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Credit Bubble Bulletin, by Doug Noland

Q3 2007 "Flow of Funds"

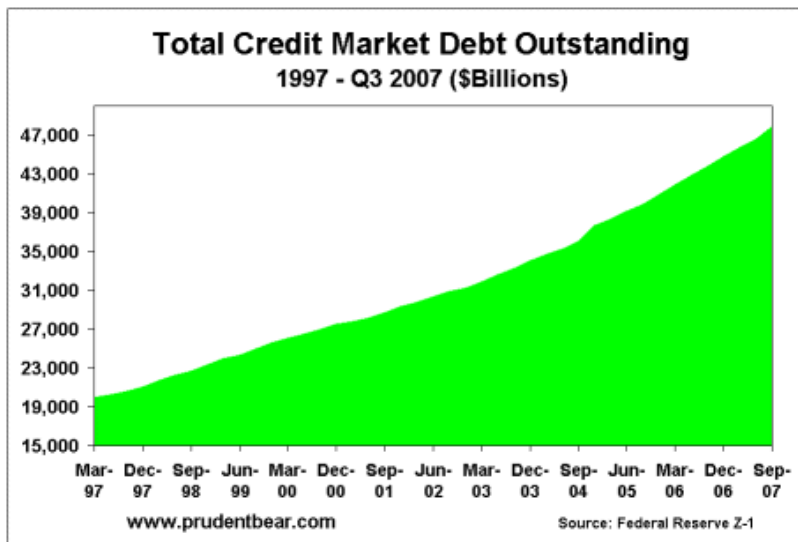
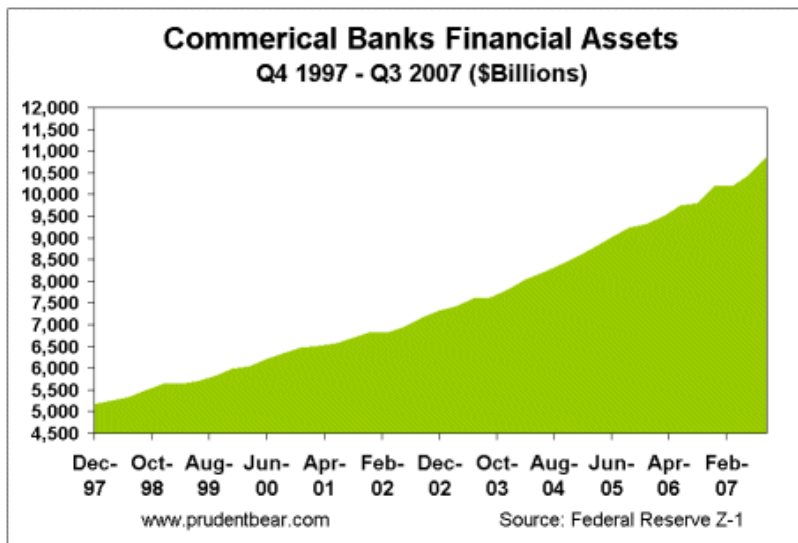
December 07, 2007

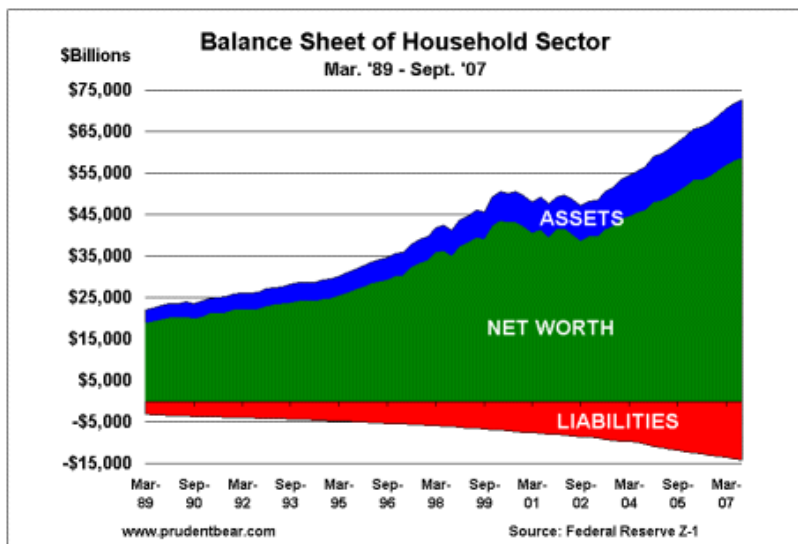
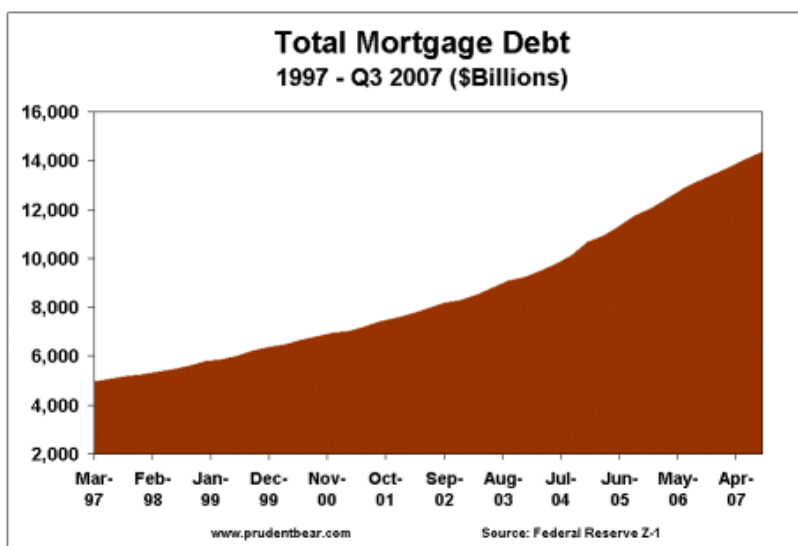
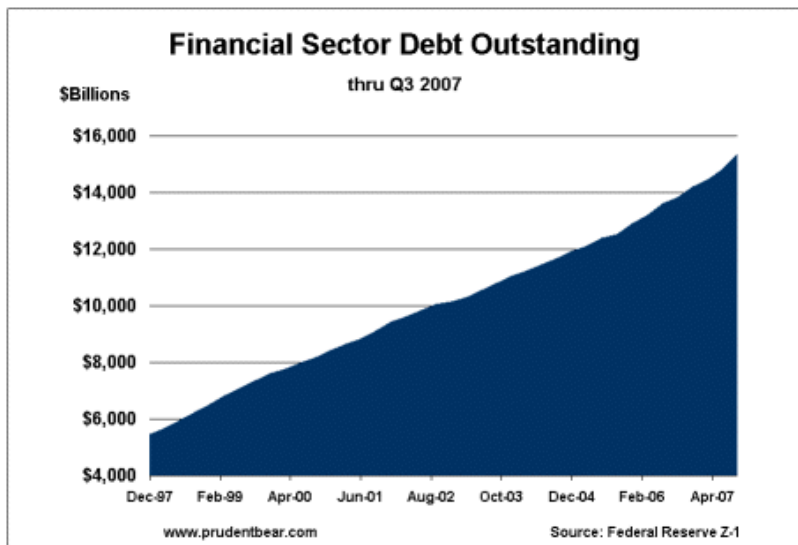
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In another volatile week, the Dow gained 1.9% (up 9.3% y-t-d) and the S&P500 1.6% (up 6.1%). The Transports jumped 4.6% (up 6.9%), and the Morgan Stanley Cyclical index rose 2.8% (up 14.2%). The Utilities advanced 3.2% (up 19.2%), and the Morgan Stanley Consumer index added 0.8% (up 9.3%). The small cap Russell 2000 gained 2.3% (down 0.3%), and the S&P400 Mid-Cap index jumped 2.9% (up 10.1%). The NASDAQ100 rose 2.0%, increasing 2007 gains to 21.2%. The Morgan Stanley High Tech index increased 2.7% (up 11.4%) and the Semiconductors 3.5% (down 8.3%). The Street.com Internet Index added 0.4% (up 16.7%), while the NASDAQ Telecommunications index declined 1.6% (up 10.1%). The Biotechs were about unchanged (up 9.7%). The Broker/Dealers gained 1.0% (down 11.7%), while

the Banks declined 0.7% (down 17.9%). With Bullion gaining \$10.80, the HUI Gold index rose 1.4% (up 21.8%).

Three-month Treasury bill rates dropped 10 bps this week to 3.07%. At the same time, two-year government yields rose 10 bps to 3.10%. Five-year T-Note yields jumped 11 bps to 3.50%, and ten-year yields jumped 17 bps to 4.11%. Long-bond yields surged 19 bps to 4.57%. The 2yr/10yr spread ended the week at 101 bps. The implied yield on 3-month December '08 Eurodollars jumped 19 bps to 3.625%. Benchmark Fannie Mae MBS yields rose 27 bps to 5.68%, quickly giving back last week's narrowing to Treasuries. The spread on Fannie's 5% 2017 note widened 1 to 61, and the spread on Freddie's 5% 2017 note widened 1 to 61. The 10-year dollar swap jumped 7 bps to 72. Corporate bond spreads were mixed to narrower, with the spread on an index of junk bonds ending the week 7 bps narrower.

December 6 – Bloomberg (John Glover and Patricia Kuo): "Defaults by speculative-grade companies will quadruple next year as the era of 'easy credit' comes to an end and economic growth slows, Moody's... said... The global default rate fell to 1% last month, the lowest since 1981. The rate will reach 4.2% by November, assuming the U.S. economy slows without falling into recession, Kenneth Emery, director of corporate default research at Moody's, wrote... In a recession, the default rate may reach 10%..."

Investment grade debt issuers included Wells Fargo \$3.0bn, Prudential \$3.0bn, Transocean \$2.5bn, United Technologies \$1.0bn, CVS Caremark \$590 million, Archer Daniels \$500 million, Danaher \$500 million, Baxter Intl \$500 million, Harley-Davidson \$400 million, Vulcan Materials \$325 million, Regions Financial \$300 million, West Penn Power \$275 million, Cintas \$250 million, Alabama Power \$200 million, McCormick \$250 million, and Protective Life \$150 million.

Junk issuers included Coso Geothermal \$630 million, and Ikon Office Solutions \$150 million.

Convertible issuance included Transocean \$6.0bn, Microchip Technologies \$1.0bn, and Hologic \$1.5bn.

Foreign dollar bond issuance included British Telephone \$1.2bn.

German 10-year bund yields rose 7.5 bps to 4.20%, while the DAX equities index gained 1.6% for the week (up 21.2% y-t-d). Japanese "JGB" yields jumped 9 bps to 1.56%. The Nikkei 225 recovered 1.8%, reducing 2007 losses to 7.4%. Most emerging debt and equities markets rallied. Brazil's benchmark dollar bond yields fell 6 bps to 5.62%. Brazil's Bovespa equities index jumped 4.2% (up 47.6% y-t-d). The Mexican Bolsa surged 5.0% (up 18.2% y-t-d). Mexico's 10-year \$ yields added 2 bps to 5.42%. Russia's RTS equities index gained 3.0% (up 18.9% y-t-d). India's Sensex equities index rose 3.1% (up 44.8% y-t-d). China's Shanghai Exchange rallied 4.5%, increasing y-t-d gains to 90.3%.

Freddie Mac posted 30-year fixed mortgage rates sank 14 bps this week to 5.96% (down 44bps in 7 wks and 15bps y-o-y). Fifteen-year fixed rates declined 8 bps to 5.65% (down 19bps y-o-y). One-year adjustable rates rose 3 bps to 5.46% (up 3bps y-o-y).

Bank Credit gained \$5.8bn during the week (11/28) to a record \$9,212 TN. Bank Credit has posted a 19-week gain of \$568bn (18% annualized) and a y-t-d rise of \$915bn, a 12.0% pace. For the week, Securities Credit added \$2.9bn. Loans & Leases increased \$2.9bn to \$6.730 TN (19-wk gain of \$405bn). C&I loans rose \$4.4bn (2007 growth rate 21.7%). Real Estate loans jumped \$9.9bn. Consumer loans increased \$4.5bn. Securities loans added \$0.9bn, while Other loans dropped \$16.7bn. On the liability side, (previous M3) Large Time Deposits slipped \$2.9bn.

M2 (narrow) "money" supply surged \$40.5bn to a record \$7.465 TN (week of 11/26). Narrow "money" has expanded \$421bn y-t-d, or 6.5% annualized, and \$463bn, or 6.6%, over the past year. For the week, Currency slipped \$0.9bn, while Demand & Checkable Deposits gained \$4.5bn. Savings Deposits jumped \$22.5bn, and Small Denominated Deposits added \$0.2bn. Retail Money Fund assets rose \$14.2bn.

Total Money Market Fund Assets (from Invest. Co Inst) jumped \$45bn last week to a record \$3.118 TN. Money Fund Assets have now posted an unprecedented 19-week surge of \$534bn (57% annualized) and a y-t-d increase of \$736bn (32.8% annualized). Money fund assets have ballooned \$760bn, or 32.2%, over the past year.

Total Commercial Paper declined \$10.1bn to \$1.844 TN. CP is now down \$379bn over the past 17 weeks. Asset-backed CP fell \$9.0bn (17-wk drop of \$342bn) last week to \$832bn. Year-to-date, total CP has contracted \$130bn, with ABCP down \$252bn. Over the past year, Total CP has declined \$89bn, or 4.6%.

Asset-Backed Securities (ABS) issuance slowed this week to a measly \$2.8bn. Year-to-date total US ABS issuance of \$526bn (tallied by JPMorgan) is running 38% behind comparable 2006. At \$224bn, y-t-d Home Equity ABS sales are off 57% from last year's pace. Year-to-date US CDO issuance of \$290 billion is now 19% below comparable 2006.

Fed Foreign Holdings of Treasury, Agency Debt last week (ended 12/5) gained \$5.3bn to a record \$2.037 TN. "Custody holdings" were up \$285bn y-t-d (17.2% annualized) and \$324bn during the past year, or 18.9%. Federal Reserve Credit declined \$2.7bn last week to \$867bn. Fed Credit has increased \$14.8bn y-t-d and \$24.6bn over the past year (2.9%).

International reserve assets (excluding gold) - as accumulated by Bloomberg's Alex Tanzi - were up \$1.240 TN y-t-d (27% annualized) and \$1.258 TN year-over-year (26%), surpassing \$6.0 TN for the first time.

Credit Market Dislocation Watch:

December 5 – Financial Times (Deborah Brewster): "Chip Mason, chief executive and founder of Legg Mason, one of the world's biggest money managers, said yesterday that the credit markets are in the worst state he has seen in his 47 years in the business. 'It is a very unusual situation. I have not seen anything like this, where nothing is traded,' said Mr Mason. Legg has more than \$1,000bn in assets under

management, including several large money market funds... Isaac Souede, the founder of Permal, another Legg subsidiary which is one of the largest hedge fund of funds, said this year had also been the most challenging he had experienced in his 21 years in the industry. 'There is a very distinct dislocation of capital which is unprecedented,' he said."

December 7 – Dow Jones (Damian Paletta): "Some lawmakers are concerned loan servicers might be sued by investors if they modify the terms of certain subprime loans as part of the Bush administration's plan to fix the problem. Many lawmakers and regulators have been hesitant to break open the contracts that are made when loans are bundled into securities and sold to investors, but servicers have complained that it is unclear how much wiggle room they have to rewrite loans."

December 3 – Bloomberg (Shannon D. Harrington): "Moody's... is preparing the biggest credit rating cuts since subprime mortgages contaminated the bond market, foreshadowing losses for investments that pay Florida teachers and money market funds. Moody's may lower ratings on \$105 billion of debt sold by structured investment vehicles after the net asset values of 20 SIVs sponsored by firms including... Citigroup Inc. declined to 55% from 71% a month ago... The assets were valued at 102% in June."

December 7 – Financial Times (Stacy-Marie Ishmael, Saskia Scholtes, and Gillian Tett): "Policymakers and investors have tended to assume in recent years that the biggest risks to financial stability were likely to emanate from the risk-loving hedge fund world. These days, however, they are confronting a new threat from a source that was considered so dull that it was widely ignored until recently - the so-called monoline industry, or companies which provide guarantees for bonds... 'There is a real issue of contagion at the moment,' says one senior former US policymaker. 'Monolines are one reason for that concern.' The contagion issue is particularly high since monolines have quietly become a crucial pillar of the financial markets in recent years. When the sector first sprang up three decades ago, the raison d'être of these companies was to provide insurance for investors holding municipal bonds. Companies like MBIA and Ambac typically lend their coveted AAA status to lesser-rated entities, allowing these borrowers to then issue top-rated bonds... However, in the past decade, monolines have rapidly expanded their operations to guarantee instruments ranging from British public-private infrastructure projects to US structured credit... 'For more than 20 years, bond insurance companies helped pave the way for small municipalities to sell debt to an otherwise inhospitable marketplace,' said Jack Ablin, chief investment officer at Harris Private Bank. 'Now that the creditworthiness of bond insurers has been called into question, bond buyers will need to take a closer look at the financial standing of the underlying bond issuer.'"

December 7 – Financial Times (Stacy-Marie Ishmael): "MBIA yesterday said it was looking at ways of raising more capital, triggering a rally in its share price a day after the bond insurer's financial strength was questioned by Moody's, the credit rating agency. The fate of MBIA and other bond insurers has emerged as a central issue in the current credit crisis. Despite relatively thin capital bases, these companies insure thousands of billions in dollars of debt, including securities backed by subprime mortgages... 'Essentially, we can assume MBIA is on super-secret probation,' said Rob Haines, an analyst with CreditSights. Michael Cox, securitisation analyst at RBS in London, said the next two weeks would be a critical period... '[These companies] have become the focus for those searching for the next domino to fall as the credit crisis unfolds,' he said. MBIA insures just over \$1,000bn of municipal and structured finance bonds. However, it only had the ability to pay \$14.2bn of claims as of September 30."

December 4 – Financial Times (Saskia Scholtes): "Six of Citigroup's seven structured investment vehicles could lose their top ratings from Moody's...the rating agency has said. Downgrades for the \$64.9bn of off-balance sheet debt vehicles, which have been put on watch, could exacerbate already stressed conditions for short-term paper backed by assets, as holders of SIV-issued paper are forced to exit the market to comply with investment guidelines... Assets in SIV portfolios are about 38% financial institution debt, 16% asset-backed securities, such as mortgage bonds, and 12% collateralised debt obligations..."

December 7 – Financial Times (Michael Mackenzie): "The buyers' strike for asset backed commercial paper (ABCP) extended to 17 straight weeks yesterday, meaning this popular source of short-term funding used by many bank entities has now contracted by a third since August. The shrinking commercial paper market is one factor behind the rising money market rates for banks, as borrowers such as structured investment vehicles (SIVs) seek direct funding from banks as an alternative to commercial paper... 'Short-term investors are deserting unsecured paper and buying Treasuries,' said Nicolas Beckmann, head of rates trading at BNP Paribas. 'Money is flying out of ABCP, bank CP, credit and mortgages.'"

December 7 – Financial Times (David Oakley and David Wighton): "Rabobank yesterday became the third bank in two weeks to bail out a structured investment vehicle in a further sign of deteriorating financial markets conditions. The Dutch bank plans to take assets of \$7.6bn on to its balance sheet to prevent a fire sale of Tango Finance.... Eddie Villiers, responsible for European sales at Rabobank, said: 'Our decision has been made purely for liquidity reasons as the assets in the portfolio are of high quality, but there is no market for asset-backed commercial paper for SIVs. We have done this for reputational reasons as our exposure to the SIV is small.'"

December 5 – Bloomberg (Darrell Preston and David Evans): "Much of the debt held by a \$14 billion Florida investment fund for schools and local governments is worth less than face value and the rest is so troubled that its value can't be determined, according to an official at the Wall Street firm hired to turn around the fund. 'I don't think there are very many securities in this market we can liquidate at par,' or 100 cents on the dollar, Chris Stavrakos, co-managing head of cash management for...BlackRock Inc., said... The more than \$2 billion of the worst securities that state officials agreed yesterday to spin off into a second investment pool have an 'indeterminate value,' he said. Of that, about \$867 million is in default, or 6%..."

December 3 – Bloomberg (David Evans): "Montana and Connecticut state-run investment funds hold debt tainted by the subprime mortgage collapse that was cut or put under review by Moody's... leaving local governments vulnerable to losses... Schools, fire departments and towns across the U.S. that use state- and county-run funds like a bank account are seeing the far-ranging effects of the housing slump, as

complex investments once sold as high-yielding, safe havens are now backed by collateral investors don't want. Modeled after private money-market funds, the investment pools are supposed to hold safe, liquid, short-term debt."

December 3 – Bloomberg (Gavin Finch): "The cost of borrowing pounds for a month surged by the most in more than 13 years as banks sought funds to cover their commitments to the start of 2008 amid a credit squeeze. The London interbank offered rate that banks charge each other for such loans due after the end of the year rose 63 bps to 6.72% today, the highest since December 1998... Soaring bank lending rates reflect growing concern about the strength of financial institutions facing billions of dollars of writedowns this year linked to U.S. subprime-mortgage defaults."

December 3 – Financial Times (Joanna Chung, Gillian Tett and Michael Mackenzie): "A severe bout of illiquidity has hit eurozone government bonds, threatening to impair the ability of some governments and other borrowers to meet their funding needs in coming months, according to market specialists... 'European government bond markets are facing challenges they haven't done for decades,' said Steven Major, head of fixed-income strategy at HSBC. 'We are seeing a repricing of risk and a level of illiquidity we haven't seen for a long time... 'There is a massive surge in funding in January and if things do not get back to a reasonable sense of normality by then, there could be some difficulties raising funds,' said Ciaran O'Hagan, strategist at Société Générale... One European sovereign debt management official said: 'It will be very difficult in the new year to conduct all the new issue activities, especially for corporates but for some sovereigns as well. There are so many standing in line and waiting.'"

December 4 – Financial Times (David Oakley and Gillian Tett): "UK bank lending rates hit nine-year highs yesterday as banks sought funds to cover their commitments for the start of next year amid a tightening credit squeeze. Sterling one-month interbank rates spiked more than 60 basis points to their highest levels since the end of 1998. European one-month rates rose to levels not seen since May 2001. US rates were also abnormally high... Behind the scenes, senior European policymakers and central bankers are in intensive talks with private sector bankers about what can be done to ease the crisis... 'We are now in the sixth month of the credit crisis. Funding costs have gone up for everyone,' Suki Mann, credit strategist at Société Générale, said. 'Although the year-end is playing a big part in the lack of liquidity, there is a worry it could go on into the New Year and that means trouble.' A senior credit strategist said: 'I have never seen credit markets trading as illiquid as this. There are lots of people hoping it will get better in January. However, this is far from certain.'"

December 3 – Bloomberg (Neil Unmack and Aaron Kirshfeld): "WestLB AG, Germany's third-largest state-owned bank, and ...HSH Nordbank AG provided financing to more than \$15 billion of troubled investment funds to prevent a fire sale of their assets. WestLB provided a credit line for its \$11 billion structured investment vehicle called Harrier Finance to repay commercial paper... HSH Nordbank said it will provide backup funding to cover all commercial paper issued by its 3.3 billion-euro (\$4.8 billion)..."

December 4 – Financial Times (Jim Pickard and Daniel Thomas): "The shadow of the commercial property crash of the early 1990s is looming over the UK once again as deal volumes collapse to a third of their previous level and property funds take further drastic steps to prevent a liquidity crisis."

December 5 – Financial Times (Stephanie Kirchgaessner and Krishna Guha): "The political tensions over the US subprime mortgage meltdown rose yesterday as the chairman of the powerful Senate banking committee questioned the role of Treasury secretary Hank Paulson in the crisis. Chris Dodd, the Democratic senator from Connecticut who is running for president, said he was 'deeply concerned' about a column in The New York Times that accused Goldman Sachs of 'injecting dangerous financial products into the world's commercial bloodstream' during Mr Paulson's tenure as chief executive of the company. 'If these facts are indeed true, the administration's inaction when this crisis began to emerge earlier this year is increasingly suspect,' Mr Dodd said. 'It is in the best interest of resolving this crisis if secretary Paulson . . . addresses the concerns. Failure to do so may be cause for a more formal investigation.'"

December 6 – Bloomberg (Gavin Finch): "The cost of borrowing euros for three months rose to the highest since Dec. 21, 2000, as banks sought funding over the year-end amid an ongoing credit squeeze. The euro interbank offered rate, the amount banks charge each other for such loans, rose 1 basis point to 4.88%, an 18th day of gains..."

Currency Watch:

December 3 – Bloomberg (Eric Martin and Betty Liu): "The Federal Reserve should raise interest rates to bolster the U.S. dollar and fight inflation even at the cost of a recession, investor Jim Rogers said. 'We should be raising rates to save the dollar and combat inflation,' Rogers...said... 'Recessions are good for an economy. They clean out excesses. You go down and then you start over from a sound base. Putting band-aids on to try to hold this thing together is madness.'"

The dollar index added 0.2% to 76.29. For the week on the upside, the Brazilian real increased 2.1%, the New Zealand dollar 1.7%, the South African rand 1.6%, the Norwegian krone 1.1%, and the Mexican peso 0.8%. On the downside, the British pound declined 1.7%, the Japanese yen 1.1%, and the Canadian dollar 0.6%.

Commodities Watch:

December 4 – Financial Times (Javier Blas): "Exploration companies need oil prices of \$70 a barrel to match the returns they made at \$30 a barrel just two years ago because of the sharp increase in costs and higher government licence fees, according to analysis by a leading consultancy. The research, from Wood Mackenzie...helps explain why non-Opec oil production is failing to accelerate its annual growth significantly in spite of record prices... The inability of countries outside Opec, the oil producers' cartel, to boost supplies substantially in the past few years has left the global economy more dependent on Opec, which controls 40% of world oil supplies."

December 3 – Financial Times (Robert Wright): "One of the biggest operators in the booming dry bulk

shipping market has warned current market conditions, where charter rates for ships have nearly tripled in a year, are 'insane' and 'unsustainable'. In a rare interview, Nobu Su, chief executive of family-owned Taiwan Maritime Transport, said he was concerned about the situation because it was putting pressure on the industry's customers... to pass on inflationary price increases to customers. Rates for dry bulk ships - which carry bulk commodities such as coal and iron ore - have spiralled because of Chinese demand... 'At present, soaring shipping rates threatened to create inflation in every economy in the world,' he added. 'I think it's insane,' Mr Su said. 'It's a very, very bad situation.'

December 4 – Bloomberg (Feiwen Rong): "China's demand for gold jewelry may increase by about 20% this year as rising personal incomes help it to race ahead of the U.S. as the world's second-biggest market, researcher GFMS Ltd. said. Gold use in jewelry in China jumped 24% from a year earlier to 221 metric tons in the first nine months, GFMS analyst Veronica Han said... That compares with 515 tons in India, the biggest consumer, and 165 tons in the U.S."

For the week, Gold rallied 1.4% to \$795, and Silver 2.4% to \$14.51. March Copper declined 1.8%. January Crude declined 43 cents to \$88.28. January Gasoline rose 1.7%, while January Natural Gas declined 2.0%. December Wheat surged 4.2%. For the week, the CRB index added 0.9% (up 11.6% y-t-d). The Goldman Sachs Commodities Index (GSCI) was little changed, with 2007 gains of 33.3%.

Japan Watch:

December 4 – Financial Times (David Pilling): "Profits at Japan's medium-sized companies fell sharply in the third quarter, leading to the first fall in five years in the country's aggregate corporate earnings... The fall, by 17% at mid-sized companies, underlines the patchy nature of Japan's nearly six-year-old recovery, which has failed to breathe life into large parts of the economy..."

China Watch:

December 5 – Financial Times (Jamil Anderlini): "China is to extend a clampdown on new bank lending into next year because of fears that rising inflation could become unmanageable, according to bankers, officials and economists. An annual economic policy meeting of top political and economic leaders that wraps up today in Beijing is expected to decide to cap the value of new loans that banks can extend in 2008 at the same level as this year. In the first 10 months of this year, before a crackdown on new loan growth was implemented, domestic and foreign banks in China had extended Rmb3,505bn (\$474bn) in new loans. The move would mean that in percentage terms, new bank loans in China would grow by about 13% next year, down from the 15% allowed in recent years, said Chen Xingdong, chief China economist at BNP Paribas."

December 3 – Bloomberg (Zhang Dingmin): "China will cap commercial banks' expansion of lending at 13% in 2008 after growth exceeded the 15% target this year, the China Business Journal reported... The government may also impose quarterly lending targets and punish banks that fail to meet them..."

December 7 – Bloomberg (Irene Shen): "China's passenger-car sales rose 17% in November from a year earlier, as economic growth boosted sales in the world's second-largest vehicle market."

India Watch:

December 4 – Bloomberg (Cherian Thomas and Kartik Goyal): "India needs to double spending on roads, ports and other infrastructure by 2012 or risk derailing its record economic growth surge, said Montek Singh Ahluwalia, a key policy adviser to the government... In the past year, India has tripled its investment target for infrastructure to \$500 billion, or 9% of gross domestic product, to strengthen its stretched public works."

December 3 – Bloomberg (Kartik Goyal): "India's exports grew in October at the fastest pace in 15 months... Shipments of manufactured goods including gems and petroleum products rose 35.7% from a year earlier to \$13.3 billion... the commerce ministry Said... Imports increased 24.3% to \$20.8 billion..."

December 7 – Bloomberg (Sam Nagarajan): "Money supply growth in India... increased 22.8% in the two weeks through Nov. 23 from a year earlier..."

Asia Bubbles Watch:

December 4 – Bloomberg (Stephanie Phang): "Malaysia's exports expanded at the fastest pace in 11 months in October as sales of palm oil and chemicals to China made up for a drop in shipments to the U.S. Overseas sales grew 14.3% from a year earlier to 54.9 billion ringgit (\$16.4 billion)..."

Unbalanced Global Economy Watch:

December 3 – Financial Times (Krishna Guha): "In almost every corner of the world inflation is uncomfortably high, creating a giant headache for policymakers as they grapple with the threat to growth from the turmoil in global credit markets. The concern about inflation would swiftly disappear if the US plunged into a deep recession, as investors increasingly fear. But for now, the dilemma is all too real. In October consumer prices rose at an annual rate of 3.5% in the US, 2.1% in the UK and 2.6% in the eurozone - where November showed a jump to 3%. German inflation is at its highest in more than a decade. Prices are also gaining at an annual rate of 6.5% in China, with rapid increases in other emerging markets too. The culprit everywhere: rising food and energy costs, underpinned by surging demand from those fast-growing developing countries... An intense debate is under way in central banks across the world as to whether the recent rapid rise in food and energy prices will continue - and what, if anything, they should do about it. 'We are seeing structural change in the historical commodity price relationships and that may imply structural changes in the relationship between headline inflation and core consumer prices,' says Ken Rogoff, a professor at Harvard and former chief economist at the International Monetary Fund."

December 4 – Bloomberg (Fergal O'Brien): "European producer-price inflation accelerated in October to the fastest pace this year, boosted by a surge in energy costs and the biggest increase in food prices in at

least 15 years. Factory-gate prices increased 3.3% from a year earlier, the most since December 2006, after rising 2.7% in September, the European Union statistics office in Luxembourg said today."

December 5 – Bloomberg (Svenja O'Donnell and Jennifer Ryan): "U.K. house prices fell for a third month in November, the worst performance in more than a decade, and services growth slowed, increasing speculation the Bank of England will cut interest rates tomorrow. The average cost of a home in Britain declined 1.1% to 194,895 pounds (\$400,000) from a month earlier..."

December 5 – Bloomberg (Alex Nicholson): "Russian consumer prices rose more than expected in November as fruits and vegetables became more expensive. Prices gained a monthly 1.2%, compared with a gain of 1.6% in October... Consumer prices rose 10.6% in the year to date."

December 6 – Bloomberg (Maria Levitov): "The Russian government's 'massive additional spending' this year, is pushing up inflation that is set to exceed the central bank's target 'by a wide margin,' the Organization for Economic Cooperation and Development said... 'Fiscal loosening is adding to inflationary pressures,' the report said. 'The amended 2007 budget will allow for massive additional spending ahead of the election cycle,' it said."

December 6 – Bloomberg (Maria Levitov): "Russia's inflation rate may reach an annual 12% this year, the Interfax news service reported today, citing Deputy Economy Minister Andrei Belousov."

December 3 – Bloomberg (Janice Kew): "South African food prices rose more than 16% in October from a year earlier, a bigger jump than official figures show, Business Report said..."

Latin America Watch:

December 3 – Bloomberg (Bill Faries): "Argentina's November tax revenue rose 30% from a year earlier as consumption surged, boosting job growth and sales taxes, Buenos Aires Economico said."

Bubble Economy Watch:

December 5 – Bloomberg (Joseph Galante): "U.S. retailers' sales rose 2.5% last month, starting off what may be the slowest-growing holiday shopping season in five years. Consumers scaled back purchases in the last week of November following Thanksgiving weekend discounts, the International Council of Shopping Centers and UBS Securities LLC said..."

December 5 – Bloomberg (William Selway): "U.S. state governments are curbing tax cuts, boosting spending at a slower pace and tapping reserves as the housing market recession ripples through the nation's economy, a survey of state budget officials shows. State spending is projected to grow 4.7% to \$686 billion during the current budget year, the smallest increase since 2004... Revenue from sales and income taxes is projected to rise 2.9%, from 5.6% last year..."

Central Banker Watch:

December 6 – Bloomberg (Matthew Brockett and Simone Meier): "European Central Bank President Jean-Claude Trichet threatened to raise interest rates if an oil-driven jump in inflation spurs wage and price increases. There is 'strong short-term upward pressure on inflation,' Trichet said... The ECB 'will not tolerate second-round effects' and some policy makers wanted to raise rates as early as today, Trichet said."

December 6 – Financial Times (Chris Giles and Ralph Atkins): "A gulf opened up between Europe's two largest central banks on Thursday after the Bank of England responded to the global credit squeeze by cutting interest rates while the European Central Bank indicated another increase was still on the agenda. The Bank of England cut its main interest rate by a quarter of a percentage point to 5.5%, reflecting its concern that the medium-term economic outlook had darkened in recent weeks. It blamed deteriorating conditions in financial markets and 'a tightening in the supply of credit to households and businesses' that threatened to depress growth and allow inflation to fall too far below the Bank's 2% target."

December 5 – Financial Times (Bernard Simon): "The Bank of Canada cut its key interest rate yesterday for the first time in more than three years on the grounds that faltering US growth now poses a bigger threat than inflation to the Canadian economy. The bank lowered its overnight rate from 4.5% to 4.25%. It was set to raise rates as recently as last summer when labour shortages, capacity constraints and rising commodity prices threatened to unleash inflationary pressures."

GSE Watch:

December 4 – Bloomberg (Jody Shenn): "The Federal Home Loan Bank system...said its debt outstanding rose \$32 billion to \$1.18 trillion last month. Discount notes, which mature in one year or less, have more than doubled to \$364.3 billion since the start of the year..."

MBS/ABS/CDO/CP/Money Funds and Derivatives Watch:

December 7 – Bloomberg (Caroline Salas and Jody Shenn): "President George W. Bush's plan to freeze interest rates on some subprime mortgages may prove to be a cure that breeds another disease. 'If the government goes in and changes contracts it will definitely have a chilling effect on the securitization of mortgages,' said Milton Ezrati, senior economist and market strategist at Lord Abbett & Co.... 'When the government comes in and says you have contracted to have this arrangement and you can no longer have it, I think it opens the door for lawsuits.'"

December 6 – Bloomberg (Jody Shenn): "U.S. mortgage assets in collateralized debt obligations have lost so much value that the top classes of the securities may be worth as little as 20 cents on the dollar in the event of liquidation, Barclays Plc analysts said in a report. About 20% to 30% of principal would be covered for the 'super senior' portions of mezzanine asset-backed bond CDOs, which mainly contain mortgage bonds and other CDOs initially assigned low investment-grade ratings, New York-based analysts Joseph Astorina, Elena Warshawsky and Wei-Ang Lee wrote..."

December 4 – Bloomberg (Jody Shenn): “Issuance of collateralized debt obligations will tumble 65% next year, with ‘little or no’ sales of CDOs made up of structured- finance securities such as subprime-mortgage bonds, JPMorgan Chase & Co. says. About \$163 billion of new CDOs will be sold, down from an estimated \$469 billion this year, according to...JPMorgan analysts led by Christopher Flanagan. The decline will occur with ‘the very concept of securitization under pressure,’ the analysts wrote.”

December 3 – Bloomberg (Hamish Risk): “Credit-default swaps on mortgage-finance company Fannie Mae and securities firms Merrill Lynch... and Morgan Stanley were the most actively traded in the U.S. last month, according to broker GFI Group Inc.”

December 5 – Bloomberg (Fabio Alves): “New issuance of securities backed by payments on automobile loans have dropped 19% so far this year in the wake of losses in the broader credit market, according to Deutsche Bank AG.”

Mortgage Finance Bust Watch:

December 6 – Bloomberg (Kathleen M. Howley): “The number of Americans who fell behind on their mortgage payments rose to a 20-year high in the third quarter as borrowers were unable to refinance or sell their homes. The share of all home loans with payments more than 30 days late, including prime and fixed-rate loans, rose to a seasonally adjusted 5.59%, the highest since 1986, the Mortgage Bankers Association (MBA) said... New foreclosures hit an all-time high for a second consecutive quarter... ‘These are the first numbers we’ve seen that combine the meltdown of the credit markets with the drop in home prices,’ said Jay Brinkmann, vice president of research and economics for [the MBA]... One in every five adjustable-rate subprime loans had late payments in the quarter, a number that excludes the one of every 10 already in foreclosure... In the quarter, 3.12% of prime borrowers made their mortgage payments at least 30 days late, up from 2.73% in the second quarter... The subprime share of late payments rose to 16.31% from 14.82%.”

December 4 – Bloomberg (Hugh Son): “H&R Block Inc., the biggest U.S. tax preparer, shut its subprime home-lending unit and cut 620 jobs after a sale to Cerberus Capital Management LP unraveled.”

Real Estate Bubbles Watch:

December 6 – Bloomberg (Brian Louis and Peter Woodifield): “Toll Brothers Inc., the largest U.S. luxury-home builder, reported its first quarterly loss in 21 years and said the housing slump is the worst the company has seen in decades... Stricter lending conditions make mortgages more difficult to obtain and rising foreclosures are adding to the biggest inventory of unsold homes in 22 years.”

December 4 – Market News International (Shannon D. Harrington): “The following text is a release from U.S. mortgage finance company Freddie Mac that reports the largest quarterly decline in 25 years of its home price index: ‘Freddie Mac announced today that its Conventional Mortgage Home Price Index (CMHPI) Classic Series registered a 1.3% drop in U.S. home values during the third quarter of 2007 on an annualized basis, down from a revised second quarter 2007 annualized rate of 0.5% and the largest decline in 25 years. Over the year ending with the third quarter, home values appreciated 1.9% on average, down from the 7.8% growth over the same period a year earlier... ‘The number of home sales fell during the third quarter, and the inventory of existing single-family homes for sale rose to 10.5 months by October, the highest level since 1985.’”

Financial Sphere Bubble Watch:

December 4 – Bloomberg (Gonzalo Vina and Sebastian Boyd): “Citigroup Inc. lost more money than it made in the four years it traded financial instruments based on U.S. subprime mortgages, a senior company executive said. William Mills, chief executive of the U.S. bank’s markets and banking division in Europe, said... ‘Our losses greatly exceeded the profits we made in this field over several years,’ Mills said at a hearing of the Treasury Committee in the U.K. Parliament...”

Crude Liquidity Watch:

December 5 – Bloomberg (Arif Sharif and Matthew Brown): “Gulf Arab nations may revalue their dollar-pegged currencies in the next two months to combat the inflationary affect of a weakening dollar, according to Standard Chartered Plc. The six Gulf Cooperation Council members, Saudi Arabia, the United Arab Emirates, Kuwait, Qatar, Bahrain and Oman are restricted in the fight against inflation because their dollar pegs force them to mimic U.S. Federal Reserve monetary policy. Rising import prices caused by the dollar’s decline and increased revenue from higher oil prices has pushed inflation to a five-year high in the Gulf region... The Supreme Council of the GCC set out plans to study ‘inflation and soaring prices and their repercussions on citizens,’ according to the Emirates News Agency yesterday...”

December 6 – Bloomberg (Zainab Fattah): “Etihad Etisalat, Saudi Arabia’s second largest mobile phone company, and Saudi Investment bank are among the companies in the kingdom increasing employees salaries to keep pace with inflation... Etihad Etisalat will raise employee pay by as much as 40%... Saudi Investment Bank will boost salaries by 15% starting next month...”

December 4 – Bloomberg (Matthew Brown): “Kuwait’s inflation rate surged to a record 6.2% in September as the cost of housing increased, offsetting a rally in the dinar since the central bank ended its peg to the dollar. Inflation accelerated from 4.8% the month before, the Planning Ministry said...”

Speculator Watch:

December 7 – Financial Times (Deborah Brewster): “The amount of money managed by so-called quant funds has dropped by up to 40% in the past six months, as the drawbacks of the once rapidly growing strategy have been laid bare by the credit market turmoil. Quantitative management, which uses computer models to make trading decisions, is behind the success of some of the best known hedge funds and institutional managers. Some estimates pegged the amount managed this way at about \$500bn before the slump hit. However, those using the strategies concede that they were unaware of how popular quant investing had become, and how many quant managers were doing the same trades. As a

result, managers deleveraging in times of market turmoil would exit the same trading positions as many other managers, resulting in sharp losses for several previously high-flying funds.”

December 7 – Bloomberg (Jenny Strasburg and Katherine Burton): “Hedge funds run by Goldman Sachs Group Inc. and AQR Capital Management LLC fell in November as swings in financial markets confounded the computer-driven trading models used by the quantitative managers. Goldman’s Global Alpha, which started 2007 with more than \$10 billion, dropped 6%, bringing the decline for the year to 37%... AQR’s \$4 billion Absolute Return fund is down 11%, after losing about 6% last month...”

December 5 – Bloomberg (Jenny Strasburg): “A group of former Amaranth Advisors LLC traders, recruited last year to start a Canadian hedge-fund unit for Moore Capital Management Inc., lost 15% in November, two people with knowledge of the firm said.”

Q3 2007 "Flow of Funds":

I’ve been examining the Fed’s quarterly Z.1 “Flow of Funds” data for some time now; I can’t recall a report as intriguing as this one. In the face of mounting financial crisis, Total (non-financial and financial) Credit growth accelerated from Q2’s 8.6% pace to a remarkable 11.1% annualized rate. The rate of Non-Financial Debt growth increased to 8.9% from 7.2%. The pace of Corporate Borrowings rose to 11.0% from Q2’s 10.3%, while Household Mortgage Debt growth slowed to 6.8% from 8.0%. Federal Debt growth expanded at an 8.8% pace, up from Q2’s slight contraction. The booming State & Local sector cooled somewhat, with debt growth reduced to 8.4% from Q2’s 10.3%.

Importantly, Domestic Financial Sector borrowings expanded at an alarming 15.6% rate, up from Q2’s already overheated 9.8%. The Banking, Money Fund, GSE and agency-MBS sectors all accelerated, expanding at double-digit rates (more detail than you care to know below). Wall Street Finance abruptly hit the wall.

During the third quarter, Total Credit Market Borrowings (TCMB) increased at a record Seasonally-Adjusted and Annualized Rate (SAAR) of \$4.989 TN to \$47.864 TN. This was a significant acceleration from Q2’s \$3.811 TN and compares to Q3 2006’s \$3.448 TN. For perspective, growth in TCMB averaged \$1.237 TN annually during the nineties. For the seven years 2000 through 2006, TCMB growth averaged \$2.803 TN. Financial Sector Borrowings expanded at an unprecedented SAAR \$2.321 TN during the quarter. This compares to a \$494bn average during the nineties and the \$981bn annually during the period 2000-2006. Total Credit Market Debt has now ballooned 20% in two years. Since the beginning of 2003, Total Debt has surged 50% - rising from 298% of GDP to 343% - in the greatest Credit Inflation in history.

With Wall Street finance under heightened stress, Bank Assets expanded a record SAAR \$1.586 TN during the quarter, or a 16.2% rate to \$10.873 TN. To put the scope of this ballooning into perspective, recall that Bank Assets increased a record \$897bn during 2006, after expanding \$763bn during '05, \$762bn in '04 and \$495bn during 2003. Bank Assets expanded, on average, \$215bn annually during the nineties. For the third quarter on the Bank Asset side, Loans expanded a record SAAR \$957bn, up from Q2’s \$461bn and Q3 '06’s SAAR \$411bn. In nominal dollars, Bank Loans expanded more during Q3 (\$249bn) than they did for the entire year 2003 (\$215bn). Bank Mortgage Loan growth slowed to SAAR \$205bn (vs. Q2’s \$266bn), while business Loan growth jumped to a record SAAR \$561bn (vs. Q2’s 195bn). Bank Securities holdings were little changed, although the composition was altered markedly. Agency and GSE-MBS holdings declined SAAR \$256bn, while Corporate & Foreign Bonds jumped SAAR \$296bn.

How did the banking system finance this record expansion – or what (perceived “money”-like) Liabilities were created in the process? Total Deposits grew at a 12.3% pace during the quarter to \$6.355 TN. Deposits were up \$539bn, or 9.3%, over the past year. Credit Market Liabilities also increased markedly. The Liability “Other Loans & Advances” increased SAAR \$332bn and Misc. Liabilities SAAR \$437bn. During the past four quarters, Bank “Credit Market Liabilities” increased 31.5% to \$1.184 TN, “Fed Funds & Repo” 11.5% to \$1.351 TN, and Bond Liabilities 21.3% to \$655bn.

Over the past year, Bank Assets have inflated \$1.070 TN, or 10.9%. Mortgage loans have increased \$333bn, or 10.5%. Business Loans were up \$221bn, or 13.1%. Corporate Bond holdings gained \$173bn, or 23%, and Misc. Assets grew \$233bn, or 13.6%. Over two years, Banks Assets increased \$17.7%, with Total Loans up 23.7%.

Breakneck Banking system expansion was matched by (non-Wall Street-backed) “structured finance.” In the face of faltering marketplace liquidity, GSE Assets expanded a record SAAR \$617bn, or a 20.7% rate. This compares to 2006’s Asset growth of \$61bn and 2005’s contraction of \$64bn. GSE ballooning peaked at \$344bn during 2001. In nominal dollars, the \$154bn increase in GSE assets during Q3 surpassed even the \$137bn increase during (the infamous LTCM reliquefaction from) Q4 1998. The entire GSE expansion is explained by the unprecedented SAAR \$759bn surge in Federal Home Loan Bank (FHLB) Loans & Advances. In nominal dollars, the \$180bn Q3 increase in FHLB “Loans & Advances” amounted to a 112% growth rate, with y-o-y growth of 27.7% to \$822bn.

Meanwhile, Agency (Fannie and Freddie guaranteed) MBS expanded a record SAAR \$623bn to \$4.26 TN during the quarter. For perspective, Agency MBS increased \$295bn during 2006, \$174bn during '05, \$63bn in '04, and \$331bn in '03. In nominal dollars, MBS grew \$168bn, or 16.4% annualized - increasing y-o-y growth to \$475bn, or 12.6%. Booming Agency MBS issuance filled the huge void created by Wall Street’s faltering “private-label” mortgage and ABS marketplace. After expanding a cumulative \$1.0 TN during the preceding six quarters, the ABS market abruptly ground to a halt during the summer, managing only a \$2.4bn increase during Q3 (to \$4.276 TN). This slowed y-o-y growth to \$470bn, or 12.3%.

Also playing a pivotal role in Risk Intermediation during a tumultuous quarter, Money Market Fund Assets (MMFA) expanded at a remarkable 50% rate to \$2.80 TN. It's worth noting the composition of the growth in Assets. In SAAR dollars during the quarter, Foreign Deposits increased \$130bn; Time & Savings Deposits \$182bn; Security Repos \$444bn; Treasury Securities \$162bn; Agency & GSE MBS \$128bn; and Municipal Securities \$149bn.

MMFA ballooned \$635bn over the past four quarters, or 29.3%. With the Money Fund complex now occupying such a critical position in the Credit Mechanism, we'll take a closer-than-normal examination of fund Assets. Over the past year, Money Fund holdings of "Foreign Deposits" increased 45% to \$102bn; "Time & Saving Deposits" 25% to \$261bn; Security RPs 38% to \$507bn; "Open Market Paper" 20% to \$666bn; "Treasury Securities" 79% to \$128bn; "Agency- & GSE-backed Securities" 16% to \$162bn; "Municipal Securities" 22% to \$431bn; "Corporate & Foreign Bonds" 22% to \$416bn; and "Miscellaneous" 113% to \$124bn.

Despite all the market turmoil, Total Mortgage Debt (TMD) still mustered an 8.0% growth rate to \$14.360 TN. In SAAR dollars, the \$1.099 TN quarterly increase was down sharply from 2006's record \$1.409 TN, yet still surpassed 2003's \$996bn expansion. And keep in mind that TMD expanded \$268bn annually during the nineties and surpassed \$1.0 TN for the first time in 2004. It is also worth mentioning that Q2 mortgage debt growth was revised up to a curiously strong 9.6% rate. During Q3, Home Mortgage Debt (HMD) slowed from a Q2's 8.3% to a 7.1% rate, while Commercial Mortgage Debt (CMD) cooled from a blistering 15% to a still hot 11%. Over the past year, HMD increased 7.9% to \$11.028 TN and CMD 13.3% to \$2.406 TN. Expect these numbers to come down significantly during Q4.

The securities Broker/Dealers saw their incredible boom hit the wall during the third quarter. After Q1's 41% growth rate was followed by Q2's 23%, growth tanked abruptly to less than 1% during the past quarter. Over the past year, Broker/Dealers Assets have expanded \$616bn, or 23.8%, to \$3.201 TN, fueled by a 37% increase in Credit Market Instruments (to \$735bn) and a 24% increase in Misc. Assets (to \$1.865TN). And while Total Assets were little changed during Q3, the composition certainly shifted. In nominal dollars, Agency & GSE MBS increased \$72bn (to \$195bn) and Treasuries gained \$72.1bn (to negative \$53bn), while Misc. Assets dropped \$70bn (to \$1.865TN) and Securities Credit declined \$36bn (to \$298bn). Corporate and Foreign Bonds were little changed at \$467bn. On the Liability side, "Securities Repos" increased \$55bn to \$1.297 TN, with notable one-year growth of \$333bn (34.6%). Over the past two years, Broker/Dealer assets have ballooned 51%, while Repo Liabilities have inflated 83%.

Funding Corp ("Funding subsidiaries, nonbank financial holding companies, and custodial accounts for reinvested collateral of securities lending operations") assets expanded nominal \$144bn during Q3, with y-o-y growth of 19% to \$1.792 TN. "Fed Funds & Repo" expanded at a 6.9% rate during Q3 to \$2.799 TN, with one-year growth of 18.2%. Finance Company Assets expanded at a 5.6% rate during the quarter to \$1.924 TN and Savings Institutions a 12.9% rate to \$1.759 TN; REITs contracted at an 8.2% rate to \$607bn; Credit Unions expanded at a 0.6% rate to \$748bn; and the Life Insurance sector grew at a 5.7% pace to \$4.950 TN.

National Income was up 5.3% y-o-y to \$12.307 TN during Q3, with Total Compensation rising 6.4% y-o-y to \$7.917 TN. State & Local government Receipts held steady at up 5.1% y-o-y, while S&L Expenditures rose 6.2% y-o-y. Federal Receipts slowed, with Q3's 7.0% y-o-y increase down from Q2's 8.0%. Federal Expenditures were up 6.0% y-o-y. Expect both State & Local and federal government receipts to slow going forward.

The Household (and Non-Profit) Balance Sheet remains a key analytical focal point. Total Household Assets expanded at a 4.8% rate during the quarter to \$72.761 TN. Household Liabilities increased at a stronger 6.7% rate to \$14.157 TN. Yet in nominal dollars, Assets inflated \$858bn and Liabilities increased "only" \$234bn – leaving Household Net Worth up \$625bn during the quarter to a record \$58.604 TN. It is worth noting that the growth in Real Estate Assets slowed to only \$119bn during Q3, while Credit Bubble excess inflated Household Financial Assets by \$699bn. Over the past year, Household Assets inflated \$5.039 TN (7.4%), with a \$1.035 TN (7.9%) increase in Liabilities leaving a \$4.004 TN (7.3%) increase in Net Worth to fuel the U.S. Bubble Economy. Declining Net Worth will have a significant restraining impact on consumption.

The Rest of World (ROW) expanded holdings of US Financial Assets increased by SAAR \$1.132 TN during Q3 to \$15.463 TN. This was a notable slowdown from Q2's SAAR \$2.507 TN and Q3 2006's \$1.928 TN, and is largely explained by a significant (and ominous) decline in the accumulation of US Credit Market Instruments. Still, ROW holdings increased \$2.251 TN over the past year (17%) and almost doubled since the beginning of 2003. During the quarter, ROW holdings of "Security RPs" declined at SAAR \$348bn and "Open Market Paper" declined SAAR \$103bn. Treasury Securities increased SAAR \$160bn and Agencies SAAR \$155bn. And in a notable development, after increasing SAAR \$457bn during Q1 and SAAR \$443bn in Q2, holdings of U.S. Corporate Bonds (including ABS) reversed and declined SAAR \$69bn during Q3.

I'm running out of time this evening, so I will attempt some concluding comments. First, looking at Q3's record Credit inflation, it is not easy to justify Wall Street's call for dramatically lower interest rates. Sure, the pace of fourth quarter Credit growth will be meaningfully slower, especially in the mortgage arena. But I believe the key insight to be drawn from the Q3 2007 "Flow of Funds" is the recognition of the enormous scope of ongoing Credit creation now required to sustain the U.S. financial and economic Bubbles. I'm tempted to surmise that the "Law of Large Numbers" has finally caught up with the Great Credit Bubble. In particular, I find it incredibly ominous that the Credit system has faltered so badly in the face ongoing financial sector expansion. Things can clearly get much worse. I don't expect the Wall Street securitization machine to anytime soon to return as a major force for Credit expansion. And I simply do not view recent spectacular ballooning and Zealous Risk Intermediation in the Banking, Money Fund, and GSE sectors as sustainable. They're clearly fraught with great risk. Messrs. Bernanke, Paulson, Bush, Frank and others will, at best, manipulate only the pace of the Unfolding Credit Bust.

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