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VOLUME 8
ISSUE 6
MARCH 24, 2006

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listeningin

Gimme Credit–Spreads

Black Hole In Derivatives Documentation Casts Long Shadow On Markets

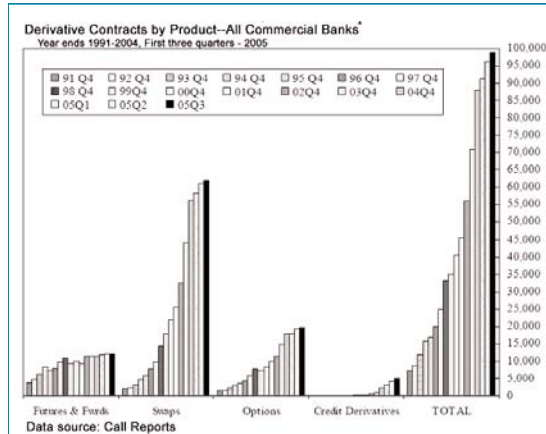
***Michael E. Lewitt** is the president of **Harch Capital Management, Inc.** (HCM), a Boca Raton money management firm that he co-founded in 1991 with fellow Drexel Burnham refugee, Joe Harch. Michael had been one of the junk bond firm's legion of investment bankers, while his partner had been a key figure on its trading desk. Already, 15 years ago, both men had spent professional lifetimes in the bond and high-yield markets. If that sound less than scintillating, consider that Michael's first career was as a tax attorney. For all of that, the wonder is that Michael is not only a savvy and articulate observer of all the nooks and crannies of the credit markets, he writes about them, in his monthly HCM Market Letter, in an engaging, lucid, opinionated and even literary fashion. Michael's topic, frequently of late, has been derivatives—his views on which (as he shared with me last Friday morning), should be required reading on the Street.*
KMW

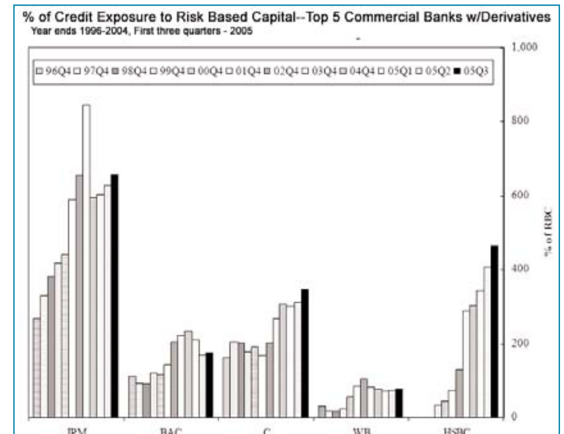
Did you see the story in the *Wall Street Journal* this morning [3/17] on all the mutual funds buying Iraqi bonds?
How could I miss it? They didn't come right out and say what I did about the Iraqi bonds in my latest HCM Market letter—that I "may have run across the world's dumbest investment"—but they sort of heavily implied it. I thought the story was pretty funny, actually.

The lead was pretty direct, for the *Journal*: *"Considering the strife bordering on civil war, this may not seem like the best time for mutual funds to put money into Iraq.*
***"But some are doing just that. Looking for high yields—and confident that oil reserves will be there to repay the debt—mutual funds are among the investors quietly buying small chunks of about $2.8 billion in bonds issued by the Iraqi government in January as part of its restructuring of debts left by Saddam Hussein."* ["*Mutual Funds Look Beyond Chaos in Iraq,*" *WSJ*, 3/17.]**
What I really enjoyed were all of the guys refusing to comment on what in the world they were buying. I mean, it's pretty imbecilic if you ask me. Why would anybody bother?

They're obviously stretching for yield.
That's for sure.

And mindless of risk.





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Published exclusively for clients of Weeden & Co. LP

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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 Stamford, CT

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Yes, it's crazy. Stretching for yield is the all-time dumbest excuse for buying something, ever. But it happens.

All too often.
Sure. There are reasons why, you know, these things have the yields that they do, but people tend to forget that.

The usual argument is that they're being exceedingly well-paid to shoulder the risk–
Well, these Iraqi bonds–which are unrated, by the way–were issued at enormous discounts to begin with. I'm telling you, a guy called me a week ago and read me his little squib–or not squib, but his half-page sales pitch. They were offered somewhere in the 50 range, so they've already traded down 100 basis points. Everybody who bought on the deal already has nice losses on these things. But who knows where they'll trade? It will depend on how bad it gets over there–which will probably be pretty bad.

Here's an idea. Maybe the Administration can save a little money by tracking the price of these bonds to find out how it's doing, instead of paying for a lot of fancy polls.
You mean maybe they could track the Iraqi bonds versus Hilary's poll numbers or something? I don't know. But the in the scheme of things, the Iraqi deal is small potatoes. Only $2.8 billion in face amount of the things were even issued. Not even a speck, versus the almost $100 trillion of derivatives outstanding. The whole thing is just surreal. I don't know what to say anymore. I feel like **Jim Grant** sometimes. Like all I am doing is pissing into the wind, if you'll excuse the expression.

You have developed a pretty curmudgeonly reputation on derivatives.
Well, yes–although, I'll tell you, this derivatives thing is funny. Sometimes I get some pretty heated mail; guys taking issue with my concerns. What I tell them is that it's not so much that all these back office problems with derivatives that I've written about recently are necessarily what is going to be the *cause* of a crash. It's that, if there is a real market dislocation or market sell-off, *what the derivatives are going to do is make such an event much worse.* Because that is when you're going to have a situation where people really have trouble getting a handle on their exposures. Then, they're going to start worrying about their counterparties–and since their counterparties in many cases are hedge funds, they really won't know what sorts of balance sheets they have. That's where the trouble is going to come–because that is the point when people start trying to sell first and ask questions later. That's the more likely scenario. It most likely won't be the fact that people don't know all their exposures that causes a major market dislocation. But once the market does encounter a problem–for whatever reason–the derivatives exposures are likely to exacerbate it quite severely.

No kidding. Even where market structures have been well-established for decades, back office issues always surface when there's a sharp market break.
Of course they do. They are real-time stress tests. Plus, of course, what will happen in that sort of situation is that the prime brokers (which all have been very aggressive) all of a sudden, get religion. You know, the Jamie Dimon's of the world will call downstairs and say, "Let's look at our exposures again," and then want to cut them. They are suddenly faced with a situation where they have to start raising their credit standards overnight. So they start pulling lines from people. And it's not quite so simple when you're pulling credit lines from people that you have open trades with. But that's clearly what will happen. That's the *normal* course of events in a significant market correction. So there will be the normal market back office problems plus there will be lines pulled, and there will be all of the added uncertainty about derivatives exposures–and all of a sudden you will have a real old- fashioned mess on your hands.

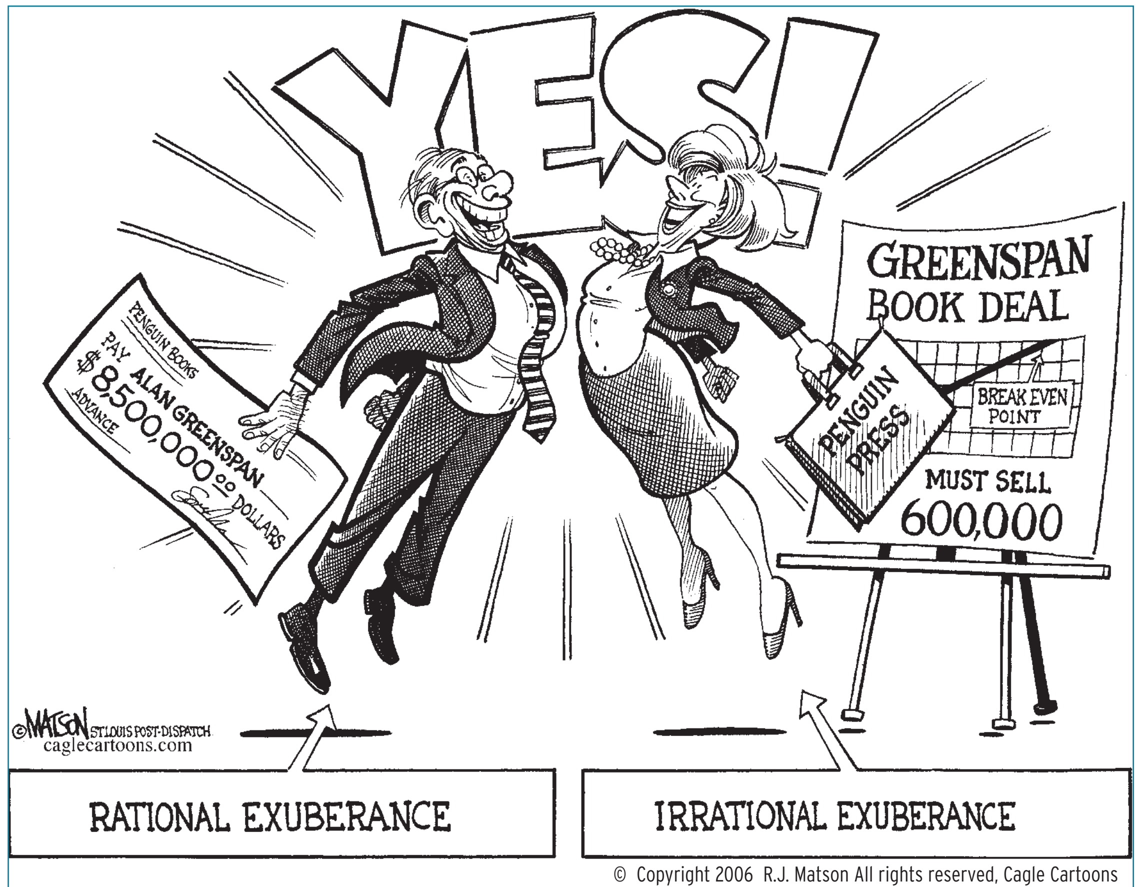
"The Jamie Dimon's of the world will call downstairs and say, "Let's look at our exposures again," and then want to cut them...And it's not quite so simple when you're pulling credit lines from people that you have open trades with."

I can't imagine how long it would take to sort it all out.
Well, the number of open trades in the derivatives markets is really mindboggling.

What is the number?
Hold onto your hat. As of last September 30, the number of trade confirmations outstanding for more than 30 days stood at 97,000. Assuming an average trade size of $5 million, this means that trades with a nominal value of $485 billion, in the words of the *Wall Street Journal*, still "lacked detailed confirmations–a problem that has left banks and brokerage firms uncertain who owes what to whom." Even if we give the market the benefit of the doubt and cut the average trade size in half, the number is mindnumbing.

But hasn't good progress been made on whittling down that number since the Fed rapped the banks knuckles last fall?

Well, the Fed did seem to take heart in the fact that more than 30% of those trades had been cleared by the end of January. But what else *could* it do, panic? That's not really a rhetorical question, because that means "only" $340 billion of open trades are on the books today. The banks' stated goal is to have less than 30% of the September 30 volume of trades still open as of June 30, or a mere $145 billion. At that point, I guess we can all go on vacation.



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The thing is, it's not as though the problem is only that the sophistication of Wall Street's back offices is just catching up to this kind of financial technology. I mean, derivatives are *much* more sophisticated instruments than bonds and the legal sides of these contracts are still not fixed in stone. They're still working out some things. It's very much still a developing business and a developing area of commercial law. The problem is that it's like an adolescent who has grown to be six feet tall by the time he's 11 years old. He hasn't grown into his body yet. So he is always tripping over his own feet. Yet people look at him and think, "Well, gee, someone that big should be able to do all sorts of things." But he can't. That's the derivatives market. It's not really ready to play in the big leagues. Its infrastructure has just not caught up with its size. Which is why it's potentially a big problem. I grant you, it hasn't been one *yet*, but only because nothing has really gone wrong in the markets.

Yet I've often heard the opposite argument— that the existence of derivatives has actually helped the market cope with shocks.

Well, I obviously disagree with the conventional wisdom on Wall Street, where derivatives are frequently described as the panacea for the world's every ill. And I'm not the *only* luddite out there on this. **New York Federal Reserve President Timothy F. Geithner** recently gave a speech to the Global Association of Risk Professionals (a really fun group,that) in which he said bluntly that derivatives: *"have not eliminated risk...[and]...have not eliminated the tendency of markets to occasional periods of mania and panic. They have not eliminated the possibility of failure of a major financial intermediary. And they cannot fully insulate the broader financial system from the effects of such failure...And there are aspects in the latest changes in financial innovation that could increase systemic risk in some circumstances, by amplifying rather than dampening the movement in asset prices, the reduction in market liquidity and the associated damage to financial institutions."*

Yikes. He obviously forgot to equivocate like a good bureaucrat should. Still, Wall Street seems to have recent history on its side. It's been a long time now since a financial accident put the whole system a risk—and that used to happen, like clockwork, in every cycle.

Well, last year was the first time that the credit markets had to deal with several large "real world" defaults by companies whose credits were active targets of speculation in credit derivatives: Collin & Aikman, Delphi Automotive and Calpine. None of them caused a market blow up, though you did see last year, when GM and Ford were suddenly downgraded, a pretty short-lived market reaction. But it was a non-event compared with what would happen if one of them actually defaulted *suddenly*. Now, I think that's unlikely, because if GM or Ford really had its back to the wall, the regulators and everyone else would get in there and try to at least forestall the default for long enough to give the markets time to adjust in a relatively orderly fashion.

You really think that sort of failure would play out in slow-mo?

Every effort would be made to try to have it happen that way–to adopt a Japanese style of failing–because it would be too dangerous to the system to have it fail the other way. Then again, I have to admit, Calpine failed pretty quickly–or at least faster than people thought it would–but even so did not cause a huge problem. The market evidently was able to handle it. But in part, as I pointed out in that piece you reprinted in your last issue **[Guest Perspective: *Over The Rainbow*, W@W, 3/10]**, because a cash settlement mechanism was quickly established and an auction held to deal with the fact that

Russian Roulette — Part I

Cumulative Default Rate for Caa-Rated Bonds

	Cumulative Default Rate													
Cohort	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1992	26.7	32.1	32.1	40.1	40.1	52.1	52.1	52.1	52.1	76.0	76.0	76.0	76.0	76.0
1993	28.6	28.6	42.2	50.4	50.4	50.4	50.4	50.4	75.2	75.2	75.2	75.2	75.2	
1994	5.1	13.8	24.3	24.3	24.3	30.9	30.9	56.0	56.0	56.0	56.0	56.0		
1995	12.4	21.0	21.0	26.8	33.9	38.7	64.5	73.4	73.4	86.7	86.7			
1996	14.2	20.5	27.9	41.4	47.4	67.6	72.6	72.6	86.3	86.3				
1997	14.9	27.7	40.3	50.9	73.1	77.2	77.2	77.2	77.2					
1998	15.2	31.6	41.3	62.9	67.7	71.8	74.3	74.3						
1999	20.4	31.5	53.0	59.3	65.7	70.3	70.3							
2000	20.0	43.6	54.4	61.6	67.2	68.2								
2001	34.2	46.6	57.7	63.0	64.9									
2002	30.2	43.8	51.9	54.6										
2003	21.8	34.6	37.1											
2004	12.8	19.8												
2005	8.3													

Table shows cumulative default statistics for companies with a senior unsecured debt rating of Caa as of Jan. 1 of the years in the far left column. By reading across, you can trace the unhappy accumulation of defaults in Caa-rated bonds.

Source: Harch Capital Management and Moody's Investor Services, "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance, 1920-2005," January, 2006.

there were probably 10 to 15 times the volume of derivatives outstanding as there were cash bonds that otherwise would have had to be used to settle those outstanding Calpine derivatives contracts. But who really knows? There are so many open derivatives contracts that it's hard to know who really took the hits. It's entirely possible that maybe there *still are* problems out there, but no one knows it yet, because they haven't closed their books.

It almost sounds like you're sorry the world didn't end—

Hardly. But at the risk of repeating myself, let me stress my strong belief that credit derivatives have been a major enabler of the current credit bubble. The advent of credit derivatives freed speculators from the constraints of the cash bond market, enabling them to place bets on individual credits—regardless of the amount of debt actually outstanding. So credit has been able to grow without restraint. And coming after the leveraged buyout boom of the 1980s and the CDO boom of the 1990s, offering credit derivatives to hedge funds has been like offering alcoholics a nightcap. Today, an investor can speculate on a company's debt even if 100% of that debt is already spoken for by other lenders. A contract is written that simply refers to that debt, and an entire parallel universe of obligations is created that mirrors what happens in the so-called real world. What's especially troubling is that as this parallel universe of credit derivatives has grown to be *much* larger than the physical universe of bonds on which it is based, it has shifted the whole balance of economic power in what used to be called the less-than investment grade *bond market*. It is now much more apt to refer to the less-than-investment grade *credit markets.* And in this brave new world, it is the larger and more liquid credit derivatives market "tail" that is wagging the valuation of the cash bond "dog."

So things have changed. But didn't coming up with the procedure to settle derivatives in cash go a long way towards resolving worries about all this magnifying systemic risk?

Again, that's what Wall Street's propaganda machine would like you to believe, because anything that increases trading volume is by definition "good" for the Street. My worry is that it's not so simple to wash away systemic risk with cash settlement and let the markets write derivative contracts in whatever volume they choose. As **Bill King** pointed out in M. Ramsey King Securities' *The King Report* [February 15, 2006], physical settlement acts like a regulator and moderates speculation. (Imagine how Brobdingnagian the derivatives market would be by now if it had had cash settlement from Day One!) The upshot is that although cash settlement *seems* to reduce systemic risk by solving the settlement problem in the event of a large default, it actually *increases* it, by encouraging speculators to believe that the system is foolproof, or nearly so. In other words, it adds a fresh moral hazard to the system and encourages still-greater volumes of speculative activity.

Perhaps we'd better back up a little at this juncture and explain to anyone who isn't familiar with you that you were being entirely too self-deprecating when you entitled your latest missive, "A Luddite's Lament."

Well, it's actually funny. I started out writing that letter thinking that I was going to call it, "The World's Stupidest Investment," but as things developed I only wrote one paragraph about the Iraqi bonds. What else could I say after noting that today's investors—doyens of credit risk that they are—have decided that a spread of less than 500 basis points over Treasuries is sufficient return for assuming the risk of Iraq meeting its financial obligations over the next two decades? I mean, I did throw in that I was sorry to have missed the roadshow—it was probably the first in history where flak jackets were required. So what else could I say? Then I found the speech that I quoted by Mr. Geithner, which just sort of took over the newsletter because, if nothing else, it suggests that the derivatives problem has hit the radar screens of regulators—the people who will be charged with cleaning up the next financial mess when—not if—it occurs.

What I was getting at is that neither you nor your partner are exactly innocents abroad in the credit markets—

No. We've been in the business of managing money in the credit and equities markets as Harch Capital Management since 1991. And my partner, Joe Harch, was a very senior guy at Drexel. [Head of Drexel's junk sales in 1988-1990.] He's actually the guy who replaced Mike Milken on the trading floor after Mike left the firm. Anyway, both of us have been involved in the high-yield mortgage market since the 1980s. I got involved back in 1987. What that perspective permits me to say is that the market today is just a completely different market than it was.

Because?

Well, the biggest thing that has happened over the last five years is the incredible growth in the credit default swaps market, to the point that, as I mentioned, the credit default swap market has become a gigantic tail that is wagging a stunted cash market dog—and enabling the credit bubble. The other major change in the market has been the NASD's imposition of the TRACE [Trade Reporting and Compliance Engine] on the corporate bond market in July 2002. The system was designed to capture and disseminate consolidated trading information on all over-the-counter transactions in publicly traded investment grade, high-yield and convertible corporate debt—which it does. There's no doubt that it has greatly increased transparency in the market for corporates—but it has also vastly diminished trading activity in the cash bond market. As you know, the high-yield bond market was basically unregulated for many years, but with TRACE, it essentially became much more regulated, which really slowed activity in the cash market. In fact, I think it was an important factor in pushing people into the credit default swaps market, which is unregulated and where people can

trade in size, because it is much more liquid.

Maybe I wasn't paying attention, but I never focused on the introduction of the TRACE system in the cash market as something spurring the growth of derivatives.

I'll tell you, a lot of veteran traders left the market after TRACE started. We had a guy here who just said, "This isn't worth the aggravation." It just makes it much harder to simply day trade bonds or to trade them on a short-term basis because everybody can see what's going on. A lot of guys who made their livings from exploiting short-term inefficiencies in the market found that they were no longer available the way they used to be. That was sort of the coup de grâce. After all, cash bonds historically had been very illiquid. Dealers were not reliably making markets in bonds, for years and years. And now you have a situation where guys are able to go into the derivatives market and do what they used to do, more readily. They can trade bigger pieces and trade without a lot of transparency. The CDS market is a true private, unregulated market. You can see it's unregulated by the fact that there are hundreds of billions of dollars of trades that have not been booked in a timely manner. It's a little bit of a black box, as well, meaning it has taken guys a while to figure out how to value these things and everything else. There are all sorts of methodologies, basically because CDS can be a lot more flexible than cash bonds. You can do a lot of different trades involving arbitrage strategies where you have the CDS on one side of the trade and you have bonds on the other side. Or you can have equities on the other side of the trade. Or options, and so on.

Or even a synthetic of all of the above, I gather—

Sure. You could have all kinds of wild stuff; it's very quantitatively oriented. The only things that there aren't a lot of credit default swaps written on are the many smaller cap, medium-cap deals, in CCC, single-B names, the sort of one-off LBOs, the companies that just have one or maybe two issues outstanding. So somebody who wants to short that part of the market, for example—and we have clients who do this—has to short the cash bonds. And you can do that. But in the much larger double-B market, the triple-B market, the large-cap Bs and the large-cap triple-Cs, things like Quest, Charter Communications, Calpine (before it went bankrupt), that whole sector of the big-cap troubled stuff, there is tons of CDS activity. On Dana, Delphi, before they filed, that kind of stuff. So the CDS market has played a huge role in allowing people to take positions on the direction of individual credits. But at the same time what the phenomenal growth of this derivatives market really has done, in my view, is take fundamental credit analysis out of the valuation process. It has taken fundamental credit analysis out of the determination of what credit spreads should be.

Which is how we get Iraqi bonds trading within 500 basis points of Treasuries?

Yes, exactly. Although I don't know anyone writing CDSs on those. It's really why low-rated high yield bonds, which in the 1980s and early 1990s offered mid-teen coupons plus warrants to bring total (hoped for) returns into the high teens and low 20s, today are sold with single digit coupons and no warrants—even though they are arguably riskier today on a fundamental credit basis. Here's maybe a better example than the Iraqi bonds, from a trade we looked at some time ago. People were doing trades involving Allied Waste CDS and Allied Waste stock. The explanation we were given was that because the stock was somewhat volatile within a range, that was affecting the spread on the Allied Waste protection, making it priced wider than we thought it should have been based on fundamental analysis of Allied Waste credit. Which seemed to create an opportunity—you were getting paid more for selling the protection than we thought accepting the (minimal) credit risk of Allied Waste defaulting was worth. You were basically getting paid extra because there was a popular trade in the equity which was volatile enough that people thought they needed protection against more than default. In other words, there were non-credit factors determining the pricing of a credit default swap—and creating opportunities because credit was being mispriced. Now, it happens that in the example I just gave you, the credit default swaps were priced on a wider spread than one would think was necessary based on credit fundamentals. But in general the mispricing goes the other way. You have spreads that are much tighter than credit fundamentals would suggest. But you are right now still in a very low interest rate, low default rate environment, especially on the longer side of the curve, and until defaults really pick up, I don't expect a lot of spread widening. Defaults are what it's going to take to shake up the less-than-investment grade market. For now, we don't have an economy that is pushing companies over the edge, other than in industries like autos, where the actual business model is broken. And even there, it looks to me like **General Motors**, trading at about 600 or 650 over, which is a spread which is too tight for the risk of a company that is going to have to restructure in bankruptcy at some point within the next five years. That is certain, in my book.

I wouldn't bet against you.

I just don't see how there's any way GM can avoid it. The spreads are too tight, but it is hard to bet against it when you have such low default rates that people still aren't worried about getting paid back.

Aren't the narrow spreads partly a result of credit investors shortening their investment horizons, much like equity guys have? The emergence of so many hedge funds that define a couple of days as long-term? I mean, default rates may be low now, but over a cycle history says they'll go to the moon on junk bonds.

Sure, investment horizons in everything have shortened. But, listen, there is a reason why bonds are rated Triple-C—because they are really crap. It's no mean achievement to be triple-C. A company has to have *a lot* of problems. They are typically seriously undercapitalized, have minimal retained cash flow in relation to debt, modest interest coverage, high multiples of debt to cash flow, a thin returns on assets and questionable managements—and those are Moody's descriptions, not mine. So you would think it's probable, over a reasonable economic cycle, for many of those junkyard dogs

Russian Roulette — Part II

Cumulative Credit Loss Rates for Caa-Rated Bonds

Issuer Weighted Senior Unsecured Rating	1 Year	2 Years	3 Years	4 Years	5 Years
Baa	0.19%	1.67%	1.99%	2.12%	2.70%
Ba	1.58%	3.50%	4.80%	4.80%	5.70%
B	9.32%	19.66%	25.93%	28.92%	30.90%
Caa-Ca	34.23%	46.64%	57.68%	62.97%	64.94%

Table shows 5-year cumulative credit loss rates for Baa-Caa bonds. Risk increases significantly when one moves from Ba to B and then from B to Caa or below.

Source: Harch Capital Management and Moody's Investor Services, "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance, 1920-2005," January, 2006.

to fail. And indeed, that's what these [nearby] tables show. But I also think spreads are so narrow today because there is so much liquidity out there and the private equity firms that own a lot of these credits can put more money into them to keep things from going south. So getting a flurry of defaults may take a little longer than it has in the past. And I don't see investors in any market looking out that far. Look at the oil situation, for instance. We have a trading-oriented fund, what we call our best ideas fund, that has been very active—and has done very well—in the oil stocks. Joe is an expert in oil; back in the 1980s he did tons of investment banking in the oil sector. What I am getting at is that if you look at the long-term picture for oil, you have to be very concerned about the fact that oil prices are going to stay high on a sustained basis. Yet, if you look at the activity in an oil stock like **Valero** (VLO), which has bounced between $48 a share and $63 this year so far, you can see that its volatility has nothing to do with the fact that Valero is the company best positioned to refine heavy crude. No one is looking to that. People are looking to what the crack spread is or what the price of oil is for the next 10 minutes, or what's going on in Iran in the next 10 minutes, or who's blowing up Nigerian pipelines this weekend. Everything is short-term, and that's true in the bond market also.

Well, if a pick-up in defaults isn't an immediate threat, I suppose all the bond jockeys expect to be able to pick up what extra return they can in junk now, and get out before the roof caves in.

That's it. And it really is hard to be worried that by the end of the year default rates will be 5%. They won't. Will they get there by the end of 2007? That's probably a stretch, too. So people don't feel they need to worry about defaults. That seems like worrying about a meteor from outer space.

Yet you're clearly concerned that we're heading into some sort of storm? And that derivatives will play a role—

Again, I'm not expecting a derivatives blow up in the CDS market to be what kicks it off. Derivatives could very well make whatever happens worse, but something else will set it off. Possibly a political event, or geopolitical event. Maybe a financial institution's exposures get out of whack—and that could involve derivatives. That would not be an impossibility. But you never know what, until it happens. As a fellow I was talking to yesterday said, we're in a situation where if you catch a cold, you'll be the victim of pneumonia. What he was saying is that the regulators are in a situation where they can't let anything go wrong. So he feels that every effort would be made to step in and try to avoid a **Continental Illinois** or a **First Executive** or whatever. And I think to some degree that's true. If there is an area where the biggest risk is, it's clearly derivatives. Not only is there the huge back office problem we discussed, but so many of them are written with hedge funds—which are not inherently stable entities. In many cases their capital bases aren't stable. If your counterparties don't have stable equity bases, stable investor bases, that's where you could run into trouble.

So you really do see a possibility that derivatives cause a blowup?

I guess I'm talking myself back into thinking that the derivatives markets could be the source of systemic risk, unexpected risk, inside a financial institution. Now, the guys who run **JP Morgan Chase** and **Deutsche Bank**, etc., these are all very smart guys. Jamie Dimon is very, very smart. But, you know, he's all the way up there at the helm of JP Morgan Chase and the exposures are massive and *each* exposure is a very complex financial equation. Not to mention that there's a huge distance between the 30-year-old kid who's managing that equation and the Chairman of JP Morgan Chase. That is an issue. There is no way the guy on top can know everything that's going on and we've seen before what can happen, so that's the risk. I'm not suggesting that they're not addressing it, because I think they are. I'm suggesting that the market grew so fast that the infrastructure fell behind and so they're having to try to play catch up before there is an accident. And the thing that I've only recently discovered is that all those gigantic numbers I quoted earlier on how far behind the banks are in closing open derivatives contracts assume that they're keeping up in real time with all of the trades they're doing currently. But that's a huge assumption, given the growing volume of current trades and backlog of 90,000 trades they have to catch up on. We're talking about a Herculean task. I mean, the banks would have to have people in all day every weekend for a year to get that done—and not just the banks, but all of the counterparties.

Shades of the '60s, when back office problems forced the stock exchanges to curtail trading and work weekends to clean up paperwork snafus.

The thing is that this time around, having been through inspections myself, I don't think the SEC staff is going to be very happy when they see all these uncleared trades. Especially now that they are starting to inspect hedge funds. I mean, they don't like it when they see trade corrections when they come in. You know, when they see that you rebooked a trade, or that there was an error, you sometimes have to do a lot of explaining to the SEC staff about what happened. "There was a mistake. A trade went in the wrong account, so here's the mistake and here is where we rebooked it." It looks like very sloppy practices to the staff when they see that stuff. So what do you suppose they'll think when they see all of those unclosed derivatives trades? Certainly not that they are the result of good ways to keep books and records.

Yet the regulatory response, so far, to all those unclosed trades has been manifestly low-key.

True. I don't know what the Fed or other regulators are holding over the banks' heads to get them to address the unclosed trades problem, but it's pretty amazing how understated the feds' efforts have been so far. I mean, can you imagine what would happen if they walked into a brokerage house and found that many unsettled stock trades! Come on. they would close that firm down in a nanosecond. The NASD would go nuts, as they should. I mean, they cite you for minor discrepancies, which is their job. So it just seems to me that the regulators, so far, just aren't being very aggressive about cleaning up the back office mess in derivatives.

"Not being very aggressive" is quite an understatement. But doesn't that really go to a point Jim Grant keeps making—that the derivatives powerhouses are too big to fail?

Exactly. What are the regulators going to do, fine everybody, close down everybody? You can't do it. It's the **Donald Trump** syndrome. The guy owed the banks too much money for them to call the loans, so they gave him an allowance. It's the same kind of thing. But it is very problematic when you see what they do take regulatory action on and then when you see something like this. Now, no one's suggesting that anybody had any intent to do anything incorrect in participating in the derivatives markets. But at a certain point when you see banks keep writing contracts, even though they know that there is a back office problem—and without catching up on their backlogs of open trades, you have to wonder what the regulators'

proper approach is. If something is too big to fail, but you keep letting the problem grow, it's just getting bigger, I don't know what you're doing to help anybody.

Another aspect of all this is that the big banks' exposures to derivatives now are so huge that even a relatively small percentage change in the presumptive profitability of that business could wreak havoc—

That was why it was so interesting when Jim Grant pointed out the CDS on JP Morgan Chase was going for like 20 basis points, down from 100. If credit default protection is selling at just 20 basis points that means no one is worried about defaults being a problem at JPM. I mean it seems like an awfully bad trade to me to only get paid 20 basis points for assuming default risk in JP Morgan —not because JP Morgan is going to go bust. I don't think it is. But if you are only getting paid 20 basis points, why bother? I don't see any upside to that trade at all, but I see a lot of downside. In fact, it's just another sign that no one is concerned about this unclosed derivatives problem, just like nobody is concerned about the "New Bank," or anything else.

It's the Alfred E. Neuman market, what else is new?

It is. Or it is still the Goldilocks market. In fact, I think the Fed will keep raising interest rates—and that it should—not because inflation is such an issue, but because *speculation* is such an issue. It's the only way for them to try to deal with it. But in that case I can see the short end continuing to go up, while the long end really doesn't move very much, because there is money, money everywhere. I mean, long rates are going to get to be 5% and a little higher, but people are just very complacent. What really scared people four or five years ago was that a WorldCom and an Enron came out of nowhere, so you couldn't trust anything. That their investment grade ratings didn't mean anything was shocking. But now no one is scared of anything—I don't even think many are scared about Iran having a bomb. It's a matter of the climate. It's a matter of timing. Right after Enron, everybody was calling for CEOs' heads and now everybody's calling for Sarbanes-Oxley to be repealed. We've gone from having Bill Donaldson at the SEC to Christopher Cox and we have a different environment. The fact is that you go from one extreme to another—not that Cox is the opposite extreme of Donaldson. I think Cox is just a little more pragmatic. But there's no consistency coming out of Washington and that's a big problem. That's why, when you see the regulators taking a pragmatic approach to the derivatives market because it's "too big to fail," it's problematic. The little guy who is not too big to fail gets squashed if he is, you know, jaywalking. That's just classic, but that's the way it is.

Well, what would you suggest the regulators do instead?

What they *should* do is put some teeth into their push for the market to clean up all the unclosed derivatives contracts. They could put some financial penalties in effect, if the banks don't clean this mess up expeditiously. If they said that they'd have the job 70% done by June, but are behind schedule when June rolls around, then you fine them.

Fine them?

I'm not talking about a token fine. Make it really cost them. I mean, that's really all that Wall Street listens to. You'd have to impose substantial penalties, otherwise the banks would merely treat any fines as a cost of doing business. That is really all that the regulators can do—other than trying to limit the growth of the derivatives market, which really would mean interfering with market mechanisms—and so that's a troubling thought. So imposing some substantial penalties until they get the open contracts cleaned up is my best idea. Of course, you'll always have a certain percentage of unclosed trades. But the amount that is outstanding currently is just way too huge. Hundreds of billions of dollars of face amount of unclosed trades. Wall Street firms are reporting record profits. The government has a record budget deficit. If the banks don't reduce their outstanding open trades by a certain amount by a certain date, then they should have to pay a certain huge amounts of fines. Let's make them pay up. And not just the banks and brokers.

Who else then?

Their counterparties have to do their part, too. They have to step up. I mean hedge funds and so on, if they're charging 1 and 20 or 2 and 20, they have the wherewithal to hire more people to get this done if they have to. On that score, when the SEC goes in to inspect the hedge funds for the first time, instead of worrying if somebody has the right address typed on every page of somebody's ADV, or if the pages are numbered correctly or the other Mickey Mouse stuff that they spend time on, they need to focus on what's important. They need to focus not only on the substantive stuff in the inspections, like whether fraud is being committed and whether clients are being cheated, but they also need to focus on whether people are living up to their systemic obligations, such as doing everything possible to make sure that their trades are being closed. That's the kind of stuff that *can* be done. I mean, regulators should focus on what's important rather than that try to cover everything.

Even if crossing all the Ts and dotting all the Is in a derivatives contract is just about as exciting as filling out batches upon batches of forms ADV?

No one ever said this stuff is fun. But people need to know who their counterparties are. The process can be very cumbersome for everyone involved. But if it's not done, and there's a problem, it will create at least twice as much work and twice as much disruption. Probably more. From a regulatory perspective, it's a problem that can be solved, the banks and the funds just have to roll up their sleeves and get their elbows dirty to do it. Frankly, as a hedge fund, we have to get our elbows dirty and make sure all our trading practices and procedures and are not only in place but practiced every day. Everybody has some open trades or DKs or whatever. You've got to follow-up, you have to have procedures to clean them up. This has gotten totally out of hand. If they don't do something, how can anyone trust their numbers? How can they manage risk, or value their holdings? How can their auditors sign off if they have, say, 15%-20% of their trades open? That would certainly concern me, if I were an investor looking at a fund.

I can think of a few other questions. With all those trades hanging open, how can they really figure out what sort of hedges they do or don't have on? Or is one of the advantages of leaving lots of trades unclosed a rather miraculous ability for each side of the trade to claim it's profitable?

Well, you're right. If you don't even know who your real counterparty is, how do you know if you'll ever get paid? How do you know that what you have on your books is really true? Everybody can say they're profitable and no one knows what the hell is going on.

Another reason derivatives have become so profitable. They're

the perfect instruments: Private, liquid, and "loss-proof".

Well, let me say this, at the very least, this is a very interesting time for investors, because we have these massive market phenomena like derivatives; we have these global phenomena like globalization and the emergence of China and India and all that stuff– and in the meantime everybody is trading like the devil every day. People are frenetically trading on the next ten minutes' news while these truly massive global forces are reshaping our world and it is very bizarre. It's like there's a disconnect between all this essentially meaningless activity in Wall Street and the really important stuff. What's amazing to me is that as an investor in this market, you're one day up, one day down, one day up, one day up. There's no reason for anything. A lot of days you're just being buffeted in the wakes of hedge funds that simply day trade. That is what has been making the market so frustrating.

I noticed you actually said some positive things about the Japanese market recently.

It's shocking, but the Japanese market actually seems to be better. It actually seems to be coming out of its long coma. And that is a huge change, assuming it's sustainable. It will change everything, globally– interest rates, currencies, everything. Some of the smartest guys I know have been telling me for a couple years that Japan was turning the corner and that they really felt it was the place to be. And they seem to be right. Nonetheless, it's still a highly phony economy. It's a totally manipulated. But they have changed their ways enough that the country finally seems to be doing better–even conceding that a lot of their growth is due to demand out of China. Though obviously, what happens with China will have a major impact on Japan's recovery. Anyway, I bought some EWJ, which are the iShares, the Morgan Stanley ETF on Japan, just because some of the research shows that when you shift from deflation to inflation–or to no deflation–that's the beginning of a great bull market. So I figured I'd give it a shot. I haven't lost money yet. That's a rarity for me in my personal investing so I'll take it. The only thing I ever did right in my personal portfolio was that I locked in the mortgage on my house on the absolute low tick on the 10-year.

Okay, so what are your best professional investing ideas here?

Honestly, in fixed income, there's almost nothing to go long. We're short triple-Cs and Bs that are tight spreads. First lien, secured, real bank debt is about the only thing we like on in fixed incomes. The other thing that is not horrible is a money market or the three- or six-month bills. They're paying over 4.5%. That's not the end of the world. To be more precise, this morning the three-months are paying 4.61% and the 6s, 4.78%. The one-month bills are paying 4.48%. Just for comparison, you'll love this, the 10-year is paying 4.67%. So you tell me, what do you want, the six-month bill at 4.78%, or the 10-year at 4.67%?

Gee, that's a tough one.

Well, listen, there are a lot of things in the equity market, both long and short, you can do here. But in fixed income, nothing. When you look at the world, Japan's interesting. Taiwan's interesting. Asia is interesting still. India is interesting. The U.S. dollar is a short, in my view, against all those countries' currencies and is still a short against the euro. In European fixed income, the spreads are too tight, but floating rate bank debt is okay. You're not going to get hurt. You earn, 5, 6%, because you earn Libor plus 150 to 250, depending on how much risk you take. But that's it. Because your normal, traditional high-yield bond is not paying you enough spread and I'm not one of these people who think you should necessarily be buying short GM paper, because GM is going to have to restructure at some point and all the unsecured debt is going to get crushed. The whole industrial business model of the United States has to change and it's going to be enormously expensive and enormously painful and enormously difficult and no politician is prepared to accept that or deal with it, but the longer we wait, the worse it's going to be. I'm not saying you have to deal with it *all* now in terms of taking all the pain, but you have to come up with a plan that over the next 20 years is going to deal with not just the companies, but with energy policy, pension policy, healthcare policy. Everything. GM is a microcosm of all the economic challenges that face this country. It's going to take leadership to deal with it because these are serious problems that have to be solved. And our system of government, while it's probably the best system out there, just is not well-designed to deal with these very difficult issues. The unions, meanwhile, are dinosaurs. They cannot be part of the solution anymore unless they change their thinking. And I don't take any pleasure in that. I don't have anything against unions, but they're going to dig their own graves, and the graves of a lot of other people, if they don't wake up.

Hope you're not counting on Washington for leadership–

No, it's pathetic. You saw the Supreme Court hearings and the rest. The problem is that we have a really weak President now, and an opposition party that obviously can't get out of its own way. I mean, I'm waiting to hear one decent idea from the Democrats. I'll grant you, I'm pretty conservative but I think we could throw all of the politicians and bureaucrats out just close down Washington for a year–and nothing would happen. I think things would be actually improve. Especially if we sent them all down to the Gulf to build houses.

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