethanol production on the economics of the meat and milk industry to the accelerating development of the BRIC economies will leave quite a bit of residual inflation ingrained even if there is a slide to very low US growth.

On current form the rangebound T-note has resistance into the low 117-00 area and every full point up, while support is back into the 116-00/115-24, and every full point down. As noted above, Europe is that much weaker, yet still prone to US influence. The US dollar is back to secular weakness, and below .7560-40 it may see .7450 quite quickly.

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Markets Summary

EQUITIES

It is not very surprising the **DJIA** should bounce from the initial test of 11,500-400, especially as conditions were so 'disorderly early last week that the Fed finally had to make good on its commitment to "do what is necessary" to prevent any financial market turmoil from spilling over into the general economy. In fact, it may be a bit late for that, as the proverbial "man (or woman) in the street" had already taken note of the slide in equity markets from what we can tell from anecdotal evidence.

Indeed that 11,500-400 remains the next major support, in spite of those levels being seen in early electronic trading last Tuesday being more than a bit below (well, maybe not quite so much in this market) the official 11,635 low of the trading session that came after pre-opening announcement of the emergency FOMC 75 basis point easing. That is especially important in as volatile a market as this one has become. This is due to the potential for the DJIA to violate the official low from last week while not only trading into the next obvious support, but also a level which has already been tested and held. Higher resistances are as noted above, in the 12,500-600 area (with a minor level at 12,800), the 13,000 area, and possibly as high as the previously violated support in the 13,250-350 area.

Of note on the technical indications is the DJIA daily MACD putting in a mild UP signal on the recovery over the past couple of days, just as it did on the Santa Claus rally (weekly MACD remains very heavily DOWN.) The recent history of this indication is the daily MACD either giving a strong test of resistance or turning UP in front of the FOMC meeting only to fail later. That is not necessarily surprising in an aggressive bear trend. Yet, the only exception was, of course, the sustained up trend follow through after the September 18th full 50 basis point easing into the top of the sharp recovery rally from the mid-August debacle.

Undoubtedly the bulls are hoping for a similar response at present to the broadly anticipated 50 basis point FOMC easing this afternoon. The difference is that the fundamental situation has deteriorated so markedly since last September that expectations prevalent at that time that Fed easing could actually reinstate the bull trend do not exist at present. Yet, the similarity in psychology at much lower levels with significantly diminished expectations is exactly what puts so much pressure on the equity markets into the end of this week.

This is not about whether a further 50 basis points of easing today can encourage more than a minor rally from the DJIA. It is about whether a drop of 1.25 percent in Fed Funds in six business days can put a bottom in the equity markets. Ergo, the continued importance of whether the DJIA can indeed sustain a recovery above the 12,500-600 area prior to slipping too far back below 12,100-000. Similar indications abide in the other equities, even the lowly NIKKEI, with the recent radical DAX weakness leaving it a bit weaker that others.

Similarly the much weaker March **S&P 500** future was certainly entitled to a bounce after a selloff of almost 250 dollars from its equivalent holiday high. Yet, it is also very damaged below even more significant support insofar as it has already significantly failed the 1,364-75 March and August respective lows (whereas 11,940 in the DJIA is its March 2007 low.) Insofar as it also left a 1,360 DOWN Break from its major channel (from the October 2002 low) along the way, that all adds to the resistance above the market, which intensifies anywhere back up into the 1,400 area that is a natural Tolerance. Near term lower support is last week's UP CPR 1,325-16 signal and Tolerance levels.

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FIXED INCOME

What a difference a New Year makes. All of the worst expectations for equities which affect fixed income in a positive manner have come home to roost in upside leader March **T-note**. After slipping back to a test of its low-mid 111-00 violated resistance (which became support) into Christmas, it recovered very quickly back above various interim resistances to test and then exceed the lead contract 114-29 high of the December contract from early December.

The rest, as they say, is history. Liberated for a further upside move and encouraged by the equity market weakness the T-note experienced the significant upside blow-off we had noted was a distinct possibility. The DJIA violation of support at 12,500-300 and also the fears of a failure of bond insurers that fomented the extended break below 12,000 created a bit of a panic in the fixed income prior to the Fed's forced inter-meeting easing.

While we noted that all bets were off for the durability of the fixed income up trend after any emergency easing (especially that close to a regular meeting), it took the stabilization of the bond insurer situation last Wednesday before the T-notes finally felt enough economic support was in place to drop back from panic highs that had propelled it through the obvious 117-00 area oscillator resistance to the extreme resistance in the 119-00 area.

As things have cooled down a bit since then, it has still held the support in the 116-00/upper 115-00 range; further support is every additional full point lower from there.) Yet, unless there is further recovery in the equities above DJIA 12,500-600, the resulting equity weakness could keep the bid in the T-note for a sustained move back up; especially if DJIA happens to fail back below the 12,000 area once again. Which is not to say we expect an immediate return to such distended panic highs such as 119-00; there is now historic and interim daily gap resistance in the 118-00 area. Yet, anything which smacks of a return to sustained further equity market weakness after such massive easing in the past week or so will likely push the T-note well back above 117-00 in the short run.

All of the European long ends as well as the short money will likely follow that lead again, with the typical country influences favoring the US and leaving Europe that much weaker. This is in large measure due to the continued hawkish ECB views on the strength of Europe being insulated from the predations of US weakness. While we have our doubts about that, it must be acknowledged that the interim cycles are so disjointed that it is possible the Bund and Gilt will continue to only rally when the T-note is in a very strong phase, and suffer more markedly anytime the T-note tops. Recall that the last top in the T-note from June 2003 coming roughly two-and-a-half years prior to the ultimate tops in the Bund and Gilt was a fairly good measure of how out of synchronization the economic cycles are since the major 2000 equity market and economic cycle high.

FOREIGN EXCHANGE

As noted previous on foreign exchange, the near term US dollar strength into mid-December appeared an extended upside reaction rather than a trend change, and the same can be said for the recent short-lived **US Dollar Index** recovery to the low .7700 area. The idea back in December that more aggressive US inflation is good for the buck because it will prevent the Fed from easing was always specious at best. We felt that could change any time lower equities required a forced easing while inflation influences are still in play. Last week's bulge into the low .7700's was equally as daft, as it hinged on the FOMC emergency easing possibly reinvigorating the US economy while others slow.

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Possibly all the folks who bought into that missed the memo on that the massive 75 basis point easing was necessary to just stabilize the equity markets after by putting the Fed at least back in step from being significantly behind the US economic weakness curve. On a technical trend view, the **US Dollar Index** did manage to leave minor UPturn in daily MACD on that rally, yet quickly lapsed back into a DOWN signal once it fell below the .7600 area once again.

Now the question is just how long it will take the renewed weakest of the weak sisters (now that GBP/USD has recovered back above 1.9600-60 to take the pound out of weakest sister designation) to fail? As the US dollar Index is already back below the previous .7620 daily H&S UP Break, its trend is now also under threat from another of the challenges of the past several weeks to its .7560 Tolerance of that (rather weak and specious) UP signal. If it finally fails by more than a bit of trading slippage by Closing below .7540, then next lower support is back to the low of the Inverse Head & Shoulders basing pattern at .7450. As that might also be knocked out on further weakness, extended supports remain .7350, .7200 and .7000.

Euro becoming weak sister in the wake of the notion that the Fed could not ease further had seen **EUR/USD** failing 1.4535-20 on a DOWN Break from a distorted (and as such also very possibly unreliable) Head & Shoulders Top. While the Objective of that pattern was down in the 1.4100 area, there was only minor slippage below the next interim support in the 1.4400-upper 1.4300 area. Now, just as the US dollar Index has key support into the .7620-.7560 area, the original EUR/USD daily channel 1.4720 DOWN Break would require a daily Close back above 1.4800 to convincingly Negate the last weak signals. That would likely liberate EUR/USD to finally trade at the very least to psychological resistance at 1.5000, with oscillator indications moreso up to 1.5100 and 1.5250.

The weakness of the British pound was also more striking previous, with **GBP/USD** now failing support in the 1.9660-00 area major congestion as it left a 1.9660 DOWN Break from its broadest weekly up channel from the major 1.7050 November 2005 reaction low. Along with the weekly and daily MACD remaining DOWN, this pointed to a potential for it to drop to the 1.92-1.91 area congestion prior to hitting the next major support. However, that this weak sister was also unable to extend its break to that sort of lower support is also a very bad sign for the US dollar. Back above 1.9660-00 GBP/USD is capable of seeing at least 2.01-2.02. Yet, its weakness against the euro means that may be the top end for now barring a more radical bout of weakness from the buck than we expect in what is ultimately an eroding (as opposed to imploding) bear trend.

As the US dollar has returned to the secular weakness, **EUR/GBP** has dropped back into a trading reaction after the comments from various ECB members brought the unmitigated hawkish views into balance with the potential for at least some greater downside3 European economic risks. While its previous surge above both long term congestion in the .7250 area and interim resistance in the .7350 area leave those as the ultimate downside supports, the actual trend channel supports this week into next are moreso in the .7400 area held so far, as well as nearby as the mid .7300's. Throw in a couple of fairly important Fibonacci retracements of the active upswing since early late-September into early October, and that is about as bad as we expect EUR/GBP to sag for now.

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As we have also noted previous regarding the recent selloff in the European currencies against the Japanese yen, the difference between the euro and the pound is also striking on that front. **GBP/JPY** fell below its 220.00 support and paid the consequences, with lower supports for its failed up trend into the 213, 210-207 (which it rebounded above after a minor washout), 205 and the 202-200 areas. On the other hand, while **EUR/JPY** did finally violate its 159.00 support (and is stalling there on the way back up), it snapped back up very quickly from the slippage below its 155.00-153.80 support once the equities rebounded last Tuesday. Indeed, even if it should fail that again, next supports is as nearby as 152-150 (the latter of which remain lows that were held in March and August of last year.)

While **USD/JPY** is still very orderly on its failure below the major 106.80 UP Break from May 2005, it is a testament to the degree to which the buck is once again weak sister that it either continues to sag below there or has very little upside follow through back above it while the yen weakens elsewhere in the wake of the equity market recovery. Next support there is 105.00-104.26, and that is most interesting in light of the US Dollar Index also now nearing its own .7560 Tolerance of the awkward (i.e. essentially unreliable) minor H&S Bottom .7620 UP Break from back in mid-December.

It all still smacks of the US equity market weakness being a harbinger for broader economic weakness likely into the first half of this year, and that keeps the US dollar on the defensive, alternating with the other weak sisters when they get awful news as well.

ENERGY

Really not too much more to say here than our initial assessment, as key levels are all clear and the market finally seems responsive to the prospect of more US economic weakness (and the potential that might spill over into the rest of the world.) March **Crude Oil** managed to hold some fairly critical support into 87-86 and rebound above 90-89. As noted above, there is some fairly hefty resistance into the 94-59 area, with 100 remaining the key technical and psychological resistance. The one thing of note is that the daily MACD here has also come back into balance from DOWN, and that is now very similar to the equities technical trend indications; interesting.

Still Not Ready

After the Fed finally stepped in to rescue mode to save the equities from what had become a wholly disorderly debacle, some folks inquired we had shifted our view on the Bernanke Fed being "Not Ready for Prime Time"?

The answer required no extensive review: Not in any way, shape or form. As noted in our analysis just prior to the actual emergency easing last Tuesday, all the Fed did was to fulfill a commitment (which is incumbent on all central banks whether they had explicitly restated it or not in recent history) to "do what is necessary" to prevent any financial market turmoil from spilling over into the general economy. In fact, we are sure it is extremely distasteful for the Fed to cut rates on an inter-meeting basis. In this case the equity markets finally stabilizing (as much in light of the bond insurer rescue on Wednesday as Tuesday's emergency easing) had to be an especially Pyrrhic victory insofar as it required such major action that close to the regular FOMC meeting yesterday and today; a clear sign of just how badly they had been behind the weakening US economic curve.

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Flailing III

What can we say in the Fed's defense other than that which we have noted so many times previous that while they were part of the problem on the way up, they really do not have much of the solution in their control on the way down? The Fed is a victim of its lack of vigilance back in late 2006 leading to excesses which created problems it can not now address with monetary easing alone.

In fact, we still find it incredibly interesting that so many smart and experienced folks are either involved in efforts or calling for programs that can not address what is an asset value destruction problem centered on US housing (as we first noted in the face of the initial interbank lending 'dilemma' back into September.) Throwing money at the symptoms of the combined US HARM interest rate reset 'borrower-at-risk" foreclosure problem that feeds the further failures in the debt securities markets (even though quite a bit of the latter has been marked down already) will not alleviate the problem. Only a 'fix' for those borrowers at risk will do so (more on that below) and the political and economic powers that be are not ready to admit that; at least not just yet.

We have had so much to say on the flailing of the various operatives prescribing tangential address of these problems that we will limit this to few telling points (as will be the case for the **RTC-2008 III** section as well.) The several things we find most interesting (and in their way disturbing in their likely lack of effectiveness) are:

- Where the heck was the much-touted Bush-Paulson 'Plunge Team' during what was surely an obvious plunge into the beginning of last week? Are they saving their ammo for that time when the Fed slashing rates does not even bring a sustained bottom in the equities? If so, this might be even more misguided an effort than we suspected previous. Frankly, we were glad they failed to show up, as there is nothing quite so demented from a capital markets standpoint than a federal government buying shares to prop up a stock market. What shares; why; for how long; what is done to prevent conflicts of interest (are Halliburton and Goldman Sachs on the list, or must they necessarily be excluded even if they should be), etc., etc.?

- Davos was a real treat. While corporate heads managed to put a great face on business outside the US, the classic macro-economic commentators sounded like a visit to depression wing of a psych ward; where was the securities firm sponsored Prozac Buffet? Mr. Paulson's predecessor John Snow actually chaired a meeting to address the question of "Have Central Bankers Lost Focus and Lost Control?" Jolly. His response was that he felt the Fed had indeed been behind the curve, but was now catching up. Not exactly a ringing endorsement. He also noted that Monsieur Trichet was likely to remain fixated inflation, but was at least allowing there was a bit more risk to the downside. That sounds fairly consistent with our previous analysis that the ECB was likely to force the Fed to over-stimulate once again.

- It was also a real treat watching the *ad hoc* combined interview of Larry Summers and George Soros from Davos as well. Summers was still backing the US government stimulus plan, allowing that it could still get bogged down in Washington DC politics. That was one of the more prescient, yet least adventurous insights of the conference. They both agreed that some part of the problem was the inability to properly price the credit derivatives risk which was still a significant part of the problem; we'll have more to share from their extended comments below.

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- Then early this week comes the ultimate *coup de grâce* for the degree top which everyone throwing money at the symptoms is still just flailing: The normally fiscal responsibility oriented IMF produces a plea from new managing director Dominique Strauss-Kahn that (according to a Financial Times article by Chris Giles and Gillian Tett, see attached) "…(*endorses*) the proposed US fiscal stimulus package and called for other countries to follow suit."

The article also says that… "Mr. Strauss-Kahn's words rip apart a long-standing global consensus that fiscal retrenchment in the US and Japan is needed to help reduce huge trade imbalances. It comes as the IMF is due to release new economic forecasts this week which, he said, would show a "serious slowdown and it needs a serious response.""

Last but not least it notes that… "Mr Strauss-Kahn's dramatic change in stance amazed Larry Summers, the former US Treasury secretary. He is known for saying that the IMF stands for "It's Mostly Fiscal" because the organisation has to be tough with countries' budgetary laxity."

Yet, as we have questioned previous, is there any degree of throwing money at the general economy, or targeting it to the lower middle class (i.e. folks who need it to cover escalating expenses and will spend it), or even the federal government buying of shares in the open market actually solve what ails the economy and markets? Especially as the government buying shares is a true exercise in futility that only makes sense if the underlying companies are indeed going strong and only undervalued in the market, frankly we still doubt it.

RTC-2008 III

All of that said, what more could we have to say about the need for a direct 'fix' for the US housing situation that would also address a significant portion of the debt securities derivatives blowups that we have not already said? Not much, but there are a couple of telling points.

The first of these is the degree to which a consensus is slowly developing around the need to actually address housing directly as a way to slash the HARM default-debt derivatives Gordian Knot. That *ad hoc* combined interview of Larry Summers and George Soros from Davos had an interesting ending due to the interviewer (CNBC's Becky Quick) being astute enough to wing mention of the housing issues into the mix. In response to the indication that the reason the debt derivatives were so hard to value is the lack of surety on the underlying assets, Mr. Stimulus Summers noted that transparency to restore market confidence cannot include fire sale pricing to a lowest common denominator. They (Soros & Summers) both agreed that some direct address of the US housing value issue would need to be addressed.

That was also still apparent in the latest HOPE NOW program 'Progress Report' a week ago Friday from Treasury Secretary Paulson (see attached.) In it he pointedly notes that… "…more than 16 percent of borrowers responded to 233,000 HOPE NOW outreach letters sent in November by contacting their servicers, far more than the normal letter response rate of 2-3 percent for delinquent borrowers."

While that is pretty impressive on a comparative basis, what does it really say about the overall situation? As in the apocryphal quip from Mark Twain, "There are three kinds of lies: lies, damned lies, and statistics." If one does the math, it is apparent there are still 195,000 borrowers-at-risk who did not even bother to call in spite of potential near term foreclosures.

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That leaves quite an additional burden on a massively over-supplied housing situation. Further, the lack of response from that many folks must mean they feel they have very little chance of qualifying for even the most generous finance in light of their income, diminished value of the home, and what are still tightened lending standards (in spite of the forbearance which has been promised.)

It is also interesting that Mr. Paulson shifted his focus to the November effort from the overall totals noted as recently as his early January update. The conspiracy theorist in us tends to believe that this was due to those showing better than the response on the 450,000 letter overall total sent out for November and December. Is it more "…lies, damned lies, and statistics" then, or just a more extensive focus on the first letters sent to the borrowers who are most at risk?

In any event, it pays to remember that the 450,000 contact attempts relate to those likely to be most at risk early in the cycle; our assumption (as noted previous) is that means the first half of 2008. As such, this is just the first tranche of what will be followed by another series of at-risk potential foreclosures on the remaining 1,350,000 homes through 2009. Even at a very optimistic assistance rate of assistance which matches the 370,000 who were helped in the second half of 2007 (see attached once again), that means a total of over 1,000,000 additional homes of the sort least likely to find a new buyer under current conditions are due to weigh on the US housing market, and those at financial risk from its derivative holdings.

As Mr. Paulson himself noted in a previous speech (on January 8th, which we have already reviewed), the current extreme weakness of house prices is also a disincentive for new buyers to step forward; especially for the lower-middle income housing that they may have been waiting to purchase. It seems a bit of a classic 'Catch-22' that will only be addressed once everyone gets the idea that US house prices are done falling quite so rapidly.

Even the estimable Mr. Greenspan had noted previous (back in December) that some form of direct assistance to at risk borrowers was the only likely solution. He has studiously avoided revisiting that suggestion of late. Possibly that is in deference to giving the Paulson plan a bit more of chance to work prior to more drastic steps being employed.

Yet, in light of the legislative negotiating problems of something as public relations friendly as a stimulus package in an election year, what chance does RTC-2008 have for being properly formulated and passed timely to stem the negative tide? Or is that really necessary if the equivalent is already in place?

Solution at Hand?

It turns out that the US government has the solution to the problem on the books already, and could possibly employ it once the situation becomes dire enough to have American taxpayers allow that they'd rather avoid living through the next worst thing to the Great Depression, or at the very least the sort of stagnation affecting Japan after their real estate market implosion back in the early 1990's. All of which is as we noted previous: in the end the Americans will whine about it being unfair, encouraging moral hazard even beyond that experienced already, rewarding bad individual home buyer behavior, and to a modest degree bailing out various culprits who foisted all of this on us in the first place (all of which is true.) Then they will ask how much, and write the check. Which will be easy in this case, as it will take the form a further round of bloat in the federal deficit, and not any out-of-pocket expense.

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The reason for that is it would be very unreasonable and ultimately less than effective to bail out the foreclosure situation while diminishing individual bank accounts. As such, there must be some underwriting by the US government for whatever form of RTC-2008 we get, even if it goes by a different name. The key here is that the original RTC was created to bail out only commercial property deals which had gone bad due to the unintended consequences of the 1986 Tax Reform Act of the US Congress. In this case it is homes at risk.

And as Mr. Richard X. Bove (pronounced boe-vay) of Punk Zeigel Securities reminded us in a recent television interview on CNBC, in 1970 the US Congress created the Emergency Home Finance Act that created the Federal Home Loan Mortgage Corporation (Freddie Mac) to facilitate a secondary market in home mortgages and extend financing to various groups.

Yet, according to Mr. Bove's interpretation, the Act also allows the Government National Mortgage Association (GNMA or Ginnie Mae) to lend on an emergency basis to homeowners at risk of losing their homes. There are specific guidelines which may need to be loosened a bit for current purposes, yet the terms of the loans can be below market interest rates which are absorbed by GNMA, which sells the loans to none other than Freddie Mac.

In theory under what used to be known as the 223 Program, and is now known as Section 8 finance, GNMA can take the unserviceable mortgage of a homeowner and provide them a five year loan at a 1.00% annual interest rate, with the restriction that the borrower must remain in the home for the full five year term of the loan. The reason we note he 'reminded' us of this facility was that a real estate syndication firm we worked with in the mid-1980's used it to create more profits for investors on a multi-family development.

In the current case, the amount of money necessary fund this brings to mind the other, archaic definition of 'Section 8': it was the classification for dishonorable discharge from the US military "for reason of being mentally unfit for service." If you're not sure what that means, watch Max Klinger in some MASH reruns. However, on the saner side, under the assumption that a span of five years might allow for recovery of both the economy and housing market, the problem of the home owner will be solved; as will the immediate problem of the derivative debt securities market; as will the problems of the communities and states that are already being stressed by shortfalls in property tax receipts compounded by abandoned homes. It is no secret that an empty house is that much more at risk than one which is occupied.

Win-win-win!! Not exactly, as Mr. Bove does acknowledge all of the moral hazard and other risks noted above. Yet, he makes a very good point that the social crisis which would be avoided in many communities is worth the price. We tend to agree, yet feel that the situation is not quite dire enough as yet to encourage this cure. While we wish his program well, if HOPE NOW doe not meet Mr. Paulson's expectations a bit further into this year, there may not be much choice but to grasp the nettle of direct borrower-at-risk support.

While we were great doubters on the ability of Freddie Mac and Fannie Mae to ride to the rescue, Ginnie Mae may be just our girl; but only once American taxpayers are become terrified enough to allow for the additional bloat in the deficit, which will surely come back to haunt us. As the late, great Illinois Senator Everett Dirksen allegedly once noted, "A billion here, a billion there, and pretty soon you're talking real money." Indeed.

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

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