



...weekly since 1976

Your guide to understanding
today's economy and
financial markets

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THREDGOLD
ECONOMIC
ASSOCIATES

The TEA Company
A Professional Speaking and
Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403

www.thredgold.com

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Hot Potatoes

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Private equity houses...secondary buy-outs...megafunds...leveraged buyouts...equity bridges...collateralized mortgage obligations...sub-prime mortgages...complex credit derivatives...widening risk spreads...PIK toggles...dividend recaps...CDOs...CMOs...IPOs...LBOs

...welcome to the exotic, complex, and at times scary world of 21st Century finance

One recently failed Bear Stearns hedge fund's name is a great example of 21st Century excesses...the *High-Grade Structured Credit Strategies Enhanced Leverage Fund*. Aggressive investors who had money in this hedge fund have essentially lost it.

The reason? More traditional investor terms still apply today, including fear...flight to safety...investor anxiety...greed...guilt by association...and shoot first, ask questions later

Domestic and global financial market developments of recent weeks have sharply raised anxiety levels about the use of aggressive debt financing, the use of private equity to "do deals," and the use of extremely complex credit derivative products to "spread the risk" around. Such anxiety is likely to rise further as additional news of weakened or failed hedge funds and postponed financing deals is released. We do not see these issues leading to U.S. recession.

At the same time, numerous mortgage companies that "specialized" in providing sub-prime mortgage loans to American home buyers have failed. Mortgage delinquencies and foreclosures are up sharply. To this caldron of anxiety, one can also add in the reality that oil prices have now reached the \$78 per barrel level.

Financial markets of all types are prone to excess...and prone to greed. Stratospheric price levels reached by many technology stocks 7-8 years ago are a good example. Rising home prices and "flipper" greed during 2005 and 2006 is a more recent example...

...unfortunately, excessive greed is many times followed by excessive fear

Bridge Lenders

Many Wall Street and global commercial banks and investment banks are currently sitting on billions of dollars of "loans" they never had an intention to keep on their books. Such firms act as the bridge lender between a private equity firm in getting a new deal financed and the ultimate purchaser of the loans, such as hedge funds, retirement funds, wealthy individuals, insurance companies, etc. Many of these ultimate debt buyers are currently telling major banks "Thanks but no thanks...we don't want any more." Nobody wants the hot potato.

The ripple in financial markets? The sharp drop in the Dow last week comes to mind. The Dow had its worst week in four years. Scared money goes in search of safety and liquidity. Hence, the sharp rise in U.S. Treasuries last week, with bond prices having their largest gain in 10 months.

Our March 7, 2007 *Tea Leaf* was titled "*Self Correcting*." It discussed the idea that economic and financial developments tend to generate financial market responses that can help to counteract recent challenges.

Two come to mind. The sharp rise in bond prices last week saw long-term interest rates fall sharply. The 10-Year U.S. Treasury Note yield reached a five-year high of 5.31% in mid-June, with related 30-year fixed rate mortgages approaching 7.00%. The Treasury yield is now around 4.75%, with 30-year fixed rate mortgages back near 6.35%. Such a decline helps housing demand.

The second development is the reality that the Federal Reserve will provide assistance if market psychology gets progressively worse. The Fed has a history of injecting new money in the economy when "crisis" is underway. They would do so again.

For example, the Fed came to the rescue in 1998 when a highly leveraged hedge fund of Long-Term Capital Management failed, pushing anxiety sky-high. This firm's management included some of Wall Street's most glamorous names. The team even included two Nobel Prize-winning economists.

Economists? Well there's the problem.

U.S. Growth

As expected, the American economy returned to more solid footing in 2007's second quarter, following the anemic growth pace during the January-March period. Both existing and new economic headwinds, however, suggest a lesser growth pace over the balance of the year.

U.S. GDP (the value of all goods produced and services provided) rose at a 3.4% real (inflation adjusted) annual rate during the second quarter, the strongest growth pace in more than a year. The 3.4% growth pace was slightly above market expectations. The solid second quarter pace was an attractive departure from the thrice-revised 0.6% growth pace during the first quarter, the worst in five years.

The Year's Best?

The second quarter's 3.4% real annualized growth pace could be as good as it gets in 2007. Prior headwinds including high oil prices, prior Federal Reserve monetary tightening, and languishing housing markets remain in play. Today's reality also includes an emerging global crisis of confidence regarding the use of debt financing whose bottom has yet to be reached (see page 1).

Second quarter growth was led by stronger U.S. exports, an impressive surge in commercial real estate construction, and stronger government spending. U.S. exports climbed to record levels in the April-June quarter, helped by powerful global growth and a weaker U.S. dollar.

Corporate investment in new structures, including office buildings, factories, and warehouses, was very strong in the

second quarter—rising at a 22.0% annual rate—the largest surge in 13 years. Spending on new software and equipment grew at a more modest 2.3% pace.

Whither the Consumer?

Of concern during the second quarter was the weak performance of consumer spending. Such spending, which represents nearly 75% of the economy, grew at a puny 1.3% annual rate, the weakest pace since the end of 2005. Consumer spending in the prior quarter was at a healthy 3.7% annual pace. It seems abundantly clear that the combination of high gasoline prices and constant national media badgering of the housing market led to weaker consumer spending.

Residential investment fell at an annual rate of 9.3% during the second quarter. While residential housing weakness still subtracts from measures of economic growth, the 9.3% rate of decline was the least painful of the past year. Housing nosedived at a 16.0% annual rate during the first quarter of the year.

Better news saw moderation in the Fed's favored measure of consumer inflation. The personal consumption expenditures (PCE) index excluding food and energy costs rose at a 1.4% rate during the second quarter, the lowest inflation rate in four years. At least for now, the 1.4% measure is comfortably within the Fed's desired 1.0%-2.0% band. Such inflation moderation will provide the Fed "cover" as expectations rise of Fed ease prior to year-end.

From Here?

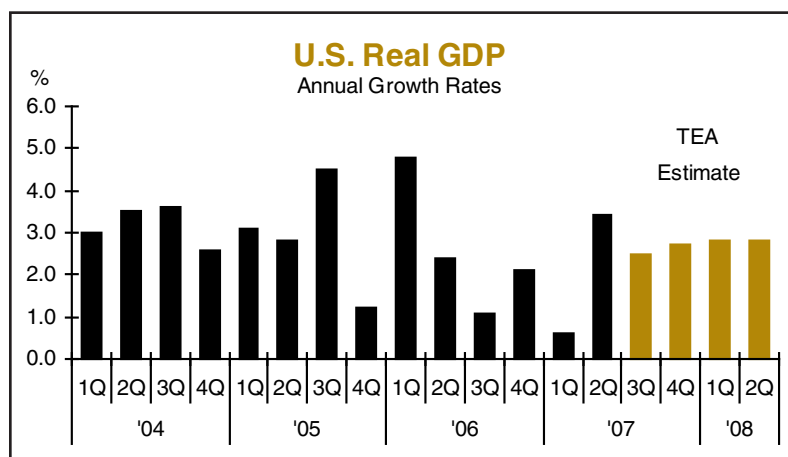
Financial market uncertainty regarding the usage of boatloads of debt in impending private equity deals makes forecasting even more hazardous than usual. Most forecasters have trimmed the prior consensus view of 2.6%-3.0% real growth in 2007's second half to something closer to 2.0%-2.5%. We see no reason to disagree.

"TEA"ser

Which person is happier; the person with \$11 million or the person with 11 kids?

Answer: the person with 11 kids because he does not want more!

—from *Tea Leaf* reader
John Roberts



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Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance from Shawn Thredgold