

## Market and Economic Overview February 2011

**BOTTOM LINE:** We've been fielding a lot of questions about the actions of the Federal Reserve and how it might affect our readers.



There have also been a lot of inquiries about what exactly we mean when we say that the Federal Reserve has been "expanding its balance sheet."

Given the number of inquiries from readers, we thought that this month we'd explain it from the perspective of the Nebraska farmer that came to visit us a couple of years ago as the federal government was bailing out large "too big to fail" financial institutions. If you don't recall the piece, here it is for you again just to set the stage for this month's discussion. This from March of 2009:

I want to tell you a story about an average American whose name is Fred\*. Fred is an older guy, approaching retirement, who has spent his entire life working on his family farm in Nebraska.

He's accumulated some wealth, although by the standards of the mega-wealthy it's really a pittance, but he's worked hard, lived frugally, and managed to accumulate some money. On top of that, Fred has been smart, albeit conservative with the way he's managed his personal finances, never borrowing a penny after he'd paid down all his debts at a surprisingly young age.

Fred, like "The Millionaire Next Door" described in the blockbuster book by the same name, drives an older automobile for which he paid cash, and even though he could easily afford a new car of almost any make and model, Fred doesn't see the need to spend the money since his old car is running just fine. And, Fred kind of likes his 1997 Cadillac Deville. Even though it's got 120,000 miles, it runs just fine and it was the first 'luxury car' Fred ever bought, even though he bought it used in 2002 at a really good price. Besides, if he traded the car in on a new model, he'd only get \$2,500 on a trade, and assuming he could be lucky enough to sell the vehicle outright to a private buyer, he might get \$3,500. Fred, having a lot of common sense, figures he might as well keep the old car and drive it.

Then one day, Fred discovers to his dismay, that the old Cadillac needs major repairs. After getting estimates, he discovers the engine and transmission repairs are going to cost him almost \$4,500; so, having some common sense, Fred decides it doesn't make any sense to put \$4,500 into a \$2,500 car – so he sells the old Cadillac to a local used auto parts supplier for \$1,000 and buys a different car.

Makes sense right?

Good thing Fred isn't a congressman or a Washington Bureaucrat. If he was, he'd not only spend the \$4,500 to make the repairs to the \$2,500 car; while he was at it, he'd get new leather seats installed at a cost of \$4,000, get a paint job added for another \$4,000, and put new tires on the car at a cost of another \$1,000. Congress would not only repair something that didn't make financial sense to repair, they'd make unnecessary repairs as well.

Too bad no one in Washington summoned Fred and asked for his advice prior to the current financial industry bailout. Fred would have likely made far different choices.

To date, the AIG bailout has cost taxpayers \$182.5 billion (Source: Bloomberg, March 23, 2009). As of last week, the total market capitalization of AIG was about \$3.7 billion. If you're not familiar with market capitalization, it's calculated as the total shares of stock outstanding times the current share value. AIG has approximately 2.7 billion shares outstanding at a share price of about \$1.40 which means you could buy the company for \$3.7 billion, yet the government has invested over \$180 billion for their 80% stake.

So, the government has 'invested' \$182.5 billion in a company that's currently worth \$3.7 billion and they don't even own it 100%. Even giving the government the benefit of the doubt, if we look at the market capitalization of AIG on October 1, 2008 when AIG was trading at \$3.95 per share, the market capitalization of the company was \$6.65 billion, yet the government committed to giving AIG far more money than the company was worth.

Where was Fred when we needed him?

This month in Moving Markets™, Fred the Nebraska farmer will help us explain what it means to have the Federal Reserve "expand its balance sheet" by "absorbing the toxic assets of these banks" (It should be noted that the Federal Reserve is also expanding its balance sheet by buying US Treasuries, a.k.a government debt, arguably also 'toxic assets' in my opinion).

As frugal as our friend Fred the Nebraska farmer is, one day he decided to go out and invest in a race horse. He'd always loved horses and since he had a few bucks put away, he decided to take some of that money and begin a race horse breeding operation, largely as a hobby but with the possibility of making some money selling colts and fillies down the road.

Fred found a couple of brood mares with great bloodlines and then bought a retired race stallion in order to begin his breeding operation. It was a big step for conservative Fred to spend \$85,000 on a stallion, but it was something that he'd wanted to do for almost the entire 64 years that he'd been on the earth. And, Fred had done enough research to know that he would likely get most of his investment back in a few years if he grew tired of the breeding business.

Fred got the barn ready and moved his new horses in. Every day Fred went out and cleaned the stalls, scraping out the horse dung and piling it up outside the barn. A couple of years passed and Fred found himself really enjoying his new business. He'd already sold 2 colts for a nice price making his little business have positive cash flow. His stallion was still worth every penny that he'd paid for him; in fact, Fred had turned down a couple of offers to buy him. Things were going pretty well for Fred.

Fred also really enjoyed the time that he spent in the barn, even the cleaning stalls part. Every day he'd diligently go out to the barn, scrape the horse dung from the stalls, and add it to the ever growing pile outside the barn. After two years, there was quite a pile – his horses were healthy.

Then, one day Fred went to the barn only to find his prized stallion dead in the stall. After calling his insurance agent Fred learned that he might be better off not filing a claim with the insurance company that he'd used to insure the stallion. His insurance agent told him that there was a government program that was established to help farmers who had dead horses. Seems the government would take the dead horse off Fred's hands and haul away the horse dung and give Fred his \$85,000.

The government didn't do this outright; the Federal Reserve administered the program since they controlled the money supply. The central bank would simply print \$85,000 give it to Fred and record the value of the dead stallion and the pile of horse dung on its books as \$85,000. If anyone asked what asset was valued at \$85,000 on the books, the answer would simply be 'toxic assets'.

While the Federal Reserve has never actually purchased horse dung for an exorbitant price as far as I know, maybe it would be more valuable than some of the assets that it has purchased – at least horse dung has some value as fertilizer.

The assets that the Federal Reserve bought from the big banks were largely loans that would never be repaid, at least in full. So rather than have a large number of bank failures, the Federal Reserve came in and took these 'toxic assets' off the banker's hands, presumably for a lot less than what the assets were really worth. On top of that, the accounting rules that the banks are required to use to report the values of their assets were changed so that 'mark to market' accounting didn't have to be used. (Mark to market accounting requires that the true market value of the asset be recorded rather than the face amount or original value of the asset.) This means that both banks and the Federal Reserve likely have assets on their books worth far less than the original value or loan amount.

The following is an excerpt from an editorial published on The Huffington Post on January 20, 2011 titled. "Hiding America's Real Economy" (emphasis added):

America's economy seems to be recovering, but is that the 'real' story?

Some fourth quarter economic indicators — retail sales, manufacturing, stock market, corporate profits — portend a rising economy significant enough to avoid another slide to the bottom.

The optimism on Wall Street is palpable as the stock market continues to rise, or melt up as they now say, a result of the positive indicators over recent months. And the heightened exuberance the consumers showed this holiday season was also a positive sign. Manufacturing has been rising for the last several months, which is seen as paramount to an improving economy.

The stock market is on its way back to its peak, due, in part, to record corporate profits.

The market is considered a forward looking indicator, and the private sector seems poised to stand on its own and no longer require the extreme measures it needed from the federal government.

So what could possibly go wrong and who would even whisper that things weren't getting better?

Though the number of people questioning the recovery is declining there are still some that do not accept the premise that all of America's economic problems are behind us and the recovery is completely sustainable.

Realists, unlike the over-optimistic beneficiaries of a rising market, look at all aspects of the economy and not just the positive headlines. Despite the promising numbers coming out of the government and corporations, repeated by CNBC and numerous analysts, there are negatives that could have a significant impact on the economy. And a few of them are large enough to warrant examination.

A realistic view of the economy would include the problems in the housing market and high unemployment, either of which could derail the recovering economy. It would also include the increasing deficit and the recent extension of the tax cuts and the unrealistic change in the estate tax — all negatively impacting a healthy recovery.

Another undiscussed element is government stimulus — in many forms. **The government is still the biggest contributor to the recovery through a multitude of stimulative and protective programs, some that are conveniently hidden from public scrutiny.**

Aside from the stimulus package of nearly \$900 billion, **the Federal Reserve has shored up the economy with possibly \$3 trillion or more — stimulation and rescue of the financial institutions and corporations — assistance unavailable to the general public and masking the extreme risks in the economy.**

These veiled economic programs will have a negative affect on the economy if they fail. The failure of any one of them could not only stall, but reverse the recovery.

**The Fed is holding over \$1.3 trillion in toxic assets of the big banks; assets that were supposed to be rescued with TARP. The Toxic Asset Relief Program was used for another purpose — bailing out the banks — so The Fed covertly bought the assets, most likely above their market value. They also loan to banks at zero percent and the banks buy U.S. debt with a two or three percent return; debt that they had a part in creating.**

**Banks are hiding potential losses on foreclosed homes by not having to mark them to market. Robo-signing repercussions could be incredibly high. The housing market had over a million foreclosures in 2010, and 2011 could be even worse.**

**Corporations are holding toxic assets off-balance-sheet, listed as footnotes in reports. States and municipalities are under fiscal stress and threat of default. The FDIC is a partner in hundreds-of-billions in loss-share agreements for seized banks and their tenuous assets.**

**Treasury has guarantees in place with banks and corporations which may exceed a trillion dollars. They also own billions of dollars in stock in banks, corporations and financial entities. The Fed balance sheet could be a more serious problem than is being discussed, and the lack of transparency is problematic.**

**These hidden programs have benefitted corporations and Wall Street, but, only marginally helped Main Street which**

continues to struggle, bouncing along the bottom destined to remain there until the next crisis; a crisis that will surely wipe Main Street out.

At some point the shadowy structures of The Fed and Treasury may be forced into the light and it could be ugly.

As long as secrecy exists throughout the financial world the U.S. and global economies are at extreme risk. This risk is bad for markets.

The world, on such dubious ground, cannot afford the huge loss the markets' will sustain. Transparency is a must—the world deserves the truth.

But, maybe, the world can't handle the truth.

## Employment

The unemployment news was better this month – the unemployment rate officially fell to 9% from 9.4%. Does that mean that more people are working?

The Associated Press reported the drop in the unemployment rate this way (February 5, 2011):

The unemployment rate is suddenly sinking at the fastest pace in a half-century, falling to 9 percent from 9.8 percent in just two months — the most encouraging sign for the job market since the recession ended.

More than half a million people found work in January. A government survey found weak hiring by big companies. But more people appear to be working for themselves or finding jobs at small businesses.

The steepest two-month decline in unemployment since the Eisenhower administration is the latest sign that the economic recovery is picking up speed.

While the AP reported that a half million people found work in January, the Bureau of Labor Statistics reported that payrolls gained only 36,000. So who is right?

Greg Hunter recently wrote this on The Market Oracle (February 10, 2011) to explain the discrepancy. He cited research done by economist John Williams of ShadowStats.com (highlighting added):

The BLS reported there was only a tiny gain of 36,000 workers to the payrolls, and even that number is a statistical lie, according to economist John Williams of Shadowstats.com. In his latest report (last Friday), Williams said, "Incredibly, despite ongoing regular overstatement of payrolls by the BLS, the BLS appears to have upped, not lowered, the excessive biases in its latest rendition. Without the higher bias, the reported January 2011 payroll gain of 36,000 would have been a decline of 52,000."

As for the big drop in the unemployment number down to 9%, you can credit that with something the BLS calls "seasonal adjustments." The government takes into consideration things like cold weather and snow when it puts together unemployment figures. Williams thinks these seasonal adjustments have been distorted by the dismal economy during the past few years. Williams says, "... the extraordinary severity and duration of the economic duress in the United States during the last three to four years has destabilized traditional seasonal-factor adjustments and the related monthly reporting of certain economic series. **The unemployment rate rose in January 2011, not seasonally adjusted.** The 0.4% decline reported in the headline January unemployment rate appears to be a seasonal-factor issue." In other words, seasonal adjustment jobs are created out of thin air and are not really there for people. In reality, unemployment increased slightly. It did not decrease.

**While we are on the subject of reality, after one year, the unemployed are no longer counted in government statistics. If unemployment was computed the way BLS did it prior to 1994, the true unemployment rate (according to Shadowstats.com) would be 22.2%.**

## Housing

According to Zillow, a Seattle based real estate reporting company, 27% of US homeowners are now 'underwater' in their home, owing more than the home is worth. Here is an excerpt from an article on Bloomberg published February 10, 2011 (emphasis added):

The number of U.S. homes worth less than their outstanding mortgage jumped in the fourth quarter as prices fell and lenders seized fewer properties from delinquent borrowers, according to Zillow Inc.

**About 15.7 million homeowners had negative equity, also known as being underwater, at the end of the year, up from 13.9 million in the previous three months, the Seattle-based real estate information company said in a report today. The total represented 27 percent of mortgaged single-family homes, the highest in Zillow data dating to the first quarter of 2009.**

Home prices are declining as foreclosed properties sell at discounts and unemployment at 9 percent limits buyer demand. **Values will fall as much as 5 percent this year, putting more homeowners underwater, before finding a floor as the economy improves, said Stan Humphries, Zillow's chief economist.**

"These seem like fairly grim numbers," Humphries said in a telephone interview. "We're still expecting a bottom in home values later this year. And this, if anything, makes me a bit more confident because I'm seeing very large corrections now, which means the market can start to repair itself."

The median value for a U.S. single-family home was \$175,200 in the fourth quarter, down 2.6 percent from the end of September and 5.9 percent from a year earlier, according to Zillow. Values have fallen 27 percent from the June 2006 peak.

The number of homeowners underwater in their home increased by 12.95% from the 3rd to the 4th quarter, that's significant. And, according to Zillow, the trend will continue. We agree. We are not anticipating a bottom in the housing market until 2012.

According to the Bloomberg article, the average home in foreclosure was delinquent on payments for 507 days, 25% longer than

one year ago.

Las Vegas leads the nation with homes with mortgages that had negative equity at 81.7%. That means that 4 out of 5 homes with a mortgage in Las Vegas were 'underwater' in the home. Phoenix, Reno and Orlando follow Vegas with 'percentage underwater' rates from 61% to 70%.

## Monthly Charts – Technical Analysis of World Markets

Click on the below links to view each chart.

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[Daily Chart of an ETF that tracks the US Dollar](#)

[Weekly Chart of an ETF that tracks the price of Gold](#)

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## 6 Responses to “Market and Economic Overview February 2011”

1. *Rob Sullivan* Says:

[February 18th, 2011 at 3:57 pm](#)

The links to the charts don't seem to be working.

2. *PATRICK IRANI* Says:

[February 18th, 2011 at 4:10 pm](#)

Excellent write up, Dennis thanks for sharng

3. *Todd Strobel* Says:

[February 18th, 2011 at 4:14 pm](#)

thanks for the update. it was great. not great actually but necessary

4. *socrates koutsoutis* Says:

[February 18th, 2011 at 6:14 pm](#)

Excellent review. Somehow this information needs to be broadcasted to the nation to show how the administration is constantly lying to the public. The president should be impeached for contineuly deceiving the public.

5. *admin* Says:

[February 21st, 2011 at 8:48 am](#)

Rob, the links to the charts are made to open in a new window or tab. If you are using a popup blocker, it may not be allowing you to open the links. After clicking on a link, look towards the top of the page for an "Allow Popups" button. Regards.

6. *mbb* Says:

[February 22nd, 2011 at 9:28 am](#)

To say "the AIG bailout has cost taxpayers \$182.5 billion" is misleading, or at the very least is misinformed. The figure quoted amounts to the sum of various lines of credit; that amount was never realized. All amounts to AIG were secured with collateral or as payments for assets.

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