

Dr. Krosby

AFTER THE FALL

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It wasn't exactly merger Monday as investors came back to a market that had shed nearly \$2.1 trillion globally just one week earlier. And before the U.S. market even opened, risk-related stories were already splashed across computer screens. IKB Deutsche Industriebank AG, whose primary customer base is small and mid-size German companies, issued a warning regarding its exposure to U.S. subprime mortgages, noting a market backdrop of "massive uncertainty." Some weeks ago, an Italian bank suffered similar losses. Indeed, the subprime imbroglio knows no geographic boundaries, as the mortgages were sliced and diced and wrapped with derivatives and sold to portfolios worldwide. In fact, it is this broad distribution that ultimately divides the pain as it unfolds, rather than having just a few banks or hedge funds sit with a ticking liability clock.

Comparisons with previous market corrections abounded, yet the market clawed its way into positive territory as a combination of end-of-the-month buying and selling, bargain hunting, and short covering dominated.

To be sure, there were deals getting done on Monday, and there were important share buybacks announced, but what brought the U.S. market back to life emanated from the financial sector as HSBC, the third largest bank globally by market value, reported first half earnings higher than consensus. Moreover, HSBC, which had been the first major bank to sound the subprime alarm in February, said it increased its provisions for bad debts, but loan defaults by subprime borrowers was less than analysts' estimates. This helped assuage fears that the subprime story was deepening. Observing that world economic growth remained on a solid footing, HSBC's chairman said: "There is still an enormous amount of liquidity chasing deployment: the Chinese reserves, the Middle Eastern reserves; there's no obvious reason to believe liquidity is drying up or even under pressure."

Also helping to soothe fears over the embattled financial sector was a Standard + Poor's credit upgrade of Morgan Stanley, which went from A+ to AA-. The rating agency said the bank "should be able to maintain satisfactory earnings even if market conditions are considerably more challenging."

But the tape showed that the most pronounced move came when GMAC, the financial unit spun off by General Motors, announced that losses at its mortgage unit, Residential Capital LLC, were markedly less than those from the preceding quarter.


So "merger Monday" was saved by a "less bad story," while "takeover Tuesday" opened in Europe with strategists assuring clients that subprime has been sufficiently discounted by the market, with the sell-off bringing levels into an attractive range for buying opportunities. The bear chorus is singing, "We've heard this song before," while the bulls chant, "It's safe, dip back in."

The sell-off had grown in intensity when Countrywide Financial, the largest U.S. mortgage lender, lowered its 2007 forecast as it highlighted the rising number of home-equity loan late payments, even among its prime borrowers, those consumers with good credit histories. Chief Executive Officer Angelo Mozilo explained that the late payment problem stems from "more traditional issues such as job loss, divorce, and health problems, not because adjustable-rate mortgages are resetting at higher rates."

Describing the current housing crisis as the worst, "with the exception of the Great Depression," Mozilo warned that a turnaround in housing prices won't materialize until demand picks up in 2009. All eyes remain on the consumer, with even more scrutiny on those in the prime category.

Mergers certainly aren't going away. On the private equity side, they surely will become more expensive to close as investors require more concessions, but deals will be closed. According to Thomson Financial, during the month of July, there were \$90 billion worth of deals among U.S. private equity investors, representing a record, with the second-highest monthly close. Public company deals should pick up steam as U.S. companies sit on unprecedented levels of cash that must be deployed. Overall, deal making, including private equity, reached \$3.1 trillion in 2007 announcements, not so far off the \$3.6 trillion total for 2006. Credit conditions—coupled with a global economic downturn—would have to tighten significantly to warrant a major slowdown in deal flow.

Share buybacks could be stifled significantly if credit conditions tighten dramatically, but buybacks will continue as a powerful mechanism for deployment of corporate cash. Based on estimates from Standard + Poor's Index Services Group, approximately \$118 billion was used for first quarter 2007 buybacks, a 17.5 percent increase from the \$100 billion posted in the first quarter of 2006.



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Earnings estimates for the second quarter continue to be revised upwards. Entering the season, earnings estimates for Standard + Poor's 500 Index companies stood at 4 percent compared with the same quarter last year. As the earnings continue to be announced, they appear poised to deliver between 9 and 10 percent returns compared with the second quarter of 2006.

While consumer spending continues to reflect more spending on food and energy (energy prices continue to move higher), the increase in exports and a modest increase in capital spending should help offset the tired consumer. Nonetheless, the decline in spending to its slowest levels in nine months gives increased significance to jobs data. As Countrywide pointed out, the late payment problems are exacerbated by job losses, even among prime customers.

The Conference Board's consumer confidence index jumped to 112.6 in July from 105.3 in June. The "jobs hard to get" category fell, while the "jobs plentiful" category enjoyed a significant bounce. The difference between the two categories is the strongest in six years.

The most recent inflation readings indicate that inflation is slowing and falling within the Federal Reserve's so-called "comfort zone." The core consumer spending deflator climbed 0.1 percent for a fourth straight month. This represents a 1.9 percent year-over-year gain, which suggests that the slowing U.S. economy has helped tame inflationary pressures.

So far, so good. The rout in the markets looks as though it took some of the froth off and allowed the much-needed re-pricing of risk to take place in both the equity and fixed income markets. Fears of credit risk contagion intensify, but with the indexes trading higher, the fears, once again, remain cordoned off in a parallel setting of newsletters and bear warnings. Risk in corporate bonds fell substantially after GMAC's earnings. The takeover of assets from a failed hedge fund, Sowood Capital Management, by Citadel Investment Group, demonstrated that there's still ample liquidity in the marketplace. Sowood lost nearly 50 percent in July, and couldn't raise the necessary collateral demanded by its lenders. Still, "subprime" has a way of resurfacing every so often. Let's hope it doesn't resurface again as a "prime" story. If it does, it'll certainly become a prime-time story. In the meantime, enjoy the gains. As last week demonstrated, declines can be swift and brutal—but there's nothing like a market going back up after the fall.



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Dr. Quincy Krosby's sources of information include Bloomberg.com, The Economist, Financial Times, Goldman Sachs, ISI Research, The New York Times, Strategas Research Partners, Thomson Financial, and The Wall Street Journal

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