September 26, 2011

During a week in which investors seemed to have lost faith in just about everyone and everything – the president, Greeks, the Fed, gold, ratings agencies, Congressional Democrats and Republicans, silver, bankers and European finance ministers – the major stock indexes plummeted, with the Dow suffering through its worst week since October 2008, during the depths of the recession. When the dust had cleared, that index had fallen 18% from its 2011 high in April and was on the cusp of bear territory (off 20%), a threshold that has already been crossed by indexes in France and Germany, not to mention the Russell 2000. And on Friday, even such standbys as gold and silver were punished, with gold having its biggest one-day decline in five years, losing 5.8%, and its worst week since 1983, while silver dropped 18%, its biggest one-day plunge since 1987. For the moment, the only refuge seems to be U.S. Treasurys, and demand drove the yield on the 30-year down to 2.872% while the yield on the 10-year note fell to a record low of 1.672% on Friday before backing up to close at 1.810% (the 2011 high was 3.77% in February.) Robert Zoellick, the president of the World Bank, succinctly summed up the current state of mind for investors when he said, "The world is in a danger zone."

The list of investor concerns is long, and, right now anyway, seemingly intractable. Here in the United States, the biggest issue seems to be the realization that our politicians learned nothing from the debt-ceiling debacle that led to our credit rating downgrade nor from the polls that show record dissatisfaction for both parties.

	Key Market Data		
	Week ending…		
	9/16/11	9/23/11	Change
Dow Jones Industrial Average Index	11,509.09	10,771.48	-6.41%
S&P 500 Index	1,216.01	1,136.43	-6.54%
NASDAQ Composite Index	2,622.31	2,483.23	-5.30%
10-Year Treasury Note Rate	2.074%	1.810%	-0.264 pct. pts.
NYMEX Crude Future (Barrel)	$87.96	$79.85	-9.45%
Euro/U.S. Dollar	$1.3798	$1.3499	+$0.0299

Last week, President Obama followed up his jobs bill, which seems to have stalled, with a new plan for cutting the deficit that seemed to have little hope of getting past the Republican-controlled House as it included tax hikes. The plan would cut $580 billion from entitlement programs in exchange for tax hikes amounting to $1.5 trillion: $800 billion from letting the Bush tax cuts expire and the other $700 billion from closing tax loopholes and limiting deductions for the wealthy. There is another $1.1 trillion in presumed savings from the winding down of the wars in Iraq and Afghanistan. And the president threw the gauntlet by saying he would veto any plan for reducing debt that included cuts to entitlements if there was no corresponding increase in revenues: "We are not going to have a one-sided deal that hurts the folks who are more vulnerable."

The GOP claimed that he was in full campaign mode, while his fellow Democrats were glad to see that the president had at last gone on the offensive. On Sunday, before the announcement was made, Representative Paul Ryan (R - Wis.) went on TV and said, “Class warfare may make for good politics, but it makes for rotten economics.” And after the announcement, Senate Majority Leader Mitch McConnell (R - Ky.) said, “Veto threats, a massive tax hike, phantom savings and punting on entitlement reform is not a recipe for economic or job growth, or even meaningful deficit reduction.” President Obama fired back, saying, “This is not class warfare. It’s math. The money is going to have to come from someplace.” Representative Gerry Connolly (D - Va.) summed up the political climate in a nonpartisan way, saying, “Again, sadly, the dynamic here is ‘my way or the highway’ – no common ground, no compromise.”

Party politics also came into play before the Fed’s two-day meeting when GOP leaders sent a letter to Fed Chairman Benjamin Bernanke, who has lately become the whipping boy of choice for GOP presidential candidates despite being originally appointed by a Republican president. The letter asked him to “resist further extraordinary intervention in the U.S. economy … particularly without a clear articulation of the goals of such a policy, direction for success, ample data proving a case for economic action and quantifiable benefits to the American people.” The letter notwithstanding, the Fed did act – and the market was not happy about it.

On Wednesday, the Fed announced “Operation Twist,” a plan to reduce the cost of borrowing for businesses and consumers by investing $400 billion in long-term Treasury securities over the next nine months to drive down rates on mortgage loans, corporate bonds and other forms of credit and – in theory – get people and businesses to spend. The $400 billion the Fed sells, which would have matured in three years, will be exchanged for maturities of six to 30 years. The Fed will also reinvest any of the proceeds and payoffs from its portfolio of mortgage-backed securities in new mortgage-backed securities (it had been letting the portfolio shrink.) The Fed said it was acting because it saw little prospect of help for the 25 million Americans who haven’t been able to find full-time work and that there was a significant risk that “strains in global financial markets” could hold back the recovery. No one seemed happy with the step: three of the committee’s 10 members having dissented, the Dems saying the Fed had not done enough and the GOP saying it had gone too far.

Later in the week, an odd alliance of the most conservative House Republicans and most of its Democrats joined forces to defeat the passage of a bill already passed by the Senate to keep the government running (the fiscal year ends this Friday) and to provide disaster relief. They had different reasons for doing so, the GOP because there weren’t enough spending cuts attached and the Dems because there were too many, but it created the perception that John Boehner (R - Ohio) had lost control of the House. The Senate then shot down a similar bill for the same reasons, and Congressmen may have to stay in Washington this week (they’re scheduled to be on recess) to sort it all out.

Meanwhile, in Europe it seems that nothing is going right at the moment.

Greece, against a backdrop of nationwide strikes, needs €8 billion ($11 billion) by Oct. 1 to avoid default. But the payment, from the first bailout, is being held up until the troika that controls the purse strings – the European Central Bank, the European Commission and the International Monetary Fund – sees some real signs of fiscal commitment coming out of Athens. The problem is that the Greek government, with its series of austerity plans, seems to have already squeezed its people to the edge of revolt.

At the beginning of the week, having been told the money was being held up, Greece’s finance minister Evangelos Venizelos was feisty, saying, “We should not be the scapegoat or the easy excuse that will be used by European and international institutions in order to hide their own lack of competence to manage the crisis." Even so, Prime Minister George Papandreou cancelled a trip to the U.S. and met with Germany's Chancellor Angela Merkel in Berlin to see what could be done.

Adding to the tension in the eurozone, on Monday, Standard & Poor's cut Italy's sovereign debt rating one notch to A, still investment grade, and added a negative outlook, saying the weak economy and political instability are an issue. Predictably, Silvio Berlusconi, Italy's president, then joined the line of leaders who have attacked S&P, as his office issued a statement saying the decision "seems dictated by newspaper hearsay rather than the reality of things and seems fouled by political considerations."

And the prospects for help from healthier economies were dismissed by both World Bank chief Robert Zoellick who said, "Nobody is going to come in with a big bag of money to buy out the problem," and by Brazil's finance minister Guido Mantega who said, "Europe has to save itself. If they don't, the emerging countries … will have little to do because the central issues aren't resolved."

The ECB stepped into the fray saying it would ease the terms at which it lends money to banks at low interest, including expanding its definition of collateral. At the same time, however, the IMF said European banks would need a big injection of cash, putting bank exposure at €300 billion ($407 billion) and saying, in its Global Financial Stability Report, that political infighting was to blame. Taxpayers, it ominously added, may again be called upon to help out.

U.S. Treasury Secretary Timothy Geithner also ramped up the pressure on Europe to do something, saying, "Decisions as to how to conclusively address the region's problems cannot wait until the crisis gets more severe."

On Thursday, the Group of 20 issued a statement to calm markets that said its members would "take all necessary action to preserve the stability of banking systems and financial markets." Details? Specifics? Sorry.

Europe's finance ministers were in Washington for the weekend for an IMF meeting, and on Saturday there was an indication that perhaps something was going to happen, possibly a bigger bailout package, but the meeting ended without any agreement having been reached. There had been a pledge by European leaders to unveil a bold plan at the Group of 20 meeting in France in November, but now that seems too long to wait.

That said, by the end of the week, the German finance minister Wolfgang Schäuble indicated that Greece was likely to get enough money to see it through the month, but that the prospects of the second bailout had dimmed. Talk of default, and contagion, was again rampant.

In other economic news, the IMF, in its World Economic Outlook, cut its global growth forecast for 2011 by 0.3% in June to 4% and warned of "severe repercussions" if the U.S. didn't address its deficit, Europe its banking system, China its lack of domestic spending, and Brazil its overheated economy. GDP growth for the United States in 2011 was estimated at 1.5%, and the eurozone was a sliver better at 1.6%. China was at the opposite end of the spectrum, up 9.5%, with India improving 7.8%.

The Commerce Department said that ground was broken on 571,000 homes in August, a 5% drop from July (1.2 million is considered to be a healthy number). And the National Association of Realtors reported that sales of previously owned homes increased 7.7% in August to hit a five-month high, but the median sale price was $168,300, down 5.1% from a year earlier.

The grimmest news for the housing market came from a study by MacroMarkets LLC which forecast that home prices will drop 2.5% in 2011 and rise only 1.1% through 2015. Prices have tumbled 31.6% from the 2005 peak, and according to the Standard & Poor's/Case-Shiller home price index, one in five Americans owes more than their house is worth and $7 trillion in equity has been lost. All told, homeowners' equity as a share of home values has fallen from 59.7% in 2005 to 38.6%.

Moody's downgraded the debt rating of Bank of America, Citigroup and Well Fargo, mainly because it concluded that the federal government will not step in to bail them out as it did after Lehman Brothers fell.

Oswald Grübel, the CEO of UBS, resigned in the wake of the $2.3 billion in unauthorized trades, which he said in an email to his staff will have "worldwide repercussions, including political ones."

And in one piece of upbeat news, the Conference Board said its index of leading indicators for the next three to six months rose 0.3% in August.

A look ahead

This week there will be a number of updates on housing, including new and pending home sales, as well as the Standard & Poor's/Case-Shiller home price index. In addition, there will be reports on both capital and durable goods, personal consumption expenditures (PCE), and the latest on second-quarter GDP, which last came in at 1%. However, investors will be most interested to see if politicians, both European and American, are ready and willing to take any coordinated steps that will show they're capable of acting together and acting decisively.

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The World Bank is an international financial institution that provides loans to developing countries for capital programs. It is made up of two unique development institutions owned by 187 member countries: the International Bank for Reconstruction and Development (IBRD) aims to reduce poverty in middle-income and creditworthy poorer countries, while the International Development Association (IDA) focuses on the world's poorest countries.

The European Central Bank (ECB) is the institution of the European Union (EU) which administers the monetary policy of the 17 EU eurozone member states.

The European Commission is one of the main institutions of the European Union. It represents and upholds the interests of the EU as a whole. It drafts proposals for new European laws. It manages the day-to-day business of implementing EU policies and spending EU funds.

The International Monetary Fund (IMF) is the intergovernmental organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rate and the balance of payments.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy.

The National Association of Realtors (NAR) is a real estate trade association involved in all aspects of the residential and commercial real estate industries. NAR also functions as a self-regulatory organization for real estate brokerage.

MacroMarkets LLC designs and develops financial instruments that provide investment and risk management services. It also holds license and sublicensing rights to the S&P/Case-Shiller Home Price Indices, a group of indices designed to measure the growth in value of residential real estate.

The S&P/Case-Shiller Home Price Indices are designed to be a reliable and consistent benchmark of housing prices in the United States. Their purpose is to measure the average change in home prices in a particular geographic market.

The Conference Board Leading Economic Index is intended to forecast future economic activity and is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of 10 key variables. These variables have historically turned downward before a recession and upward before an expansion.