THE FULL HOUSE TRADER MONTHLY FORECAST

January 2008 Edition
Part 1: Economy
Jan. 15, 2008

TECHNICAL MARKET OBSERVATIONS
Jan. 15, 2008

ECONOMIC BACKDROP

1) "Recessionary" concerns mount in the U.S.
   A) Job market weakness
   B) Retail sales for important month of Dec. were uniformly weak
   C) Auto sales weaken
   D) Housing sales remain very weak, inventories very high, and the extent of the mortgage lending crisis remains unknown.

2) At the core, consumer spending softens while household debt levels continue to rise

3) Major regulatory stimulus efforts are now underway.

   As evidence of increasing global economic slowdown mounts, the Fed announces their willingness to provide more monetary stimulus

   A democratic congress once so concerned about Federal Deficits is now joining with the White House to construct a package of Federal deficit-spending stimulus

4) There is NO POLITICAL DISCUSSION of the coming Baby-Boom financing crisis (see article)

5) The "silver-lining" scenario is based on the stimulus package working, global economic demand holding up, and an improvement of the housing/mortgage mess in 2008.

6) Interestingly, we are starting to see the "from weak hands to strong hands" transfer process that occurs in all bubbles. Note the proposed acquisition of Countrywide Financial (weak hand) by Bank of America.

   In the real property market, expect to see weak, highly-leveraged developers and their properties acquired by stronger, lower-levered entities. Strong, low-leverage REIT's are the predictable long-term winners in this rotation which may take several years to complete.

STOCK MARKETS

LONGER-TERM (Major Trend of a Year or More)

1) Since October we've warned of a bearish divergence between the advance-decline line (as "reflected" in the Value Line Arithmetic Index) and popular capitalization-skewed indices like the S&P 500, NASDAQ Composite, Dow Jones Industrials, etc.

   We've also noted the bearish pattern of both financial industry stocks and the Japanese Nikkei average, both of which have led the overall U.S. market direction for several years.

   We've also noted the downtrend in corporate earnings and estimates in 2nd Half, 2007.

2) In December we wrote that the technical stock market charts heading to January were a mixed lot of erratic patterns with some indices positive (ex. SP 500), some negative (ex NASDAQ & RU 2000) and others rangebound.

3) Market action in January has now swung decidedly downward. This action has the appearance of "capping" the extended bull market rally from the October 2002 / March 2003 double bottom. From technical perspective we can now begin drawing the first downtrending resistance lines which must be broken to the upside before an overall bullish technical pattern resumes.

   It is very early in this process, but assuming an important bearish market tone here, the average bear market historically has lasted around 9 months. If the current pattern were to "fit" the historical, this would favor downside market tendency into the Oct '08 earnings season. Setting long-term targets is highly speculative but 1150-1200 is strong support for the S&P.

4) Importantly, the apparent "top" in Oct./Nov. 2007 did not see historically high stock index valuations by P/E and other measures. All else equal this suggests a "milder" selloff.

   <u>Longer-term, selloffs present buying opportunities. This is a good time to be assembling a buying list for longer-term investing.</u>

5) We note that other major and emerging global stock markets have also formed similar topping patterns in the past few weeks.

<u>SHORT-TERM STOCK MARKET (Several weeks to several months)</u>

S&P (currently 1375). Looking for a test of the 1325-1350 area in the next week or so. Thereafter a failed rally to +/- 1400.

Downside targets over the next few months: the area of substantial horizontal support in the 1250-1325 range.

<u>BONDS</u>

DEC Comments: "Some further selloff in the coming weeks, targeting 112.00. Thereafter a resumption of the rally is the most likely [technical] scenario... looking to take out the early Dec. high, targeting 117.00 or so..."

Today: In late Dec. the 10-Year treasury pulled back to our 112.00 target (hitting 111.50). The rally then resumed towards our 117.00 upside target, hitting 116.41 on Wed (see chart)

While this market has now reached our upside objectives and is due for at least a refreshing pause, strong upside momentum has not been broken. Unless a sense of stronger economic potential develops shortly, this market is likely to trend higher in the months ahead.

Treasuries may become a "following" rather than leading market here, biding time and waiting for specifics of proposed monetary and fiscal stimulus initiatives.

FOREX

From Nov: "The $ remains under our critical 7-point resistance and therefore in a downtrend"

From Dec: "...The dollar index has staged a mini rally from just under 75.00 to around 77.00. As forecast in Nov, this rally is likely to fail and return to re-test the 75.00 low in the weeks ahead. Note also mirror upside action likely in Gold..."

TODAY: As forecast, the US $ rally broke in late Dec., re-targeting it's Nov. low near 74.00. Today, penetration of the Nov. low is the most likely short-term scenario, targeting the 72.50 - 74.00 range.

Longer-term the dollar is in a plausible "basing" zone but must first make a bottom, then a follow-thru pattern THEN break our 7+ point downtrending resistance. Whatever happens, look for mirror opposite activity in Gold short-term.

GOLD

From Nov: Targeting upside of 875-900

From Dec: "...Still looking for Gold to take out it's November high in the coming weeks. Lowering target range from 875-900 to 850-870 at this point..."

TODAY: The forecast gold rally exploded in late Dec, taking out the Nov high AND breaking our most bullish 900.00 target.

We noted in Dec. that Gold has fufilled our technical targets against all major currencies. While this reflects long-term strength, shorter-term it creates more vulnerability to a $ rally.

Technically we note that markets like to reach "round" numbers. Gold is now tantalizingly close to the $1,000 mark. If the dollar evolves in a "final plunge" formation this is within reach.

From a more important fundamental-policy perspective, it's very likely that the broad-based Gold rally reflects a market fear of coming currency debasement. We've spoke of this for several years now. The new "stimulus package" of lower interest rates and greater federal deficit spending and debt adds to this perception of monetary value erosion.

ENERGY

From Nov: "....expect one more rally to re-test the high..."

From Dec: "...We are now watching the rally forecast in Nov. It's very likely that Crude Oil, Heating Oil, and Gasoline all put in marginal new 2007 highs in the next week or so. Crude is now targeting the $106 - 107.50 range..."

"...Thereafter, the top is likely in for a month or two during seasonally weak Jan/Feb..."

TODAY: Short-term the crude-complex has topped for this seasonal cycle and is now in the seasonally weak period. Look for crude to target the 80 - 85 support range. These markets remain in longer-term bullish patterns and new highs are likely to be set later in 2008.

Odds of Recession Seen Rising

Economists in Survey Predict Slower Growth, Unemployment Increase

BY PHIL IZZO

Economists surveyed by The Wall Street Journal see increasing odds of a recession this year along with mounting inflationary pressures, an uncomfortable mix that could play a role in shaping the 2008 presidential campaign and complicate life for the Federal Reserve.

In the latest monthly survey, economists put the chance of recession at 42%, up from 38% in December and 23% just six months ago. On average, the 54 forecasters who participated see the economy expanding at less than a 2% annual rate in the first and second quarters. Last month's survey estimated 2007 growth at 2.5%.

A*

B*

"The U.S. economy in 2008 will be like a cat on a hot tin roof that has already used up eight of its nine lives," said Stuart G. Hoffman of PNC Financial Services Group Inc. Amid rising unemployment, higher oil prices and troubles in the credit and housing markets, "you worry about the cumulative effect that it all has on psychology," he said.

On the political front, most of the respondents expect a Democrat to be elected president this year, although they personally prefer a Republican. Some 56% disapprove of President Bush's handling of the economy, about the same as the 59% of the public who disapproved in a recent Wall Street Journal/NBC News poll.

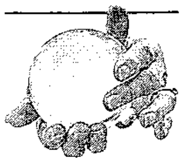
Three economists forecast a recession in 2008. Setting off the alarm bells was last month's jump in the nation's unemployment rate to 5%. "Historically, this has invariably been associated with recession, typically starting immediately and almost always within three months," Goldman Sachs Group Inc. said in a research note.

The economists expect the unemployment rate to be 5.1% by June and 5.2% by December; both predictions exceeded earlier forecasts. They also expect the economy to add just 74,000 jobs a month over the next year, the fewest since the question was added to the survey in 2004.

Price pressures are expected to increase this year. The average forecast for the year-to-year rise in the consumer price index was 2.7% in

the central bank to cut interest rates by at least another half percentage point over the first half of the year. Indeed, in a speech yesterday, Fed Chairman Ben Bernanke, opened the door to a "substantive" rate cut, saying the "outlook for real activity in 2008 has worsened." But Mr. Bernanke said he didn't expect a recession. (Please see article on page A1.)

The continued uncertainties and the Fed's response to them so far appear to have taken some of the shine off Mr. Bernanke. When asked to grade the Fed chief, economists on average gave the chairman a score of 80 out of 100, the lowest mark of his tenure.



See It All

Get full survey results and download the data, including forecasts for economic growth, unemployment and inflation. Go to **WSJ.com/Economist**

"If he were an Olympic skater, his technical score would be close to a 9 or 9.5, because we have gotten a lot of stimulus in monetary policy in recent months. His artistic score, or the execution of those moves, however, are closer to a 3.5 or a 4, which would knock him out of medal territory. There is no performance without passion and conviction," said Diane Swonk of Mesirow Financial.

With the chance of recession rising, the economy is overtaking Iraq as voters' top concern, polls show. Michigan, where the Republican race heads next, has been hit hard by foreclosures and a loss of manufacturing jobs.

When asked whom they expect to win the presidency, 63% of the economists in the survey picked a Democrat—with their choice split between Illinois Sen. Barack Obama, with 33% of the total, and New York Sen. Hillary Clinton, with 30%. (The survey was conducted before Mrs. Clinton's win in New Hampshire.) Republican Sen. John McCain was the pick of 30% of economists, with two other Republicans, former New York Mayor Rudy Giuliani and former Arkansas Gov. Mike Huckabee, each getting 3%.

However, when asked their per-

proved. That is especially startling considering 59% of the economists said the stock market performs better under Republican presidents, compared with 28% who said it favored Democrats. Most economists who disapproved of Mr. Bush cited an increase in government spending. Many praised the president's tax cuts.

However, the economists expressed doubt the tax cuts, which are due to expire at the end of 2010, will be extended. The top marginal tax is 35% on ordinary income and 15% for dividends. When asked what those rates would be in 2011, the economists, on average, expected a 38% tax on ordinary income and a 22% tax on dividends. "The Bush tax cuts will leave with Bush," said Neal Soss at Credit Suisse Group.

Though the slowdown will increase the focus on the economy in the run-up to the November election, analysts said it will have recovered to some extent by the time the next president takes office. "Length of recession doesn't vary very much: about three quarters and that's it," said David Wyss of Standard & Poor's, who isn't predicting a recession.

President Bush is considering a stimulus package to boost the economy, but it isn't clear what kind of measure might pass Congress.

Separately, a global financial group predicted yesterday that global growth will slow this year, largely due to the crisis in the U.S. for subprime loans.

The Institute of International Finance, which has 370 member organizations, said the turmoil has damaged banks in Europe and worsened "fragile confidence" in Japan. It expects the U.S. to avoid a recession—but predicts growth will be a relatively weak 2.3% this year. The group expects Europe's economy to expand 2.1% and Japan 1.3%.

Growth in developing and emerging markets, meanwhile, will slow from its feverish pace but remain quite strong, the group predicted

(A) *R-RISK ESTIMATE HAS ↑ FROM 25% TO 45%

(B) GROWTH EST. FOR 1Q '08 HAS ↓ FROM 2.5% to 2.0%

Darkening Outlook

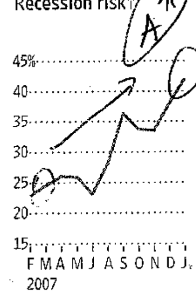
Economists surveyed by WSJ.com are becoming increasingly pessimistic about the economy.

Looking ahead:

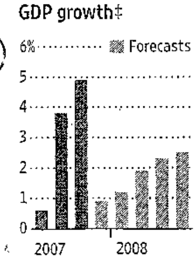
Change from 2007 4Q to 2008 4Q	Fed forecast*	Economists' forecast
GDP growth	1.8% to 2.5%	2.0%
Price index for personal-consumption expenditures	1.8% to 2.1%	2.3%
PCE price index, excluding food, energy	1.7% to 2.1%	2.0%
Fourth-quarter 2008		
Average unemployment rate	4.8% to 4.9%	5.2%

*Federal Reserve officials' forecast from the minutes of the Oct. 30-31 meeting

Recession risk†



Quarter-to-quarter GDP growth‡



Sources: Federal Reserve; Bureau of Economic Analysis; WSJ.com †No survey was conducted in July ‡At an annualized rate

(4)

WEAKENING CONSUMER IS PRIMARY ECON. CONCERN.

Economy Hit As Consumers Tighten Belts

Firms Signal Concern Over Late Payments; 'The Teeth of the Storm'

BY JUSTIN LAHART AND KELLY EVANS

The consumer leg of the economy, which has been remarkably stable throughout the housing downturn, may now be tottering.

The Dow Jones Industrial Average tumbled 246.79 points, or 1.9% to 12606.30 yesterday on the back of fresh signs that consumer spending is slowing. In an indication that even well-heeled shoppers may be cutting back, luxury jeweler Tiffany & Co. said that its U.S. sales slumped during the holiday period. American Express Co. warned late Thursday of rising delinquencies and slowing spending among its cardholders.

They joined a host of companies with close ties to consumers sounding alarm bells. A number of retailers, including Kohl's Corp., cut earnings projections after reporting weaker-than expected sales Thursday. Credit-card company Capital One Financial Corp. said its 2007 earnings would fall short of its earlier forecast. And AT&T Inc. said it has been cutting off more land-line and high-speed Internet customers for non-payment.

December auto sales also slumped broadly, with a 3% drop in sales compared to a year ago, according to industry tracker Autodata Corp.

"All of these things that are taking place—credit markets, energy prices, housing—are hitting consumers right now," says J.P. Morgan chief economist Bruce Kasman. "We're in the teeth of the storm."

Consumer spending fuels around 70% of U.S. economic output, so a pull-back could severely crimp growth. To be sure, U.S. consumers have been resilient in past years and have continued spending even as economists have grown worried about the housing downturn. But now, evidence is mounting that consumers are curbing their spending as they grapple with a growing load of debt.

That's not to say that Wall Street's fears of impending recession will become reality. Mr. Kasman puts the

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Consumer Woes Start to Damp

Continued from Page One

odds of recession at 40%, in line with most other economists recently surveyed by The Wall Street Journal. But it does appear that the trouble that began in the housing market is spreading to other sectors. What's more, high household debt loads may signal that consumers are in a particularly fragile state.

According to the Federal Reserve, credit market instruments—mostly home mortgages, auto loans and credit-card receivables—have hit the equivalent of 18.7% of household and nonprofit organization assets, an all-time high.

'In Terrible Shape'

"Households are in terrible shape right now," says Northern Trust economist Paul Kasriel, who thinks there's a 65% chance of recession next year. "They don't have any reserves to really fall back on."

With house prices falling and mortgage-lending standards tightening, consumers can no longer easily tap into the value of their homes the way they could when prices were rising and lending was easy.

That means that some consumers need to cut back.

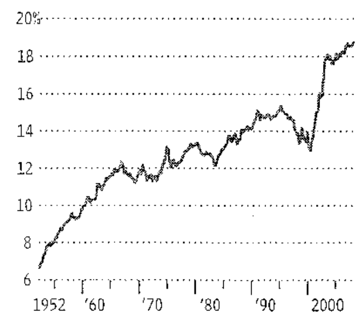
Connie Beckers, a 52-year-old artist living in Minneapolis, Minn., says she has always been careful about her money. But she has been especially frugal since last fall, when her adjustable-rate mortgage reset, increasing her monthly payments by $300. She's now working two jobs to make ends meet.

"I have to work extra hard to make extra money," she said. "I live on a very, very tight budget. I shop at secondhand stores for my clothing. I don't buy anything new. Part of that is my choice, but it's also a financial thing."

Housing pressures may be weighing on consumers, but high energy and food costs are also a factor. According to AAA, regular unleaded gasoline is averaging $3.10 a gallon in the U.S., up

Rising Debt Levels

Credit market liabilities as a percentage of household and nonprofit organization assets



Source: Federal Reserve

CONSUMER DEBT IS AT "ALL TIME" HIGH

Tiffany Outlook Is Lowered On Slowing Luxury-Goods Sales

... LUXURY AUTO'S ALSO DECLINING (see next story)

5

Auto Executives Grow More Pessimistic

Luxury-Car Sales Show Latest Sign of Trouble; Big 3 Prepare for Slump

By Neal E. Boudette

DETROIT—Several auto-industry executives are signaling increasing pessimism over what is already expected to be a weak year for car and truck sales, with some suggesting economic difficulties could be affecting upscale consumers more than expected.

THE DETROIT AUTO SHOW

"We already have a depression in the housing industry and a recession in the auto industry," said Michael J. Jackson, chairman and chief executive of **AutoNation** Inc., at an interview at the North American International Auto Show here.

He added, "We'll see if it spills over into a full recession, but the economy is very vulnerable right now." AutoNation is the nation's largest chain of auto dealerships by locations.

2 The latest sign of trouble: Luxury-car sales, which some had hoped would hold up, are now showing more pockets of weakness. The figures follow last week's move by jewelry retailer **Tiffany** & Co. to cut the top end of its profit forecasts, a potential sign that affluent Americans are also being hit by the weakened housing market.

Sales in the luxury segment fell 6.1% in 2007, despite strong sales for some newly redesigned big-sellers like **BMW** AG's 3 Series compact sedan. Hit hard were midsize and large sedans, which sell for $50,000 and up and normally generate huge profits for premium auto manufacturers. Sales of Mercedes-Benz's flagship S-Class sedan, which was overhauled only a year ago, tumbled 15.6% last year.

Audi AG, the luxury brand of **Volkswagen** AG, saw its sales rise 3.8% to 93,508 vehicles, but only because it added a new sport-utility vehicle called the Q7. Without it, the brand's sales fell 9%.

James Selwa, president and CEO of **Maserati North America** Inc., said sales of his company's cars are continuing to rise, but noted they sell for over $100,000 and typically appeal to people who have more than $10 million in assets and are unlikely to feel much of a pinch in any economic downturn.

But he is now seeing signs of economic stress among people one rung down on the economic ladder—a group he calls the "mass affluent."

3 These are consumers who typically made money in the stock market's run-up in the 1990s, bought expensive homes, refinanced their mortgages and now are getting squeezed.

"They are feeling a lot less wealthy now," Mr. Selwa said.

At the Detroit show, luxury car makers unveiled a range of new vehicles aimed at wealthy buyers, from an Audi sports car with a big V12 diesel engine to the new BMW X6, a kind of cross between a sports car and a sport-utility vehicle. (For more from the auto show, please see article on page D5.)

Yet concern about what unexpected shocks to the economy might be lurking in 2008 remained on executives' minds.

"The mood here is somber," said Mr. Jackson, the AutoNation CEO. Later today he will elaborate on his worries before an audience of auto-industry analysts at an annual gathering on the sidelines of the Detroit show.

4 Many repeat customers at AutoNation's dealerships are coming in with much lower credit scores than they had a few years ago, and delinquencies on auto loans have crept up, Mr. Jackson said.

Dieter Zetsche, chief executive of Mercedes owner **Daimler** AG, said he doesn't expect the U.S. economy to fall into recession and believes the Federal Reserve will cut interest rates. On the other hand, he said, "there are a number of concerning signals and probably more bad news to come out" in the banking and credit markets.

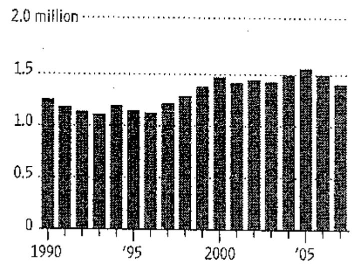
There is no doubt 2008 will be difficult for mainstream auto makers, especially Detroit's Big Three. **Ford Motor** Co., which lost $12.6 billion in 2006 and is likely to report another loss in 2007, expects industrywide sales of cars and light trucks to slow significantly in the first half of the year. Ford, **General Motors** Corp. and **Chrysler** LLC have already planned major production cuts in the first quarter in anticipation of the slump, but may be forced to increase incentives to prop up demand. 5

—*Mike Spector contributed to this article.*

Feeling the Squeeze

Luxury vehicle sales, which have stayed strong in the face of weak performance by other automobile classes, may have finally succumbed to overall market reluctance

U.S. luxury car sales



2007 U.S car sales

Class	Vehicles sold, in millions	Change from previous year
Small	2.4	0.6%
Medium	3.5	-2.8
Large	0.2	-10.5
Luxury	1.4	-6.1
Total	7.6	-2.6

1

Source: Autodata

❖ **Trickle Up:** Some auto industry executives are increasingly pessimistic about the auto market this year, pointing in part to sales of luxury vehicles.

❖ **Another Indicator?** Luxury car sales will be closely watched after Tiffany scaled back its earnings forecast.

❖ **The Impact:** Weak luxury sales could further crimp auto makers' results and suggest a widening impact of the weakened housing and credit markets.

1 ALL SIZES ARE WEAK... Med, Large, Luxury are negative

2 LUXURY SEGMENT IS FALLING... (once seen as pocket of strength)

3 "MASS AFFLUENT" CONSUMER weakens as home re-fi's dry up.

4 LOWER CREDIT SCORES + HIGHER DELINQUENCIES

5 PRODUCTION CUTS WILL FURTHER SOFTEN ECONOMY

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BROAD-BASED DECLINE IN RETAILING

Little Cheer, Some Relief

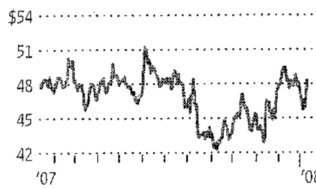
Retail sales for December 2007

	Total December sales		Comparable stores
Discounters	In millions	Chg. from year ago	Chg. from year ago
Wal-Mart[1]	$46,597.0	+8.4%	+2.4%
Target	9,262.0	+0.1	-5.0
Costco[2]	7,550.0	+10.0	+5.0
Department stores			
Macy's	$4,624.0	-7.4%	-7.9%
J.C. Penney[3]	2,819.0	-4.5	-7.5
Kohl's	2,672.9	-3.4	-11.4
Nordstrom	1,222.9	-3.8	-4.0
Dillard's	1,167.3	-4.6	-5.0
Neiman Marcus	723.0	+4.9	+2.9
Saks	447.7	+0.8	+0.8
Apparel			
TJX	$2,500.0	+6.0%	+3.0%
Gap	2,200.0	-6.0%	-6.0%
Limited	1,744.0	-14.0	-8.0
AnnTaylor	274.2	-3.8	-9.4
Teen apparel			
Abercrombie & Fitch	$657.0	+9.0%	-2.0%
American Eagle Outfitters	313.5	+17.5	+12.2

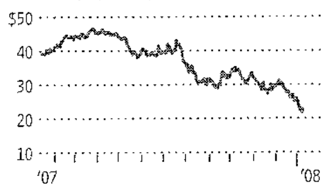
[1]Comparable sales for U.S. stores only, excluding fuel sales
[2]Comparable sales for U.S. stores only [3]Department stores only
Sources: the companies; WSJ Market Data Group

52-week share price

Wal-Mart
Yesterday: $48.40, up 3.2%



Macy's
Yesterday: $22.60, down 0.3%



Limited
Yesterday: $16.01, up 2.0%

Retailers Saw Weaker December

Sales Report Caps A Difficult Year; Clothing Takes Hit

BY KEVIN KINGSBURY AND GARY MCWILLIAMS

U.S. retail sales last month weakened, especially among clothing chains, but weren't the disaster some predicted.

The report capped a year that turned out to be retailers' worst in at least four years and a holiday season that hit a five-year low.

❖ **The Tally:** December retail sales were weak, but not the disaster some had feared.

❖ **Bright Spots:** Wal-Mart sales hit the high end of its forecast. Videogame retailer GameStop boosted its profit outlook after booming holiday sales.

❖ **To Sum Up:** A slight sales gain for the industry as a whole lent some reassurance that consumers continue to spend.

and said it expects to deliver earnings in the fiscal fourth ter profit wouldn't match the $1.29 per-share profit of last year. Late Wednesday, it said Chief Executive Robert J. Ulrich will retire May 1 and be succeeded by President Gregg W. Steinhafel.

Costco Wholesale Corp. reported a stronger-than-expected 7% rise in December same-store sales. It posted a 5% U.S. gain, one percentage point of which was due to rising gasoline prices. Same-store sales internationally jumped 16% because of the slumping dollar; excluding that, the increase would have been 5%.

"... worst year in last four..."

"... worst holiday season in last five..."

HOUSING CONTINUES TO WEIGH ON ECON & MARKETS

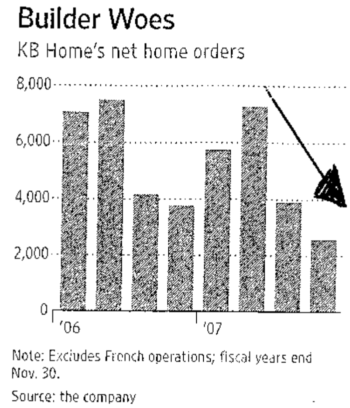
No Bottom Seen Yet for Housing

Continued from Page One

we get through the toughest housing correction in our lifetimes," Daniel Mudd, chief executive officer of Fannie Mae, the government-sponsored mortgage investor, said in a speech to the U.S. Chamber of Commerce in Washington yesterday.

Rumors that Countrywide might be preparing a bankruptcy-court filing fueled its decline. The company vehemently denied such plans. "There is no substance to the rumor that Countrywide is planning to file for bankruptcy," a Countrywide spokesman said.

The weak earnings report by Los Angeles-based KB was a



Note: Excludes French operations; fiscal years end Nov. 30.
Source: the company

← NEW ORDERS STILL TANKING

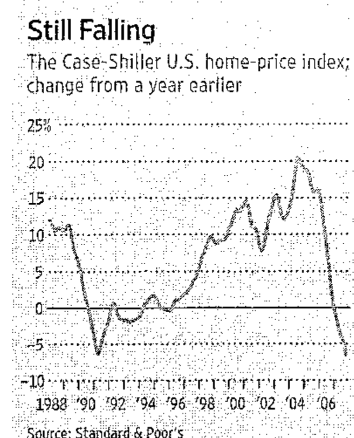
HOME PRICES STILL FALLING →

Pace of Decline In Home Prices Sets a Record

By James R. Hagerty And Kelly Evans

A closely watched gauge of U.S. home prices shows they are falling sharply across most of the nation, as a deepening slump in the housing market threatens to damp consumer spending.

Home prices in 10 major metropolitan areas in October were down 6.7% from a year earlier, according to the S&P/Case-Shiller home-price indexes, released yesterday by credit-rating firm



Source: Standard & Poor's

Standard & Poor's. That exceeded the previous record year-to-year decline of 6.3% in April 1991, when the economy was emerging from a recession.

S&P Raises Projections Of Sour Subprime Loans

← SHAKEOUT IN BAD MORTGAGE LOANS IS NOT OVER...

By Serena Ng

There may be another wave of credit-rating downgrades of subprime-mortgage securities.

Standard & Poor's Corp. yesterday sharply raised its projected losses for subprime mortgages made in 2006 to 19% from 14%, as loan delinquencies are rising. Those mortgages were important building blocks in billions of dollars worth of mortgage-backed securities issued that year.

Analysts said the rating company's new loss expectations are much closer to the bearish scenario implied by the depressed values of the ABX index, a market index made up of derivatives tied to subprime bonds.

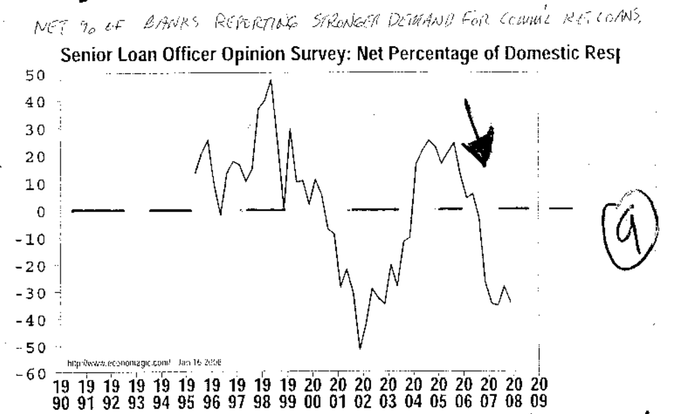
Despite its deteriorating outlook for the housing market, S&P said actual losses among 2006 subprime loans totaled just 1.13% at the end of 2007, a number below its expectations.

S&P has slashed ratings on the bulk of 2006 subprime-mortgage bonds that were originally rated triple-B, but most double-A and triple-A bonds haven't been affected. The rating company's new loss estimates now suggest that many double-A bonds would be downgraded because losses may eat significantly into the cushions below them.

But monthly performance data indicate that 28.8% of loans were delinquent, and the numbers are still rising. In addi-

DON'T EXPECT RELIEF FROM COMMERCIAL REAL ESTATE WHICH IS IN IT'S OWN PULLBACK...

NET % OF BANKS REPORTING STRONGER DEMAND FOR COMM'L RE LOANS



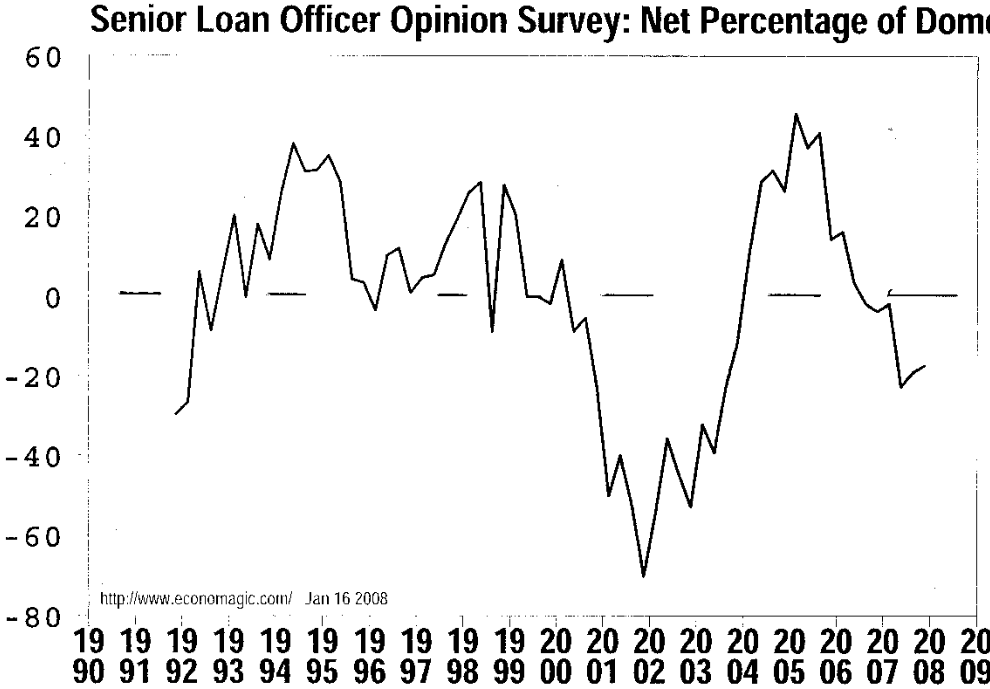
VERY LOW DEMAND FOR COMM'L MORTGAGES

HOUSING BUBBLE TIMELINE (Est.)

2008: Serious shakeout & capitulation
Remedy programs initiated

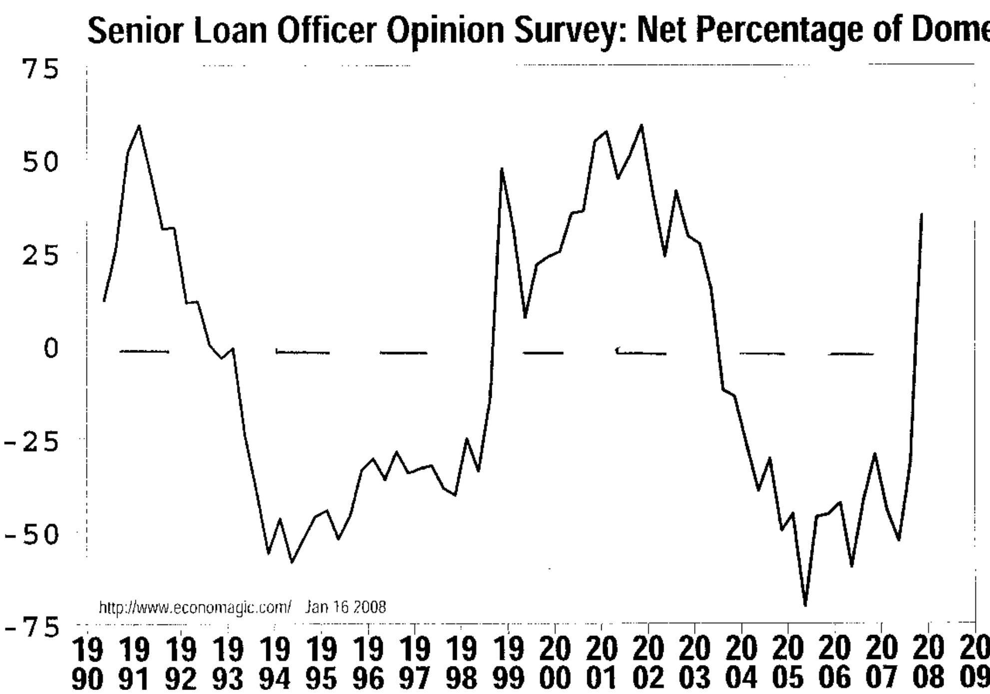
2009: Price bottoming

NET % OF BANKS REPORTING STRONGER LOAN DEMAND by LARGE COS.



LOWER DEMAND FOR CREDIT

NET % OF BANKS INCREASING LOAN RATE SPREADS ON LOANS to LARGE COS.



CRITICAL

BANKS TIGHTEN LOAN STANDARDS EVEN AS FED TRIES TO EASE!

TAX STIMULUS IS NEEDED (again)

FOR AN ECONOMY RUNNING ON CREDIT, THESE ARE SIGNS OF SLOWDOWN

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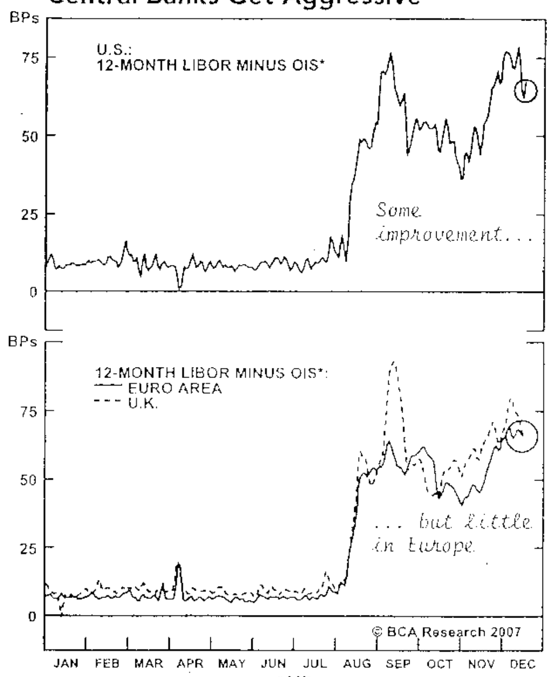
NOTE SEEDS OF IMPROVEMENT IN CORE INTERBANK MARKET.

DEC

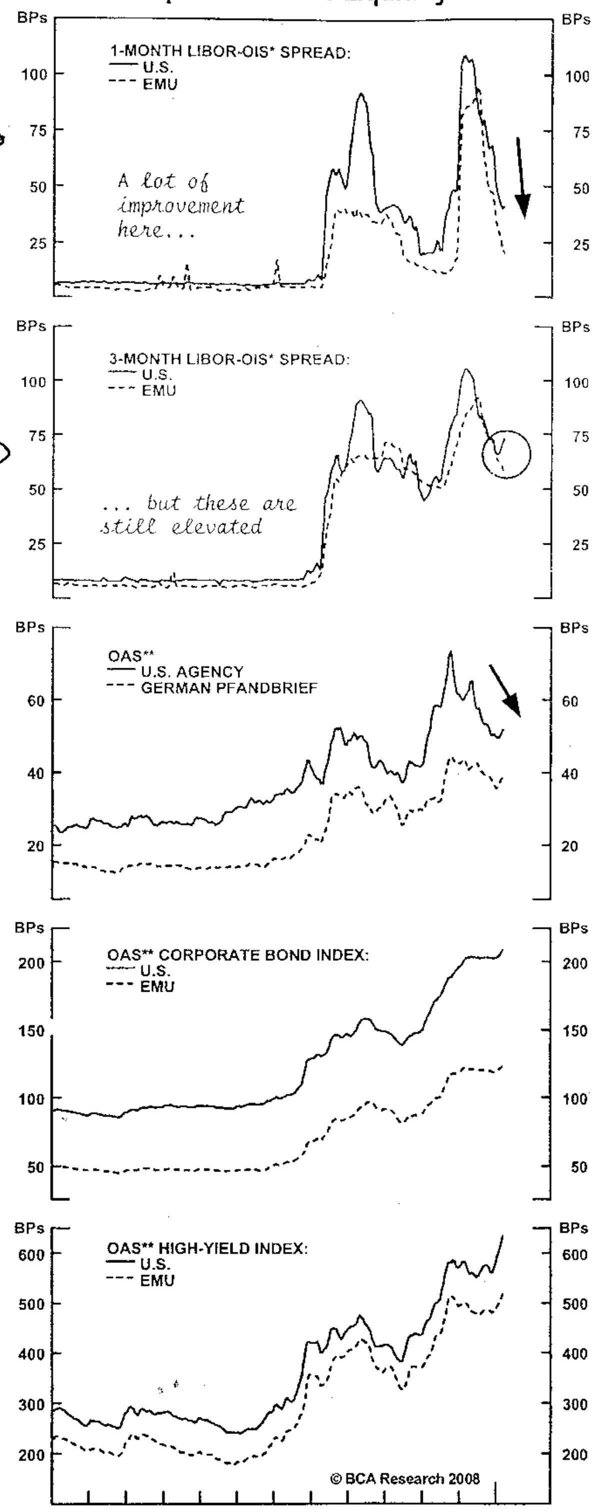
CHART 1
Central Banks Get Aggressive



*OIS = OVERNIGHT INDEX SWAP

JAN

CHART 1
Some Improvement In Liquidity Premia



*OIS = OVERNIGHT INDEX SWAP
**OAS = OPTION-ADJUSTED SPREAD, SOURCE: MERRILL LYNCH

Another criticism is that the policy action treats the symptom, but not the underlying illness: illiquid and questionable debt that has made banks reluctant to lend to one another. The subprime/CDO train wreck has caused a widespread tightening in lending standards that is unlikely to improve even if bank funding issues are solved. The Fed's TAF will not accept subprime-related debt as collateral. Similarly, the other central banks are only accepting high-quality paper. All this is true. Still, it is critical that central banks get the interbank markets functioning properly because these markets are the main channel through which monetary policy operates. Dysfunctional money markets make it all the more difficult for the financial system to digest the subprime/CDO mess.

What is worrying is that the Fed and the ECB are still quite concerned about inflation. The Fed has eased, but reluctantly so. The BoE and BoC appear to believe that the risk to the economy from

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Stimulus Plan Has Flicker of Hope

Democrats Don't Want To Be Tied to Bush Tax Cuts; Deal May Top $100 Billion

BY SARAH LUECK
AND MICHAEL M. PHILLIPS

WASHINGTON—A top House Democrat said Congress and the White House can come to an agreement on an economic-stimulus package—provided Republicans don't insist the plan includes making President Bush's signature tax cuts permanent.

Rep. Barney Frank (D., Mass.), chairman of the House Financial Services Committee, suggested lawmakers and administration officials, particularly Treasury Secretary Henry Paulson, have begun to find common ground on a plan to spur the nation's economic growth. (1) With concerns growing that the economy might slip into recession, House Speaker Nancy Pelosi (D., Calif.) met this week with Federal Reserve Chairman Ben Bernanke, who supports doing something to counter the fallout from the meltdown in the subprime mortgage market, according to Mr. Frank.

"I think we could make a deal if you look at what Bernanke and Paulson have been talking about; that is, people have to set aside their longer-term ideological agendas," Mr. Frank said in an interview. He predicted a stimulus plan would ultimately cost more than $100 billion.

The delicate negotiations have only just begun. President Bush, traveling in the Middle East, hasn't weighed in. The Senate, where passing legislation is trickiest, doesn't return to work until next week. Democratic leaders are scheduled to meet with Mr. Bush next week, when Mr. Paulson also is expected to discuss the economy with Senate Republicans.

Looming over the talks is the question of whether Mr. Bush has enough political muscle to persuade Republicans to deal with Democrats. The president's approval ratings are low, and Republican lawmakers may see more benefit in drawing distinctions with Democrats in an election year, rather than going along with them.

Still, Democrats are hopeful that compromise will emerge. Both parties are under pressure to respond to voters' fears about their mortgages, their jobs and their pocketbooks. Mr. Frank said he expects an accord to include "some tax relief right away to people who are going to spend a lot of money" and "some alleviation of the plight of people who would be worst hurt," such as expanded unemployment insurance and food stamps.

Barney Frank

Some Democrats also are pushing for heating assistance for low-income people and accelerated spending on public-works projects. Republicans want tax breaks for business; top on the White House list are tax rebates for individuals and rules that would allow companies to deduct the cost of new equipment more rapidly.

"There are some things that are pretty clear cut," Mr. Frank said. "That they put aside the long term—making the tax cuts permanent—and talk about getting the money out." (2)

Yesterday, the National Retail Federation, whose members had a dismal Christmas season, called for legislation to spur the economy. "Stimulus that helps consumer spending will benefit all industries in the private sector," said Tracy Mullin, president of the group, which encompasses more than 100 retail associations.

White House spokesman Tony Fratto declined to say whether the president is willing to postpone debate over extending his cuts in personal income-tax rates, estate taxes and other taxes, which are scheduled to expire in 2010. "I'm not going to get into what may or may not be in a possible proposal, bı

ministration and the Republicans to make those tax cuts permanent," Mr. Fratto said.

Still, he said that "should the president decide to go forward with new economic-growth policies, there's no reason why we couldn't find bipartisan support."

House Republicans yesterday wrote to Ms. Pelosi warning they would oppose efforts to use tax increases to offset the cost of stimulus measures, in compliance with the rule requiring Congress to pay for any spending increases or tax cuts. It appears House Democrats are more likely to want to comply with the rule than their counterparts in the Senate.

Separately yesterday, the nonpartisan Congressional Budget Office issued a report warning that many of the stimulus proposals being floated in Washington would have only limited effect on the economy because they would be too slow to take hold or cost too much in relation to the economic boost they would provide. The quickest and most efficient way to get money into the hands of consumers likely to spend the extra cash, the CBO said, would be extending or expanding unemployment-insurance benefits or increasing food-stamp benefits. (3)

"Most of the stimulus options under discussion would be difficult to actually get out the door in the first half of 2008," (4) CBO Director Peter Orszag said in an interview. The CBO said allowing companies to speed tax write-offs for new equipment would provide only a limited boost to the economy in the immediate future.

Even a direct tax rebate, such as the $300 to $600 checks sent to taxpayers during the slowdown early in the Bush administration, would take months to organize, the report said.

The CBO also cast doubt on the effectiveness of an approach favored by some Democrats, a quick increase in spending on bridges, roads and other infrastructure. "Even those that are 'on the shelf' generally cannot be undertaken quickly enough to provide timely stimulus to the economy,"

Fed Chief Opens the Door To 'Substantive' Rate Cuts

pg 13

BY GREG IP
AND JOELLEN PERRY

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Federal Reserve Chairman Ben Bernanke, citing the growing threat to the economy from fragile financial markets and weakening employment, opened the door to "substantive" cuts in U.S. interest rates.

Mr. Bernanke's comments yesterday suggested that after months of being out of step with the nation's markets, the Fed is drawing closer to their view that much lower rates are needed to keep the economy from stalling, despite the risk that rate cuts could fuel inflation.

In a speech that reflected more urgency about the economy than he has expressed since August, when the current credit crunch began, Mr. Bernanke strongly hinted the Fed would reduce its short-term interest-rate target, probably by half a percentage point from its current 4.25%, at the central bank's next meeting, Jan. 29-30. While the Fed could act before then, it would be unlikely to do so in the absence of a dramatic deterioration in the markets or exceptionally bad economic data.

Mr. Bernanke told Women in Housing and Finance and the Exchequer Club in Washington that inflation remained a concern but indicated that

Please turn to the back

(1) TREASURY + CONGRESS "common ground"
(2) FISCAL URGENCY: "Get money out"
(3) C.B.O. CONCERNED THAT STIMULUS CANNOT BE QUICKLY IMPLEMENTED
(4) FED CHAIR SIGNALS ALL-OUT MONETARY STIMULUS...
...BUT, IS THIS THE "RIGHT" PACKAGE?...

The Right 'Stimulus'

We've been saying for some time that the economy could use another tax cut, so perhaps we should be pleased that Washington is suddenly talking about a fiscal "stimulus." The challenge now is getting politicians to distinguish between policies that actually "stimulate" and the equivalent of dropping hundred dollar bills from helicopters.

Marginal, immediate and permanent.

Not that this recent talk isn't progress of a sort. At least the politicians are beginning to understand that the Federal Reserve can't flip its easy-money switch and immediately end the credit crunch, forestall home foreclosures, and leap tall buildings at a single bound. Chairman Ben Bernanke implied in a speech yesterday that big interest-rate cuts may be coming, and bond markets immediately sold off. Currency traders may also have their say, especially if the European Central Bank decides to tighten. Monetary policy can't do everything, and it becomes dangerous if it tries to do too much.

Which brings us to the Beltway's new fiscal stimulus debate, such as it is. The White House is leaking trial balloons about its proposals, while the Democratic intelligentsia is already promoting its ideas. So far, nothing we've seen would stimulate much beyond campaign rhetoric.

Former Treasury Secretary Larry Summers is leading the charge for the Democrats, pushing what he calls a "timely, targeted and temporary" tax rebate of $250 per tax filer, and $500 per couple. The White House is floating its own rebate of $500 or so for families with taxable income of less than $100,000 a year. Mr. Summers says his plan would put money in the pockets of "those who would go out and spend it."

Or not. Mr. Summers is pushing a version of single-entry Keynesian bookkeeping, which holds that if the government hands out cash to workers they will spend it and "stimulate" the economy. But the money the government would thus "inject" in the economy has to come from somewhere. That is, it has to be raised in taxes or borrowed, which means it is taken from someone else in the private sector. Under more accurate double-entry bookkeeping, this stimulus is likely to be minuscule.

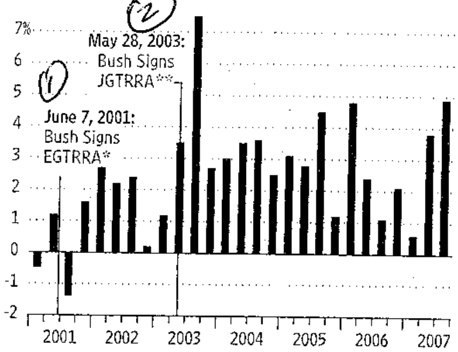
As for "spending it," we tried this a few years back and it didn't work very well. As part of the grease to pass his 2001 tax cuts, President Bush agreed to a $300 rebate ($600 per couple) urged on him by Senate Democrats. As the nearby chart shows, the economic gain was short-lived to the extent there was any at all. Several economists have also done research suggesting that the bulk of that rebate was in fact saved, not spent. That's virtuous, but it isn't a "stimulus."

More encouraging is a White House leak to allow so-called "bonus depreciation" for businesses for 2008. This would increase business cash flows, and a version of this proposal seemed to help in 2003-2004. The problem arises if such a tax cut is temporary. This would give businesses an incentive to speed up spending this year, but in part by stealing it from next year.

A real fiscal stimulus is one that immediately and permanently changes the incentives for individuals and business to work, invest and take risks. That's the comparative lesson of the two Bush tax cuts, as the chart again illuminates. The 2001 tax cuts were useful as a way of getting marginal income-tax rates down eventually. But in addition to the rebate folly, the rate cuts were phased-in and thus gave everyone an incentive to postpone investment. The stimulus came in 2003 when the marginal rate cuts were accelerated and capital gains and dividend rates were slashed immediately.

Tax Cut Timeline

Quarterly GDP growth, 2001-2007



* Economic Growth and Tax Reform Reconciliation Act
** The Jobs and Growth Tax Relief and Reconciliation Act

Source: Bureau of Economic Analysis

The irony is that these are precisely the lower tax rates that Mr. Summers and Democratic politicians want to raise. No brand of Keynesianism we've studied says you stimulate an economy by raising taxes. This promise to repeal the Bush tax cuts is already having an impact on investors as they consider what the tax on capital and business will be like next year. If Democrats really wanted to spare a President Obama from a first-year economic problem, they'd promise to make the 2003 tax cuts permanent.

As for a stimulus now, one that works would be marginal (at the next dollar of income), immediate and permanent. A proposal to bring the U.S. corporate rate into line with the rest of the world would help, and even better would be an across the board cut in income taxes to 30% from 35%. That would be real recession insurance.

NOTE THAT THE MARGINAL + CAPITAL GAIN RATE CUTS (2) SEEM MORE EFFECTIVE THAN THE TEMPORARY REBATE CHECKS (1)

(14)

PREDICTABLY, OUR "LEADERS" COMPLETELY AVOID DISCUSSION OF THE TICKING BABY BOOM FINANCING CRISIS.. "PAINFUL ACTION" NEEDED..

Presidential Candidates Shrink From Budget Issue

Worsening Fiscal Picture Looms, But Hopefuls Prefer Not to Look

BY JACKIE CALMES
Washington

ONE THING UNITES ALL the presidential candidates, of both parties: None are honestly facing up to the huge budget challenges that will confront the next White House resident.

In fairness, if any of them did, voters probably wouldn't give them the keys.

The next president will be inaugurated just as the first of 78 million post-World War II baby boomers begin to retire, and in his or her first term they will be making their claims on Medicare, Medicaid and Social Security. Annual deficits will start climbing, even without any of the new spending that the candidates promise for defense and domestic programs.

War costs will continue to pile up. Net interest on the national debt, to creditors in China and elsewhere, already is one of the single-largest spending items, and growing fast.

Meanwhile, revenue will be many billions less than projected. That is because all the candidates have promised to fix or even repeal the alternative minimum tax—which was intended for rich tax-evaders but not indexed for inflation—so that the AMT won't hit the increasing millions of middle-class voters due to be ensnared otherwise.

Even as Democrats and Republicans on the campaign trail are vaguely promising "change"—and making it sound easy—back in Washington the director of the nonpartisan Congressional Budget Office, Peter Orszag, testified on Capitol Hill in mid-December about the nation's long-term budget outlook, and he wasn't optimistic. "Under any plausible scenario, the federal budget is on an unsustainable path—that is, federal debt will grow much faster than the economy over the long run," he said. And that, he added, means more borrowing from abroad, and less investment and income growth at home.

The main culprit, according to the budget office's latest report, is the projected explosion in costs of health care, exacerbated by the rising claims of aging baby boomers. "Therefore," Mr. Orszag said, "efforts to reduce overall government spending will require potentially painful actions to slow the rise of health-care costs." An economist, Mr. Orszag is a Democrat, but his message echoes that of his Republican predecessor as CBO director, Douglas Holtz-Eakin, who is now the chief economic adviser to presidential candidate and Arizona senator, John McCain. Yet pain isn't something candidates talk about.

Mr. McCain does stand out among Republicans, and some Democrats, for having a detailed proposal to constrain health-care costs. And he and former Republican Sen. Fred Thompson emphasize more than others in both parties the need for cost-saving changes to Medicare and Social Security, if not the specifics. On Social Security, Mr. McCain—like most Democrats—would consider raising revenue by lifting the cap on wages subject to Social Security payroll taxes (the 2008 cap is $102,000). Mr. Thompson's more politically risky plan would reduce the initial level of benefits to future retirees, using a formula similar to one Mr. Bush floated in 2005—unsuccessfully.

All the Republicans favor extending the Bush tax cuts, which otherwise would expire in the next presi-

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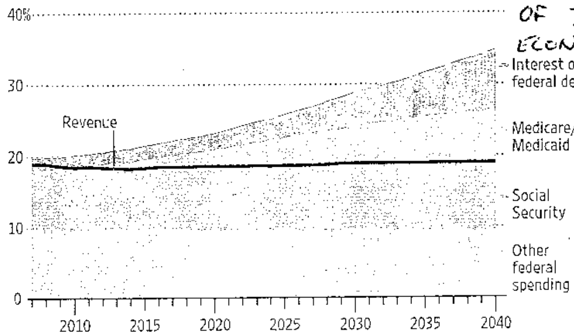
Racking Up Debt - FED. GOVT. "GROWS" FROM 20% to 35% OF THE ECONOMY!!

Projected federal revenue and spending as a percentage of GDP



Source: Congressional Budget Office's estimates based on current fiscal policies

Candidates Shy From Budget

Continued from page R1

dent's first term, and rule out any income-tax rises. When quizzed about Social Security's looming instability, all of the Republicans say they support letting workers divert payroll taxes to personal accounts. But that would add to the program's financial woes for decades, requiring additional taxes, benefit reductions or borrowing—which is why Mr. Bush's own proposal never went anywhere even in a Republican-led Congress.

Despite the country's worsening fiscal picture, the Republicans' platforms don't sound all that different from Mr. Bush's back in 2000, when the country was at peace, running a surplus and paying down the debt. Besides echoing his call for overhauling Social Security, they favor more tax cuts, look to market-based remedies for health-care savings and promise deep cuts in other federal spending, without specifics.

But even slashing the overall federal budget—which ranges from agriculture subsidies and parks to research and weaponry—wouldn't avert the crisis that Mr. Orszag and others forecast: As CBO data consistently show, the ballooning costs are mostly in Medicare and Medicaid, and to a lesser extent Social Security and interest on the federal debt—not in the annual appropriations that include much-criticized "earmarks" for lawmakers' special projects.

The Democratic candidates are even less inclined to detail how they would curb the growth of Medicare and Social Security. Their party considers both programs its legacy. Neither they nor the Republicans would reverse the prescription-drug benefit that Mr. Bush added to Medicare, though its long-term costs dwarf the government's entire tab for Social Security's unfunded obligations. Democrats, in fact, would expand the drug benefit to do away with the so-called doughnut hole, where a beneficiary's coverage lapses before kicking in again when costs reach catastrophic levels.

Unlike Republicans, Democrats also aim for universal health care, to cover the 47 million uninsured, and propose new spending and tax incentives for energy and technology innovations, arresting global warming, and for education and college aid. They also promise to restore pay-as-you-go budgeting to the federal government. The biggest offset they offer to "pay" for their proposals is ending Mr. Bush's tax cuts for the richest Americans, typically those making more than $200,000 a year.

But what sounds like an all-purpose source of revenue is anything but. Eugene Steuerle, a senior fellow at the nonpartisan and centrist Urban Institute think tank, and a former Reagan Treasury official, says that returning income-tax rates for the wealthy to pre-Bush levels would mean about $50 billion a year. While no small amount, that is less than a third of the fiscal 2007 deficit. It would cover no more than half the revenue cost of overhauling the AMT, and a few months of Medicare's cost increase.

Whoever is elected, Mr. Steuerle says, "still must either retract many of the promises made to the middle class, increase its taxes, or both. Right now, the leaders of both political parties consider it political suicide to lead the way."