
January 2009: Report to Socrates

1. Introduction

The credit crisis is like a glacier: it moves with irresistible momentum, grinding into flour the landscape and rocks beneath it. Central banks and governments have tried to maintain the size of banks and other financial institutions. They have been reduced of their extremities and have become rounded. They will get smaller as the grinding persists. The glacier has now reached new territory, observers are especially conscious of the manner that it is bulldozing its way through the motor car industry, but it is also destroying demand, and thereby economic growth and employment.

The report looks over the last month, as usual, and stresses the importance of the mall in the USA and an impending disaster as sales collapse in a highly leveraged sector. The report also takes a glance at the year.

As to the future, we will observe that no one really knows how to stop a glacier. It could be that throwing more money at the juggernaut perpetuates the conditions which fuelled the glacier

2. An Overview

- >Housing remains the key. The UK market fell as massive 2.6% in the single month of November, and 14.9% on an annual basis. The average house is 124% higher than 10 years ago, which indicate that the bubble has not deflated. Housing demand in the UK is constrained by perceptions that prices will weaken constraints on spending, and a shortage of mortgage finance. Incomes rose by 3.3% in September, below the Retail Price Index (5%). Fuel has risen by 39% in the year and food by 10%- reducing real income and discretionary spending. The number of sales was 64% lower. (Data from Halifax Price Index).
- The Case _SchillerS&P500 has fallen to 150 points, way off its high of 189.93 in the second quarter of 2006. The National association of Home builders said its index is at its lowest point of pessimism since its launch in 1985. Builders have high inventory, few sales and see mounting foreclosures. Their pessimism is

worth comment as greater Federal assistance is anticipated. Moreover, interest rates have declined. Nevertheless house sales are slower than expected.

- This confirms the depth of the recession as consumer sales have been dismal and many malls are fighting for their lives, struggling with rising vacancies, softening rents and high debt loads. It is broadly considered the worst season in history for retail sales. At the end of October, the International Council of Shopping Centers forecast the closure of 6100 stores (before Circuit City and KB Toys failed). Taking into account other stores, it predicted that 148,000 stores would close in 2008 and 73,000 in first half 2009. Retail chains report clothing down 20%, electronics and appliance down 26% and luxury goods down 35%. (Source: SpendingPulse). Malls can survive losing half their tenants if the malls are debt free, but they are highly-leveraged, and must grapple with lower income and rising debt cost. There is a term “economic vacancy” used by research firm Reis, which relates to retail space that surpasses the amount that retail sales can support. Reis estimates that one-sixth of mall space is superfluous “and needs to go away”. The B and C malls are especially vulnerable because their anchor tenants like Bon-Ton or Sears are doing badly. US retail sales were 4% down in December yoy, the worst decline in decades. The UK has a similar decline, but data is not yet available: the media reports a rush to post-Christmas sales where big name retailers are offering some 90% discounts. There is evidence that Aussies and Kiwis spent hard on Boxing Day but I think the money ran out quickly: my daughter reports an amazing drop off in McDonalds, and staff being sent home. The British retail Consortium reported sales down in December by a huge 4.1%. Many high profile retailers have failed.
- 2008 is a terrible year for US stock markets. The S&P500 is down 40.6 on Dec 28 (2 trading days to go). The worst year was 1931 when it fell 47%. 2008 is undoubtedly the worst for wealth destruction- the Wilshire 5000 has lost \$7.3 trillion. The Dow recovered to 31% down (at 8515 from 13,043) and the NASDAQ 42%.
The Dow fell 300 points in December.

2 Market Dysfunctions remain

- Interest rates. On Dec 23, US Treasury issued \$50 billion of debt at minimal cost to taxpayers. \$22 billion was a zero interest on one month bills. Many bidders were disappointed as the bid-to-cover ratio was 4.41, the highest in 7 years. The market is so wary that investors will hand over money free for safe keeping. Investors have been scalded by equity collapse, hedge fund fraud etc, and now merely want to be sure they are not losing capital. Yield on the 2-year bond is a record low. The Dec auction also sold \$28 bn of 5-year at a record 1.539%.
- Things may change when a tidal-wave of supply arriving in the coming year. The existing \$5 trillion treasury market will expand to \$6.5 - \$7 trillion to fund its financial market rescues. Yields should rise, but this will create steep capital losses for bond-holders.
- A zero return on treasuries indicates that panic remains in the market. The VIX index is in the low-40, confirming the panic. No market price or index, however, better expresses to present degree of risk aversion and lack of confidence in the future than zero interest rates! The VIX index in the 40's is an improvement, but for years it has been around 10. This year has been the most volatile, with the collapse of the Wall Street banking model, bringing previously unheard of VIX heights of 80, and the S&P 500 has had ten days of 10% market fluctuations. Billions of survivor's dollars are in bomb shelters.
- Credit markets are improving. The key bank-to-bank lending rate, the Libor has trended downwards since October because central banks have pumped cash into the banks. There may not be a lot of inter-bank lending taking place, as indicated by banks placing money (about 250 billion Euros) with the European Central Bank overnight rather than lending it out in inter-bank markets. The two-year US Swap Spread- a gauge of counterparty risk and financial system risk- has shrunk by 40 points since the Fed slashed rates two weeks ago.
- Equity markets are likely to remain subdued as zero interest rates betray a lack of confidence, some panic remains, and inter-bank activity is very muted. Matters might change when a new President is inaugurated, but equities are still not cheap on fundamental of earnings, which are undermined by a deepening recession
- December was a disaster for commodities as well as stocks. This writer has had to come to terms with his unwarranted optimism about oil prices. Peak oil will keep oil expensive in the long run, but there is enough supply to cope with rapidly diminishing demand now. Prices fell by 30% in December, before the Israeli assault on Gaza gave oil (and gold) a huge stimulus. Oil output may decline as OPEC has foreshadowed cuts and a target price of \$75. This writer has also been wrong on gold, underestimating its strength, even before the atrocities in Gaza. The commodity of the year is Cocoa.

Commodity	month high	low	change	yr high	yr low	change
Oil	55	30		145	30	
Coal futures	72	59		143	50	
Gold	760	871		1032	682	
Copper	1675	1248		4,078	1,248	
Alumn	89	71		1.50	89.	

Source; Findata

September was a disaster for commodities; it is only while compiling this table that I realise that December is as bad, especially for oil, copper and aluminium which lost about a third in price. This year is worse than any year in the 1930's for key metals.

4 Exchange rates.

	Sep	Oct	Dec	12 month low	high
NZD-AUD	0.8250 -	0.88	84	0.77	0.89
NZD-USD	0.6857 -	0.58	57	0.56	0.82
NZD-GBP	0.3716	0.3746	40	0.36	0.41
NZD-EUR	0.4689 -	0.4480	41	0.45	0.54
NZD-JPY	72.77	58.15	52	57.24	91.47

Note the volatility/range against the yen, The Kiwi has made huge losses, while it is low in its range, it may go lower as interest rates

My currency of choice is the Yen, as it was in previous reports. The Kiwi has strengthened against the dollar. I am personally bullish about the Aussie, but do not recommend others to share that enthusiasm. Sterling is a dark horse (as predicted last month). It has gained this month.

The currency of the year was the dollar. At the beginning of the year, I expected it to weaken. It has been vigorous, especially since September when US investors recalled external assets in a massive deleveraging process. Although the US is in recession, and increasingly in debt, I cannot confidently predict US\$ weakness. The Euro seems more vulnerable as Germany rails against other member states being ill-disciplined.

5 Global economics

2008	Global GDP % growth 2009	% growth 2008	Inflation (%) 2008	Current AC (% GDP) Dec	Year
USA	1.6	1.3	4.2	-4.8	6.
UK	1.2	0.6	3.7	-3.4	E
Euro zone	1.3	0.9	3.6	-0.3	7.
Japan	1.0	0.9	1.6	3.7	
China	9.8	8.5	6.7	8.3	
India	7.4	7.1	7.1	-3.2	
Australia	2.7	2.6	4.4	-5.1	
New Zealand	1.5	2.8	3.0	-7.6	

Source Forbar

I expect global growth to become minimal. All of the major economies are in recession, and I do not imagine any will break into growth in the next half year. The collapse of the motor car industry is a symbol. US manufacturing has obvious problems with union labour and poor design. But efficient German, Japanese and Swedish producers also have encountered a collapse in sales. Japan has had its biggest ever fall in export demand. China had export declines for the first time in 7 years, and its growth is in jeopardy. Demand for commodities and finished goods is so low that marine freight rates have fallen by up to 95%. I regard this decline as very serious. Credit remains a problem especially emerging countries. I expect much dissatisfaction with governments: Greece began it, but maintaining cohesion in the face of depression will test the fabric of Spain, Russia, and China as well as more obvious states, some of which already depend on IMF loans. The IMF has lowered its forecast rate of growth.

6 Investment Opportunities

I have nothing to add to last month's appraisal, except that I was too optimistic about bonds. I can see no strong trends. I repeat that: "Cash is king. It is a time to adopt an absolute attitude and avoid loss."

7. A review of 2008

2008 was the worst year for world markets since 1931. In some ways it is worse. No British Empire bank failed in the 1930's, but several have been rescued recently. Commodity

ties have fallen further than they did in the 1930's. In many countries house prices have also undergone an unprecedented fall. The real economy is suffering, with car manufacturers everywhere under pressure—they thrived in the 1930's. Unemployment is low, but rising. No one knows how deep the recession will be. Equities are priced for recession; bonds are priced for a depression.

However, some things are a lot better now than in the 1930's. Authorities around the world recognize that the slump is a common problem. They are co-ordinating action, especially in reducing interest rates, recapitalizing banks, stimulating the economies and avoiding short sighted actions in limiting international trade and investment.

What were outstanding points in the year?

1. Meltdown Monday, 20 September 2008 will be a day to live in infamy, along with Black Tuesday 1929. It was the day when Lehman Bros filed for bankruptcy. It started an incredible panic in which investors pulled out of many financial institutions. Great names like Merrill Lynch and Goldman Sachs were saved by state intervention. AIG, the world's biggest insurer had to be saved. The world stood on the edge of a precipice and survived narrowly. Perhaps the Fed's call for a bailout of \$700 billion helped, but banking almost failed. So much happened; the stock market sank, other markets teetered on the brink as liquidity disappeared. Commodity prices began their steepest ever fall. Several institutions died like the venerable Reserve Primary Fund (a money market fund) and insurer Washington Mutual.

Investors retreated from all activities; - equities, commodities, commercial paper, and hedge funds. They retreated into government bonds. Their retreat shut down municipal and corporate bonds. They also withdrew from emerging markets.

When they sold Argentinean or Russian securities they bought the dollar. Its rise created mayhem. Consumers stopped buying and a recession became inevitable.

Wall Street Journal report on Dec 29 analyses reveals that the Lehman Brother's bankruptcy filing destroyed \$75 billion of assets, which might have been saved if there was time to unwind derivatives etc.

2. The slump or recession had begun a year earlier. I called it in July 2007 because of the housing problem and also because of a lack of takers for securities offered by investment banks who had bought out Boots in the UK and Chrysler. The banks had ceased to function. The crisis later erupted into a catastrophe because there was no exchange where securities, toxic or otherwise, could be sold. Hedge funds collapsed when they could not meet margin calls. Banks continually revised their assets values lower as the many securities had minimal value. They had to be recapitalized. The failure of Bear Stearns in March was dealt with; the

Fed took over Fanny Mae and Freddie Mac. There were some signs of progress until Meltdown Monday erupted.

3. Three-front war. Since Meltdown, global authorities have waged war on three fronts:
 - Central banks have acted to prevent more Lehman-like collapses. Troubled institutions have received capital to restore their balance sheets and prevent bankruptcy. CitiBank and Royal Bank of Scotland were rescued. Even in far-flung Australasia, Governments followed the lead of the Irish government in guaranteeing deposits. New Zealand gave funders guarantees. It seems likely that few banks will now be allowed to fail
 - Bank –to-bank lending dried up because banks were suspicious of skeletons in the closet. This had a deleterious on lending to commerce, which went into a downward spiral as credit was extremely limited. Without credit it became hard to sell houses or cars. A revival of interbank lending is very incomplete.
 - Many governments have tried to off-set declining expenditure of capital investment and consumer spending by vigorous pump priming or fiscal stimulus. Most governments have programs featuring infrastructure, tax concessions and often vouchers. The US and UK are reputedly planning to drop money from helicopters. More recently, the battle has moved to shore up car manufacturers. There are few signs of the slump lessening.
4. Housing remains important .Falling values, especially in the US, UK, Spain, Ireland and Australasia, are enough to drag their economies into recession. In the US falls of some 20-30% have occurred in the sun states and more will follow as Moody's estimate that Miami housing is selling for 22 times annual rental instead of a "normal" 15 times. About 18% of US homes are "upside down" (the owners have no equity) and this may grow according to Fitch, which predicts another 10% fall. Alt-A residential packages issued in 2006 and 2007 will be revalued soon, leaving many investors with more toxic CDO.

The CEO of Barclays believes UK houses are only mid-way through a 30% fall. He concedes the "madness" of banks offering 100% or more mortgages.

Persistent negative wealth effects from the slide in house (and share-market) prices will create deflation. This will also hamper economic growth. If we assume that households will try to reduce their debt, and increase saving by around 6%, they will reduce consumer spending. As consumer spending is 70% of US GDP, saving will reduce growth.

5. Retirement plans awry. A huge number of investors have taken terrible blows by remaining fully invested in markets. Shares indices are down by around 40%.

Some funds have lost more. In New Zealand, a high proportion of finance companies have failed. Investors in affected companies may lose most of their investment. It is hard to quantify the damage done to a generation of people who did not understand fully the risks they were taking. Others were deceived. Many fell foul of the optimism of 2005-7, when it seemed a good idea to build anywhere near the sea or resorts, regardless of employment opportunities. A large number of people now look for safety in a bank deposit which may soon yield a measly 3-4%.

A huge number of people world wide have lost a lot of security. They face difficult choices in the time they remain in the workforce, and what level of consumption to aim for. This factor will reduce spending and economic growth, but it is hard to determine by how much.

6. Rising anger. New Zealanders have not shown much anger yet against the proprietors of failed finance companies. Elsewhere there is palpable anger against the executives of the five big US investment banks that were instrumental in passing toxic parcels of CDO etc into the world security systems. They rewarded themselves for this despicable act by sharing out a bonus pool of \$US 36 billion in 2006. There is similar anger in the UK, where gross events include massive golden parachutes to incompetents who brought distinguished banks to their knees. A recent example of anger was displayed by the US Senate against indigent car makers who travel by private jet.

I find it difficult to reconcile arrogance of bankers, especially Swiss bankers, with their record of stupidity. Throughout my youth they cultivated an aura of omnipotence and sagacity. Only they understood money. Only they had integrity and dependability. We know now they had no idea of risk evaluation; their decisions were driven by bonus considerations; and they were near criminal in their ability to cook accounts and hide bad assets.

As I write, many banks are owning up to lending to Madoff, the former NASDAQ chief, who ran a \$US50 billion ponzy scheme. I understand that some of the money extended to Madoff was off-balance sheet despite a hue-and-cry for greater transparency, especially in banks getting relief from taxpayers. There are also hard questions to ask about why the SEC never looked him over, and why his auditor was a one man part-timer.

My final point is that the world is in a catastrophe and no-one knows how it will end. There is no obvious solution.