# CHAPTER 2

## GREAT OPTIMISM ON WALL STREET

**EARLY JANUARY 2008**

***NOTE: After the holidays, hope in the markets was that the Fed would now step on the accelerator and that it was "bargain hunting time." "Wall Street analysts flooded the media with predictions that stocks, commodities, and oil would resume their bull markets. After all, you do not fight the Fed. But my work suggested that these analysts and leaders in Washington would all be wrong.***

***Here is what I wrote at the time in the January 7 issue of Bert Dohmen's WELLINGTON LETTER which was headlined:***

### Bear Market Confirmed!

So, where do the markets go from here? I think it's very simple: we have an economy in recession, although it's not yet recognized. It usually takes one year after the onset of a recession for most economists and analysts to see it.

***In fact, I announced in December 2007 that "The Recession has Started." One year later, the NBER (National Bureau of Economic Research) confirmed that indeed it had started in December of 2007.***

***I continued in the January 7 issue:***

We have the consumer padlocking his wallet. The rest, namely corporate sales and profits, naturally follows—downward. And that means the ludicrous forecasts of double-digit profit growth by Wall Street firms will turn out to be just another siren song to lure unsuspecting investors to buy stocks, which the big trading operations want to sell short.

In the meantime, the large financial firms are rushing to the Middle East and Asia trying to find capital for their firms so that the firms don't fall below required capital ratios, which would threaten their very existence. Much bigger write-downs of assets held by these firms will occur in 2008, meaning they need to get even larger capital infusions than have been announced.

**The world's greatest credit bubble in history is imploding.** At the same time, our central bankers, especially in the U.S., are totally unprepared to handle it. They have repeatedly shown over the past 12 months that they do not even recognize the severity of the problem, much less come up with a solution.

And that's how a financial crisis evolves and naïve investors are used to taking stocks off of the hands of the professionals who don't want them.

Write-downs at the big financial firms continue to grow at an astronomical pace. William Tanona, a Goldman analyst, said in a report that he raised his fourth-quarter write-down estimates for Citigroup to $18.7 billion from $11 billion. Merrill Lynch's forecasted write-downs are up to $11.5 billion from $6 billion, while JPMorgan's will rise to $3.4 billion from $1.7 billion, according to Bloomberg.

Mr. Tanona said Citigroup will lose $7 per share, compared with a previous loss estimate of $1.50 per share. JPMorgan—even after its write-down—will still have about $5 billion in exposure to collateralized debt obligations (CDO).

***(Note: "write downs" refer to reducing the value of the assets held, such as securities, as their values decline.)***

## The CNBC Survey of Big Money Managers

This survey of the biggest money managers was conducted by CNBC. As you will see, they don't share my bearish opinion.

> Only 2% thought the chance of recession is over 50%. **More than 50% of managers believe the S&P 500 will finish up at least at 8% in the coming year**, while financials will be the strongest sector and materials will be the weakest. Out of these, 33% said the index would gain 8%, while 23% expect a gain of more than 10%.

Well, we shall see. However, history shows that the majority is usually wrong.

***In Bert Dohmen's SMARTE TRADER service for traders, I wrote on January 4, 2008:***

> Now Wall Street finally gives us new "revised earnings estimates." It appears that Wall Street is done selling their own portfolios, so now their Pied Pipers who appear in the media can become more candid. On Oct. 1, the earnings estimate for the 4$^{th}$ quarter for the S&P was a gain of over 11%. Now the estimate for that quarter has been revised to a DECLINE of over 9%.
>
> Wow! That's a surprise to all those who listen to the media. That's a change of 20 percentage points—very significant. We said earnings would see a decline, but this is even greater than what we thought would happen so soon. Of course, first and second 2008 earnings will plunge even more.
>
> What's important is that the huge market top now becomes more visible. There is no going back to the good old days. Once the majority of money managers realize this, the major goal will be to sell in order to raise cash, not to find stocks to buy. And that will dramatically change the supply/demand equation for stocks.
>
> Once the November lows are broken, all the stocks bought during 2007 will be held at a loss (per the indices). It means that all this stock becomes potential supply whenever the indices try go above the November levels again—that's a huge amount.

The only bullish story left for the Pied Pipers to peddle is "global growth" and the "commodity boom." Well, you don't have to be a rocket scientist to figure out that if the U.S. goes into recession, the global economies will follow. And so will commodity prices.

We heard today that the Federal government is looking into different types of criminal wrongdoings at Bear Stearns, and possible other large Wall Street firms. I said several months ago, in my view that firm is toast. In fact, all of Wall Street may have significant problems fighting criminal and civil suits. What Wall Street did once again, just as in other times, is to sell garbage packaged very attractively, but too complicated for the average buyer to understand.

***Let's go back to the January 7, 2008, issue of the Bert's WELLINGTON LETTER. The charts shown there give the reader a terrific insight into looking at the markets using sophisticated technical analysis.***

## PRESIDENT BUSH CONSIDERS ECONOMIC STIMULUS

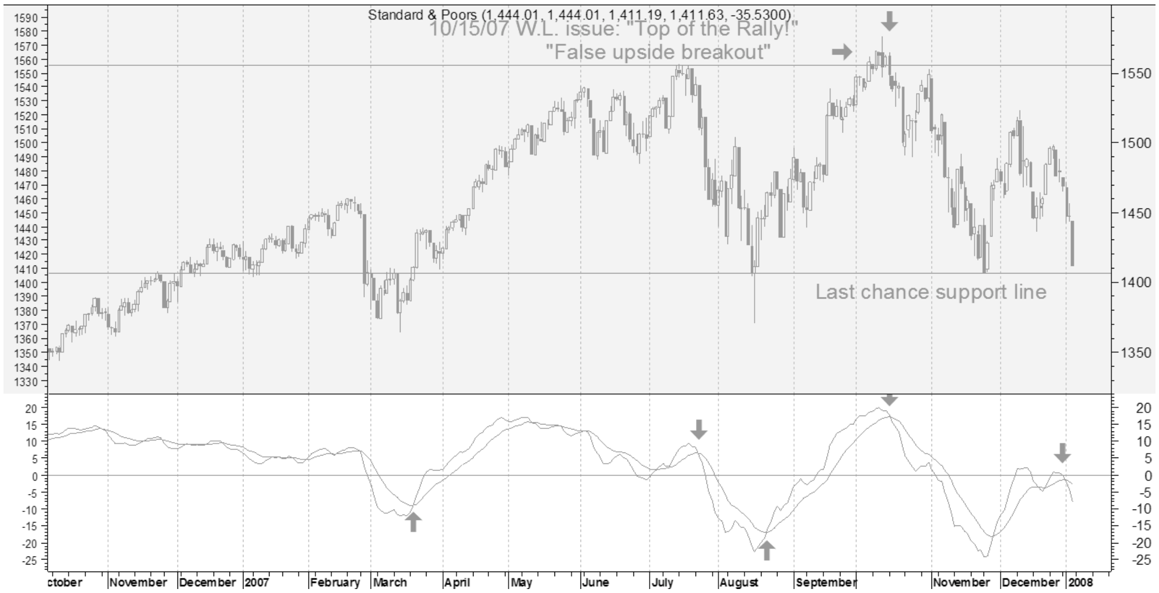
Bush met last Friday with Federal Reserve Chairman Ben Bernanke, Treasury Secretary Henry Paulson, and top financial regulators. He will give his remarks on Monday on the health of the economy, and probably reveal an economic stimulus plan. The White House called Friday's meeting the President's Working Group on Financial Markets. Well that's the official name of what we always call the "Plunge Protection Team" (PPT), which became the Group's nickname after the 1987 market crash. This team has the authority to support the stock market when it becomes "disorderly."

**The meeting suggests that whatever plan is laid out by the President the PPT may try to generate a good stock market bounce. Whatever they come up with probably will not be a solution, but in Washington, it's always the perception that counts. And one strong up day in the stock market will produce that perception.**

THE CHARTIST'S VIEW

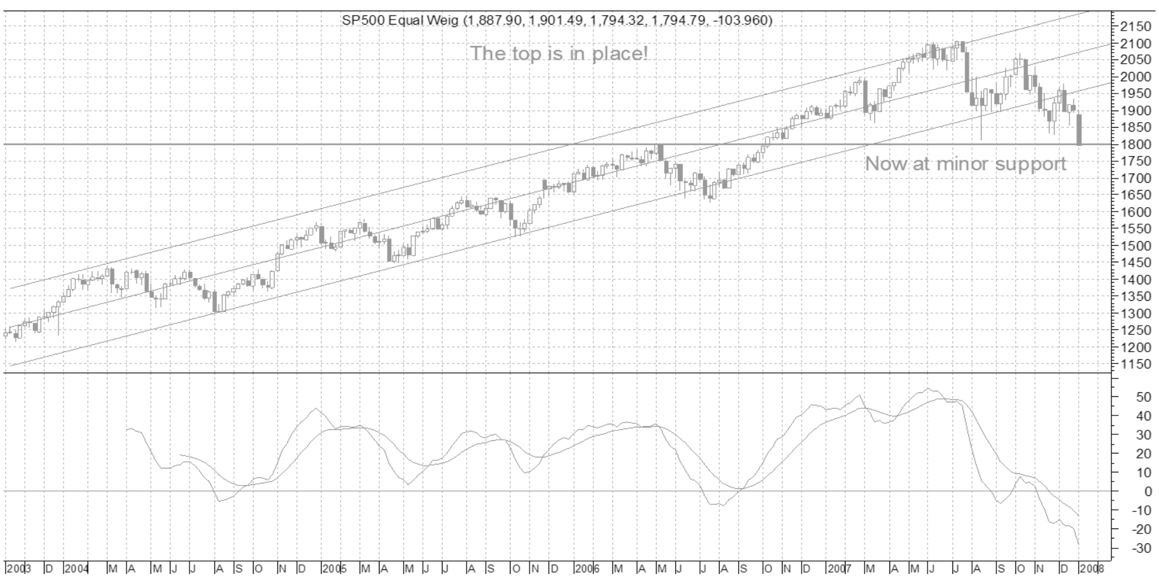
The S&P 500 INDEX (D) chart below shows that neither the November low nor the August low has yet been penetrated. However, this index is strongly slanted toward the big cap stocks. About 30–40 of the 500 stocks in the index make up most of the movement of the index. It depends how on how many shares a company has outstanding, which in my view is not very relevant. The MACD indicator below is on a strong sell signal. Note how we correctly identified the October high as a trap for the bulls.

## S&P 500 INDEX




The next chart, the S&P 500 EQUAL WEIGHTED INDEX (W), shows the longer term. This index is similar to the one above, except that each stock has an equal effect on the index. It is much more relevant in reflecting actual portfolio performance. Note that it has broken the November low, as well as the very important August plunge low. That means the long-term bull market top has been completed. Near-term however, there could be a bounce, as it has reached the first support level.

## S&P 500 EQUAL WEIGHTED INDEX (W)




The chart below shows the NASDAQ COMPOSITE INDEX (D) and the S&P 500 INDEX (D). We have shown this before, as it demonstrates that the tech stocks, as represented by the NASDAQ, have been used to present the illusion of market strength. Actually, it was primarily a few stocks, like AAPL, RIMM, AMZN, GOOG, which had all the strength. Now that the job of selling their own portfolios has been completed by Wall Street, those formerly strong stocks can also be dumped. Don't even think about bargain hunting in these issues! Note that at point 5, the NASDAQ was once again stronger than the S&P.

**NASDAQ COMPOSITE INDEX (D) and the S&P 500 INDEX (D)**


## CONCLUSION

**Our indicators confirm that we are in a bear market. And in a bear market, about 90% of all stocks decline.** Instead of trying to find the 10% that will buck the trend, it's better to profit from the decline. And that is what we do.

***In the January 7, 2008, issue I discussed the economy. Once again my view was totally opposite of those voiced by the economists whom you always see in the media. Here is what I wrote:***

## THE ECONOMY

On Dec. 28, the New Home Sales number for November was released: sales were down a big 9.0%. However, **manufacturing in the Chicago area** picked up.

Economists are now trying to put a positive spin on that. They say housing is only "5%" of the economy, and manufacturing is much more important. There is a problem with that theory: the housing depression causes destruction of wealth of the consumer, and the consumer is the primary driving force of the economy, making up over 70% of GDP.

Manufacturing is a lagging statistics. Companies continue producing goods long into the start of a recession, always hoping that there won't be a recession. Usually 12–18 month into the recession, they stop listening to economists, realize that sales are plummeting, and they slow production, start layoffs, and give up on the recovery.

The ISM Index (Purchasing Managers) for December produced a negative surprise as it slipped below 50, which is regarded as the dividing line between expansion and contraction. This survey of national manufacturing activity fell to 47.7 from 50.8 in November. It's just one month of data, but it's another sign of a significant slowdown in economic activity driven by a credit crunch.

As subscribers know, the consumer is the first one to signal a recession. Manufacturing and unemployment lag significantly, from 6 to 12 months. How can we see what the consumer is doing? Just go to your favorite family restaurant. Restaurants where we used to wait for 30–45 minutes, now have tables available as you walk in—on a weekend night. Waiters tell me that whereas they used to get tips from 15–25%, now they usually get 5–10%, and many times nothing. They say that credit card charges are routinely refused when they go to charge the customer's card. People are really stretched out. And we are still in the very early stages of this recession.

Many of the bullish analysts are still convinced that the only problem out there is housing and homebuyers. We've been saying for about one year, that the problems go much deeper. This is not a "subprime mortgage crisis" as so many call it. **We are witnessing a collapse of the greatest credit bubble ever created in history.**

Today, we heard that late payments on consumer loans, including those for autos, home improvements, and certain home equity loans, are at the highest since the last recession in 2001.

Delinquency rates on consumer loans increased sharply in the July-to-September quarter and are the highest level since the second quarter of 2001, when a recession was starting.

Defaults on prime mortgages are soaring. Many of these homeowners had refinanced their homes again and again, and therefore were classified as "prime" because it gave them a high credit score. But they never had to show proof of income or assets. Many of these homebuyers then got second mortgages, which actually made the debt on the house higher than the value. And that was in good times. With home values plunging, it doesn't make sense for these people to continue making payments. So, they just walk away.

On Jan. 4, we got the latest employment report. It shocked the markets. Only 18,000 jobs were added. Even that low number is deceptive. Without government jobs, there would have been a decline of 13,000 jobs. And without the artificially imputed jobs number of around 150,000 for alleged employment gains in small businesses, the number would have been seriously bad. The unemployment rate jumped to 5% from 4.7%, the highest since November 2005.

These numbers once again show that initial statistics out of the government should be disregarded. The prior month's employment report got many economists excited about the great job growth. We pointed out at the time, that the numbers were wrong, and possibly fudged. A much more reliable employment, especially in an economic downturn, is the "Household survey." Here they actually call families instead of imputing some artificial numbers. What does the household survey show?

There was a loss of 436,000 jobs in the household survey. That's Recession.

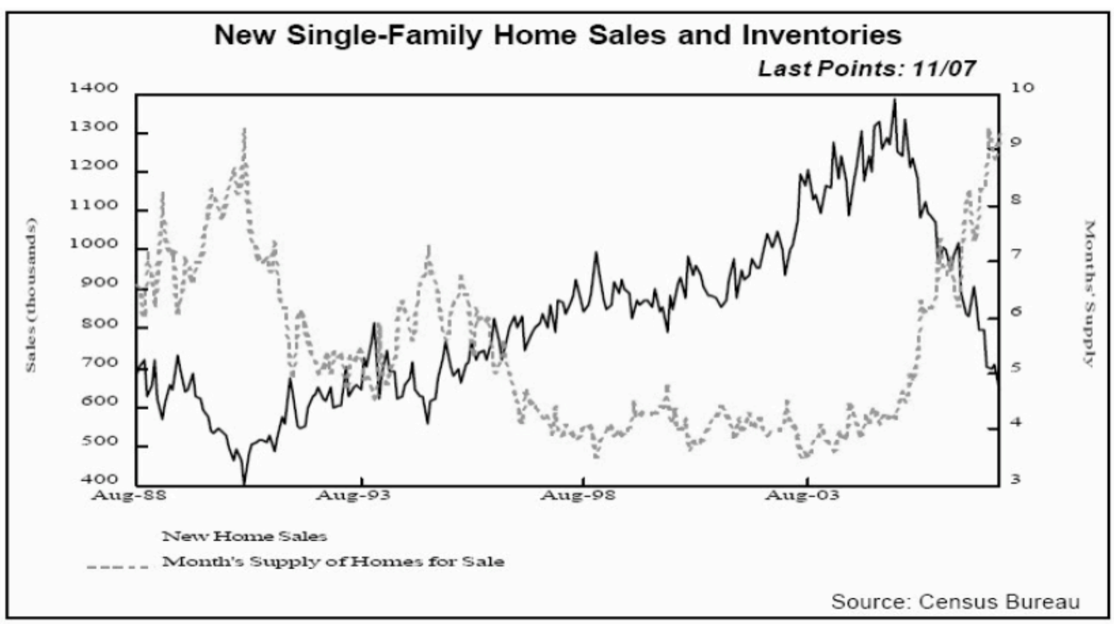
> **This supports my case that we are already in a recession. The last time we saw such a sharp, one-month rise in unemployment was in January 2001. That was followed by a 22-month bear market in stocks.**

Housing is getting worse, no matter what Wall Street's cheerleaders try to tell you. The Shiller index of 20 major cities shows a decline of 6.1%. Professor Shiller commented, **"To see as bad a fall as this, you would have to go back to 1940!"**

**Well, that's the Depression of 1930s!**

On Jan. 3, it was reported that U.S. mortgage applications to buy homes fell to the lowest level in more than 4 years, while demand for refinancing loans dropped to the lowest since December 2006. Yes, with the new lending standards issued by the government, fewer people can qualify. As is usual, the regulators close the barn door after the horses have escaped.

Look at this chart of New Single-Family Home Sales and Inventories. Homebuilding is one business you wouldn't want to be in right now. Some analysts are suggesting going bargain hunting in this sector. I wouldn't touch it until we see at least one big bankruptcy of a homebuilder.




The *Economist* reported that from 2001 to 2006 the value of residential property in the developed world rose by some $25 trillion (with a T). That's only in 5 years. That's more than the combined GDP of the developed nations. Our view has been that real estate prices will eventually be back to 2002 levels, erasing most of the gains. **That means that possibly $20 trillion to $25 trillion of homeowner wealth may be wiped out. That has**

**never happened in the history of the world. It will produce more than just a mild recession.**

## IT'S NOT JUST A SUBPRIME CRISIS

Early in 2007, the Fed Chairman, along with economists and analysts, said publicly that the subprime problem was small and could not infect any part of the financial markets. I disagreed strongly in this publication. They apparently ignored that the "toxic waste," sold with fraudulent ratings by the ratings agencies, was leveraged by incredible amounts. Hedge funds, banks, pension funds, and unsophisticated investors around the world bought this stuff, relying on the AAA ratings of the large U.S. agencies. The buyers didn't realize that these ratings were bought and paid for by the investment banks packaging and selling this garbage.

It's a repeat of the early 1990s, where the large Wall Street firms developed very complicated derivatives using emerging country debt, and sold it to unsophisticated banks, pension plans, and investors worldwide. The firms knew it was garbage, but the complexity disguised it. What made it possible to sell this confetti? The AAA ratings of the large ratings firms. For more on this, read the book by a former derivative salesman of Morgan Stanley, entitled *F.I.A.S.C.O.* It shows clearly that these firms are actually peddlers of scams. It makes the Mafia look like little schoolchildren.

Now we hear that some hedge funds have leverage of over 50 times their capital on some of this stuff. That means that a 2% decline in value wipes out their capital. But the declines have been much worse. One financial firm late last year dumped all of its CDOs. It got on average 25% of face value. That's a 75% decline. By now, the market value is probably even less. These are the bankruptcies of 2008.

> **Yet, the large money center banks, investment banks, and Wall Street firms have only taken write-downs of maybe 10%–20% of similar stuff in their portfolios. If they would take a 75% write-down, they would either go bankrupt or have new owners … speaking Chinese or Arabic. And that will happen this year.**