

The Blob on Wall Street

December 15, 2008 Newsletter

***Beware of the blob, it creeps
And leaps and glides and slides
Across the floor***

***Right through the door
And all around the wall***

A splotch, a blotch

***Be careful of the blob—Burt Bacharach
From the movie, 'The Blob'***

[Click Here for Movie Trailer for 'The Blob'](#)

***Thanks to my good friend, Robert Ross, Of
RBS/ABN Amro for the 'Blob' concept.***

What is the Blob on Wall Street?

The Blob is a morass of financial intervention that has eaten every bad financial deal too large to let die on its own. To understand the Blob, we must first understand how and why the Blob was formed in the first place.

The evolution of the Credit Crisis began in the mid 1990's when the money supply began to grow at unprecedented rates. As the money supply grew dramatically, stock prices then began their ascent to the bubble highs of 2000.

Once the stock market bubble was popped in 2000 and stocks began to plummet, it seems that the Greenspan-led Federal Reserve became a serial bubble blower. The Fed lowered rates dramatically into the 2003 low of 1%, a rate that was not only likely too low given the actual economic statistics, but was also left at 1% for too long.

Because of this, another bubble formed, much at the urging of Fed Chairman Greenspan. With 30 year mortgage rates near all-time low rates, homeowners were enticed to bypass fixed rate mortgages and were openly encouraged to take on

adjustable rate mortgages. And the housing bubble was born.

Lending standards fell as money flooded the system, courtesy of a too-easy Fed. Individuals and institutions that were burned by a busted bubble in stocks became infatuated with the real estate market and prices were bid up to ridiculous levels. Real estate was not only bid up in the residential space but in commercial real estate, hotels, and raw land around the globe. The combination of easy money and rising prices enticed even the most conservative investors to embrace real estate as stories were told that real estate, unlike stocks, was something tangible that you could touch and feel.

Enter the world of Wall Street alchemy. One of the old phrases on Wall Street is 'if the lady wants green shoes, sell her green shoes'. Let's say that real estate is the base asset. With money so easy and cheap, and credit spreads so tight as a result, the alchemists concocted first, second, third, fourth, and fifth derivatives of the asset itself, real estate. Since it was assumed that real estate was so tangible, so steady, that surely the loans would be 'money good' and the derivatives of these loans would be 'money good' as well. It seemed like such a cinch, that you could take a bunch of loans, lever them up, and break them into tranches that included equity, mezzanine, subordinated and senior tranches that offered dramatically higher yields than stodgy Agency Mortgage Backed Securities and Treasuries.

This worked wonderfully until something horrible happened—many loans that were based on little or no credit history and little or no documentation began to perform poorly and the delinquency and default rates began to rise, and they continue to this very day.

As default rates rose the alchemist's products became a nightmare for those that bought them. Who bought them? Banks, insurance companies, mutual funds, hedge funds, money managers—the usual suspects that were stretching for yield and trying to beat their benchmark. Some companies like Ambac, MBIA, AIG went so far as to issue CDS (credit default swaps) against this esoteric garbage, which eventually led to their demise as the stress tests they used in their models failed miserably.

As the real estate defaults piled up, the owners of the nuclear waste started to write down the value of the assets which ended in the demise of firms like Lehman and Bear Stearns and the near demise of many others, not to mention the nationalization of Fannie Mae and Freddie Mac, among others. All of these assets had to go somewhere eventually, and they did, into the BLOB.

The Blob is no more than a SIV (structure investment vehicle) that sits in the middle of the investment landscape absorbing all in its path, with OUR money. Yes, 'We the People' own the Blob—

Despite all of this action, the real economy is contracting on a world-wide basis. Enter Alphabet Soup, a land of acronyms that allows the Fed and Treasury to bail out companies and industries, all in an effort to slow the Great Credit Unwind. To

the creature that has engulfed trillions of dollars of assets that never should have ever been created in the first place.

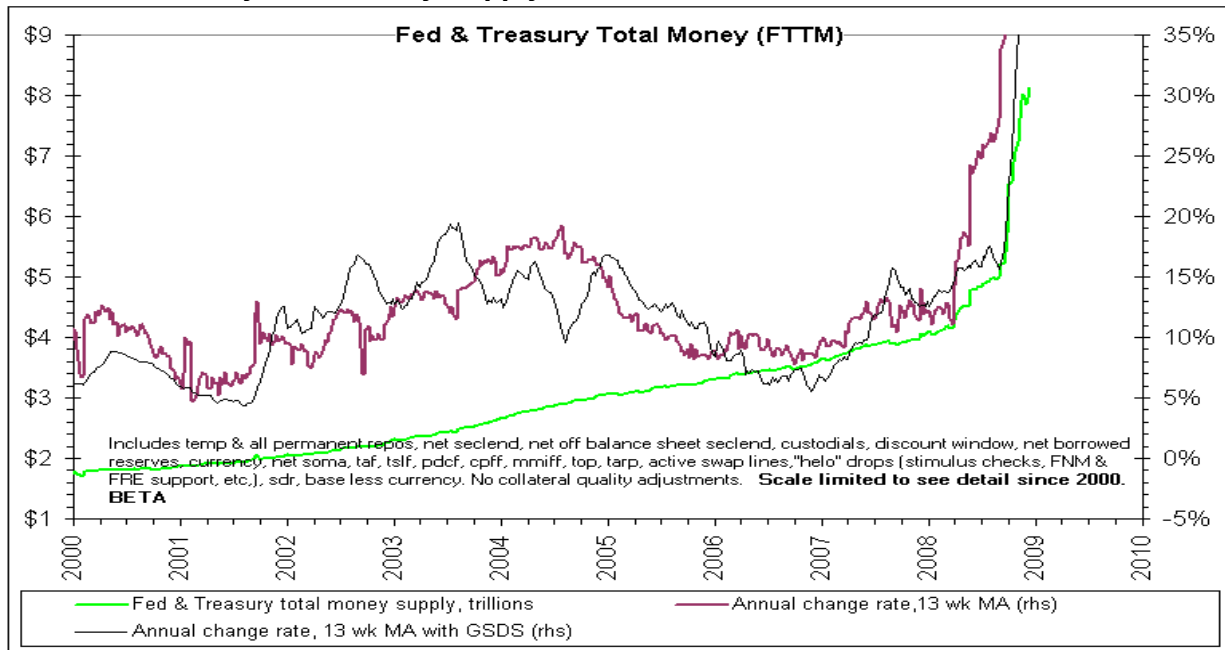
Thank you Wall Street alchemists!

Alphabet Soup is served!

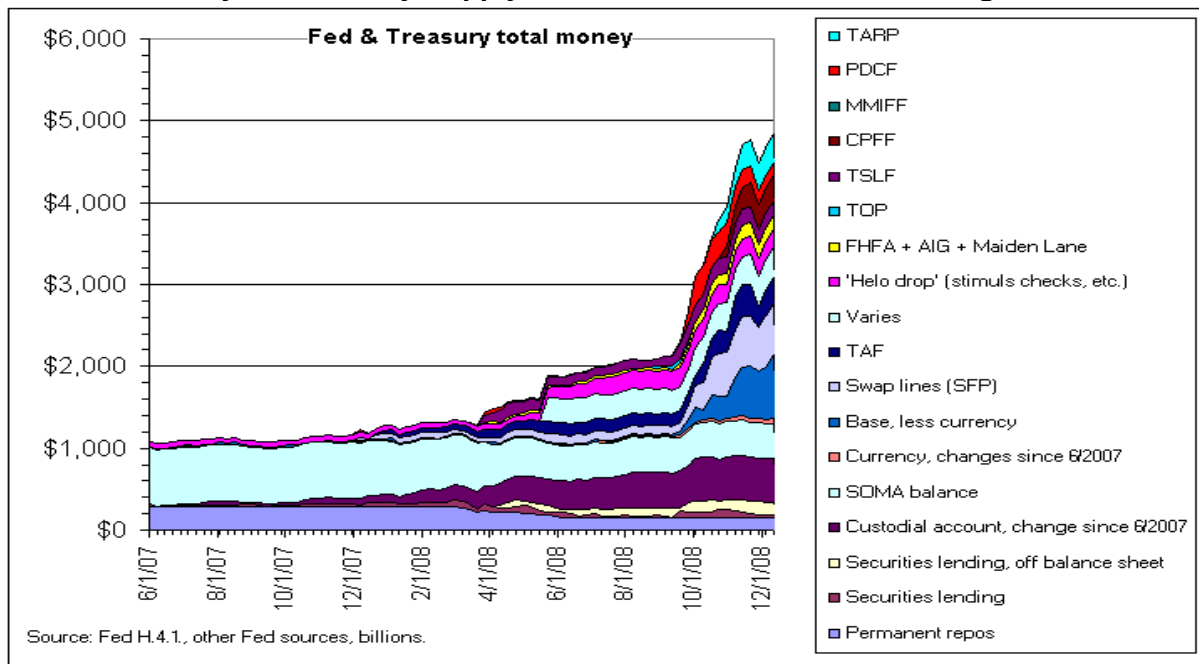
I would like to re-visit a graphic from my last piece on interventions (courtesy of www.nowandfutures.com) that shows all of the interventions/interruptions/bailouts that the Fed and Treasury have implemented in an effort to stem the Credit Crisis that began with the unwinding of two Bear Stearns hedge funds last summer. Let's keep in mind that even before the creation of the Alphabet Soup of Intervention the Fed had already begun to try to shock the market into shape with changes in the Discount Rate along with other actions. Each action seems to have been executed in a way to have the greatest impact on the financial markets.

be honest, I cannot say if these programs will work, but so far, the markets and economy have responded with a resounding 'thumbs down'.

Fed and Treasury Total Money Supply



Fed and Treasury Total Money Supply increases since Credit Crisis Began



I have commented recently that it feels like we are on the path to Socialism. While I am not an expert on Socialism, I can most certainly say that the markets don't feel all that 'free' right now. The poster child for Alphabet Soup is TARP, or the 'Troubled Assets Relief Program', the definition of which can be found below:

TARP--TARP allows the [United States Department of the Treasury](#) to purchase illiquid, difficult to value assets from banks and other financial institutions. TARP also allows the Treasury to purchase whole loans and make direct equity investments in banks themselves. The targeted assets are securities backed by mortgages, sometimes described by the government, media, and others as 'troubled' or 'toxic' assets. Investment banks created these securities by pooling mortgages, both prime and sub-prime, which were commingled and then securitized into tranches (slices) according to priority of repayment. These tranches were rated by ratings agencies from AAA+ down and sold like bonds, with coupons paid out of cash flow and principal repaid at the end of the instrument's life. However, these assets began to fall steeply in value when some of the underlying sub-prime and prime mortgages starting defaulting in higher numbers than anticipated. This caused immediate losses in the lowest rated tranches

in terms of both cash flow and principal, but also caused losses in principal (the value of the 'bonds' themselves) within the higher rated tranches as the ratings on all tranches in a pool were downgraded by analysts. Rising default rates on the underlying mortgages over time caused the market prices for these tranches to fall until they were essentially illiquid and untradeable, as the sheer difficulty of accurately pricing the many underlying mortgages caused investors to shun them as an asset class. At the same time, [Mark-to-market accounting](#) rules required banks to report losses on the value of their tranches, causing their earnings, balance sheets and stock prices to fall. TARP is intended to improve the liquidity of these assets by purchasing them using secondary market mechanisms, thus allowing participating institutions to stabilize their balance sheets and avoid further losses.

At first, I was aghast that the Treasury would take my hard earned cash and actually buy the 'esoteric securities' that bailed out the financial alchemists whose experiments had gone bad. Lo and behold, I was not alone as Congress struggled with the decision as well, resulting in the initial non-passage of TARP, and an immediate nasty sell-off in equities world-wide. Politicians, of course, so near an election, did not like to see their constituents assets get crushed so a new TARP was cobbled

together, one that was 400 pages long and contained a provision that escaped my analysis.

The CPP, or Capital Purchase Program allowed the Treasury to make direct capital injections into an initial 9 'Chosen' financial institutions via preferred stock and equity warrants (there are now 8 as Merrill Lynch, in the meantime, has been forced into the waiting arms of BankAmerica, who incidentally announced a 12% layoff of its entire work-force the other night). So, according to TARP, the money was supposed to buy securities from banks that were priced too high and would be held by you and I until the market 'normalized', whatever the heck that means. Instead, we now own the preferred shares of banks at interest rates I don't agree with. That is not a free market.

No Soup for Me- please!!!

As if the Fed and Treasury hadn't committed enough capital for bailouts, the one that probably irks me the most, as it was so full of fibs and mis-statements, not to mention, further disruption to the free capital markets, is the FDIC's TGLP (Temporary Liquidity Guarantee Program).

According to the FDIC's website, ***'The Board of Directors of the Federal Deposit Insurance Corporation (FDIC) today approved a final rule to strengthen the agency's Temporary Liquidity Guarantee Program (TLGP). The Program guarantees newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and provides full coverage of non-interest bearing deposit transaction accounts.'***

The FDIC adopted the Temporary Liquidity Guarantee Program on October 13th because of disruptions in the credit market, particularly the

interbank lending market, which reduced banks' liquidity and impaired their ability to lend. The goal of the TLGP is to decrease the cost of bank funding so that bank lending to consumers and businesses will normalize. The industry funded program does not rely on the taxpayer or the deposit insurance fund to achieve its goals.

To which I say HOGWASH! This bit of the Blob allows the under-capitalized FDIC to extend credit to under-capitalized banks at rates that are absurdly low. The FDIC currently lists 171 'troubled banks' among the 8,000 or so that they guarantee.

In fact, just this past Friday, the FDIC seized Sanderson Bank of Sanderson, Texas and Haven Trust Bank of Duluth, Georgia (find the link to the FDIC's website here [FDIC](#)). The Blob just ate some more, in this case tens of billions of dollars of 3% bonds issued by banks whose bonds otherwise trade in the 'free market' closer to 10%. The reason that the Blob and other investors are willing to accept 3% for a FDIC/US Treasury backed bond while bonds that trade without the Blobs influence change hands at 10% is because the 10% bonds trade on their own merit. So I suppose the Treasury decided to encourage banks to lend at lower interest rates to lower credit rated borrowers, even at the risk of starting the whole process of poor lending practices all over again.

If this is not sickening enough, the FHA/VA is doing the same thing, encouraging FHA borrowers to re-finance without documentation and without appraisals (even without termite inspections!) via the FHA's Streamline Program ([Streamline FHA Program](#)).

It seems that Fannie and Freddie, now part of the Blob, are considering jumping on the bandwagon and allowing folks to re-finance without an appraisal as well.

Dec. 10 (Bloomberg) -- Fannie Mae and Freddie Mac, the mortgage-finance companies seized by the U.S. government, are considering waiving a requirement for new appraisals on refinanced loans, their regulator said.

"If they refinance someone, rather than doing a loan mod, do they need a new appraisal if they already have the credit?" Federal Housing Finance Agency Director James Lockhart told reporters after a speech in Washington today. "That's an issue that's being discussed. They're looking at it."

Call me a cynic, but aren't we encouraging the banking and financing system (at least what is left

of it) to start the whole process of poor lending all over again? Since I own my proportionate share of

the Blob sitting in the middle of the financial system, shouldn't I have a say in what I want to do with my hard earned cash? In a free market, I suppose that I would, but like I said the market isn't as free as what most of us are used to!

25 banks have now failed this year with the latest couple costing a cool \$200 million or so. The FDIC is so remarkably under-capitalized that it takes the Treasury/Blob to throw another \$250 billion at the program just so lousy banks can get cheap financing to make questionable loans. Importantly, in the FDIC's most recently released 'troubled bank list', we find 171 institutions with tens of billions of dollars of assets at risk. No wonder the FDIC has been absorbed by the Blob as well. What a country. See the entire article from Bloomberg here-- [Bloomberg FDIC Article](#).

What will the Blob Absorb Next?

Today's political hot potato is whether the automobile industry should be bailed out. The free market types will tell you 'hey, these companies have been uncompetitive and mismanaged for so long that they should be forced into Bankruptcy Court'. Those close to the area geographically will tell you that we shouldn't bail out AIG, brokers and banks, while others like GM/Ford/Chrysler are forced into bankruptcy. The truly free market types will say that all should be allowed to fail and that free markets should remain free, even if it means pain, severe pain for a while.

For what it's worth, my stance is that some intervention is necessary, so long as the parties have acted responsibly previously and have a logical plan for a way forward. The crisis clearly needs to be slowed down, but force-feeding the Blob and everything that it has consumed into my portfolio doesn't feel quite right.

With the unemployment situation growing into an unmitigated disaster, it is not hard to sense the fact that consumers will begin to save more and

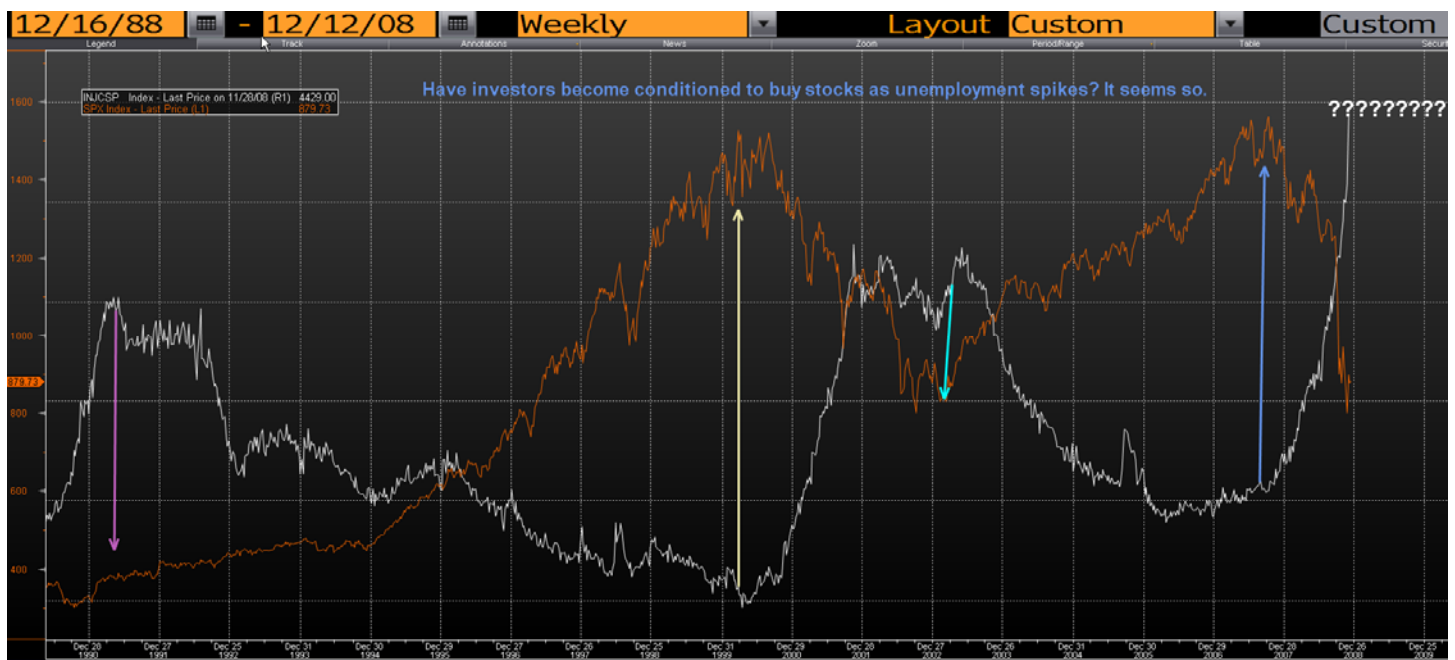
consume less as they fear losing their job. It may just be me, but I sense some social acrimony slipping into our society and hope that I am wrong—but the table is set for higher continuing claims and a higher unemployment rate.

I can see that the Fed, Treasury, FDIC, etc are trying to force consumers to borrow, but due to the global deflation of asset prices (real estate, debt and equities), I imagine it will be tougher to get folks to break out their wallet. They simply cannot, or will not. The recovery will likely be longer than many would like to believe.

While Treasury bill rates and rates on Treasury Money Market Funds approach zero, the question on my mind is 'will investors stay in investments that yield zero, or move back out into the risk spectrum?'—at least those that can. Others, even wealthy folks may retrench as those that believed the 'buy and hold mantra' of the past may have seen their portfolios decimated. Absolute return investors are left to pick from the wreckage, but carefully, present company included. While unpopular for quite a while, absolute return investing just became popular again, just a bit too late

Many have asked me lately why I think the stock market refuses to fall meaningfully as unemployment claims pile up and unemployment rates increase along with initial claims and layoffs. In the chart below you can see that over the past 20 years or so, investors have become accustomed to 'buy bad news' which is the way we usually operate. Please note as I have stated many times before that investors were conditioned similarly to buy stocks when consumer confidence fell, but this time is different because of the sheer virtue of the unwind of credit. This does NOT mean that we will not get meaningfully long equities or credit for periods of time but will do so in a measured fashion. We must, of course, remain objective and open-minded and respect the tape.

Continuing Unemployment Claims versus S&P 500



For decades, the USA has been an exporter of jobs, notably manufacturing jobs to other countries. I have to admit that I scratch my head when I think of automobile manufactures with bloated balance sheets and ridiculous cost structures now come hat in hand to the Blob for cash. Please do not get me wrong—I feel bad for people that lose their jobs or are afraid of losing their jobs. But I suppose I have been fired or laid off a few times and can't recall anyone sending me to the Blob for cash. I found another job.

The real issue, now and what I am most worried about is that we are no longer exporting jobs (those are gone, probably for good), we are now exporting unemployment. What I mean by 'exporting unemployment' is that the rest of the world, notably emerging markets/nations are feeling the pain of the unwinding of the leveraged consumer as consumption falls and confidence remains low for extended periods.

In short, those that bought into the 'de-coupling' scenario are now likely surprised that many emerging markets, here-to-fore thought to be impervious, find themselves in a bigger tailspin than the USA. I expect this to continue for a while, until the world realizes that our 0% Treasuries are backed, well, by The Blob in the middle of the board. It is why I expect hyper-inflation and a very weak dollar before all of this is over and those that are buying low coupon Blob backed assets will wish they hadn't.

**Bennet Sedacca,
President**

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