welling@weeden

http://welling.weedenco.com

VOLUME 4
ISSUE 7
APRIL 5, 2002

INSIDE

Listening In
Outspoken Analyst Charlie Peabody Sees Credit Risks Being Repatriated To Banks In Delayed Recognition Of Asset Impairments Financial Engineering Can't Hide; Says Residential Housing Is Next Bubble To Pop
PAGE 1

Street Beat
"The Oracle" Says That It's Tech's Turn
PAGE 8

Guest Perspectives
Doug Noland: *Monetary Disorder*
Paul McCulley: *Subs or Complements*
News Bite :)
Arb Notions
Acute Observations
ALL ON WEBSITE

listening**in**

Send In The "CLOWNs"

Charles Peabody On How Credit Risk Is Coming Home To Roost

Expect ***Charles Peabody*** *to speak his mind and you'll never be disappointed. And, while that sterling character trait has discomfited any number of his former bosses on Wall Street, Charlie's current position is quite secure: He's his own boss these days, at* ***Ventana Capital****, a New York City-based independent banking research boutique he started in 1997. Independence clearly agrees with Charlie—and his clients. His views on the market's current crop of financial foibles and follies are as pungent (and bearish) as ever. As for the housing "bubble," read on.*
KMW

Are you having fun yet, Charlie?
I am, actually. We've been very, very lucky. This is the right time in the cycle to be an independent research boutique. Our clients have gone out of their way to support us and make sure that we succeed. We have a tremendous amount to be thankful for in terms of the client base that we've been working with and so, yes, I'm very fortunate and as a result, I'm having fun. I'm doing what I want to do—and being rewarded for it.

Isn't it wonderful to be an "overnight success."
I've been trying to do this the last 20 years. But as you know, Wall Street doesn't allow you to do it. So I finally left Wall Street in March of '97. Now that it's all starting to come together, I'm happy to say, it is a nice thing. But it's not exactly overnight. I'm sure you're in the same position.

You couldn't be more right about this being prime time for independent analysts.
We've seen this cycle before, as you know. If you study history, you can see that it comes in 20-30 year waves. There's always some sort of ethical, moral, or financial blow-out on Wall Street—and it then spins off two types of boutiques: the M&A boutiques, like the Wassersteins and the Gleachers, and the research boutiques. These boutiques then thrive for 20-plus years—until they end up doing something stupid and sell out to the Merrill Lynches of the world.

Or until the principals decide to retire and look to the behemoths as an exit strategy.
I must admit I'm not quite there—not even remotely thinking about an exit strategy!

No surprise. I hear you're too busy producing distinctly contrary research on banks and such—
We try. We're not always right, although we strive to be. But we do try to look at things differently than what you may hear from other people—and we hope to be more right than wrong. Two things differentiate us. The first is that we are probably much more balance sheet-oriented than earnings-oriented. The other is that we make no secret about it: We are skeptics. We have something of a bearish bias in our approach to analysis. This is probably my New England upbringing surfacing. I tend to look at things, first to try to understand what the downside risk is. Then, if I determine that the downside risk is limited, I'll go ahead and recommend a company without necessarily knowing all about the upside—just knowing that the risk/reward is favorable. Conversely, though, because we approach stocks by trying to understand the downside risk first, we do uncover a lot of short opportunities. And, unlike most analysts, that's an area we've been willing to delve into.

So you're willing to risk appearing un-American!
That feeds into my next point. One thing I love to do is surface issues and then force Wall Street to debate me. Especially because, by surfacing issues, I get to choose what side I want to be on. And it's funny, but it seems that if I choose one side, Wall Street always automatically chooses the other side, just to prove me wrong. Which is another thing that differentiates us, as well. I'm willing to start with a macro bet which then feeds into a micro realization. By contrast, most of my Wall Street brethren who do banks are unwilling to make the macro call.

Why should they risk being doubly wrong?
Well, making the macro call is a way of being early. But it's also, I grant you, a way—in these volatile markets—of being wrong. You can be right, *eventually*, on your macro call, but suffer a tremendous amount of pain in the interim.

welling@weeden

Published exclusively for clients of Weeden & Co. LP

Kathryn M. Welling
Editor and Publisher

Jean M. Galvin
Business Manager and Webmaster

Karin-Marie Fitzpatrick
Editorial Assistant

Alexander Isley Inc.
Graphic Design

Weeden & Co. LP
Board of Directors
Donald E. Weeden
Barry J. Small
Robert A. Cervoni
Timothy McDonald
Robert DeMichele
Daniel V. Panker
Richard Sharp

welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com.

First-class postage is paid at Verplanck, NY

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright Act imposes liability of up to $100,000 per issue for such infringement. welling@weeden does not license or authorize reproduction by clients or anyone else. However, multiple copies are available to clients upon request and limited reprint arrangements are available. Copyright 2002, K.M. Welling and Weeden & Co. LP. All rights reserved.

Charts, pages 6,7 by
Ventana Capital LLC

Which is particularly germane with "everybody" keeping score daily, if not hourly.
You not only have to be a fundamentalist these days, but you've also got to be a psychologist, and those two roles are hard to bring together sometimes. But the shortening of investment horizons is real, and you have to deal with it. That's another reason I like to keep an eye on the macro–because it helps me make an early call. After all, the raw materials for my industry–the banking industry–are money and interest rates. So I don't know how you can divorce money and interest rates from your call. Yet, most analysts and portfolio managers will *not* make an interest rate call. They just won't. To them, it's a bad risk/reward. Yet, what is ironic is that they're willing to make an economic call. That's essentially what you see behind this recent run in the bank stocks. Especially since last fall, the analysts (and investors) have been willing to make a bet that the economy would be bailed out and revive. But they've been unwilling, at least up to this juncture, to see the potential in that same scenario for negative interest rate consequences.

"We're about to see what I call 'the repatriation of credit risk' done in an *adverse selection* way."

Stocks and rates have been divorced, why should they get back together?
They will get back together. In fact, I don't know if it'll be a significant correction or one of these 10%-15% corrections, but I think we're going to see some sort of correction in the major banks between now and the FOMC meeting on May 7th.–

Why?
No. 1, to start to reflect the realities of a different rate environment, and No. 2, to start to reflect some of the regulatory and economic risks that still lie out there for these banks.

What about the argument I hear all the time, that the level of interest rates–or even the trend–doesn't matter to the big banks because they're so sophisticated in managing their spreads? Isn't that a cop-out? Banks always have some sensitivity to rates.
It is. And they do. But analysts always will be willing to believe what they want to believe about that process. This is where the focus on accounting really needs to gain a greater foothold on Wall Street. Despite all the publicity, analysts still ignore the accounting gimmickry that goes on. Let me give you one example. **Bank of America** (BAC) in the early part of 2001 made a big interest rate bet–and it was the correct bet. They won the game, if you will. I've likened it to John Bunting's bet back in the mid-1970s–

Refresh my memory.
He was the Chairman of First Pennsylvania.

Oops.
That's right. It was a big money center bank that decided rates and the economy would have to trade in parallel. They had a lot of credit problems and decided that if the economy got weaker and credit quality continued to suffer, they could offset those losses with their big interest rate bet–by generating earnings from falling interest rates. But as you also recall, what we got was stagflation. The economy continued to be problematic, but interest rates skyrocketed. So First Pennsy failed. It was that same sort of bet on a parallel move in rates and the economy that Bank of America put on about a year ago. The difference is that BAC won the rate bet and their profits on that rate bet allowed them to offset credit losses. Bank of America did this in the swap market. So last year it had these huge unrealized gains in the swap market. Anyway, I think it's going to be very interesting to see how the Street treats all of this.

Implying all earnings aren't created equal?
As you know, the Street has bought into the EVA [economic value added] concept. Well, from an economic value added point of view, these swap gains were at their peak last September, when they had roughly $2.6 billion of unrealized gains in their swap portfolio. They closed out most of that portfolio in the third and fourth quarter and booked the gains in equity, in what they call "other comprehensive income." But it's only over the course of this year that they're going to flow those gains into the P&L statement as interest income. So they will report what looks like rising earnings because they'll take those gains out of one pocket and put them into another pocket. But from an economic point of view, their peak value was last year. That's the kind of accounting game I see going on quite a bit, which I personally resent, particularly from an organization like Bank of America, because they've done it in so many different areas–they've used accounting to obfuscate true fundamental trends.

I admit it, I'm a glass-half-empty-type myself. But the lack of transparency in swaps and derivatives of all sorts–and the banks' enormous exposures there–seem to represent an analytical black hole.
They do. In the credit loss area, the big game for Wall Street now is to take these big one-time hits–

For instance?
Let me use Bank of America, as an example again,

although I could use any number of different organizations, **PNC Financial Services Group** (PNC), Bank of America or **JP Morgan Chase** (JPM). Anyway, the big game today in the credit loss area is to move these loans into "held for sale," on the balance sheet and take a big one-time charge, which they call non-recurring. Then they just carry these loans until liquidation–but in the meantime they report all revenues from those loans as part of their operating earnings. Yet, if there's a further write-down, they report that again as a non-recurring one-time item. Remember the consumer finance operation that Bank America decided to discontinue last August? It was actually a situation that I had heard about in July. So I wrote a report saying that they were going to do this. And sure enough, they did it. They called the charge non-recurring and took a big goodwill writedown because this was a consumer finance operation that they had bought. But then Bank of America continued to report all the ongoing revenues from that portfolio as part of operating income.

You're kidding?
No. I don't know how you get away with that. You write off the goodwill; you *say* you're going to discontinue the operation. So everything bad you report as non-recurring. But then you keep going forward reporting the revenues from that portfolio.

That hardly seems kosher. It seems contrary to the spirit of GAAP, if not the letter.
It is. But I understand what Bank of America and the others are trying to do. Basically, this is an industry that is trying to restructure, but doesn't want to lose earnings momentum in the process. If you decide you're going to exit a business and you take a big charge to do it–if you were to put those assets in a separate bucket, you would lose all those revenues. How do you make up for that lost revenue? The way Bank of America did it was through this big interest rate bet to replace the lost revenue. They obviously want to give the impression that core earnings have not stalled because they don't want their stock to take a hit, which would make them vulnerable to the consolidation process. Presumably, the whole reason for these restructurings is to justify their independence, so they don't want to expose themselves as vulnerable during the transition process.

Which is another way of saying that the banks' managements want to make sure the buck doesn't stop—
And it really doesn't. Because we've used financial engineering to obfuscate a lot of what ails this industry.

At least they seem to have gotten good at it. In every other recession I can remember, you could count on a big bank failing because it got carried away with oil loans or whatever during the previous expansion. This time around, the spectacular train wrecks haven't involved the big banks—at least not yet.
No, you're absolutely right. If I can digress for a second, in the 1980s as you recall, the banks were the end receptacles for every credit debacle there was–whether agriculture or HLTs or LDCs or energy or real estate. So the banking industry in the '90s finally said, "Let's get smart and create a platform that allows us to originate credit, warehouse it temporarily and then distribute it, so that we are no longer the end receptacles." That platform was very successfully created in loan securitization. But the process–the need to create new vehicles to offload this credit risk–and the extended economic cycle, I think, created an environment in which underwriting standards were abused. That's what happened in that 1997-2000 period. In other words, the financial engineering became more aggressive, 1) to obscure the true credit risk or 2) was used in a more deceptive manner to make the credit risk look more palatable to the end buyer. In the meantime, I think that the lenders who were trying to offload this credit risk were lending money with weaker underwriting standards because they felt like they would never have to see it again. That was what the '90s were all about: How do we offload credit risk to some third party? And in that process we transformed a traditional loan into some obscure type of security that became hard to value.

Implying that there are tons of those securities out there being carried at fanciful prices?
There are a lot of different aspects to this process that are coming back to haunt the system, but generally I think we're about to see what I call "the repatriation of the credit risk" done in an *adverse selection* way.

Gee, that sounds delightful.
What I mean by that is if you underwrote somebody's commercial paper but agreed to back it up with your commercial paper back-up lines–well, suppose all of a sudden, the end receptacle they were dumping that paper into doesn't want it anymore. Suppose that Xerox or that GE or that Qwest or that Enron then draws down that commercial paper back-up line and overnight you've got x-billion dollars outstanding to that weakening credit. That's one way of repatriating credit risk. The other is that you've created these special purpose vehicles like PNC did, where you tried to offload the credit risk into the special purpose vehicle and then fund it in the public marketplace. But either through accounting rules or through other mechanisms, you're seeing that credit risk being put back onto your balance sheet. I'd note, too, that Fannie Mae and Freddie Mac–the GSEs [government-sponsored enterprises]–are no different than these special purpose vehicles. So we also saw the banks trying to offload credit risk onto the GSEs' balance sheets, because they had a greater degree of leverage capability. That's what all these various vehicles allowed the banking system to do. The banking system acted strictly as a through-put mechanism. If the banks had been the end receptacles, that would have limited the amount of leverage created in the whole corporate American system. But because you could offload credit risk onto Fannie Mae's balance sheet, you could leverage much more than you could historically. Likewise, because you could use these special purpose entities to offload credit risk, you could leverage astronomically. It's quite simple, really. A bank's leverage is limited to 15:1 or 20:1, but the GSEs can leverage 35:1 or 40:1, and the special purpose entities can leverage to no end, assuming access to liquidity.

The GSEs leverage a lot more than that if I read Doug Noland correctly—*[w@w Dec. 17, 1999]*
Yes, if you include the derivative structure, you're absolutely correct, but I was talking in terms of on-balance sheet structures. The banks have leveraged much more than 15:1 if you include the off-balance sheet structures, too. I think that's why we have a corporate America and a consumer that's extremely over-leveraged. Because the banking system used financial engineering to offload this credit risk in an astronomical way. Now we're seeing, bit by bit, that those vehicles either didn't have the funding structures to hold those credit risks through a down cycle or didn't have the risk-management capabilities to understand the risks they were taking. The upshot is these vehicles are succumbing and credit risk is starting to be repatriated back into the banking system.

So we *are* going to see problems in the banks, just with more of a delayed reaction than in the old days?
My thinking is that after a brief period of repatriation, we're going to see individual banks surface in a more ugly manner than we have up until now. All of which is a long-winded way of saying, "Yes, you're right. Up until now we haven't seen it." We're at the intermezzo, the sorbet. And that's breeding a false sense of complacency because I don't think people understand that this is an *adverse selection* repatriation process.

Because good credits don't get repatriated. And when the music stops someone is going to be left holding bag?
Right. It is the banks that are acting as a shock absorber right now, buying time for these organizations that are being cut off from the marketplace for whatever reason. The other thing that I'm sure you appreciate is that in banking and in the financial world, price disruptions–particularly if they're negative–are always considered temporary, unless they persist. And they have to persist for 12 months-plus before they are recognized as a permanent impairment of an asset value. All you have to do to see that is just look at the big venture capital charges that the banking system has taken. It wasn't until the second quarter of 2001 that they took their first big venture capital charges. Yet when when did Nasdaq peak? In March of 2000?

Point well taken.
The reason I mention that is that a lot of these structured products are sitting out there with significantly impaired values–CLOs or CBOs or CDOs, collateralized loan obligations of one flavor or another. Essentially, that's what PNC had created with their special purpose entity, for instance. But as assets become impaired in those vehicles, they're not recognized immediately in the P&L or in the equity accounts of these banking organizations.

This is where the bankers practice forbearance—and the bigger the exposure, the more forbearance.
You got it. Eventually these CLOs will be renamed *CLOWNs, for "collateralized loan obligations worth nothing."* This is a process that helps explain why we're going to get a slow and delayed recognition of the leverage and the impairment of the system.

Isn't that actually good, in the sense that a slower unwinding is easier to manage?
It exactly is–and that's what I think is behind the regulators' approach. As you remember, the regulators all got slapped on the wrist back in 1992-'93 for creating the credit crunch by swooping down on New England and California and hitting them hard on their real estate exposures. The regulators got blamed for being heavy handed.

As if *they* created the S&L mess!
I know. That was a lot of Monday morning quarterbacking, quite honestly. The regulators' actions did create a clearing vehicle and a clearing price and a cathartic event, which allowed the system to recover. But it *was* scary and disruptive at the time. What I sense, and I'm guessing here, is that this time around the regulators have decided on using a process where they're going to hit one institution at a time, and then allow a pregnant pause to develop before they go after the next.

What makes you think so?
I say that because that seems to be the modis operandi in the sub prime area. They first went after Providian and hit them hard. But then they allowed a pregnant pause to develop. And these pregnant pauses are interesting because they allow Wall Street analysts to come back out and say, "See, that problem was unique to Providian."

Just in time to get their heads taken off on the next one—
Exactly. Then the regulators went after NextCard and then they went after Metris. But each time they allowed a pregnant pause to develop-which allowed Wall Street to rejuvenate enthusiasm and say, "It's all behind us." I think that's what we just saw starting with PNC. Meaning that they were the first example of a shot across the bow on these off-balance sheet structures. But I don't think they'll be last. We're going to see the regulators come in and hit JP Morgan Chase, for example, on how they've accounted for some of these off-balance sheet vehicles.

So things will continue to get interesting-er and interesting-er.
I think so. That seems the way the regulators want to go this time: Hit one institution, allow a pregnant pause to develop, allow Wall Street to get excited. In fact, I think that's what we saw here in late February and throughout March in the banks has been about. We were feeling like there was breathing time here; that the 10Ks weren't going to produce any disclosures. But now this regulatory and economic risk is about to take hold again. Obviously, I'm guessing that this is behind what the regulators are up to. But this does argue for a much more drawn-out recognition process than we saw in the 1990-91 impairment of the system. Which may mean we have this earnings malaise where the banks earn at a sub par level, at let's say $2.50 each year, for the next 3-4 years. To some extent that's what you've already seen in the last 2-3 years. A lot of these companies have been earning at these sub par levels, but we've seen no big baths.

Isn't it a matter of picking your poison? Is it better to take a big hit and get it over with, or lots of small ones over a long time?
Well, this is where I don't understand reality in terms of managing an organization. I am of the mode that likes to deal with it, get things behind me. But in a consolidating world, does that leave you vulnerable if no one else is doing it? I think it does, and since most of these CEOs are independent-minded, they don't want to risk being exposed. If you stick out too much you become vulnerable.

I guess, but the banking industry has been in a consolidation mode for I as long as I can remember. There can't be anyone in the industry to whom this is news!
No, but this is where I struggle. What's the right thing to do to deal with the problems versus how do you manage an organization to survive, if that's part of your goal? The way I would respond is if these guys screwed up so badly that they're in that position, then you don't want them managing your assets. You want somebody else managing those assets and they *should* be consolidated away.

You're a hard man.
But I do recognize that one of the dilemmas facing some of these CEOs is how do I restructure and deal with my mistakes without exposing myself–and my organization–to the consolidation process?

Falling on swords is not part of the culture, generally.
No, it's not. Although I think you're going to see some of that at JP Morgan Chase.

Really? All we've heard so far are protestations of innocence.
According to Mr. Harrison, that's true, "We just got caught by the perfect storm; it's none of our doing."

Of course, what they were doing that far offshore, in that leaky boat, in the middle of hurricane season, who knows?
Good point! One thing I would mention to you, which I have not seen written up on Wall Street, came out in their recent 10K. Marc Shapiro, who is one of the bank's potential victims of the Enron debacle, used to represent all three functions that he oversees–finance, credit risk management and market risk management–on the executive committee. But now Dina Dublon, who is the CFO, is also on the executive committee and she wasn't last year. I think that's a positive, because if you looked at that executive committee last year, there was only one risk manager and a lot of producers. That one risk manager was Shapiro. You can imagine what kind of voice he had. Now he should have some

support. One of the smart decisions they've made was to keep the JP Morgan name. It has given them that extra sense of credibility that the old Chase name never would have carried. But if you look at the management, it's all the former Chase management team. If you look at last year's executive committee, you had three representatives from the old JP Morgan: Sandy Warner, Walter Gubert and Ramon de Oliveiria. This year, only Gubert remains. That has been the history of that management team, whoever they merge with, they assassinate. There are no representatives from the old Chase anymore, Tom Labrecque and that whole crew are gone. The core management team is really made up of the old Chemical, Manny Hanny people.

Did you spot anything revelatory in JPM's *financials?*
Yes, part of what I do is look at how the legal entity cash flows work. In banking, cash flow analysis has no place other than between the legal entities. What's interesting is that JP Morgan Chase has been starting to hoard liquidity at the parent company level. If you read their 10K section on liquidity management, they talk at length about the need to withstand a prolonged period (which they describe as 90 days) during which they cannot access the public markets for funding and can't upstream dividends from the subsidiary bank (which is its primary source of liquidity) to the parent company. So I think that they are recognizing–and again this is prudent management–that they might face some difficult times here. They are at least getting ready to deal with it from a liquidity point of view at the parent level. So the tea leaves to me say that this organization is preparing for more difficult times. It may be as a result of the semi-acknowledged regulatory review that's going on in there.

The what?
We know that the Fed is in there doing a special review of their accounting and off-balance sheet structures.

And you think JPM is preparing for the possibility the Fed finds something it doesn't like?
Yes, and their choice is not too dissimilar to the Enron organization's. The question is how do they want to deal with it? Do they deal with it more privately or in the public limelight? I'm not sure I have an answer.

How strongly do you believe in "too big to fail"?
I believe in it big time! My career is not without mistakes. Back in 1990 and 1991, when I was at Kidder Peabody I was very micro-oriented–and learned the hard way to add some macro aspects to my analysis. Anyway, I had done–excuse me if I sound a little bit arrogant–so much work on Citibank at the time that I was absolutely convinced that the bank was insolvent. I even went down to Washington and testified in the Senate about the health of the banking system. Told them I thought Citibank was insolvent. This was at a time when [Citicorp Chairman] John Reed was in [Kidder's] Michael Carpenter's office practically every other month telling him to shut me up. What was ironic about it was that at the same time, Gary Wendt, who then was the head of GE Capital, was escorting me down to Washington and encouraging me to tell the Senate how poorly managed the banking system was and how much they needed to be regulated–he obviously wanted me to help get them more regulated. So Carpenter on one hand was telling me to shut up and Gary Wendt on the other hand was telling me to "speak your mind, speak your mind." And I was very naïve, really a political pawn, not knowing what I was doing or saying.

Ironically, you were right about Citibank, except that it *was* just too big to fail.
Exactly, I learned my lesson. I was absolutely convinced that Citi was insolvent–and I underestimated what the Fed could do. So "too big to fail" does exist–and there's no question, either, that JPM Chase is in that category.

That still leaves open the question of valuation.
It does. In my mind, at the very least, this thing is likely to be a low $20 stock at sometime this year. I think the dividend will be cut.

I couldn't believe they didn't cut it last quarter.
I'm surprised by that, too. But they went out of their way to tell people that they were going to maintain the dividend in the short run. In their 10K, they said that even though we may not earn the dividend, we hope to pay it out of parent company liquidity. That is something that you should be aware of now–their ability to upstream dividends from the subsidiary banks to the parent company is legally constrained. Now (as of yearend) they can only upstream $2.2 billion, while their annual dividend requirement is $2.7 billion. So they have to really earn it in order to pay it. In fact, they have to *more than earn it* because there is something called "The Source of Strength Doctrine." This was also evident in PNC's 10K, which came out last weekend.

The what doctrine?
The Fed's source of strength doctrine says that the parent company has to be a source of strength to the subsidiary banks. If the subsidiary banks are fundamentally weak, the parent company has to take whatever resources it has and infuse them into the subsidiary banks to shore them up. That's what the FDIC cares about. It doesn't care about the holding company because it doesn't have any insured depositors there. So if you have resources that are being paid out to the public marketplace at the parent company level in the form of dividends, that instead could be used to shore up the subsidiary, the Fed is going to step in and say, "Sorry, we're not going to let you do this anymore."

Since when?
Well, this doctrine actually emerged from the 1990-91 experience, so we haven't been through a cycle where it could be tested–

Until now.
Which is why it was interesting, when PNC's 10K came out last weekend, that they referred to the source of strength doctrine as one thing that could cause the Fed to prevent them from paying dividends out to shareholders–even though they intend to do so. I mention this because it was new news to me and everyone else: PNC in their 10K also acknowledged that as of yearend they were no longer allowed to upstream dividends to the parent company. I had not been aware of that, and I don't think anyone else was aware of it. But they did go on to say, "We have $800 million of liquidity at the parent company level that we are going to use temporarily to pay our dividends out of to the public shareholders. In the meantime, we'll restore the earnings power at the subsidiary bank and get back to a legal dividend paying capacity." But then they had to go on to acknowledge that, under the source of strength doctrine, it's conceivable the Fed could come in and prevent them from paying those dividends out of the parent company's liquidity.

What is the threshold at which the subsidiary banks can't upstream dividends to the parents?
There are two different rules. The primary one is two years of retained earnings plus current year net income. So if your retained earnings haven't grown over last two years, the only way you can pay the dividend is if you earn it in the current year. That is what caused the Fed to cut off PNC from upstreaming dividends and that's the trigger that JP Morgan Chase faces now. By the third quarter–unless JPM has a miraculous earnings recovery–they won't be able to upstream dividends anymore. Then the only question is what kind of dispensation does the regulator give them to continue paying the dividend temporarily, even though they are not technically in compliance? It is possible they'd get special permission to pay the dividend. The regulators always leave themselves some flexibility.

Okay, Charlie, let's talk housing. You're a bear, right?
Well, another thing that I think distinguishes our macro work from others' is that we try to look at the *unintended* consequences of government interven-

tion. When Greenspan in December of 2000 said he was going to start to ease, and to inject liquidity into the marketplace, we wrote about how, if you look back in history at the times liquidity was injected to stem a deflating asset, what you find is that liquidity never really seeks out that deflating asset. (The deflating asset in the most recent case was the TMT sector.) Instead, the injected liquidity goes out and seeks an inflating asset–and creates an even bigger bubble, which then that creates a crisis somewhere else down the line.

And you have an idea where that will be–

Our feeling is that our new bubble is the residential housing market. Think about human behavior. If, for 12 months you've been suffering significant losses in TMT and all of a sudden you get an injection of liquidity, you're not going to go out and buy more TMT. But if, in that same 12-month period, your house has appreciated in value quite considerably, you're going to continue to re-invest in that asset. So that the housing bubble exists, in my mind, is a consequence of Greenspan. I think the TMT bubble was a consequence of Greenspan. Each time he has injected liquidity to salvage something–whether it be LTCM or Asia or whatever, he has created an unintended consequence and that unintended consequence has come back to haunt him.

There are those who argue that housing is no bubble–

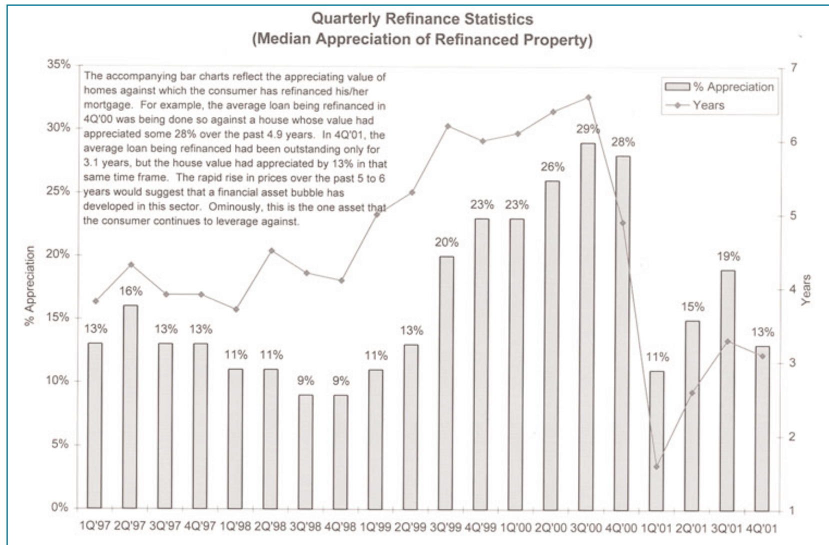
I've probably heard them all. One argument I hear a lot from people insisting there's no housing bubble is that it can't be a bubble because we haven't seen significant price inflation. In other words, housing hasn't had the 30%-50%, or 100%-200% gains that you saw in the TMT sector. But that doesn't mean the real estate bubble can't have as big an impact on the consumers' wallets as the bursting of the TMT bubble. Among other things, it's a larger base. You've got $11 trillion invested in housing whereas in the Nasdaq you only had $5 trillion at its peak. And an even 20% decline off a $11 trillion base can have a bigger wealth effect than a 30%-60% decline on a $5 trillion base.

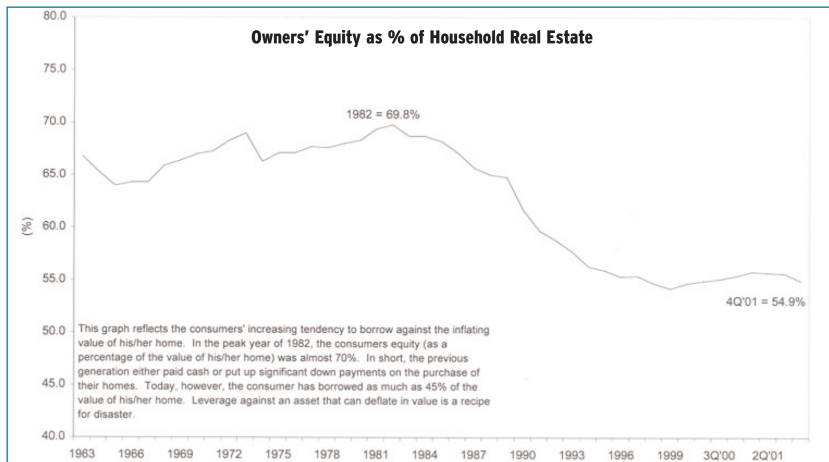
Not only that but, I suspect, the housing losses would be greatly magnified by leverage. There's far more leverage underlying home equity than ever was used to buy shares on Nasdaq.

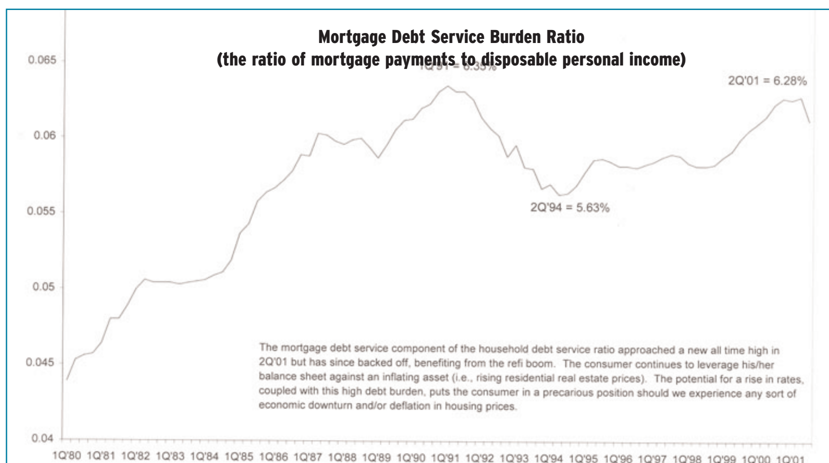
You're right about that. It's a much more significant asset, more widely owned. I've studied bubbles, looked at their prerequisites–and they're there in housing. The three things, to my mind, needed to create a bubble are 1) a levered primary asset. In this case, your primary asset is your house. And if you look at the refi statistics and the cash-out statistics, the consumer has levered. The second is, have you taken your savings or your capital and put it in vehicles that can inflate or deflate in value? And typically in the bust part of a boom/bust cycle, it deflates. In this case, if you look at what the consumer has done over the last two decades, he's taken money out of FDIC-insured CDs or similar vehicles where he was guaranteed to earn cents on the dollar and moved it into mutual funds–and last year he saw his first decline in net worth in what, 40-plus years? So they've definitely moved their savings into vehicles that can decline in value. No. 3 is that you have to have your cash flow curtailed or cut off. Typically that has been associated with unemployment at the consumer level. But I think the reason we started to see strains at the consumer level this time without high unemployment is that a lot of people assumed that their incentive pay or their bonus or their second or third shift was a constant. They lived a lifestyle that assumed that it would always be there. That is starting to be taken away from the consumer to some degree and so I think his cash flow has been curtailed but not eliminated. Obviously, unemployment rising another 200-300 basis points would be significantly damaging to housing. But in the meantime, the rising rate environment, which is a consequence of Greenspan's decision to err on the side of allowing this economy to gain strength, is going to start to deflate the asset price bubble in housing. The catalysts will be the rise in rates, first at the long end and then at the short end, and the double-dip recession.

But what makes housing a bubble?

The rapid rise in prices over the past 5-6 years suggest it, for one. The top chart [opposite page] shows the appreciating value of homes against which the consumer has been refinancing–and how quick the consumer has become at "monetizing" it. The next one is another way of looking at consumers' rising appetite for borrowing against the inflating







value of their homes. But leverage against an asset that *can* deflate in value is a recipe for disaster. The bottom chart [opposite] shows how precarious the consumer's position would be, should we experience housing price deflation. Ominously, my next chart (top, this page] shows that year-over-year housing price appreciation may have peaked a year ago. But consumers are still borrowing with pretty good abandon against their equity [middle chart]. The big question is whether this is a sign of confidence or desperation.

You're not sanguine?
I'm afraid not. The housing cycle has been extended– turned into a bubble–by all the excess liquidity the Fed pumped into the system to try to salvage the TMT sector. And housing price appreciation has permitted consumers to continue their consumption binge. But we're now entering a period when liquidity will be increasingly withdrawn from the residential mortgage sector–which means asset price deflation looms in housing.

Withdrawn? Why? Housing *is* a hard asset. Maybe its strength is sending us the same message as the revival of precious metals stocks and rising long rates—something to do with inflation or even stagflation.
I guess, if credit continues to flow to housing, it certainly can continue to inflate. The GSEs obviously play a big role in that process. But what I'm beginning to sense is that there is a desire in Washington to rein in the GSEs–

Only if they can figure out how to do it very gingerly.
Right, you obviously don't want to be too disruptive, but what I'm hearing from my Washington contacts is that Peter Fisher and John Taylor, who are allies of Greenspan at the Treasury–I don't know if you remember but Peter Fisher used to run the trading desk at the Federal Reserve Bank in New York and was very close to Alan Greenspan. He helped bail out LTCM-

Headed the "plunge protection team."
They recognize that Congress is going to do nothing to rein in these GSEs and that that is politically stupid. So I think they've decided to pursue two other courses to rein in the GSEs. No. 1 is to try and create a true, independent regulatory watchdog for them. Their watchdog is currently OFHEO, but OFHEO-

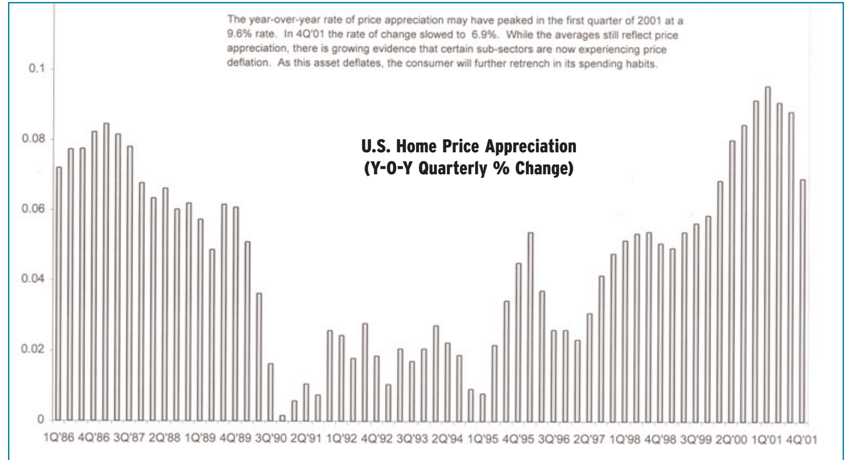
Oh Fails!
Well put. It doesn't have the resources because it's subject to the Congressional appropriations process. So it can't hire talent and resources to truly intellectually be an equal to what these GSEs can produce. What the Bush Administration has proposed in their 2003 budget is to take OFHEO out of the Congressional appropriations process and make them a truly independent watchdog with some teeth–and then staff it with talent. The other idea is to use market discipline. I don't think that the editorials about the GSEs that you've seen in the *Wall Street Journal* lately got there by accident. A lot of people forget that in March of 2000, Gary Gensler, who was then the Under Secretary of the Treasury, very publicly stated that GSEs are not government-guaranteed–

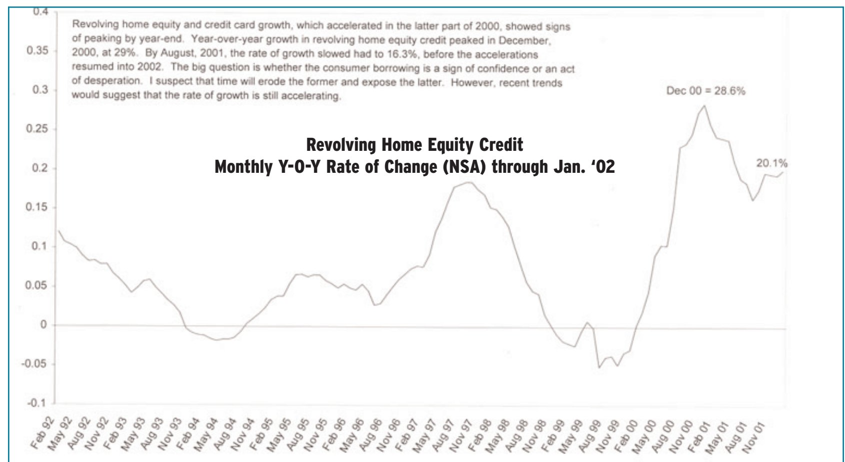
Caused a bit of a stir, he did.
Sure did. He created a widening of credit spreads and some difficulties on the funding side temporarily for Fannie and Freddie. That's the second way of slowing down their growth, using the marketplace to impose market discipline. If you create a widening of credit spreads to make it more costly to fund, maybe you can slow the growth of the GSEs– even if it is a dangerous process.

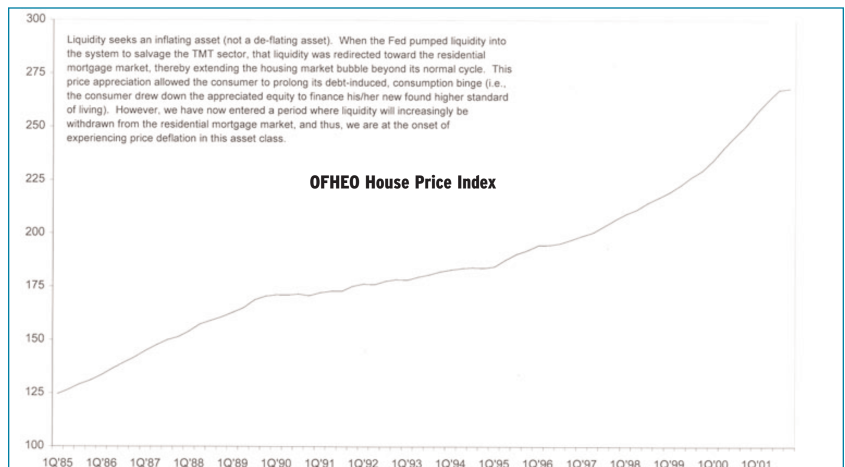
Not only dangerous, but the question is, who needs whom more, Wall Street or the GSEs? Or who has co-opted whom?
Wall Street owns the bedroom and is renting it out to Lincoln and the GSEs. But everything I hear is that the Administration is moving toward reining in the GSEs –

That would certainly slow the flow of credit into the housing market—and a lot of other places.
It would, and at the same time, the rising rate environment should make it more difficult to get credit to the housing market. Bubbles need ever increasing sources of liquidity and when you start to constrain liquidity, you soon start to see some deflation in the price of that asset. That's why I'm having a hard time seeing housing as an ever-inflating asset at this point in the cycle.

Thanks, Charlie.







streetbeat **By Kathryn M. Welling**

Tech's Turn?

Why A Veteran Stock Watcher, And Bear, Expects The Naz To Revive Soon

The tricky question here is what is sentiment? Is it bullish, is it complacent? Is it cautious or bearish?

Pick an indicator, any indicator, and you can make just about any case you want these days. Oh yes, and define what "market" you're talking about, please. Are you referring to the name brand averages that have been struggling, with very little success, to tread water all year, or to the broad market, as depicted, say, by the rank and file stocks' smart ascent as depicted in the NYSE advance/decline line? Or perhaps to the small caps, which have been on fire?

The trend, where is the trend? The complaint is getting to be darn near universal. Even hedgies with hair-trigger reflexes and average holding periods to match express frustration with a volatile market that seems to be moving in every direction—except towards those where they're positioned in search of profit. And that's well before they get around to lamenting the entirely lamentable geopolitical environment—from which the investors, like all other mere mortals, are lamentably uninsulated.

Enlightenment is clearly called for. Which is why I called on ***The Oracle***. Not the software company. I call him *The Oracle* because he's among the wisest of the wise I've had the pleasure to get to know on Wall Street. One of those truly rare birds who blends fundamental and technical market savvy, along with long personal experience in the hurly-burly of investment strategy with a seemingly inexhaustible supply of (un)common sense. But I also call him *The Oracle* because, now blissfully free of institutional entanglements, he has gone seriously private. Let's be clear. He's no less serious in his pursuit of both capital gains and market wisdom, just exquisitely picky about sharing. I was delighted when he took my call.

The market, as ever, is a puzzlement, he granted. And yes, the breadth statistics do seem to indicate that a lot of stocks are extended. But unlike the talking heads on the tube, *The Oracle* is not obsessing on which companies are going to announce unpleasant earnings surprise; not even over the latest atrocities in the Mideast. Even as the stocks sagged Tuesday, he opined: "I think the market is going to go higher in the short run. That is, the rally that started in February is not over. We had a new momentum high. More specifically, 25-week breadth and 10-day breadth and 5-week breadth *all* made new momentum highs. My point is that, usually, a move doesn't finish at peak momentum. What normally happens is that the market backs off from that point. Then goes up again and fails on a momentum basis. Only then then do you generally get a top. Now, it's not impossible for it to happen the other way, but it's rare."

Then came the real surprise. With so many stocks looking extended, I asked, where's the fresh burst of buying enthusiasm the aging rally needs going to come from? But I should have guessed. *The Oracle* is contrary to the core. So naturally he replied, "Look at the part of the market that has been not participating, has been lagging. Which, of course, is technology and especially Nasdaq technology. I think there's room for a surprise on the upside there."

Not a lot, he hastened to add. He's not expecting old favorite techs to suddenly emerge as new leaders. Just to play catch-up over the next month or so. The bad news is that he expects, "we'll have a market peak by the end of April, and then a corrective move of some kind, that will take some months to complete." Say, essentially, all summer, should seasonal patterns hold.

But it wouldn't knock The Oracle's socks off, either, it's the long-suffering techs that bounce most zestfully in the fall. "Nasdaq has gone through a major bear market since March of 2000," he points out, while the broad list has done surprisingly well—a mirror image of the schizo market that reigned for the prior two years. The Nasdaq made a low in September, rallied and then tested with a 50% retracement through February. A pattern the Oracle sees as a very close fit with those traced out by every other market he's looked at that had major bubbles followed by a crash. To wit: The Value Line in 1969-'70, the Nifty Fifty in 1973-'74, the oil and oil service stocks in 1981-'82, and the Japanese market in 1990-'92. All experienced giant waves down lasting two years and slashing 60% or more from the indices. And the Naz now certainly qualifies for that club.

The good news is that all of them (except, so far, the Naz) then enjoyed a heck of a bounce. "Value Line retraced 33% in 1970-'71; the Nifty Fifty, on average, retraced 50% of what was lost in the big decline. The oil service stocks retraced 40% and the Japanese market retraced just about 30%." It tickles *The Oracle's* contrary fancy. "Nobody expects the techs to take the lead now. Most of the fundamentals are being pushed out to improvement not coming until '03. There's not a lot you can say that would encourage most investors to believe in a tech rally—to me, it's perfect." And a brief April rally would only seal the disbelief. But then late this year, he suspects, "you start seeing higher lows and higher highs until you have had a retracement that's comparable to those earlier 30%-50% retracements of big declines." So somewhere in this next six months to a year, he's betting, there will be a very decent recovery in tech land, taking the Nasdaq back up as high as 2500, maybe even as high, on the outside, as 2800.

If you're of a delicate, and bullish, persuasion, stop reading there. Because *The Oracle* isn't. All of those post-bubble markets, he notes, died after their last gasp rallies. So he sees a long tech bear.

Which means that a schizo market will be looking better all the time,

EDITORIAL STAFF CONFLICTS AVOIDANCE POLICY DISCLOSURE

In keeping with Weeden & Co. LP's long-standing reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that our analyses reflect our best judgments, not merely our personal preferences nor those of our colleagues, sources or pocketbook.

Accordingly, all information gathered by a welling@weeden editorial staffer in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staffers and their immediate families will not trade any security mentioned in the journal for at least one week after publication. All editorial staffers of welling@weeden and/or their family members will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Securities positions entered into by welling@weeden editorial staffers and/or their families will be held for at least six months unless dispensation is received, under extraordinary circumstances, from Weeden & Co. LP's compliance officer. Any preexisting securities position in any company, mutual fund or partnership portfolio covered in welling@weeden will be specifically disclosed in that issue and that position frozen for six months from date of publication, again, absent extraordinary dispensation from compliance.

WEEDEN & CO. LP CONFLICTS AVOIDANCE POLICY

Weeden & Co. LP and/or affiliates or employees may hold positions or options in securities discussed herein and may effect transactions inconsistent with the research. This material is based on data from sources we consider to be reliable, but it is not guaranteed as to accuracy and does not purport to be complete. It is not to be construed as a representation by us or as an offer or the solicitation of an offer to sell or buy any security. Nor as a determination that a particular security is suitable for any client. Weeden & Co. LP does not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Opinions are subject to change. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP may make a market in securities mentioned.

Weeden & Co. LP is a member of the New York Stock Exchange and the National Association of Securities Dealers.