

# Rohr Report

## ***Capital Markets Observer***

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#### Key Views

▪ “Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.” So said Winston Churchill after the mid-late 1940 British Commonwealth victories in the aerial warfare Battle of Britain and the tank war against Rommel at El Alamein in Egypt. As noted in Tuesday’s *TRENDVIEW BRIEF UPDATE*, the Senate won its campaign for direct assistance to at-risk mortgage borrowers with the passage of Dodd-Shelby Housing and Economic Recovery Act in the Senate on Friday. While not a panacea, it is, perhaps, a light at the end of the financial crisis tunnel.

- Of course, the timing of that does not escape anybody’s view of how influential ‘facts on the ground’ have been of late, as we have suggested for some time. Yet, the most interesting aspect of the “end of the beginning” is undoubtedly the capitulation of the administration and Fed as they seem to at least tacitly accept both the inevitability of that direct assistance, and possibly even the degree to which it is more enlightened than they dared allow previous. We have much more to say on that below.
- The most striking influence was the need to extend more explicit support to GSE’s FNMA and FHLMC in the face of the near implosion of their equity valuation last Friday. And that overshadowed extreme events in the broader banking system that included the failure of IndyMac Bancorp (the third largest US bank failure ever.) All of those real world influences put paid the Bush administration’s ideologue free market approach to which the Fed had been in thrall previous. Nobody jumped up and explicitly declared, “Wow, we really blew it; you guys were right.” In fact, that is not necessarily the case in any event, as some reasonable attempt at purely ‘free market’ address of the problem was indeed necessary first step. Yet the tacit acquiescence to some form of direct at-risk borrower assistance was obvious below the surface. Pressed several times about financial exposure (however remote) of the American taxpayer to any ‘guarantee’, Mr. Bernanke repeatedly noted it would be okay when housing recovered.
- As all of that will be explored at length in the topical discussions below, more important at present are the other ‘facts on the ground’: the very interesting price trend responses. Just as subtle as the administration reversal of position on allowing that direct at-risk borrower assistance was Tuesday’s late session equity market weakness. However, that was in response to some specific weak earnings reports and bad inflation indications rather than broader dread resurfacing. It might also have been due to Mr. Bernanke’s negative housing views, and Ms. Yellen’s Tuesday speech lacking reference to direct at-risk borrower assistance; perhaps she missed the memo.

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- And just to be clear in case the metaphorical reference is not explicit enough, the “end of the beginning” neither means that the equities and the US dollar will quickly return to bull markets, nor that the long dated government bonds will succumb to the loss of their haven bid (as we have projected) overnight, with somewhat less weakness in the short money occurring until equities basing action is more apparent. While Congress’ at-risk borrower assistance plan will help, it will take some time to be implemented, and markets have quite a bit of negative news to digest in the meantime. Initially look for that to buffer, rather than fully reverse, equity market weakness.
- That makes our summary view of the markets a very big shift to a more stable situation, even if short term volatility remains high. The real risk will be in the potential for another government bond market break if indeed the equities stabilize into a two way street with a modest downward bias until the DJIA 10,700 support is hit in the near term. This also means that the US dollar will remain in the same sort of churning basing action as the equities, as the sharp break in US equities leading the way back down was part of the rationale behind the recent US dollar weakness. Continued weak economic news will also likely restrain energy markets, even though Crude Oil remains in its intermediate term up trend unless it violates the low end of the 132-128 support noted previous.
- Regarding equities, we are still going to concentrate on DJIA for the sake of brevity, and the fact that it remains the trend setter (if not always the most volatile.) In spite of the bounce back above 11,000 area ‘big penny’ and other actual technical support, the more critical DJIA technical level is 10,700. It is the confluence of major technical supports noted in Tuesday’s **TrendView BRIEF UPDATE**: a major congestion level from all the way back on the bull move into early 2004 highs, with quite a few subsequent periods of highs and lows forming around it until the DJIA was finally ready to push above the 11,750 2000 all-time high in late 2006 (with the last major pullbacks to 10,700 into June-July 2006); also the major Fibonacci 0.50 retracement of the 2002-2007 bull move; and on a psychological level it is also just about how far DJIA might slip below the 11,000 area prior to looking like it is in free fall for a quick drop to 10,100-000. As such, if DJIA breaches 11,000 in a disorderly manner, by roughly 10,700 we suspect ‘the powers that be’ will feel pressure to ‘do something’ beyond that done already. Discount Window access for lottery tickets, or accelerate at-risk home owner support?
- The balance of the technical structure is the DJIA failure through serial supports in the 11,350, 11,500 (the actual heavy intermediate term support the market was trading at in electronic overnight action prior to the Fed pre-opening intervention on January 22<sup>nd</sup> that left the) 11,635 major January low and subsequent 11,731-56 Spitzer-Stearns March lows. Those are all now resistance, and 11,350 is especially important late this week as a determinant of whether markets are stabilized or merely going through a minor bounce prior to the next round of pressure. That is because of the confluence of the aggressive down channel from the top of the mid-May recovery rally at 13,136 now projects to that area late this week along with daily MA 18 and the January-March weekly oscillator lows (that were knocked out on the recent drop below 11,500) at MA 41 minus 1,300.
- The levels for other equities are September S&P 500 resistance back into the 1,258-62 January-March lows, 1,278 and 1,295 violated daily Area Gap support levels, and support into 1,228-20, 1,200-1,192 and 1,172. DAX resistances at 6,200, 6,320, 6,420 and 6,520, with support into 6,165-53 (the low end of which is last week’s Close), 6,000 and 5,850. FTSE has resistance into 5,338 and 5,415 (January and March lows), with support into 5,130-00 and 5,030-00. NIKKEI: 13,000, 13,400, 13,600 vs. 12,650, 12,300 and 12,100-000.

- However well one would like to think the US government bond market (and other sovereign debt) has acted in the face of tightening credit markets, that was to some degree an artificial 'haven' bid. Unfortunately the unusually sharp drop in the prices of the GSE's was not something that we could have predicted either as to its timing, or that it would be the factor which illuminated our view on the bailout mentality finally coming home to roost in the equities and by extension the long dated government debt markets.
- What we do know in the wake of last Friday's activity is that had the equity market weakness been based on some other stocks weakening, September T-note pushing above key 114-16/115-00 resistance might have run up as high as the 117-16/118-00 area resistances. Yet, in the light of the nature of the specific GSE weakness, the September T-note did not even finish the week above 115-00. After being up near the 116-00 area on Thursday, selling off back below 115-00 right along with the DJIA being down over 200 points early in the session was a dauntingly bad failure; one that could have been the death knell for the current government bond market rallies in Europe as well as the US.
- As noted on Monday, the key now will be if the T-note stalls on any subsequent attempts to get back above 115-00, and that has already been shown to be the case. While it can squeeze up again anytime the equities get back into trouble, it will likely also become increasingly vulnerable if equity breaks back to (or just below ) this week's low demonstrate diminished volatility. Sustained Closes back below the major 114-00/113-24 area would represent T-note succumbing to historic tendencies to remain below that area for a swing down to 110-00 or even 108-00 (as noted previous.) The really interesting aspect of yesterday's sharp selloff was the degree to which the T-bond that had largely been more buoyant than the T-note for quite some time saw the September contract drop precipitously back to Monday's mid 115-00 low. That was down almost a point-and-a-half as compared with T-note's less than half point drop. Possibly a technical adjustment; yet the degree to which negative real yield must be reversed at some point implies greater weakness further out in the yield curve (i.e. no return for a more extend period.)
- Lower interim T-note supports remain in the 113-00 and 111-16 areas noted previous on both the contract and continuation projections. Given the tacitly stronger European economic situation and inflation concerns (revisited in last Thursday's ECB Monthly Bulletin), it is no surprise the Bund stalled on the squeeze near the top of 112.50-113.00 resistance. Lower interim support remains in the 111.00-110.75 area, with more major support at recently retested 110.00-109.65 basing area from last summer. The somewhat more vulnerable UK economy still sees the Gilt challenged in the vicinity of its own 106.50-.70 resistance, with higher resistance not until the 107.50-108.00 area. That said, the Gilt will be very vulnerable on any equity market basing activity, and extended lower supports remain in the 105.00 and 104.00 areas, and into 102.90 lows from last summer.
- Technical levels for short money forwards are geared to March 2009 contracts, and have remained considerably consistent in spite of the equity market weakness. That is due to the lack of any rationale for a major easing by any central bank in the face of the inflation pressures. For the Eurodollar 97.00 area is resistance with a Tolerance to the 97.10 area just tested; very interesting for the degree to which it removes the anticipation of any FOMC tightening. Lower support is 96.70-.65 and 96.55-.45. Short Sterling resistance at 94.30 has been exceeded temporarily, but with not much chance it will push above 94.50 soon, with support into 94.00-93.90. Euribor resistance is 95.00-.05 that reflects a steady hand from Überhawk ECB. Lower support is 94.75 and 94.50, and all may come under pressure if the US housing bailout passing buffers equities' weakness.

- While the foreign exchange has been much more subdued, last Thursday's ECB Monthly Bulletin refocus on sustained inflation concerns left it a bit more hawkish than some (albeit not this analyst) had expected. The recent data has reinforced that focus, and along with the ever more glaring weaknesses in the US economy that weighs on the US dollar. While we were not convinced the US dollar was back to being the secular weak sister of late due to weakness in the Japanese yen and British pound, this week's activity reinvigorates that very weak US dollar view. That said, USD/JPY back below the low end of the 105-106 range held the previously noted trend support Tolerance (broadest upward channel from the low back in March) at 104. Much below that it can drop back to 102.50 or even 100.00. EUR/USD back above the 1.5750-1.5800 interim resistance and even the previously resilient 1.5900 area resistance looked ready to finally push above the mid-April 1.6000 area high. Yet that push was short-lived, highlighting the degree to which a sense of basing in equities can also support gradual improvement in the buck; either through economic sentiment or attendant hawkish Fed expectations.
- That is also true for broader indications from the US Dollar Index. Capitulating after its mid-June weekly Close above .7350-70 resistance, its recent recovery only reached the .7300 Negated up break from that previous rally prior to weakening again. That the ECB's ostensible move to 'neutral' is brought short term relief left no mystery as to the reason for the renewed weakness after last Thursday's hawkish ECB Monthly Bulletin. However, even though it dropped back below supports in the .7250 and .7200-.7180 areas, the low end of the previous (mid-March) .7150-20 support held. While that is no guarantee it will continue to do so, it speaks of the net US dollar trend is attempting to bottom in spite of weakness against strong commodity currencies like Australian dollar.
- It is important to recall that the euro did not so much bottom in October 2000 as the US Dollar topped in the face of the secondary failures of the US equity markets as the NASDAQ 100 slid below 3,300(!!). Considering whether the US Dollar has bottomed is now therefore as much an exercise in whether European economies are weakening enough to be over-valued in the wake of the ECB rate hike two weeks ago. As we suspected, that has already confused the 'interest rate differential' camp that saw EUR/USD drop sharply from above 1.6000 in the near term.
- GBP/USD also remains a trading range affair between 2.00-2.01 and 1.95 in spite of the ostensible US dollar down trend. Higher resistances are 204, 206 and 208, with key lower support into the 1.93 area. EUR/GBP is a similar .8000-50 to .7850-.7750 ranging affair.
- The continuing energy rally saw August Crude Oil reach next major weekly oscillator thresholds in the 147 area last week; that's up to 149 area this week. As there is not much of a spread at all between the August and September contracts as the former heads toward expiration, all of the same technical levels apply. While due respect must be given the sharp selloff this week that has done much to lift the near term spirits of the equities markets, in both percentage and technical trend terms, it is quite a bit less than a definitive trend reversal of the extensive previous strength. As such, heading into next week we still caution the energy bears that much above 150-151 the next ostensible oscillator resistance projection would not be until the 158-160 area (which would be anew all-time high for the oscillator projection.) While the current selloff has chewed through previous hefty congestion levels and September contract aggressive up channel support in the 140-138 area, lower supports at 132-128 and low 120 area remain more important. There is also a curious lack of volume, as in previous selloffs back in January and March.

## Overview

Except for the Mr. Bernanke's Senate and House semiannual testimony, it was hard to conceive from this past weekend that this week would be even more interesting than what had transpired over the past several. Yet, in the wake of extreme administration and Fed actions to rescue the GSE's last week the appearance of Messrs. Paulson and Cox was rightfully added to the end of the Bernanke interview.

While there had been some very productive developments in the Senate as well late last week, the issue of whether President Bush would sign any direct at-risk borrower program into law was still a bit problematic. Not so after Secretary Paulson's very subtle signal that the administration was ready to provide constructive extensions (depending on one's point of view) within the framework of the Dodd-Shelby housing crisis relief legislation. While not a panacea, and only addressing one aspect of the problem, it is a primary relief for one of the most troubling and critical aspects of the problems.

The bill and nature of the administration's very subtle acquiescence are reviewed in the topical discussions below. Yet, what is not reviewed there is the rationale for being so demure in acceptance of the inevitable. We appreciate that this is grudging to some degree by virtue of not wanting to admit their to the broad public that their ideologue free market approach had been insufficient to the task at hand (which many of us knew for quite some time.) Yet, now that they are on board it would be more productive to get a bigger psychological bang for American taxpayer's buck by being more enthusiastic.

It all reminds us of the *Dr. Strangelove* (Kubrick's 1964 anti-nuclear paranoia epic) take on the lack of publicity regarding the Russian 'doomsday machine' that would destroy earth if it sensed a nuclear attack on

Mother Russia. As a B-52 bomber wing attack had been launched by deranged US air wing commander General Jack Ripper (no kidding; it was Sterling Hayden's character name in the movie), the Russian foreign minister had to sheepishly allow that they had been waiting for the big May Day Parade to make the announcement.

At that point US President Merkin Muffley (Peter Sellers) and the generals in the War Room admonished him that it doesn't make a lot of sense to have a terror weapon capable of inflicting global Armageddon and keep it a secret. It is much the same with the administration's sheepish acceptance of Congress' at-risk borrower assistance.

Having another weapon in the arsenal with which to attack the forces weighing on the US financial system and economy (with no small degree of global fallout now becoming apparent) would seem to be something to announce loudly and happily. We have no doubt if it were a new fighter-bomber for the Air Force there would have been a high profile press conference. And maybe that will change once the legislation is signed into law. At that point the inter-branch cooperation will allow the administration and the Fed to let their previous adherence to a overly stringent free market ideology die a quiet death. It is the way in Washington that mistakes tend to lapse in a whimper instead of a bang. Just like our estimation the Fed might cut in a crisis; the Dodd-Shelby bill turned out to be the solution instead.

And even if the administration were to be more upbeat addressing one of the core weaknesses plaguing the economy and the markets, a lot of damage already done is going to remain. That is due to the degree to which the credit crunch will ripple through the economy for some time even if the US housing situation gradually rights itself.

Certainly the problems will not likely show real stabilization for at least several months. A good reference for this is Fed analyses. We must allow the Fed was late to realize that the housing problem was going to be a major issue for the economy. In that regard, the shift toward being very downbeat may actually be a contrarian indication that we are nearer the bottom than they suspect; especially in the wake of passage of the Dodd-Shelby at-risk borrower relief.

Yet, a look at what Mr. Bernanke had to say over the past couple of days along with the Beige Book content is only augmentation for our new favorite housing crisis Cassandra, San Francisco Fed President Janet Yellen. A copy of her Tuesday speech *Stabilizing Communities and the Negative Effects of Foreclosures* is attached for review, and the associated housing graphs can seen at: <http://www.frbsf.org/news/speeches/2008/0715a.pdf> (not attached due to its size.) Forget CA, AZ and NV for a moment, and take a look at MI, MN, IN and OH.

Needless to say, all of this rippling out from money centers to regional banks is going to mean disturbing headlines weighing on consumer confidence as well as the equity market psychology for some time to come. Anybody expecting sustained improvement in the equity markets need only look at the today's mixed headlines to preview the intermediate term cross currents.

In today's Financial Times we see both the agony and the ecstasy: US inflation bad; Wells Fargo results good; Natixis subprime writedowns; short sellers caught out by cost pressures; SWF's cut exposure to weak dollar; and our favorite contrarian view of the week: Banks to feel pain until 2010. The reason we like that as contrarian is not because we have any inside knowledge of why the credit markets might improve. Rather, that view is based upon money market 'butterfly trade' expectations.

In other words, here is another example of otherwise talented analysts inferring that a market pricing is a 'prediction', which we have warned in many situations for years is just not the case. Even the Fed Chairman had to admit that he had been misguided in relying on energy market forward contracts as a sign of price relief. Forward contracts are a clearing house for investor sentiment; and that sentiment is just another form of opinion (regardless of the fact it has been funded) which is very often misguided.

Yet, it all amounts to the very mixed picture we would expect, and that will leave many markets 'two-way streets' with intermediate term active price reversals now that most of the 'impulse' portion of the second wave of the equity market bear is likely 'priced in'. That means they can still work their way lower, yet are less likely to enter into a more panicky down trend. Similarly the US dollar can also come back under pressure when equities weaken, but is likely basing out in the longer term trend.

The one real at-risk market is the long dated government bonds, as extensive negative 'real yield' has built up during the 'haven' buying fomented by the equities' sharp selloffs and worries over lower rated bonds. That will need to equalize at some point, and it is historically typical for the 'govvies' to need a full point premium to inflation to attract sustained buying. That in turn indicates pricing closer to the lows of last year already neared by the European bond markets instead of the major premium still commanded by their US equivalents.

Once people get burned in one asset class, for defensive purposes they often inquire where is the next 'bubble'? While there is something to be said for the commodity markets being overpriced in the long run, the actual next bubble that is likely to shock the uninitiated is government bond markets, especially in the US.

## **Malleable Mind Frame Minuet**

The Winston Churchill quote from the top of this advisory is relevant enough to repeat. "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." (*November 10, 1942 Mansion House speech in London.*)

Of course, it relates to the limited glimmer of light at the end of a very long tunnel that the British and Allies would still need to painfully navigate to the 'broad, sunlit uplands' at the other end; that phrase is from another of Churchill's speeches: his June 1940 "Their Finest Hour" speech informing the British people they would need to be very tough and use all of their resources in defense of England in order to win the war.

The US economy is also in a bit of a battle today against a very formidable foes: the continued drop in home prices that is at the core of so many explicit personal and institutional financial problems that have increasingly become systemic rather than individual; and the expanding sense of personal financial insecurity that is being experienced not just at the housing level any more, yet fully out into the banking systems with the first sighting of bank account withdrawal lines in recent memory. At least in the US; the UK preview was the Northern Rock debacle of a similar poorly financed savings organization.

Yet, if not the 'cavalry to the rescue', it may be 'Congress to the mitigation' at present; over the previous strenuous objection of the administration 'free market' ideologues. However, it appears the administration has had to prove more malleable in the face of daunting 'facts on the ground' belying the effectiveness of its previous approach.

The first relief came from a more mundane acknowledgement by Chairman Bernanke

during his regular semiannual testimony in front of the Senate: The twin problems of high inflation and very weak economic indications (in spite of middling activity at present) would require the Fed to wait a while until it could entertain the idea of raising interest rates to address high prices.

Well, at least we can thank goodness for that nod to reality that is in line with our oft quoted *Rohr #1 Rule for Central Bankers*: "If you are going to manage the economy, first you need an economy to manage." Bad effects from the violation of that rule were glaringly obvious in the Japanese experience in the 1990's that the Fed (and the rest of us) would likely rather avoid.

Yet, Mr. Bernanke had studiously avoided any extensive exploration of the US housing issues in his formal statement. That was to be expected, and also acceptable in light of the obvious full exploration they were going to receive during subsequent multi-agency discussion of the GSE's and overall housing situation. Yet, committee members could not help but inquire on a key issue that related directly to the Federal Reserve's seemingly endless expansion of a liquidity 'guarantee' to various entities beyond the commercial banks that were the only previous beneficiaries of that privilege.

As such, during Q&A there were extensive questions about exposure of the American taxpayer to the liabilities those guarantees might produce in a worst case scenario. There were sensible answers that related to the unlikely nature of broad systemic failure. Yet the more interesting bits were regarding the degree to which the agency liabilities that were being effectively underwritten had some rather substantial underlying asset value that would buffer any net losses if the guarantees were ever indeed implemented.

Of course, that raised the issue of how the Fed could be sure the assets would indeed significantly offset risk of loss; especially as so many of them in the case of the financial services industry at large, and especially the GSE's were residential real estate that had not seen any sign of a bottom, or even a mitigation of asset value destruction since last summer. The latter was also reinforced once again by Ms. Yellen's Los Angeles speech Tuesday afternoon.

Good question. And in light of his previous very downbeat assessment of real estate market prospects, the further comments from the good Chairman seemed almost bizarre at that point. More than once in the extended Q&A he indicated that the risks were overblown because the US housing market would recover at some point, and that would make many of the dire current concerns seem misguided.

At that juncture it was possible to draw only two conclusions. Either the Chairman had decided to abandon whatever remaining credibility he had on the shoals of purely political Pollyanna pronouncements (much like his previous reliance on the futures markets 'predicting' energy prices would drop into the middle of this year), and just 'tell them what they want to hear.' Or, there was something more afoot that would only become apparent once he was joined by Treasury Secretary Paulson.

In the event, it is clear that the latter was the case. And in fact that would turn out to be nothing less than the Bush administration's version of 'Malleable Mind Frame Minuet.' Suddenly showing a significant degree of flexibility, it is nonetheless doing so in a subtle, almost stealthy, manner.

We chose to characterize this particular bit of dance (of which we see so many in the political arena every day) as a minuet because of that rather subtle and intricate nature. Yet, as much as it takes some

substantial inference to see through the charade of the Treasury and Fed appearing to only endorse the portions of the Senate (and ultimately House of Representatives) bills which suit their GSE reform agenda, there are several very telling indications that there will be administration acquiescence to the direct at-risk borrower relief effort.

First of these was indeed Mr. Bernanke's reference to improvement in US housing being central to the address of losses elsewhere. While it is a very belated latent admission of what we among many more esteemed figures (Messrs. Hale, Summers, Greenspan, et al. noted in previous analysis and attachments) had been saying for some time about the problem being asset value destruction, it was appreciated nonetheless.

As Treasury and Fed stuck with their previous ineffective piecemeal approach, their advice to everyone from commercial banks to brokers ultimately to the GSE's was to 'raise capital.' Yet, that would do no more than absorb losses, the usefulness of which was belied by the extreme slide in Fannie Mae and Freddie Mac stock prices last week. The bottom line that they either had not understood (which is unlikely), or which they chose to ignore in a triumph of hope over experience is this:

Once conditions are weak enough, nobody wants to invest more equity into entities all tainted by the same problem. Prior to the final extreme drop in Fannie and Freddie stock prices on Friday, The Financial Times' John Authers shared a most prescient view with its readers from the very start of his *Short View* column that morning: "It looks as if the equity markets have designed a better liquidity trap - and US mortgage agencies are trapped." (A copy is attached for your ease of review.) He goes on to explore the lack of ability to raise more equity when the rationale for holding equity in those entities has evaporated in the face of asset value risk weakening their stock prices.

And that multi-faceted problem is driven at the core by the continued weakness of US housing; especially the momentum of the drop in prices. As noted previous by all well-informed parties (including Messrs. Paulson and Bernanke prior to realizing that view belied the efficacy of their programs), lower prices are an incentive to purchase homes, but *sharply lower prices are a disincentive* for prospective home buyers.

It is sad it took the near catastrophe of the implosion of equity value of the GSE's to focus the Bush administration and Fed on addressing the multiple problems for which weak US house prices are the core. Yet, this is Washington, and there is a tendency for folks on one side of an ideological divide to play out what has already been shown to be a deficient hand to its bitter end.

That end for the claims of efficacy for the Hope Now program and other purely 'free market' efforts to address the problems without explicit direct relief to borrowers facing foreclosures came late last week. Committee Chairman Dodd gave a very eloquent opening statement that was as supportive of current efforts as it was critical of previous failures (attached for review.)

Yet, not included there (and not available it seems except in the official minutes of the hearing that we did not have time to seek out as yet) is his very brief statement at the top of the combined Paulson-Cox-Bernanke testimony. He was rightfully forward and accurate in his sharp assessment that (paraphrased here), "We have struggled for a full year to pass legislation that many at first characterized as a costly bailout." He continued, "...the evolution of the situation has led us all to unprecedented ideas."

What a wonderful example of rightful pique transformed into eloquent critique. Similar sentiment on that issue and others was evident at Chairman Barney Frank's House Financial Services Committee hearing.

Explicit acquiescence of the administration in the Congressional efforts came in the very subtle minuet of the third part of the three part program that Secretary Paulson presented in his opening statement at the Senate hearing: "...to help protect the financial system from future systemic risk, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by providing the Federal Reserve authority to access information and perform a consultative role..." etc., etc. (Paragraph 3 on page 2 of the attached.)

There were immediate questions as to the efficacy of Fed involvement with the GSE regulator, and will be no small amount of debate as to its role. However, that is really beside the more important implication of this statement: Administration acknowledgement that the Congressional housing relief bills will indeed become law and be funded.

While it is a matter of inference rather than explicit statement from Secretary Paulson, nobody really expected him and Messrs. Bush and Bernanke to jump up and say, "Wow, we had it wrong; we really do need some fairly extensive at-risk borrower relief." Yet, if Secretary Paulson is going to move to strengthen Congressional GSE reform legislation in any manner, it allows that the Dodd-Shelby bill (reconciled with the House version) will indeed be signed into law and funded as part of that reform.

Is it possible that President Bush will veto a bill presented for signing into law that his Treasury Secretary has already deemed beneficial, and has discussed augmenting with constructive additional actions? While there have been some less than effective (and psychologically burdensome) actions by the administration along with its attempts to shore up general optimism, that would be tantamount to asserting that the President is the administration's real original thinker on finance to whom Secretary Paulson defers. Not Likely.

As such, the administration engaging in this Malleable Mind Frame Minuet is a subtle yet seemingly explicit endorsement of the Congressional housing crisis relief effort. Given that the serial bailouts of so many other institutions (or at least some significant portion of them) might be avoided by addressing the core housing problem to some meaningful degree, and some of the worthy owners kept in their homes at the same time, this came none too soon.

The events of the last week also illustrate the degree to which a previous assertion of ours is true: ultimately the active election cycle in the US will get ‘the powers that be’ on board proposals that benefit the public, and surmount what are often specious political concerns (more on that in **Fiddler’s Notion** below.)

At times this requires the problems to be extreme enough to pressure those who are recalcitrant into doing the right thing, and that is a classical part of ‘business as usual’ in our messy system. Highly visible banking problems assured action was taken.

We return to Sir Winston’s wisdom that we cited several weeks ago one more time: “(*democracy is*) ...the worst form of government except for all the others that have been tried from time to time.” Possibly direct assistance for at-risk borrowers is the worst form of assistance to address the US housing crisis. Yet, as compared to highly abstract concepts that attend the attempt to try a new form of government, at least it has the advantage of supplementing other forms of addressing the crisis that have already been shown to be insufficient on their own.

## **Stalking Horse**

To appreciate the degree to which Senators Dodd and Shelby are extremely talented tacticians as well as enlightened on the multiple benefits of the direct assistance to at-risk mortgage holders requires some appreciation of the specifics of the bill broadly described as the Housing and Economic Recovery Act of 2008 (HERA.) That is with due respect for and credit to the very astute staff members who assist the senators in these sorts of things.

The real beauty of it is the degree to which it blends necessary Government Sponsored Enterprise (GSE) reform with a multitude of programs to mitigate foreclosures or their knock-on effects on communities. Not the least of these is direct assistance to at-risk borrowers that is criticized by some as not substantial enough to make a difference. Yet, as in our previous analysis, we rather like the view of the current bill setting up the mechanism (a sort of stalking horse), and expanding it once it is proven effective.

There is current evidence that is at least tacitly intended, and historic precedent for it being the right thing to do.

Yet, back on the tactical view of the bill, in a nutshell it had enough beneficial aspects to override the objections of the nay-sayers (literally, as it regards voting on legislation) when the time was ripe. And the time finally became ripe last week. To paraphrase the old cliché on constructive opportunism, “Chance favors the prepared legislation.”

Secretary Paulson was not just covering for the failure to act previous when he noted he had been a big advocate of GSE reform. There were indeed entrenched interests both at the agencies and on either side of political aisle in both houses of Congress and the executive branch who all had agendas that delayed or denied any reform. It was a tough brief, and lack of progress on that does not rest with any one branch or party or administration.

Yet, when the time came, something would indeed need to be done, and done quickly. Even moreso than the highly desirable reform of the GSE's was going to be the need to take additional steps to stem the still rising tide of US housing foreclosures, and the attendant weight on home prices which were already having an effect on consumer sentiment. As noted extensively in previous analysis, symptoms turning up in various businesses' and markets' lack of liquidity is based on fears of weakness and inability to price underlying real estate assets; and US home price slippage is the core problem comprising the neck of that venomous hydra.

Needless to say, in addition to that drag on consumer psychology, the next shoe falling on financial services fears in the form of the failure of IndyMac Bancorp last Friday along with the GSE's near meltdown was a critical inflection point. That might lead some to feel that this is just another 'knee-jerk' Washington DC reaction to score political points in front of an election.

*Au contraire.* The Dodd-Shelby legislation was honed in such a hostile environment, and given enough time to cure any initial weaknesses that it is in fact a paradigm of positively constructive response to a thorny (in fact what Mr. Paulson himself described as intractable) conundrum: Supporting the individual homeowners mistaken (and in some limited cases misled) about their ability to service Hybrid Adjustable Rate Mortgages (i.e. with substantial interest rate resets) without either a handout or a wholesale nationalization.

A closer look at the summary of the legislation is very instructive on the creative manner in which this is accomplished. While the first section is focused on the long delayed housing finance reform, it is section 'B' that is truly intriguing.

That is both for practical implications of its effective regulation and fair and balanced aspects of what in the bad old days would have been a simple handout subject to abuse. (A copy of the summary of the bill is attached for your review.)

Its basic 'five principles' include various constructive aspects to ensure loans are long term and only provided to those who can really afford them, mortgage holders will need to absorb some fairly significant losses (yet less than foreclosure), safeguards that preclude loans to obvious deadbeats, the availability of loans only to owner-occupiers (a big point on not supporting speculators), and a specific point acknowledging that this is not some old-tyme feel-good government program. Point 5 specifically addresses the same sort of illiquid credit market concerns and capital hoarding in anticipation of far greater write-offs that we have been citing as a major problem for some time.

Awhile back we were of the view Congress was fine for not much more than populist cant to generate sound bites for election campaigns. However, the elevation of their insight and practical understanding of finance and markets on the part of Senator Dodd and Representative Frank (we have no direct knowledge of Senator Shelby's previous positions) means that very solid ideas on everything from trade to fiscal matters can be expected from Congress.

That's at least as large, and in the long run an even more important sea change than the administration and Fed shift of the past several days.

The reason we mention that at this juncture is the most creative and intriguing aspect of HERA may be the third of the five principles: "No windfall for borrowers. Borrowers will share their new equity and future appreciation equally with FHA." !!!!

High kudos to whoever came up with that; as that is why the ‘costly bailout’ camp was always misguided in their specious political opposition. The government will assist the owner-occupier in remaining in their home as a ‘partner’ who is going to reap half of the appreciation of the value of the home. That goes a long way (across the full gamut of successes and the inevitable failures) toward explaining how the senators can claim the likelihood of no net cost to the American taxpayer.

Going back to our Britain in World War II analogy, this may be the most enlightened government dice roll since the Lend Lease Program (i.e. both providing England the equipment and financing it while it fended off Germany until the US entered the war.) If the whole economy melts down in a way that requires wholesale recapitalization as in the 1930’s, then the amount lent to at-risk borrowers will be negligible by comparison. However, if the at-risk borrower assistance actually diminishes defaults and begins to restore some degree of confidence, the ‘Stalking Horse’ has done its job and the program can be expanded.

The extended beauty of that is any further funding can be far more concentrated on the at-risk borrower support. There are only so many dollars that can be spent on GSE regulation, and the support to communities with a high level of foreclosures becomes a blessedly lower priority if the foreclosure problem itself is significantly mitigated.

And what might be that historic basis and current evidence for our expectation the \$300 billion is just to get the mechanism tested prior to broader funding? Of course, the historic reference on this is Resolution Trust Corporation (RTC.) Once it was seen to be effective in assisting the savings organizations offload commercial property investments which had become overblown during the aggressive US real estate tax

shelter era, further funding was made available to ensure that full re-liquification of the US banking system was completed.

As a cautionary aside, that’s another aspect of our assessment this is just “the end of the beginning”: it was the Crash of ’87 that created the liquidity crunch which led to the protracted economic weakness during 1989-1992 that required the RTC to step in; and over similar expense and moral hazard objections that HERA has had to surmount. The obvious lesson is that stopping the rot in US housing is just the initial step in what is still going to be a trying economic time.

The current assumption that assistance to more at-risk borrowers than current HERA funding will allow comes from our endless capacity for inference once again. If one takes a look at Senator Dodd’s HERA passage press release to his constituency on his Connecticut website (which is also attached for your ease of access), the background states, “It is estimated that over 23,000 Connecticut families have mortgages that are delinquent, and almost 10,000 Connecticut families are in the process of foreclosure.”

That’s pretty depressing whether or not the 10,000 in the process of foreclosure are a subset of the 23,000 that are delinquent. Yet, in the specific benefits cited for his Connecticut constituents, in the “HOPE for Homeowners Act” summary he notes that, *“If signed into law, over 3,700 families with mortgages in Connecticut would likely be refinanced...”*

Hmmm. Let’s assume that fully half of the 23,000 delinquent households will not qualify for refinancing (which may be over estimating the number who do not meet the criteria.) That still leaves 7,300 families who could use the help, but for whom funding is inadequate. Let’s make another couple of wild (yet hopefully accurate) assumptions:

That the lower foreclosure rate does indeed help to restore stability to the US housing market, and that this same scenario is being repeated to a significant degree in most other Congressional districts.

What if this (now heavily bipartisan) effort manages to exhibit some degree of success by sometime into October? Last question: What are the chances in that case there will **not** be more funding (or a firm commitment) for something that all of Congress realizes is the answer to the national dilemma and their local popularity at the same time?

Remember that bit in the previous topical discussion about how likely it might be that President Bush is the administration's real original deep thinker on finance to whom Secretary Paulson defers? We can apply almost as assured a "Not Likely" to the potential of no further funding for HERA's

at-risk borrower foreclosure prevention program if it is showing any reasonable results. And with good reason.

In summary, what we have in the HERA legislation passage is partial (50 percent) and temporary (for the life of the mortgage) socialization of a limited portion of the US housing stock that is causing the problems.

Consistent with HERA guidelines, that is on a rational basis that both mitigates the burdens to so much else of the financial services industry and economy at large, and provides a return to the American taxpayer if the rational expectation of a return to a normalized housing market and economy (as is likely across time) is the result. Especially so if stabilization of home prices removes the previously noted disincentive to purchase, and that sees new buyers step forward after the current uncertain period.

### The Fiddler's Notion<sup>SM</sup>

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 Dairymen*. 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<sup>SM</sup> 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.

### Demonstrably Trivial Recalcitrance

We return here to a previous observation on the very specious nature of some resistance to the Dodd-Shelby bill that was so purely political it illustrates why things that are constructive are so hard to push forward in

Washington DC. While it repeats some previous observations, those are very consistent with inquiring how and why something as necessary and constructive as this bill took so long to enact.

This is substantially a full reiteration of **The Dodd Cookie Jar Conundrum** we explored a couple of weeks ago. Any of you who already recall this can skip this section.

As noted back at that time, there was a silly and minor distraction impeding the rightful housing assistance from the US Congress passing as a necessary and desirable bit of legislation. Recent revelations that Senate Banking Committee Chairman Christopher Dodd received substantial preferred home loan deals from the now infamous Countrywide Financial loan company (no less) are raising these specious concerns.

The best consolidated review and analysis of the situation that we have found is from specialty publisher Condé Nast, which has recently broadened out from typical travel and food periodicals into a financial focus with 'Portfolio.com'. The analysis of this situation can be found on their site at: <http://www.portfolio.com/news-markets/top-5/2008/06/12/Countrywide-Loan-Scandal#>

A brief sampling of the extensive coverage of the issues and facts surrounding loans made to Senator Dodd and other V.I.P.'s includes the select observations:

"Senator Dodd received two loans in 2003 through Countrywide's V.I.P. program... ...\$506,000 to refinance his Washington townhouse, and \$275,042 to refinance a home in East Haddam, Connecticut. Countrywide waived three-eighths of a point, or about \$2,000, on the first loan, and one-fourth of a point, about \$700, on the second, according to internal documents. Both loans were for 30 years, with the first five years at a fixed rate.

"The interest rate on the loans, originally pegged at 4.875%, was reduced to 4.25% on the Washington home and 4.5% on the Connecticut property by the time the loans were funded. The lower rates save the

Senator about \$58,000 on his Washington residence over the life of the loan, and \$17,000 on the Connecticut home. The former employee says the float-downs were free. Senator Dodd's wife, Jackie Clegg, said in a brief interview that two other lenders they checked with offered comparable interest rates."

As we assume Ms. Clegg's statement is in good faith, that means other major lenders were also keen to provide advantageous terms to those they viewed as 'preferred' clients back on the heyday of their strong business expansion. As a perspective on all of this, and whether the benefits derived by the good Senator (and others) amount to anything that should be considered relevant to the passage of the US housing bailout legislation is actually quite interesting.

As noted previous, it is only realistic to presume the \$300 billion program price tag is just a starting point to get the mechanism going. For the sake of discussion, we are going to allow the cost of the US at-risk borrower support might actually run closer to \$600 billion or so. At that potential level of program cost, it is greater by a factor of 8,000,000 to Senator Dodd's misstep by of accepting what is a \$75,000 'gift' across the life of the loans (as such, very significantly less in net present value rebased 30 years.) In fact, there is no proscription on a 'gift' as long as no influence or favor is provided the giver, and there is no sign of abuse here.

Yet, in an election year in the US, that demonstrably trivial suspicion of corrupted judgment (which Senator Dodd would be daft to exhibit at this point) was holding up what is possibly the only real alternative to continued devolution into despair from US housing's foreclosure-based 'unpriceable' debt securities problem. That is also related to interbank lending conundrums, as well as extreme financial burdens on individuals, communities, municipalities and the states. Only in America.

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

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