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By John Mauldin

The markets rebounded strongly this week, bouncing off a 10% drop in the previous weeks. Is it a signal of renewed economic vigor? Or is it a dead cat bounce? This week we take a look at problems at the edge of the economy which threaten to derail not only the recent robust growth (at least in the statistics) but also the markets. And we start with a personal story which I think will help us understand the current situation. Stay with me here.

A Thanksgiving Fire Drill

Last Thursday, we sat down for a massive Thanksgiving dinner at my 21st floor apartment in Dallas. All seven kids, my 90-year-old mother, and an assortment of friends and relatives (about 15 of us) started to work on a 16-pound prime rib, 18-pound turkey, and massive amounts of potatoes, mushrooms, and lots more. Grace was said, the wine was poured, and we were feeling good about life.

And then about 15 minutes into the meal, the fire alarm went off, telling us to evacuate. This was annoying, as it seemed like we have had a false alarm at least once every few weeks in the past few months. So, we did what we have done in the past and ignored the alarm. After all, this is a modern structure (only 4 years old) with fire sprinklers everywhere. We assumed that someone had a grease fire in their kitchen that would quickly be put out.

But the alarm kept sounding quite loudly, which did tend to interrupt conversation. As my dining room table is near the floor-to-ceiling window, we tended to look out when we heard sirens. And sure enough, the fire truck pulled up alongside the building. “Good,” we said, “they will get that grease fire under control.” And we continued eating and drinking, although with a heightened sense of concern. Fires in apartment buildings are not to be taken too lightly. People do die from them.

And then a second and a third fire truck parked underneath the window. That was a tad disconcerting, but surely they were just making sure that there was adequate back-up. It was when the 8th truck pulled up within a few minutes that I began to get more than a tad concerned. They were pulling hoses and running around very quickly.

At that point, we started trying to figure out how to leave; but how do we get a 90-year-old fragile lady down 21 flights of stairs? We spent a moment pondering that, and then my youngest son came back into the apartment to report that he could smell smoke a few floors down in the stairwell. Well, that was not good. #2 son said to come to his window at the back of the apartment, where we looked out and could see a rather significant amount of smoke coming from the 2nd and 3rd floors. No, this was not good at all. No one was panicking, but we began to think about how to get us down the stairwell and soon.

And then I got a call from a friend who was late coming to dinner. "The fire marshal told me that you have to get out of there NOW!" All this in just a few short minutes, mind you.

So, we started to move to the stairs. Fortunately, there were two rather big, strong young men at dinner (one was my oldest son and the other was a boyfriend who was just back from a tour in the army, but both chiseled out of granite). After several attempts, we decided that taking mother down piggyback would be the best. The young men took turns carrying her.

At first, I still thought it was overkill, but as we got to the 16th floor the smoke in the staircase was very apparent. By the 12th floor it was hard to breathe, and at the 7th floor the smoke was too thick to go on. One of the kids opened the hall door and went and checked the next stairwell, which was freer of smoke. So we changed exits and got out to the street, smelling of smoke – but we were all safe.

It seems some idiot must have tossed a cigarette down the trash chute and started a fire in what is a rather large trash collection bin for hundreds of apartments on the bottom two floors. The fire should have been contained, but the concern was that if anyone had left a trash-chute door open, the fire could have easily spread to a higher-level floor.

And what about the modern fire sprinklers in the trash collection area – the ones I was relying on? They inexplicably did not go off in the trash bin, allowing the fire to blaze on garbage and grease, but the heat rising set off the sprinklers in the trash chutes on higher floors, causing a lot of smoke as the water fell onto the trash, with the smoke escaping into the stairwells.

But all was not lost. It seemed that three of us grabbed a bottle of wine as we left! ("Train up a child in the way he should go…") So, we sat outside and waited, sipping on a brilliant chardonnay and a full-bodied cabernet for an hour or so until the very professional firemen cleared the building of smoke and let us back up, where we finished dinner, with lots of stories to tell. And my middle daughter had her ten seconds of fame, as she made national news. It was more excitement than any previous Thanksgiving, and one we will talk about for years.

The Financial Fire Trucks Are Gathering

I rather think the stock market is acting like we did at dinner. When the alarms go off, we note that we have heard them several times over the past few months, and there has never been a real fire. Sure, we had a credit crisis in August, but the Fed came to the rescue. Yes, the subprime market is nonexistent. And the housing market is in free-fall. But the economy is weathering the various crises quite well. Wasn't GDP at an almost inexplicably high 4.9% last quarter, when we were in the middle of the credit crisis? And Abu Dhabi injects $7.5 billion in capital into Citigroup, setting the market's mind at ease. All is well. So party on like it's 1999.

However, I think when we look out the window from the lofty market heights, we see a few fire trucks starting to gather, and those sirens are telling us that more are on the way. There is smoke coming from the building. Attention must be paid.

Before I go into a rather disconcerting letter today, let me start out by reminding readers that I still think we see a mild recession rather than a serious one. I think many of the problems and concerns I outline will be dealt with over time. But we are going to see a low-growth Muddle Through Economy for 2008 and into 2009. So, with that, let's jump in.

First, an increasing number of well-respected analysts are suggesting that a recession is either already starting or will soon be here, and the list is growing every week. *The Economist* predicts a recession is highly likely. Jan Hatzius of Goldman Sachs forecasts a recession and that the growing credit crunch will reduce lending by about $2 trillion (that's with a *t,* thank you).

The normally bullish Richard Berner of JP Morgan writes: "Risks to the consumer are rising, and <u>the risk of outright US recession is higher now than at any time in the past six years</u>: Housing is in sharp decline, consumers are vulnerable, and companies may cut capital spending and liquidate inventories. A strong contribution from global growth is still a huge positive, but spillovers from US weakness to trading partners may hobble that lone source of strength. These pressures could last longer or be more intense than I expect. And even if the economy skirts overall recession, corporate earnings will likely decline."

Second, there are signs that credit is going to be both harder to get and more expensive. Loan loss provisions by banks have spiked to their highest level since 1987, and it is clear that we are going to see even more write-offs and larger losses in the banking sector.

In Greg Weldon's latest letter (and one of the best he has ever written), he looks at the latest report from the FDIC (the organization which guarantees bank deposits):

"Net charge-offs totaled $10.7 billion, the largest quarterly amount since the fourth quarter of 2002. Loan losses were up in most of the major loan categories

(residential loans, home equity lines of credit, construction and development loans, and nonresidential property loans).

"And subsequently … Loan-loss provisions totaled $16.6 billion, more than double the $7.5 billion insured institutions set aside for credit losses in the third quarter of 2006, and the largest quarterly loss provision for the industry since the second quarter of 1987.

"We see … post-2000-01 (2002), post-1990-91 (1992) … and … 1987 … were repeatedly cited by the FDIC as reflecting a similar macro-credit situation to that which exists currently.

"Except … this episode is only just beginning."

The Credit Markets Get Tighter

While space does not permit, notice that it is not just residential mortgages that have become a problem. Home equity, credit cards, auto loans are all seeing a serious rise in delinquencies and foreclosures. Banks are having to eat into their capital base in order to reserve for growing losses. And that means they have less money to lend. And indeed, every survey I have seen for the past few months points to ever-tightening credit conditions for both business and consumers.

Let's take a few instances to look at what is happening. HSBC has had to take back $45 billion of investments in two Structured Investment Vehicles (SIVs) that it sponsored, called Cullinan and Asscher. Michael Lewitt of HCM writes:

"Moody's Investor Service ('Moody's') reported in early November that Cullinan's net asset value had declined to 69 percent of capital while Asscher's had dropped to 71 percent. HSBC said it does not expect any "material impact" on its earnings or capital strength from this transaction. A senior HSBC official tried to spin the bank's move as one that would "set a benchmark and restore a degree of confidence in the SIV sector." For anybody who is prepared to believe that palaver, *HCM* would only respond with the adage, "Fool me once, shame on you. Fool me twice, shame on me." There is no confidence to restore in the SIV sector because there is no viable SIV sector anymore. Cullinan and Asscher are a case in point since their assets are being removed from that very sector with this transaction! HSBC's SIVs have more than $34 billion of senior debt according to Moody's, making it the second largest bank sponsor of these ill-begotten vehicles after Citigroup (which is facing the prospect of adding about $40 billion of SIV assets back onto its balance sheet). Some observers viewed HSBC's move as a negative since it meant HSBC would not be participating in the Super-SIV, but HSBC would seem to be doing more than its part by assuming $45 billion of the estimated $300 billion problem."

If Moody's is right, that would suggest there are about $12.5 billion in losses at today's mark to market. While the equity investors in the SIVs will share a potion of that,

typically that would be no more than about half the 30% loss, and often a lot less, depending on how aggressively the SIVs were constructed. That would mean anywhere from $7.5-10 billion in losses to HSBC. While the bank can certainly deal with a loss of that size, it will affect the capital structure.

HSBC is a well-run bank. It is not unreasonable to think that there are major losses in the other $255 billion in SIVs. The Super-SIV being put together by Citi, JP Morgan, and Bank of America will take some of that paper, but a lot of the rest is going to end back up on the books of the banks which sponsored them, or investors are going to take serious losses in what they thought was short-term AAA commercial paper.

And it is not just SIVs. A money market fund run by the state of Florida for its various pension funds, county governments, schools, and other government enterprises has suspended redemptions after $27 billion of a 42-billion-dollar fund has been redeemed in just 30 days, as news of problems spread. The fund has invested $2 billion in structured investment vehicles and other subprime-tainted debt, state records show. About 20% of the pool is in asset-backed commercial paper, said executive director of the State Board of Administration, Coleman Stipanovich, this week. “There is no liquidity out there, there are no bids” for those securities.

It was not clear whether the fund started with 20% in asset-backed commercial paper or that was the end result after redemptions. But it does mean there is the potential for large losses. And this is a fund where various governments hold their short-term cash, which will be needed to fund current obligations.

There are similar problems in all parts of the world, from Australia to Norway. Yet another German bank is in serious trouble, after it was thought to have been fixed. The European Central Bank pushed $70 billion (50 billion euros) into money markets on Wednesday, even as lending rates rose to new highs. And from Bloomberg:

“The cost of borrowing dollars for one month jumped the most in more than a decade as banks sought funds to cover their commitments through the start of next year. The one-month London interbank offered rate [LIBOR] for dollars surged 40 basis points to 5.34%.” (Thanks to Bill King for sending me the above information.)

Pushing on a String – the LIBOR Conundrum

And that is a major concern, as there is a large disconnect in the market. Notice in the graph below how close a connection there is between the two-year Treasury note and 30-day LIBOR rates. (courtesy again of Greg Weldon, www.weldononline.com)

That is, until recently, as two-year rates have plunged to 3.01% and LIBOR has risen to the above noted 5.34%. This is a major fire alarm, telling us there is something wrong in the building. And what is wrong is that banks are in trouble. And we are not talking just US banks, we are talking about banks all over the world. They are having to bring SIVs and other products onto their books, make provisions for larger losses, and so on. But as Greg points out, the growth in "assets" that came from deposits was only about 10% of the total growth, meaning the rest is loans outstanding.

Where are they getting their capital? Buried in the text of the FDIC report, Greg found this line: "Insured institutions increased their reliance on wholesale funding sources." They are having to borrow money at a much higher level than normal, sending rates up.

The structured security market is in a freeze, which is the funding source for much of the credit in the US and the world for such everyday things as car loans, credit cards, student loans, commercial bank loans, commercial mortgages, and construction. The CLO (mostly bank loans) market is reeling. There is no effective subprime mortgage market. Now, maybe the world settles down after the holidays. But right now, there is nothing to suggest that.

Indeed, Greenspan warned in 2005 of exactly the scenario we are seeing today. He was talking about the rise in housing prices and other assets, and then concluded (emphasis mine):

"Thus, this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. **Such an increase in market value is too often viewed by market participants as structural and permanent.** To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. **But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a**

consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

So, even as the Fed cuts rate, the cost of financing and credit is going up. The odds for a 50-basis-point cut at the next meeting are rising with the arrival of each new fire truck.

But what about inflation? If (and it is *if)* we get into a real debt (credit) spiral, that is hugely deflationary. Massively so. The Fed will once again be facing deflation of a kind that will be far, far worse than what we thought we faced in 2002. This one will be brought on by a deflation in the credit markets.

The Fed needs to act preemptively, and the sooner the better. Remember Greenspan's speech a few years ago, in which he opined that the Fed needed to focus on avoiding the truly dangerous long-term situations rather than smaller near-term problems? The truly dangerous problem is a credit crunch. Lower rates in a credit crunch will be like pushing on a string. Think about Japan in the '90s. Even zero rates did not help.

This current credit crunch has the potential for growing into a full-blown credit crisis, the likes of which we have not seen in the modern world. It is not altogether clear that cutting rates at 25 basis points per meeting is going to do anything to help, if the cost of borrowing does not come down. We are in an entirely different type of crisis than we have ever seen. It is not for certain that the old tools, the fire sprinklers, if you will, will be enough. We may need to adapt to a new, interconnected world.

The real problem is not one of credit or even liquidity, but of confidence in the assets you are purchasing. If you cannot trust an AAA-rated piece of paper in a state-run money market fund, you get very concerned about where to put your money. Until the markets start offering investment products with full transparency and real guarantees for the higher-rated tranches, it is going to be difficult to restart the asset-backed security markets.

(And with credit insurers being threatened with a drop in their credit ratings due to inadequate capitalization for the mortgage guarantees they provided, even insurance is no longer seen as a solid back-up. That is a major fire truck parking next to the building, but one that is being ignored. Talk about a threat to the entire system.)

One encouraging thing to note is that large hedge funds are stepping in to provide liquidity and loans where banks and the usual markets cannot. Of course, they do this at a price. Abu Dhabi got 11% for its money for bailing out Citi, although they did agree to convert their debt into stock at higher prices than the current market price. But 11% for a few years guarantees them a total investment at what they must have considered an attractive rate.

Sovereign wealth funds run by countries now control $2.5 trillion. It is estimated that this will grow to $10 trillion within 5 years. They are going to be a major force in the markets. While some view this with alarm, others will note that the California pension funds are a sovereign wealth fund of sorts.

Now, maybe this is all just a fire in the trash bin, started by a subprime mortgage market gone wild. Maybe the fire sprinklers will work. But it seems to be spreading. Did someone leave a trash chute open on one of the higher floors? The Fed needs to turn the fire hose onto the problem before it spreads any more. I think we see a 3% Fed funds rate sooner than most of us think.

Gentle reader, be careful as you exit the building, there might be more than smoke. And be sure and grab some wine on the way out. You might as well enjoy it while you wait to get back to dinner.

And let me leave you with this positive note. I still think that we only see a mild recession, as we will muddle through this problem. Just like the problem with foreign loans made by US banks in the early 1980s, which essentially left every major bank in technical bankruptcy, we will structure things so as to buy time to work things out. It took 6 years, but eventually the banks were able to work through their problems.

The Fed will cut and cut again, making it cheap for risk takers to play in the market. Some will argue that we need to let there be a credit-clearing deep recession. I doubt we will see that. We will do as humans have always done and do what we can to avoid immediate pain. A Muddle Through Economy will be the result that will stay with us for a long time.

GDP Funny Business

Just a quick note on the recent third-quarter GDP number. The headline number of 4.9% sounds quite strong. But I view it with a little skepticism. About 1% of the number resulted from an increase in inventories, which borrows from the future. Even so, a 4% GDP is strong. But what I find interesting is that the inflation number which is subtracted from the nominal GDP number was just 1.6%, when it was 3.8% in the second quarter. Did anybody notice that price increases were much smaller in the third quarter? Not in my part of the world. A drop of that magnitude makes no logical sense, although I am sure someone can back it up with statistics.

I think we will be lucky to see anything north of 1.5% this quarter, although I hope I am wrong.

Europe, New York, and South Africa

Let me give you a little heads up. I am going to be sending you two special Outside the Boxes next week, on Monday and then again on Tuesday. The letters I mentioned above by Greg Weldon and Michael Lewitt are especially brilliant, and

deserve a wider audience. I have never done this, and don't think I will do it often, but they have some great insights.

I will be going to Switzerland, Barcelona, and London in the third week of January, and then South Africa in May. And speaking of South Africa, I will get the privilege of meeting and interviewing Jacob Zuma, the deputy president of South Africa's ANC party next week, courtesy of George Friedman and my friends at Stratfor. As readers know, I have a special interest in South Africa. I will report back.

I will be in New York this weekend to attend a fund-raising event hosted by Minyanville.com, courtesy of Todd Harrison. I know that I will get to see a lot of friends there, and if you come, be sure and say hello. And my South African partner Prieur du Plessis will be in town with his wife Elizabeth. I am looking forward to seeing them both.

All of that travel reminds me that I have a lot of international readers. If you are looking to travel or to find that second home away from home, you might try subscribing to *International Living*. I know I mention it from time to time, but I do enjoy reading it, and it is a cheap pleasure for me.

It is time to hit the send button. The Mavericks game starts in a few hours, and I want to be there for the tip-off. Have a great week.

Your grateful for firemen on Thanksgiving analyst,

John Mauldin