

Basic Points

HOMEICIDE: THE CRIME OF THE CENTURY

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Basic Points

An Investment Journal

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HOMEICIDE: THE CRIME OF THE CENTURY

Overview



Note to readers: this was written as of 10 pm, October 7, and may not reflect the drama that unfolded later that night. We wanted to ensure readers received this analysis, but understood that events are proceeding at warp speed.

When Wall Street decided that its route to return to the glorious profitability of the tech mania was via Main Street, a fateful series of interlocking conspiracies, crimes and blunders began to unfold. Collectively, they are a new economic crime that has brought the global financial system to the edge of an abyss: *homeicide*.

The premises behind this monstrous perversion of capitalist ethics were (1) Wall Street and Main Street were both seeking a new investment medium to restore the lost equity wealth of the tech crash; (2) US house prices nationally had not experienced a down year since the Depression; (3) new investment products based on systems designed by mathematical geniuses could create complex products that could mix widely varying levels of risk and magically create AAA-rate investments that would attract a far wider range of institutional investors than mortgage lenders; (4) Fannie Mae and Freddie Mac were able to borrow in unlimited amounts, due to (a) their [unstated] government guarantee, and (b) their powerful Congressional allies who saw them as huge donors and as the key to expanding home ownership among poor Americans who had trouble getting high loan-to-value mortgages from traditional lenders: if these traditional renters could be drawn into the home-buying market in unprecedented numbers, they would be a powerful force to kick the housing recovery into overdrive; (5) a new breed of mortgage originators would cut through the red tape and constraints of traditional lenders, and generate the loans that Wall Street could package at sky-high profit margins; (6) Basel risk-adjusting rules favored home mortgages because of their decades of low loss rates, which meant the worldwide appetite for AAA-rated mortgage paper would expand rapidly, thereby offsetting the US limitations based on the near-zero American savings rate; and (7) the Fed's rapid expansion of money at Depression-level rates would stimulate the growth of hedge funds whose purchases would validate the arcane assumptions underlying these new collateralized debt instruments.

What Wall Street could do, so could European banks and investment banks. The American housing bubble became the model for the UK, Ireland, Spain and elsewhere.

Home, sweet Homeicide. Too many homes were built for too many speculators and too many people who had no real hope of servicing their debts; too much price appreciation spawned by unlimited supplies of capital, greed, fraud, and folly wounded entire financial systems across the world, murdered banks and mortgage lenders, devastated millions of homeowners, and triggered a global recession.

Governments and central banks have swung into action to contain the damage and rescue their financial systems. Deleveraging is proceeding at a mind-numbing pace, devastating stock and commodity markets. Short-term paper markets trade, if at all, at glacial speed.

We changed our Recommended Asset Allocation in a client conference call on September 19. Our new asset mixes are shown on the adjoining page, and we are leaving them unchanged.

Recommended Asset Allocation

Recommended Asset Allocation (for U.S. Pension Funds)				
	Allocation Basic Points Sept. 10, 2008	Allocation Changes Sept. 19, 2008	Asset Allocation Oct. 7, 2008	Change
US Equities	21	20	20	unch
Foreign Equities				
European Equities	7	6	6	unch
Japanese and Korean Equities	5	3	3	unch
Canadian and Australian Equities	8	7	7	unch
Emerging Markets	11	10	10	unch
Bonds				
US Bonds	7	8	8	unch
Canadian Bonds	4	5	5	unch
International Bonds	11	11	11	unch
Long-Term Inflation Hedged Bonds	10	10	10	unch
Cash	16	20	20	unch

Bond Durations				
	Years Sept. 10, 2008	Years Sept. 19, 2008	Years Oct. 7, 2008	Change
US	4.00	4.00	4.00	unch
Canada	4.25	4.25	4.25	unch
International	3.75	3.75	3.75	unch

Global Exposure to Commodity Stocks				
	Sept. 10, 2008	Sept. 19, 2008	Oct. 7, 2008	Change
Agriculture	35%	35%	35%	unch
Energy	29%	28%	28%	unch
Precious Metals	25%	28%	28%	unch
Base Metals & Steel	11%	9%	9%	unch

We recommend these sector weightings to all clients for commodity exposure—whether in pure commodity stock portfolios or as the commodity component of equity and balanced funds.

HOMEICIDE: THE CRIME OF THE CENTURY

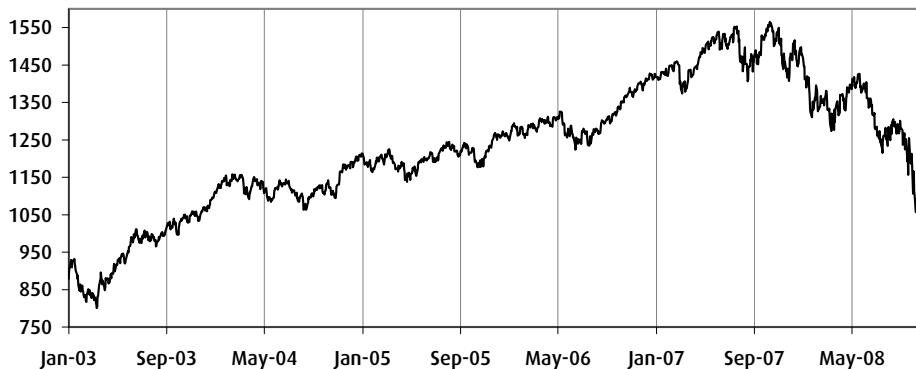
Why did this decade experience a record house-price boom that would put the entire global financial system at risk?

- Inflation has not been in a multi-year uptrend that could trigger a 1970s-style inflation mania.
- Unlike previous bubbles, there has been no outsized demographic pressure from a torrent of young people entering the work force. Indeed, average population ages have been rising steadily across the OECD because of the baby bust that began in 1970.
- Nor has there been a new baby boom that pressures families to trade up to accommodate rising family sizes.
- Nor has there been such robust economic growth that workers' real incomes have risen sharply, expanding mortgage-carrying capacity faster than the supply of homes for sale.

**"Safe as houses," and
"Money in the bank"
...have become the
recipes for fear and
misfortune.**

This stock market crash was not rooted in a revival of a Triple-Waterfall-style equity mania that drove overall valuations to towering peaks. It was born out of the bursting of two bubbles: housing and investment banking. An avalanche that began in the US and spread to Europe has now become a worldwide financial crisis. "Safe as houses," and "Money in the bank" were the historic recipes for caution and prudence. They have become the recipes for fear and misfortune. We have titled this sordid story "homicide."

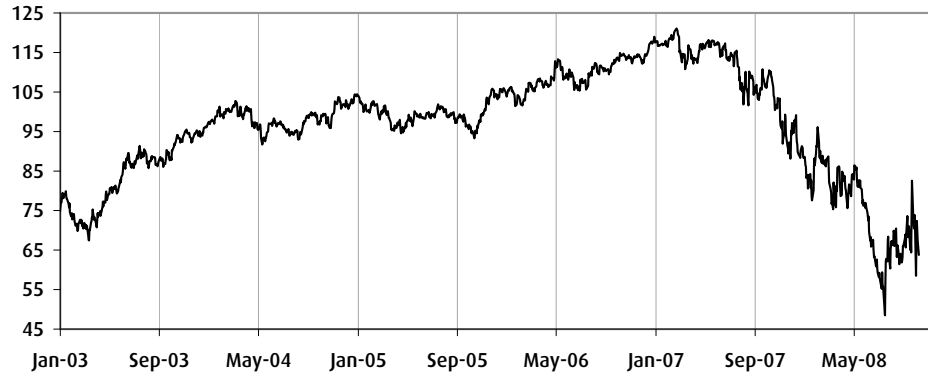
S&P 500
January 1, 2003 to October 7, 2008





**...the crisis has labored
in continuous triage
mode...**

**Bank Stock Index (BKX)
January 1, 2003 to October 7, 2008**



In the summer of 2007, the Fed responded to the early rumbles from melting snow with a rapid series of monetary easings. But the situation continued to worsen, and the team of Paulson and Bernanke was formed. It handled the collapse of Bear Stearns and IndyMac with dexterity, but the situation continued to worsen. As market imbalances intensified and bank stocks plummeted, they launched what we called “The Midnight Massacre of July 13th,” which triggered a 40% rally in bank stocks and an avalanche-like collapse in commodities.

Since then, the crisis has labored in continuous triage mode, as governments and central banks are forced to decide which patients on the critical list could be saved, which could be merged forcibly with healthier banks, and which had to be allowed to die.

The most dramatic US move was the announcement of a \$700 billion Troubled Asset Relief Program—TARP, which would permit the Treasury to buy up to \$700 billion of illiquid financial assets from banks. It was immediately labeled as a bailout of Wall Street, thereby adding a political crisis to the financial crisis. Senators and Congressmen were deluged with mail and phone calls opposing the program, thrusting the supposedly nonpolitical rescue team into the midst of a hard-fought US election campaign.

Cause and Effects

How did we get here?

How did we get to the most severe freeze-up in short-term credit markets since the Depression, even though US Second Quarter GDP growth was positive—and above most forecasts?

How did we get a financial sell-off that became a full-blown crash after oil prices had already fallen by 30%?

How did we get into such a mess that the Dow drops 777 points—not because of a terrorist attack but because of an attack against Capitalists in the Capitol?

How did we get to the point that, even with Congressional approval for the \$700 billion rescue/bailout/TARP (choose your term), the TED Spread—the thermometer of the health of the global banking system—remains far above 300? (This indicator, which has never failed to signal a financial crisis, reached 215 the day of the 1987 Crash; it is the yield spread between front-month T-Bills and Eurodollars.)

We didn't start writing about the subprime/CDO scandal until March 2007 (*Don't Ask; Don't Tell; It's Subprime Time!*).

Since February 2002, we had devoted most of our energies in arguing that the over-arching economic and financial development of our time has been the emergence of gigantic economic powerhouses in the Third World, most notably China, India and Brazil.

As hundreds of millions of people have migrated from poverty to middle class status, the investment theme has been "Back to basics." When previously poor people move into dwellings with indoor plumbing, electricity and basic appliances, and graduate from oxcarts and bicycles to motorized transportation, the demand for energy and metals outpaces the world's existing productive capacity. When they graduate from a diet based on rice bowls and bread to a high-protein diet based on meat and/or milk, they challenge the world's ability to meet the skyrocketing demand for vegetable protein—in corn, soybeans, barley, wheat, oats and sorghum.

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Then the stench of necrosis on the balance sheets of major banks floated upward and began to pollute the bulls' testosterone.

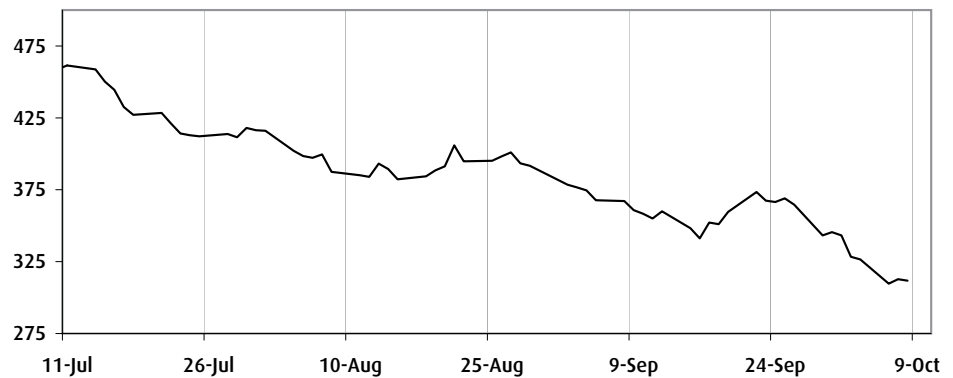
Our confidence in this once-in-human-history revolution was vindicated. Stocks of commodity-producing companies consistently outpaced global equity markets. Commodities, and stocks of commodity producers actually went to new all-time highs *after* the implosions of Bear Stearns and IndyMac.

**RJ/CRB Futures
January 1, 2002 to July 11, 2008**



And then commodities set off in a race to catch up to the equity bear market—and actually pull into the lead.

**RJ/CRB Futures
July 11, 2008 to October 7, 2008**



When bank stocks began reporting large writedowns in July 2007, we argued that a financial bear market had begun that would probably trigger an overall bear market. Instead, the S&P and other major indices climbed to new peaks.

Then the stench of necrosis on the balance sheets of major banks floated upward and began to pollute the bulls' testosterone. But rapid, generous infusions of cash from Sovereign Wealth Funds arrived in late 2007 and early 2008, as the Old, Old World came to redress the imbalances of the Newly Rich in the New World.

Basic Points

In retrospect, the crash was foretold last year by Nassim Taleb in his seminal work, *The Black Swan*. The title comes from the shock of the first British emigrants to Australia at seeing black swans. They absolutely knew that all swans were white. A Black Swan event is something that almost everybody believes cannot happen. (This a much more elegant variant of “Shared Mistake,” the theme of our book, *The New Reality of Wall Street*.) Prof. Taleb explained how Wall Street failed to learn from the collapse of Long-Term Capital Management, that haunt of Nobelists and other incorrigibly hubristic gamblers. The fund managers fatally relied on the mathematical models that were the breakthroughs that had convinced the Nobel Committee to award the Nobel Prize in Economics to two of their partners. Taleb scornfully dismissed the Nobel Committee. In his view, not only were the mathematics defective, but they were based on the absurd premise that anyone could devise a model that included all the risks that capital could ever face. Russia’s collapse set off a plunge in Third World equities that destroyed LTCM. They hadn’t programmed Russia into their model. Nor did the backdating used in the model extend to 1987.

Our innate skepticism about the assumed 99-44/100% reliability of macro models comes from our recollections about Herman Kahn in 1972. He was the global intellectual darling who, after years of labor, unveiled the first all-inclusive computer-based econometric forecast of the global economy. It was a masterpiece, using, we were told, every important economic variable. Sadly for the brilliant scientist, the model didn’t include the price of oil, or the availability of anchovies—because nothing of any importance had happened to oil prices or the anchovy harvest for years. Then came the Yom Kippur War and the El Niño-driven disappearance of the anchovies; the world was beset with fuel and food inflation, and the Kahn model that would supposedly be the global standard for years was abandoned.

Wall Street’s “Black Swan” for this decade was house price deflation. Bear Stearns, Merrill Lynch, and other investment banking organizations built models based on the evidence that house prices nationally had never fallen for as much as a year since World War II—which meant forever. (The 1930s were considered to be as irrelevant for assessing modern liquidity and solvency risks, as the Crisis of 1907.) So that careful editing of historical data meant there was no endogenous risk in housing mortgages as an asset class. The Street then proceeded to add layers of complexity that made individual mortgagors’ ability to service debt impossible for external valuator to appraise. Most notably, the modelers made no provision for the possibility that widening the housing market to include millions of marginal and

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...an ideal economy in which everyone made a precarious living taking in each other's laundry.

submarginal borrowers who had historically been excluded from the ranks of approved borrowers might be a new risk factor, or that the boom in home equity and piggyback loans would put millions of "conventional" mortgagors at risk. The rating agencies, enticed by huge fees, looked at the models, and began issuing AAA ratings by the trillions. Investors near and far rushed to load up on high-yielding risk-free merchandise.

A new "shadow banking system" of hedge funds, Credit Default Swap players, and supercharged investment banks emerged to control and manage the absorption of the torrents of complex products. Supplies of these computer-spawned marvels seemed unlimited, because their issuance was unconstrained by such old-hat prejudices as requiring homebuyers to show records of steady employment, or certifying that monthly mortgage payments should not exceed set percentages of after-tax income of the borrowers. Mathematics-based hedge funds sprang up like mushrooms after a summer rain. Each time they bought a CDO, or a piece thereof, they confirmed that the price shown on the Banks' books for these creations was genuine market value.

The resultant housing boom delighted home builders, realtors, home owners, speculators, mortgage originators (old, new, and fly-by-night), Fannie and Freddie and their Congressional skills, Wall Street, and George W. Bush.

The boom was also great for the employment data. At one point, the number of licensed real estate brokers in California was almost equal to the number of houses sold the previous year.

When we read that statistic, and looked at such indicators as the booming stock price of Countrywide Financial, we recalled the story of a somewhat skeptical 19th Century macro-economist who theorized, during a boom, about an ideal economy in which everyone made a precarious living taking in each other's laundry.

The other major contributor to the seemingly exponential growth of these mathematical masterpieces was a new banking creature, the Structured Investment Vehicle, or SIV. The SIV was the second serious deviant from the international banking solvency and liquidity systems that were the brainchild of history's greatest Federal Reserve Chairman, Paul Volcker.

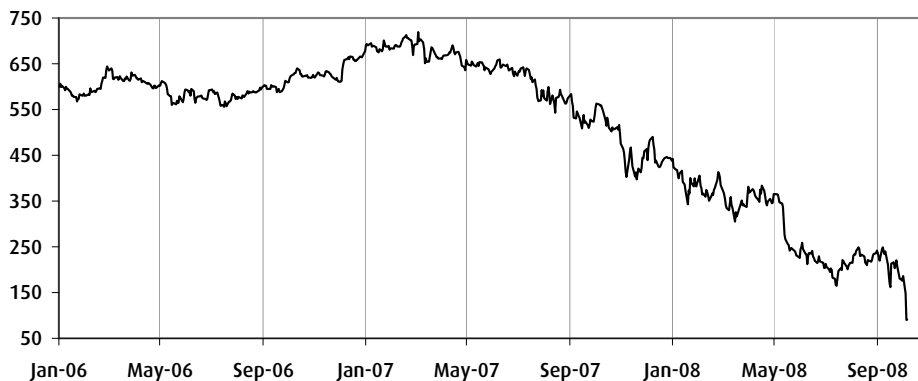
Basic Points

Mr. Volcker's going-away gift to the global financial system when he retired in 1987 was organizing the committees and research for what would be known as the Basel Accord. Like the other central bankers, Mr. Volcker was thoroughly sick of having to bail out bad banks. So the Accord was a rule-based system for analyzing all global banks' balance sheets according to an international formula. This was resisted by many nations' regulators, but the selling feature was that it was voluntary and didn't displace local rule-making. Any bank considering making interbank loans to a bank in a foreign jurisdiction could look at its risk-adjusted financial statement and see whether it would be a reliable borrower. Result: interbank lending accelerated to undreamt-of peaks, and bank failures became almost extinct. In the history of global finance, there had been no similar achievement. As the memory of past banking crises receded, financial friction virtually disappeared and credit flowed more and more rapidly at a time the WTO was also expanding global trade to undreamt-of levels.

The Age of Pure, Free Global Capitalism had dawned with the end of the Soviet Empire.

Tragically, this success spawned frustration and greed among many leading international banks who believed their own risk models made the Basel Rules obsolete—for them. So they managed to get agreement on a replacement for Basel, called Basel II, which let some conspicuously virtuous European banks which had demonstrated unbroken success of their own risk models use those models for balance sheet valuation. In recent months, some of those virtuous banks have been publicly deflowered, notably the bank that liked to claim that its long and storied history has been characterized by old-fashioned Scottish canniness:

Royal Bank of Scotland (RBS – LSE) January 1, 2006 to October 7, 2008



**In recent months,
some of those
virtuous banks
have been publicly
deflowered...**



“Thou shalt not covet thy neighbor’s house” wasn’t meant to apply to an investment house.

Some of the big North American banks became so envious of the heavily-levered investment banks—like the glittering Goldman—that they determined to find schemes to expand their leverage to levels more in accordance with their own intellectual brilliance. They believed they were as smart as Goldman, Morgan Stanley, and Bear Stearns, so why shouldn’t they earn the kinds of bonuses those investment banks’ top managements earned? Surely “Thou shalt not covet thy neighbor’s house” wasn’t meant to apply to an investment house. Besides, publishing the Ten Commandments in public places had been banned.

Thus were born the SIVs. Whether by coincidence or not, they came on the scene at about the time an impatient and greedy group of managers within a US natural gas utility known as Enron decided to abandon the staid utility model and become a virtual corporation that was attuned to the cool ethos of the tech boom. Enron wanted to achieve greater leverage and flexibility, so they set up off-balance-sheet companies known as Special Purpose Entities (SPEs) to raise funds to finance Enron’s rapid growth.

Enron’s greed and deceit ended badly. And, in the ensuing furor over its collapse, Washington responded with Sarbanes-Oxley, which passed in indecent haste, and with the prosecution and conviction of Enron’s top management.

However, the bankers who had set up SIVs apparently learned nothing from Enron’s collapse, except the importance of not being caught. Their SPEs (SIVs) were financed separately and raised gigantic sums, but the banks’ “sponsorship” of these new creatures was somewhat vague. The SIVs didn’t go on the banks’ balance sheets for Basel or regulatory purposes, but because they borrowed using short-term commercial paper and invested long term, they greatly expanded banks’ real leverage, and increased the all-important Return on Equity—a crucial component of senior officers’ bonus packages. The operating principle was that the extra returns from leverage were evidence of the extra brain power of bankers.

Banks can go bust in three ways:

1. Through a liquidity crisis arising from borrowing short and investing long and being forced to pay off short-term debt at a time the long investments, though still of good quality, are too illiquid to provide needed cash.
2. By borrowing short and investing long in bad investments that cannot be sold at anything approaching the price at which they were acquired.
3. By getting caught both ways...*spectacularly*.

Basic Points

An example of this third management technique was Merrill Lynch's bull rush into subprime and other dubious Collateralized Debt Obligations under the high-paid leadership of Stanley O'Neal, whose expertise and judgment deserve comparison with Fannie's CEO, Franklin Raines. When his desperate successor, John Thain, was trying to clean up Merrill's heavily compromised balance sheet, he found a hedge fund buyer for CDOs which agreed to pay 22 cents on the dollar for perfumed paper acquired only a year or so earlier at par. But even at that "fire sale" price, Thain had to agree to a form of put option that meant the real purchase price was six cents.

That story was on the minds of many of the critics of the TARP program. How much will the Feds pay for some once-valuable paper for which they have tried, without success, to find buyers?

The SEC is apparently now willing to let banks use some higher valuation for "illiquid" paper on their books than mere "fire sale" prices, although FASB protests that such an approach would be terribly misleading to investors. "Toxic," a widely used term as in "the toxic trillions of Wall Street junk," is no longer an acceptable description of the kinds of products that the taxpayers will soon own. We suspect that the banks won't be doing much writing down of values—now that there's a willing buyer out there which doesn't want to abuse its economic power by the infliction of unnecessary pain.

How much of this stuff that danced to the beat of sexy algorithms has taken up long-term residence on the balance sheets of the banks? How much of it is kept under special refrigeration to slow its rotting rate?

At the time Citi was announcing its deal with Wachovia, analysts noted that Citi had \$500 billion of "illiquid assets" and Wachovia had \$180 billion. Had that deal survived the competing bid from Wells Fargo, it would have raised the possibility that P&B Co. could spend almost their entire allotment with just one phone call.

Astonishingly, Citi has elected to file a \$60 billion lawsuit against Wells and Wachovia to block their merger. The damages claimed are almost double Citi's market cap. In the midst of the worst financial crisis since 1929, Vikram Pandit seems to be trying to ensure that the other big source of high-paying New York office jobs—tort lawyers—gets to share in the bailout proceeds. They have been feasting on the Street's problems for so long that it may have seemed unfair to leave them out.

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Fannie and Freddie (F&F) managements can justly lay claim to having pulled off the most impudent and brazen accounting scam of all time.

Writing in *The Financial Times*, John Gapper cites a finance blog called Dealbreaker that claims mortgage-related investment banking generated \$2 trillion in fees since 2003. We find that number somewhat improbable, but we admit that we have long since reached the stage of numbness about the scale of the Street's excesses.

Einstein once said that the difference between genius and stupidity is that there is a limit to genius.

We have long been inveighing against "bankerly cupidity and bankerly stupidity," and can relate to the voters' rage against "Wall Street Fat Cats." That wrath is stoked by many members of Congress. It is particularly convenient for them that the public believe this crisis was caused solely by Wall Street. Although we strongly believe that there has never been such appalling misbehavior on such a grand scale in the entire history of banking, we are confident that historians will include two other groups in this indictment.

(1) *Fannie, Freddie and Their Congressional Shills*

Fannie and Freddie (F&F) managements can justly lay claim to having pulled off the most impudent and brazen accounting scam of all time. These companies' speculations and peculations were so serious for so long—and they had so much support from powerful Congresspersons whom they financed so openly—that they achieved the unique feat of maintaining stock exchange listing and Triple A ratings despite being unable—for years—to issue financial statements that could draw an approving signature from auditors. Enron's bosses went to jail for far less—and got paid far less. F&F could be so open about their misbehavior because they had such powerful backing from Senate heavyweights such as Senator Chris Dodd and Chairman Barney Frank. F&F make the con artist hero of Leonardo DiCaprio's *Catch Me If You Can* look like a cautious piker.

The disappointing Bush Administration never made a greater demonstration of its inadequacy than when it caved in to Democratic Congressional pressure against reining in F&F. In 2005, while F&F were still concentrating on their traditional business of investing in and guaranteeing "conventional" mortgages, they began to invest very heavily in subprimes, Alt-As, and other exotica. The stated justification: providing housing for the poor. Possible other justifications: increasing stated earnings and thereby heavily increasing bonuses to top management, and underwriting the work of liberal Congresspersons with ACORN and other far-left organizations that enrolled voters and promoted subsidized housing.

Basic Points

Fannie's management during the time it became incapable of filing honest financial statements reflected its structure as a government/private sector organization. "No man can serve two masters," we are told, and Fannie knew who its real master was. CEO Franklin Raines had been Clinton's budget director and Counsel Jamie Gorelick had been his Deputy Attorney-General.

In 2005, the Administration and the Federal Reserve became alarmed at Fannie's expansion into lower-quality investments, its soaring leverage, its marketing of its debt to government and investors across the world as being "effectively government-guaranteed," and its shameless lobbying with favored Congresspersons. Alan Greenspan publicly warned of a potential disaster for taxpayers. The Senate Banking Committee actually passed a resolution reining in the miscreants. Problem: the Democrats on the Committee unanimously opposed the resolution, which meant it had no chance of overriding a Democratic filibuster, so the Republicans threw in the towel. Barney Frank and friends denounced the "ideologues" who spoke of taxpayer risk. The skills insisted that not only was there no taxpayer guarantee, none was needed because F&F were strong financial institutions. Those arguments were repeated by the same chorus members right up to June of this year, so powerful was F&F lobbying.

F&F may have been Congressional spawn that triggered a \$4.2 trillion addition to the national debt, but in one respect they resemble Wall Street. When their top management people left amid the firms' collapsing stock prices and fraudulent financial statements, they took Street-style bonuses. Raines and Gorelick took away more than \$120 million. Neither had any expertise for the job of running the world's biggest mortgage lending company. They were hired for their background as leading Liberal functionaries who could work with the "progressive" elements in Congress of both parties to ensure that Fannie was allowed to escape regulatory constraints and continue lobbying, and they did those jobs admirably. Although Democrats were usually the biggest recipients of their payments to sitting politicians, many powerful Republicans also were rewarded for keeping silent whenever the Administration or Greenspan protested that F&F were dangerous and out of control. So a bipartisan coalition worked to ensure that F&F were never subject to meaningful supervision—and that the money flow to borrowers whose circumstances would never have given them access to mortgages in earlier cycles would keep accelerating. Bush in effect gave his imprimatur to this process when he hymned the joys of "the ownership society."

...a bipartisan coalition worked to ensure that F&F were never subject to meaningful supervision...



...it becomes apparent that a lot of Americans had fun during the buildup to the current collapse.

He based these policies on Margaret Thatcher's successful program of transferring ownership of "council houses" from municipalities to residents. He was unfair to Mrs. Thatcher. Not only was this a boon to councils in Midland towns dominated by decaying "dark Satanic mills," but also the book value of those properties was so modest that the mortgage costs to the new owners tended to be within their meager means.

Where Congress is concerned, there's plenty of blame to go around. Republicans may choose to point the fingers now, but they didn't work hard to educate their own wayward members about the unwisdom of accepting payments from F&F. Had these out-of-control speculators been reined in three years ago, Wall Street would not have had an assured receptacle for hundreds of billions' worth of low-quality mortgages, and that would have operated as a constraint on the absurd expansion of subprime lending through Countrywide, New Century Financial and other reckless lenders. As the saying goes, "The fish dies from its head down."

(2) *Improvident Homeowners*

Some pleasures, and some antisocial behavior can be performed solo.

Others need at least one partner.

When people who had no savings and no record of steady employment were offered the pleasure of home ownership by mortgage representatives enjoying the pleasure of extra bonuses for "selling" the most exotic mortgages that would give investment bankers the pleasure of packaging them with other mortgages in sexy new products that gave pleasure to really smart mathematicians who gave pleasure to institutional salespeople who sold them to institutional investors who had the pleasure of getting extra high yields from AAA-products, it becomes apparent that a lot of Americans had fun during the buildup to the current collapse.

All those mortgage lenders, packagers, software designers, investment bankers, and salespeople who were having fun, needed the homebuyer— the apex of an upside-down triangle of pleasure-seekers.

Basic Points

It has become almost an article of political faith that all the blame for the current crisis falls on greedy denizens of Wall Street. When somebody who has never made a payment on his/her mortgage is foreclosed, this is presented as an utter tragedy for which a corrupt system must be blamed—not the people who lived rent-free in a house they couldn't possibly have ever afforded, and will now have to, once again, pay rent.

Woody Brock, one of the wisest and wittiest of men, remarks, "Were consumers truly unaware that they chose to get in over their heads as they maxed out four credit cards as opposed to one? Moreover, were those who acquired houses really unaware when they chose and signed up for ARMS that their monthly costs would one day rise sharply? Toilet-Training 101 anyone?"

We realize there are, in fact, many, many cases where people who really did intend to make their payments were sold unnecessarily complex and expensive products by unscrupulous representative of such organizations as Countrywide. Bank of America has announced agreement with various states' attorneys-general in an \$8 billion program that slashes mortgagors' interest rates to as low as 2% for a relatively short term and may, in some cases, actually reduce the principal on the mortgages. B of A had provided for this settlement in its closing valuation of Countrywide, understanding that much of that company's portfolio was scandalous.

High urban house prices are not, in reality, generally beneficial to the economy. That's one big reason why Congress should be leery about trying to prop up home prices—the other being that lower prices will attract new buyers who can actually afford to buy the properties. Companies seeking to open new operations tend to shun communities where home prices—and taxes—are high, unless those are the only places they can find the kind of employees they need. Expensive housing forces workers to travel great distances to get to work, and diverts excessive amounts of long-term capital away from job-creating investments. Unfortunately, after the tech Triple Waterfall, millions of burnt equity investors concluded that housing was the best way to save for their retirement.

It has become almost an article of political faith that all the blame for the current crisis falls on greedy denizens of Wall Street.



**Various commentators
now speak of
“The mother of all
reflations.”**

No wonder that polls show that more than 75% of Americans think the country is going the wrong way. No wonder that many economic seers are issuing bleak forecasts for a US economy that must absorb trillions of dollars in writedowns for home mortgages, LBO loans, credit card debt, home equity loans, auto loans, and commercial real estate mortgages.

No wonder that passage of the TARP bill didn't immediately unfreeze the short-term credit market. In discussions with short-term traders at Harris Investment Management, we were told that “there are no buyers.”

The outstanding supply of US commercial paper is down by more than \$200 billion since August. Corporate issuers who couldn't roll over their offerings are drawing down their bank credit lines. Because banks face gigantic demands from their top-quality borrowers as commercial paper disappears, the banks decline to lend to each other, driving up the TED Spread. In the hours after the announcement of the passage of TARP in the House, the TED Spread remained frozen at 387—its highest reading since the crisis began. The Fed is making massive loans, but the system seems incapable of thawing.

In a conference call last week about the cash crunch whose listeners included corporate CEOs and CFOs, we suggested that the companies remember Johnny Cash's rule: *Walk the line. Hang on to your cash and don't assume that cash will be available for non-routine purposes, such as for buying back stock at seeming bargain prices.* As one client told us yesterday, “There is, essentially, no short-term market anymore.”

Is The Commodity Story Dead?

With the passage of TARP, P&B Co. assume (hope) that they will be able to set up mechanisms for speedy acquisitions of frozen assets that will start the thawing of the banking system.

No one knows how long this will take.

Various commentators now speak of “The mother of all reflation.” The assumption is that the FED, ECB, and other central banks will be making even more massive liquidity injections, and that all central banks will be cutting rates. (The US markets are already pricing in a 1% fed funds rate.)

What should be worrying investors is the remarkable strength in the dollar at a time when there is the lowest-ever liquidity in US debt markets. The dollar rose to a new recovery high last Monday, which was the day the House voted down the rescue. Germany's Finance Minister called it the worst-ever disgrace for US capitalism, and *schadenfreude* swept across Europe with hurricane force.

Basic Points

The dollar's strength is illusory: it comes from the desperate unwinding of US-based hedge funds, as they sell foreign stocks and bonds to cover debts and withdrawals. As they repatriate those funds, the dollar climbs.

This is an Orwellian situation: Weakness is Strength.

Gold actually fell last week, delighting most central bankers and giving Bernanke greater freedom to cut rates. That was the first financial crisis in more than thirty years in which gold failed to rally. To many observers, this signals the onset of runaway deflation—which the Fed will offset with runaway reflation. Such reflation should be bullish for gold.

Gold rallied on Monday, but the gold mining stocks fell; when the margin clerks are in charge, they sell whatever can find bids.

***This is an
Orwellian situation:
Weakness is Strength.***

Gold (US dollars)
January 1, 2002 to October 7, 2008



Gold (Euros)
January 1, 2002 to October 7, 2008





When the currency of a virtually stagnant economy that is still trying to escape from a Triple Waterfall Crash looks like a powerhouse, it signals the forcible unwinding of the Carry Trade.

But gold has performed well against many paper currencies, declining mainly against the dollar and yen. When the deleveraging of hedge funds slows down, this would remove a prop from the dollar.

The yen has been in its own bull market against almost all currencies, and particularly the commodity-related currencies. Example: It is up 40% this year against the Australian dollar.

When the currency of a virtually stagnant economy that is still trying to escape from a Triple Waterfall Crash looks like a powerhouse, it signals the forcible unwinding of the Carry Trade. Commodity investors will recall that those few and brief occasions when commodities and commodity stocks were hammered, the yen climbed sharply. Since the Bank of Japan's rate is a microscopic 0.5%, and the yen is a liquid currency, hedge funds and other levered players have long sought to fund their borrowing in yen. Now that global stock markets are being pummeled at least as much as—or more than—New York, speculators in those markets are repaying their yen loans. The commodity bear market will surely end when the yen rolls over.

Many of the best-performing equity hedge funds were heavily invested in commodities and commodity stocks. After the July 13th massacre, these funds were hit hard, and faced withdrawals. In recent weeks, other hedge funds have been feasting on their brethren. Knowing that the high-fliers were long leading commodity stocks, particularly the oil sands and agriculturals, the predators shorted these stocks.

They are delighted to find stocks they *can* short, so going after Potash, Monsanto, Deere, Mosaic, Suncor, and other major winners is like shooting fish in a barrel as long as overlevered hedge funds are still having to raise cash.

Thanks to SEC Chairman Chris Cox, more than 1,000 leading US stocks are immune from short-selling. This intervention in market processes began with the banks, then spread to all financials, and in recent weeks to any company with a finance subsidiary—including even IBM. GE was an obvious beneficiary of this rule, but the stock is down roughly 50% in the last year anyway. As a victim of the short-term paper squeeze, GE was forced to raise \$17 billion in equity in a deal with Warren Buffett, and an equity offering at a \$2 discount to then-market prices. (GE is just about the only AAA-ranked US Industrial company, although AAA doesn't mean what it used to.)

The SEC's short-selling rules have been painful for the hedge fund industry. The disciplined, model-driven funds that account for a large percentage of trading at New York are obviously constrained.

Basic Points

That ban is due to expire tomorrow night. What will happen then?

The stock group hurt worst has been the commodities—particularly the agriculturals. Not only have commodity prices slumped sharply since the July 13th Massacre, but some of the most conspicuous winners among equity hedge funds were those with heavy exposure to such stars as Potash, Mosaic, Monsanto, and Deere.

The adjective to describe the new behavior pattern is “lupine.” Many of the hedge funds tended to trade together on the upside, which meant that collectively they were huge holders of the stocks that had done best.

Wolves hunt together, searching for quarry, and using tactics such as encirclement for mutual benefit.

Until the supply of food dwindles. Then the wolves start to attack each other.

What has been happening is that hedge funds know which of their brethren are most heavily exposed to the commodity stars, and are facing cashout demands from frightened clients. Darwinism asserts itself, as other funds short these stocks, unrestrained by the uptick rule that, until last July, prevented an unending bear raid. The more they drive down the stocks, the more the desperate owners have to sell. Example: Mosaic fell 41% last Thursday after reporting huge earnings gains that were below the Street consensus, and announcing a plan to cut back on phosphate production in the face of climbing inventories. The stock now sells at roughly 4 times earnings. Similar fates befell the other food blue chips.

In pondering the impact of this unprecedented government intervention into stock markets, we hypothesized a series of pleas from high-end private golf courses to Fish & Game authorities about the pestilential population of Canada geese. In response, the regulators announce a one-year ban on shooting wild ducks—but not geese. With all those hunters eager for action in hunting season, they would certainly clean up the supply of the geese, while the mallards and teals would be almost unable to believe their good fortune.

We cite these cross-currents to explain why we have little confidence that the stock market has yet reached bottom. The US recession has only begun, and recessions and deleveraging are spreading across Europe. As unemployment increases, so will mortgage foreclosures—in the US, and in such bubble real estate jurisdictions as Ireland and Spain.

...they would certainly clean up the supply of the geese, while the mallards and teal would be almost unable to believe their good fortune.



An unwary observer might conclude that Organic Farming had triumphed: farmers are going to use horses and oxen instead of tractors...

We also suspect that the coming winter will be colder than usual, which will mean higher prices for natural gas and heating oil than most consumers expect, based on the sharp pullbacks in prices of oil and gas since June.

Why?

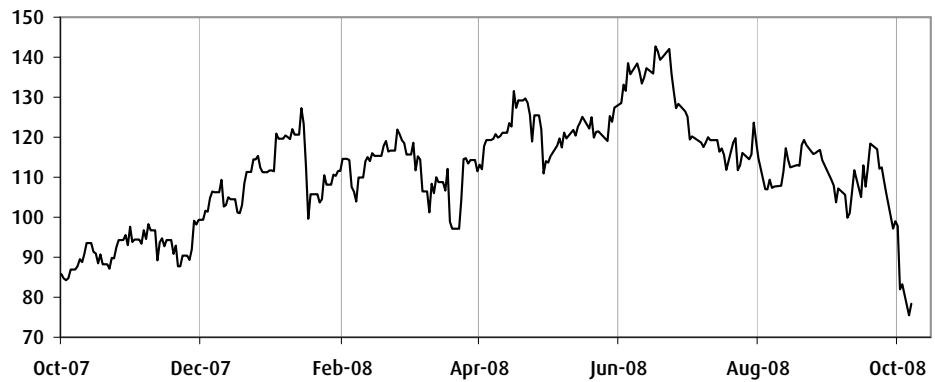
Because, according to NASA, sunspot activity and solar winds are at fifty-year lows. Climatologists resist drawing any conclusions from such aberrant behavior, stating that no one has shown how sunspots affect global temperatures. That, over the centuries, low sunspot activity has occurred at a time of global cooling is clear, but the scientists argue this could be just a coincidence. In fact, the National Weather Service is predicting a warmer-than-normal winter in the Midwest.

Which leads us naturally to discussion of the devastation inflicted on our most-favored stock group.

The panic selloff in agricultural stocks has been truly brutal. An unwary observer might conclude that Organic Farming had triumphed: farmers are going to use horses and oxen instead of tractors and will produce their own seeds. Such a switch would integrate farm operations by supplying the needed fertilizer and immunizing farmers against rising energy prices. This back-to-nature approach would also generate extra revenues for farmers through school visits so children could pet animals and ride in carriages.

Consider the performance of some of the world's most renowned agricultural companies lately:

**Monsanto (MON – NYSE)
October 1, 2007 to October 7, 2008**



2007A EPS: US\$3.41 2008E EPS: US\$3.45

Source: Chart – Bloomberg, Mean Estimate – Reuters

Basic Points

Potash (POT – NYSE)

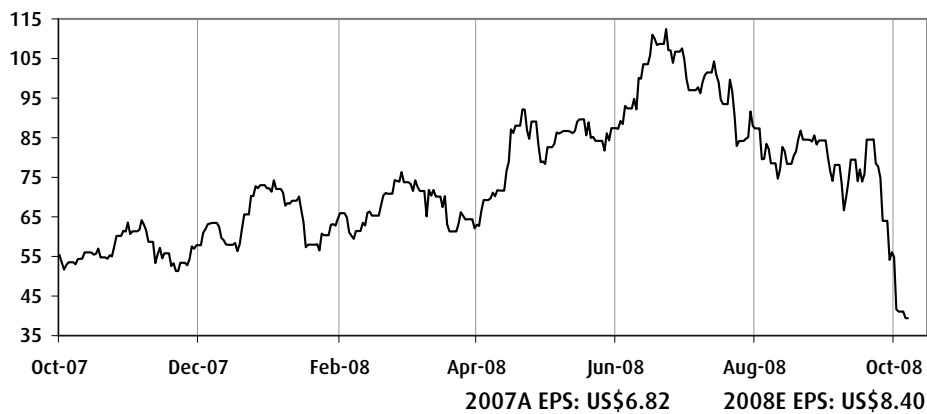
October 1, 2007 to October 7, 2008



Source: Chart – Bloomberg, Mean Estimate – Reuters

Agrium (AGU – NYSE)

October 1, 2007 to October 7, 2008



Source: Chart – Bloomberg, Mean Estimate – Reuters

Mosaic (MOS – NYSE)

October 1, 2007 to October 7, 2008

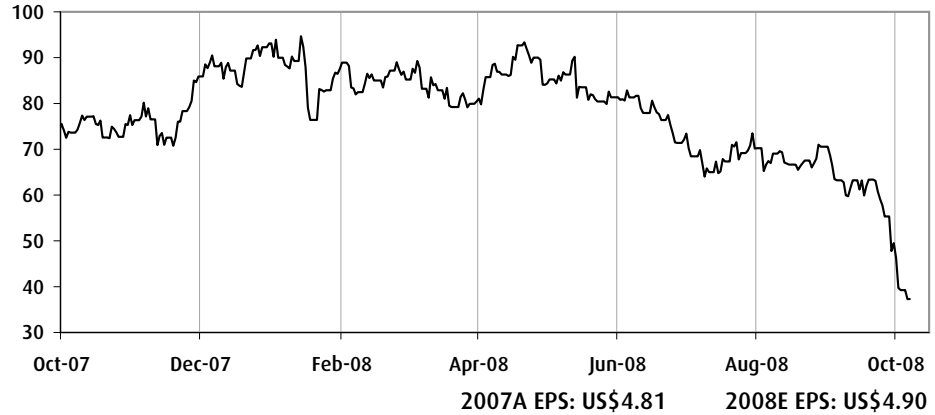


Source: Chart – Bloomberg, Mean Estimate – Reuters



**We are, frankly, stunned
by these collapses.**

**Deere (DE – NYSE)
October 1, 2007 to October 7, 2008**



Source: Chart – Bloomberg, Mean Estimate – Reuters

**CNH Global (CNH – NYSE)
October 1, 2007 to October 7, 2008**



Source: Chart – Bloomberg, Mean Estimate – Reuters

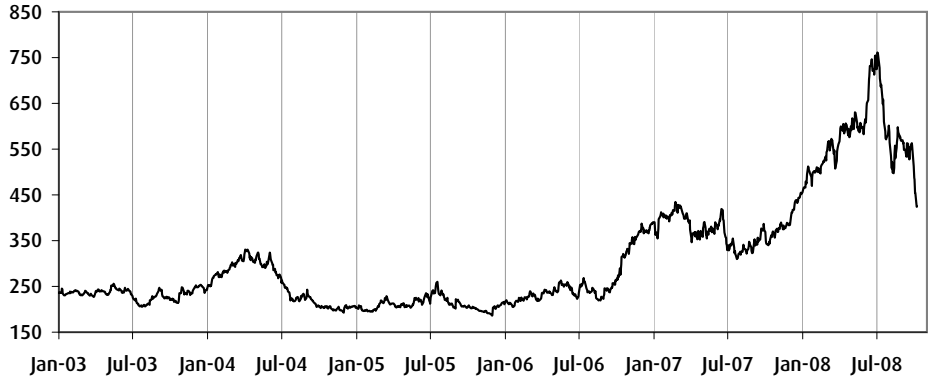
We are, frankly, stunned by these collapses. We have argued that the agriculturals were the best-insulated against a global economic slowdown, because the world remains short of vegetable protein, and there are so few companies with the strength, technology, and distribution to be significant contributors to handling that other crisis—the global food crisis.

Basic Points

Yes, grain prices are down from their highs, but remain at highly profitable levels for farmers—and high compared to previous years

Corn

January 1, 2003 to October 7, 2008



Yes, grain prices are down from their highs, but remain at highly profitable levels for farmers...

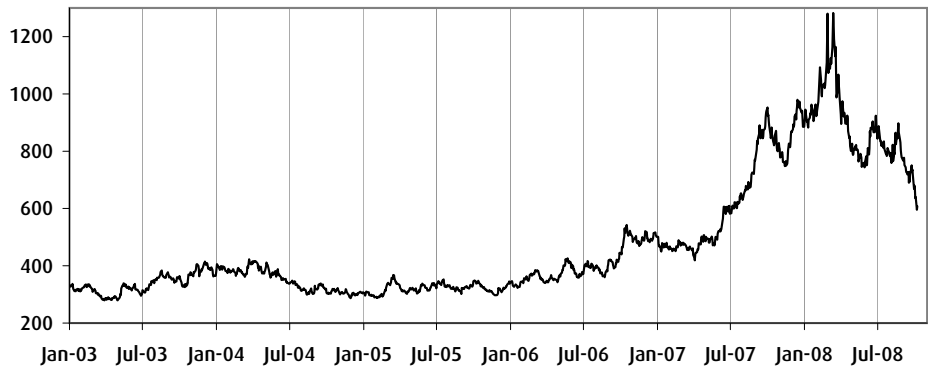
Soybeans

January 1, 2003 to October 7, 2008



Wheat

January 1, 2003 to October 7, 2008





...these stocks are the cheapest they have been since the commodity boom began.

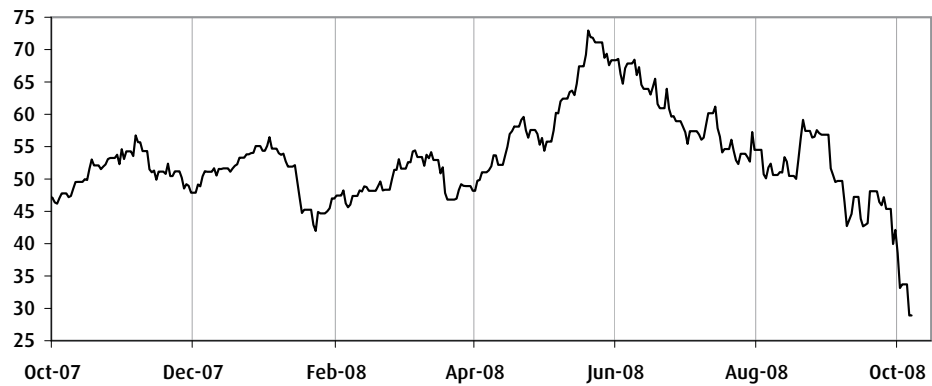
Monsanto raised its earnings forecast for a second time in three weeks—and for the seventh time this year, and was rewarded with a 20% plunge in its stock.

We have no real idea when the lupine short-selling will exhaust itself or where these great companies' shares will settle out. We have no reason to believe their earnings growth will disappear.

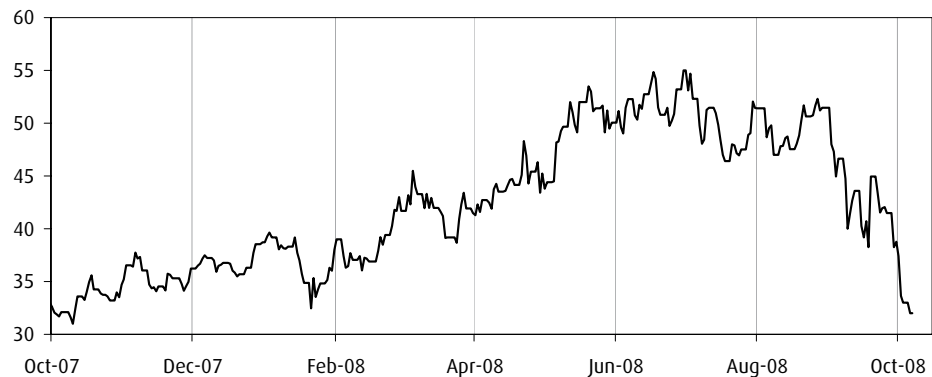
In other words, these stocks are the cheapest they have been since the commodity boom began.

The oil stocks have collapsed along with crude oil prices.

Suncor (SU – NYSE)
October 1, 2007 to October 7, 2008

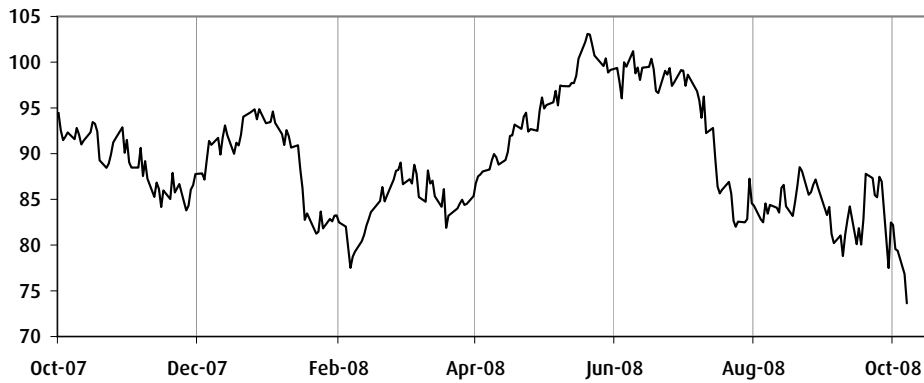


Canadian Oil Sands Trust (COS.UN – TSX)
October 1, 2007 to October 7, 2008

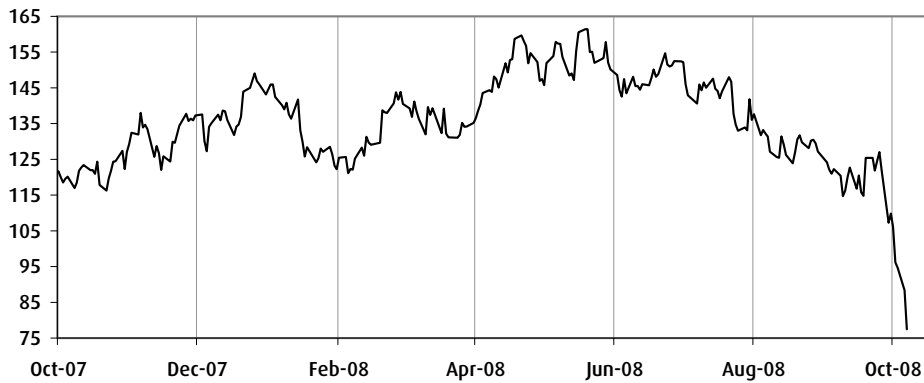


Basic Points

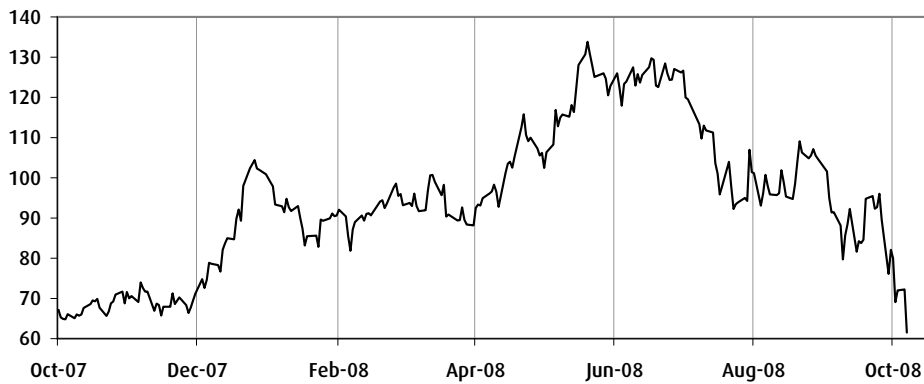
Chevron Corp. (CVX – NYSE)
October 1, 2007 to October 7, 2008



Transocean Inc. (RIG – NYSE)
October 1, 2007 to October 7, 2008



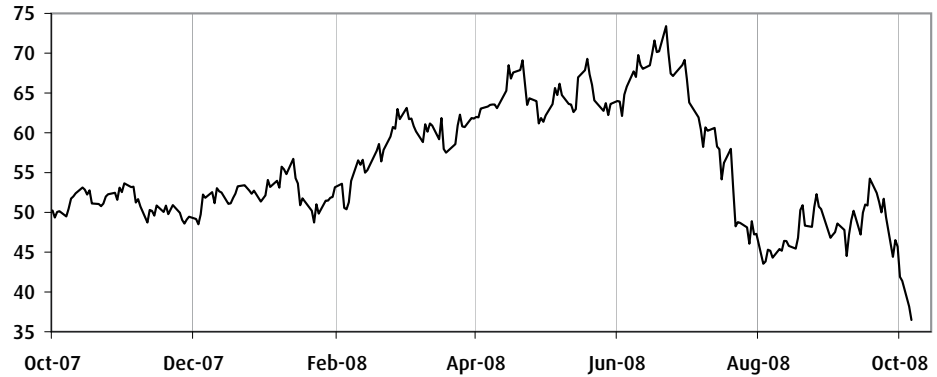
Hess Corp. (HES – NYSE)
October 1, 2007 to October 7, 2008





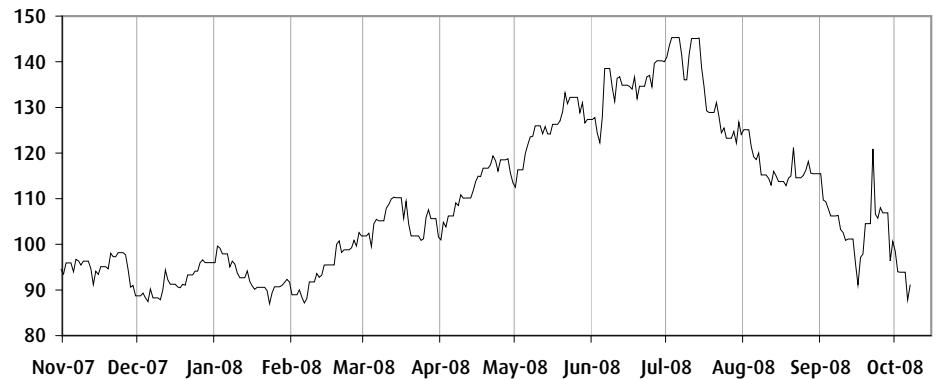
...the most propitious time for making such purchases is when the semi-forced liquidation of both commodities and stocks drives prices to Slough of Despond levels.

**XTO Energy Inc. (XTO – NYSE)
October 1, 2007 to October 7, 2008**



Crude's selloff has been concentrated on the near-months:

**Crude Oil
November 1, 2007 to October 7, 2008**



Since Finding and Development costs for new oil in politically-secure regions are running in the \$70 range, those \$96 prices are essentially asset-accretive, even with oil down from \$145. As long-term investors, we want to own companies that are building their long-term positions within their industry, and the most propitious time for making such purchases is when the semi-forced liquidation of both commodities and stocks drives prices to Slough of Despond levels.

Basic Points

The Alberta oil sands stocks have been hit particularly hard as Barack Obama surges ahead in the election polls. As discussed below, Mr. Obama is the political equivalent of somebody who went 100% short with a vast fortune a few weeks ago. The worse the financial crisis becomes, the higher his poll standings rise.

Why is his surge bad for Suncor *et al.*?

Because he has pledged to protect the US consumer from “dirty oil,” and those who are lobbying to block expansion of an Illinois refinery to use Alberta oil are doubtless all going to vote Democrat. Investors rightly believe that, with all the bad news for commodities these days, they don’t need to increase the political risk in their portfolio. Many leading Democrats have been playing up to Chavez, while displaying the kind of hatred for “Big Oil” that they would be too polite to apply to Ahmadinejad—whom Obama has promised to meet. If Obama is truly serious about this ideological hatred of Canadian oil resources and really believes that wind and “new technology” are coming so fast as to make reliable oil supplies unnecessary, then he would not be the cool, smart person we believe him to be—and shouldn’t even be an alderman of Chicago, let alone President of the United States. We’re betting that he’ll display common sense on this, as on so many other questions where we assume he will disappoint his most foam-flecked supporters. As we discuss below, this man strikes us as being, like Ronald Reagan, far more prudent than many of his most enthusiastic backers, and has grown from being a Daley foot soldier and the chum of Hyde Park radicals and liberation theologians to being an extremely impressive candidate for the Presidency—evidencing, like Bill Clinton, both the common touch and common sense. He is far too shrewd to make America even more dependent on the affections of Chavez, Putin, and the leaders of the Gulf States.

The mining stocks have been savaged by falling base metal prices, rising metal inventories, and a fast-spreading global recession. The base metal stocks’ collapse is the one big selloff that is based on actual economic data, rather than runaway pessimism.

Mr. Obama is the political equivalent of somebody who went 100% short with a vast fortune a few weeks ago.



...Americans, who, (its snootiest critics believe), seem to find saving as unattractive as public nose-picking or belching.

THE INVESTMENT ENVIRONMENT

1. *America and China*

What started as the eagerly awaited disciplining of the spendthrift and arrogant Americans has become a crisis that alters the global landscape.

Last week, major institutions in Britain, Belgium, and Germany were rescued by their respective governments, and stock markets across Europe joined the US in the contest for the World Diving Championship. (The European Central Bank has no jurisdiction over bailouts: they are up to the nations directly involved.) There was financial turmoil in South Korea, India, Pakistan, Russia, Iceland, Brazil, Mexico, and Canada—and there were even signs of trouble in Dubai. And everywhere, there was speculation about what the impact would be on China.

Until the US housing bubble-burst became a global challenge, much of the discussion about China's growing economic might was fearful and/or resentful. How long would it take for China to impose its will on the world through sheer economic supremacy?

In recent days, much of the chatter seems to be along the line, "What if China also goes down? Does that mean a new Depression?"

Few commentators seem to believe the US can right itself. Since the 1950s, the US has grown its debt (public and private) faster than it has grown its GDP. In this decade, each \$100 growth in total debt has produced only \$19 growth in GDP. The rest of the world has, from its savings, been involuntarily subsidizing an excessive lifestyle for Americans, who, (its snootiest critics believe), seem to find saving as unattractive as public nose-picking or belching. By that standard, the mortgage collapse is simply the most egregious example of the American belief that the rest of the world owes it a living. Those millions of homebuyers who got 100% financing for buying homes far above their true economic status while maxing out their credit cards were doing it The American Way. Don't they know the nation is fighting two wars and just keeps going deeper into debt? So sniff the moralists—from France's Sarkozy to Germany's Minister of Finance.

However, a few of America's critics are already beginning to fret about a world in which America was so financially distressed and preoccupied with its own problems that it would let the rest of the world look after itself.

Basic Points

Europe likes to talk about its sophisticated “collective diplomacy,” in contrast to America’s arrogant go-it-alone approach to North Korea, Iran, and other troublesome nations. So, now that America is going to look inward, here’s your chance, Europe!

Four European finance ministers met last weekend with just that kind of goal in mind, and the result was little more than Europe has to show for the seven years of “constructive engagement” it has showered on Iran, along with tens of billions’ worth of weaponry and sophisticated nuclear hardware. Ditto with North Korea, Hamas, Zimbabwe, Sudan, and other global nuisances.

What if we can’t unite Europeans in contempt for American foreign policy? What will unify the Eurozone then?

And as for the delicious spectacle of the Great Capitalist bailing out banks (and maybe auto companies—and even California), isn’t it rich? They always ridiculed our social model and tried to impose neoliberalism. So what’s that got them?

What is beginning to worry these Michael Moore-style triumphalists is that there may be only one alternative to the US in terms of economic dynamism and willingness to project power internationally—China. That is one reason why so many frightened investors want reassurance that China is still barreling ahead.

China moved to top-dog status in 1997–8, when it was the only Asian nation that didn’t devalue its currency. That gave the smaller mainland nations an umbrella as they struggled to recover from the serial collapses of economies and currencies. (That Japan also devalued and snuck under that umbrella triggered China’s outrage in September 1998, which finally forced Japan into a sharp upward revaluation of the yen; that led to the Great Symbiosis, which was, more or less, a shadow Bretton Woods for nearly a decade.)

We believe that the US will emerge from this crisis as the leading nation within the OECD, but we suspect that a new Sino-American bipolarity will result. China has the cash and the economic growth; the US has the economic and military scale to be in that global gin game for decades.

If we are right in this assessment, within a year, China will have made several bold and assertive acquisitions abroad, using some of its vast hoard of Treasuries and Fanny-Freddie paper to buy reserves in the ground in politically-secure areas of the world—or undersea.

This panic-driven selloff in commodity stocks makes such acquisitions cheap—and well-nigh irresistible—for a nation that takes the long view.

**This panic-driven
selloff in commodity
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long view.**



Since the female of the species is deadlier than the male, Mama Bears are greatly to be feared.

2. Mama or Papa Bear?

Clients have begun asking us whether we think this is a Mama or Papa Bear Market.

For those who haven't read our book (*The New Reality of Wall Street*), there are four kinds of bear markets—Mama, Papa, Teddy, and Baby. The ones that matter are the parents: a recession-sniffing bear is a Papa, and there is always a Papa before, and in the early stages of, a recession. Since the female of the species is deadlier than the male, Mama Bears are greatly to be feared. There are two kinds of Mamas—Mini and Big. A Mini-Mama is an asset class that experiences a Triple Waterfall rise and crash—such as the rise and fall of gold, silver and oil in the 1980s and Nasdaq in the 1990s. A Big Mama is an era-ending event that smashes asset values on terrible scale—the Triple Waterfall crash of 1929–33, the Triple Waterfall Crash of 1972–75, and the Japanese Triple Waterfall Crash, 1989—?

If this turns out to be a Big Mama, the Dow and the TSX are headed for 5,000 or less, and the S&P for 500. At the plunge pace of the past six trading days, we could be there in time for Hallowe'en, which would probably lead to an explosion of costuming for True Ghouls.

We don't believe that is probable:

1. Real yields on government paper are negative across most of the OECD—and particularly in the US.
2. The US downturn began at a time of a record low Inventory/Sales ratio.
3. The Baby Bust began 36 years ago, which means there should be no bulge in youth unemployment.
4. Ben Bernanke has drunk deeply at the Pierian Spring of learning about past financial crises. He knows how the Crash of 1929 became the Great Depression—a collapse in monetary expansion, a rise in taxes, and the adoption of the Smoot-Hawley Tariff. He was even nicknamed "Helicopter Ben" for his throw-away line that, if necessary, the government should scatter money from the skies.

Basic Points

5. When the US went down in 1930, there was no nation able to step into the breach. Britain had lost its major-league status in global finance because of crushing debts from WWI. France was similarly burdened. Germany was recovering from its Weimar disaster with some toxic new politics. China had not been part of the global calculus for more than a century. Japan was autarkic and inward-looking, focusing on building a navy and army to become Asia's ruler. The USSR under Stalin had become an experiment in adapting the concepts of Hell to Earth. This time there is a global order that embraces most of the world's economic activity. Unlike recent crises, the Third World is a collective creditor this time and heavily subsidizes US and European interest rates. Its demography, in effect, offsets the long-term suicidal demography of the advanced industrial nations, with Japan in the vanguard.
6. When the Mama Bear Market of 1973 struck, food and fuel inflation was destabilizing the industrial world. As central bankers tried to offset the economic downturn and insulate their citizens from soaring food and fuel prices, all they actually accomplished was driving commodity prices higher and economic activity lower.

This time, Bernanke and Paulson launched the July 13th "Midnight Massacre" which had as one of its goals forcing hedge fund liquidation of commodity futures and commodity stocks. They succeeded brilliantly, partly because political pressure forced unwinding of many large pension funds' passive investment in commodities at the same time hedge funds were in panic liquidation. As hedge funds delevered, unwinding their long and short positions, oil fell from \$140 to \$90, corn from \$7.75 to \$4.25, soybeans from \$16 to \$9.25, and copper from \$4 to \$2.50, the leading voices demanding strong monetary policies went silent. As Bernanke begins reflation, he will not be putting upward pressure on commodities but will be supplying underlying support for the real economy. History may well record that the "Midnight Massacre," which was a devastating attack on hedge funds and commodity investors, was the most brilliantly executed piece of surgical intervention in modern monetary history. It stopped F&F from meeting their richly deserved fate—total collapse—it triggered a short-covering panic rally in bank stocks of 40%, and it will have the effect of lowering top-line CPI for months to come. And some people think Bernanke is a pottering academic?

**And some people
think Bernanke is a
pottering academic?**



From the perspective of the average voter, this catastrophe was caused by Bush and bankers, and it's time to boot Republicans out of office.

Nevertheless, this market is frighteningly fragile. As this is being written, Morgan Stanley stock is down 39% and is pulling down the entire New York market. The reason isn't a massive writedown, but an allegation by a fired SEC employee after an investigation two years ago of John Mack, Morgan's CEO. The timing of these "revelations" is suspicious: apart from Mack and the stockholders and employees of one of the Street's great firms, the biggest loser is John McCain, because the October 7th Presidential debate occurred with the Dow at yet another low.

In better times, that would have cost the stock a buck or two, because investors would know that the worst outcome would be a firing.

If this is enough to destabilize the markets, then we are either at a near-term bottom...

Or maybe this really is a Mama Bear.

Conclusion

Most of the OECD is in recession and nearly all the world's stock markets are in bear phase. This could yet become a Mama Bear but we suspect it will prove to be a Papa, which means it has only a few months to run before commencing base-building.

Coming out the other side, the global economy will be decisively led by China, and the shares of the companies which sell what China needs to buy will be market leaders.

In one sense, commodity stocks never gave up their leadership: they stayed in powerfully bullish mode for ten months while the banks were dragging the rest of the stock market into a bear pattern. They then became market leaders on the downside as the smashing of commodity prices and the deleveraging of hedge funds made them the most brutally bashed stocks for a few weeks. They will lick their wounds, while still recording high returns on equity and still boasting high quality balance sheets. When the next global economic recovery takes flight, their profits will reach new peaks.

The US Election: Last Call

Two Presidential debates remain, but this election looks to be virtually over. Latest polls show Senator Obama leading by 7 to 9 points. At the time of the first announcement of the P&B Co. rescue, Mr. McCain held a slight lead. This kind of late-campaign swing means that doubtful voters have decided that only one thing really matters to them: the economic crisis. From the perspective of the average voter, this catastrophe was caused by Bush and bankers, and it's time to boot Republicans out of office.

Basic Points

We have consistently maintained that the race was too close to call. The recent dramatic events in Washington and New York have transfixed the voters. “Everybody is a stock investor now.” Everybody seems to have heard a story about problems in the banking system.

These problems showed themselves on Bush’s watch, and McCain certainly didn’t see them coming. He still talks of the “solution” as being lower taxes and a combination of better and less regulation—and an end to earmarks. He is a gallant man, and a great American, but he’s bagged with Bush.

We ended up our political predictions last time by suggesting that the Vice-Presidential Debate would have the biggest TV audience since the Super Bowl. Well, it may not have reached *that* peak but it drew 73 million viewers—40% more than watched Obama and McCain—the largest debate audience since the single debate between Reagan and Carter in 1980.

Pretty impressive that Joe Biden could draw that big a crowd, isn’t it? It couldn’t have been Governor Palin, because the mainstream media are virtually unanimous that she is an embarrassment.

After watching both debates, we can say we were impressed with all four candidates. Senator McCain was classy and courageous, a national hero of invincible honesty to the core, Senator Biden was smooth, experienced, and charming, with the most dazzling smile we’d ever seen on a politician, Governor Palin was feisty, mostly on the mark, and was an astonishingly fine debater against one of the Senate’s icons after just five weeks’ training...

But Senator Obama was clearly the one to watch. He is cool, charismatic and cerebral, displaying a Presidential temperament. We believe he should do America proud. Not because of his political biases—he has the most Liberal voting record of any Senator, (even the Socialist), and his background includes close association with some really scary people of the radical Left. We doubt he’ll be as good at crossing the aisle as was Clinton. (Yes, despite his personal failings, Clinton was a problem solver, a great consensus builder, and a fine President. He was remarkably free of leftist dogmatism, and, with Tony Blair, was one of the two most truly modern and enlightened political leaders of his generation.)

But Obama probably won’t need to work with a consensus. He will likely win big, and that top of the ticket power will lead to powerful Congressional majorities, which will make consensus unnecessary.

**Pretty impressive that
Joe Biden could draw
that big a crowd, isn’t it?**



George W. Bush gave the nation big government conservatism, which is as oxymoronic as pro-war Liberalism.

And it is the Liberals' turn to rule. The Republicans had their chance to demonstrate that conservatism really works to expand human freedoms and promote economic growth. They let that opportunity get away.

George W. Bush gave the nation big government conservatism, which is as oxymoronic as pro-war Liberalism. He got the nation into a war whose risks he underestimated, in order to destroy weapons of mass destruction, whose risk he overestimated. He sought to be the Education President, which, in effect, meant an attempt to federalize the nation's schools at vast taxpayer expense without introducing alternative schools so that the poor would, like the rich, have some choice of schooling.

Bush's weakness was most tragically demonstrated in his failure to stand up against the corrupt management of F&F and its powerful Congressional skills, and to respond to warnings from advisors about Wall Street's huge embrace with F&F to expand the market for mortgages. Bush could thereby probably have prevented this global financial crisis, one of whose victims is John McCain, who might well have won the election if the economy were still cruising along and the Dow were still above 12,000.

Meanwhile, while Bush was missing opportunities and creating problems in the White House, in Congress, as McCain said in the debate, "We Republicans came to change Washington and it changed us." Corruption in Congress, the Republicans' winning card in the wipeout election of 1994, turned out to be deeply durable.

Barack Obama managed the remarkable feat of defeating the Clintons. Although John McCain is doubtless better qualified to be Commander in Chief, and has a tradition of working as a moderate with Democrats to get things done, he has to win the election first. It doesn't look as if Fate will give him that chance.

Senator Obama is the nominee of the party that deserves the chance to demonstrate that thoroughgoing Liberalism is what the nation needs. It couldn't have a better, or more seductive voice. Democracy is, at its heart, based on the concept that the Opposition must get a chance to strut its stuff. A win for the Democrats is a win for democracy.

INVESTMENT RECOMMENDATIONS

1. Our Recommended Equity exposure is at or near minimum, depending on a client's overall portfolio structure and risk tolerance. At 46% for pension funds, it is close to an absolute bottom level of 40%. At 20%, Cash is at our maximum.
2. Long-term investors should not delay much longer in picking among the wounded commodity stocks on the market's bloodied battlefield. The best of these companies are among the best the world has to offer, in terms of importance to the global economy, competitive position, balance sheets, cash flow, and management quality. At current prices, many of them sell for no more than a discounted value of their reserves in the ground, with no allowance for their balance sheet assets.
3. The agriculturals have been savaged to an astounding extent. The global food crisis has been put on hold, but it will only take one medium-sized crop failure to bring it back with even greater intensity. A relative handful of great companies has the facilities, technology, management, and distribution to mean the difference between widespread global starvation due to scarcity and excessive food prices, and enough protein production to meet the needs of a billion people escaping diets of rice bowls and bread.
4. The massacre of their stock prices means that these industries will not be able to expand their operations and create oversupplies of their products. That means they will make even higher profits in the next phase of this super-cycle.
5. One side effect of the "Midnight Massacre" is sharply lower US interest rates, due partly to the short-covering rally in the dollar and to the collapse in stock prices forcing asset reallocation. Those lower rates will mean that the millions of US mortgagors facing resets in the next twelve months should not be facing the kind of ghastly monthly carrying costs that the most bearish forecasters were predicting as little as five months ago.
6. Commodity prices fall during recessions—but the real value of great commodity stocks does not. Why? Because recessions are devastating to smaller, undercapitalized commodity producers, and they become easy pickings for the majors once they see light at the end of the tunnel. "There's nothing surer, the rich get rich and the poor get poorer" was a Depression song, but it will doubtless have relevance as the big commodity companies survey the landscape.



7. Gold and gold mining shares remain the best way to reduce endogenous risk within an equity portfolio. Although inflation is bound to recede for at least a few months, the amount of stimulus being injected into the global system will prove highly intoxicating once the downturn bottoms out, and gold should move to new records.
8. This “largo” phase of the commodity sonata has more tragedy in it than we expected or, indeed than most symphonies (apart from Tchaikovsky’s) have in this movement. We should have alerted clients to the rapid deterioration in the fundamentals in the prior issue of *Basic Points*. We tried to make up for that default in our September 19th Conference Call, which not only advised significant cutback in equity exposure, and significant increase in Cash, but also cut Commodity Stock Exposure to Energy and Base Metals stocks in favor of the Precious Metals. We believe these rebalancings should be some consolation to investors in the risky times ahead.
9. The scale of debt buildup, the scale of the complexity of assets accumulated during the late stages of the bank mania, and the scale of deleveraging mean that the level of overall endogenous economic risk is truly unknowable. We know that, with the collapse of Lehman, many hedge funds have sustained big losses subject to what could be protracted legal proceedings. Those assets may have been sold or may be overhanging the market. Never before have so many politicians and so many bankers colluded to behave so badly. We still doubt that their malefactions have created a Mama Bear market, but we’ll probably know within weeks.

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