Smoling Stockbroking Pty Ltd

Hello to all,

This report from the US last week contains some interesting figures and macro views on the worlds largest economy.
I am of the view that the US is currently experiencing a recession and the current market volatility is a result of the market going through the process of dealing with uncertainty and attempting to reconfigure.
Historically recessions take on average 6-8 months to work through and I believe we are well into this process.
Investing in quality companies at low price levels with a 12 month plus time horizon is the prudent approach to take.
We created the financial world we share and it is a reflection of us.......an emotional market?
I think so.

Kind regards.

Brad Smoling F. Fin MSDIA

MONEY AND MARKETS»

Friday, February 8, 2008

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The Recession Side Is Winning

by Mike Larson

Dear Subscriber,

I'm no longer a huge football fan, and I'm not much of a political junkie, either. But this past week's action really got my blood pumping.

The Patriots and Giants slugged things out for four long quarters. Deep passes into the secondary. Crushing sacks in the backfield. Power running and smashmouth blocking. It was a great game up until the bitter end.

Then on Tuesday, the primary action ran hot all night long. First, Obama would pull ahead. Then Clinton would win another state and recapture the momentum. A state that many expected to go to Obama — Massachusetts — instead fell into the Clinton camp. But late voting results in Missouri were enough to push Obama over the top in the key Midwestern state. It was another pitched battle the likes of which we haven't seen in politics in some time.

No doubt both of those battles were exciting. But I think there's an even more dramatic — and more critical — struggle going on right now. I'm talking about the economic clash of the titans unfolding right before our very eyes ...

On one side, there's a massive credit crunch that's driving bank losses through the roof ... that's causing lenders to snap their wallets shut ... and that's pressuring everything from retail spending to commercial construction.

On the other side, you have a federal government and Federal Reserve that are doing virtually everything in their power to intervene in the markets. Dramatic interest rate cuts, an epic flood of liquidity, unprecedented intervention in the mortgage markets, almost $150 billion — or more — worth of tax rebates and incentives. Money is pouring forth from every nook and cranny in D.C.

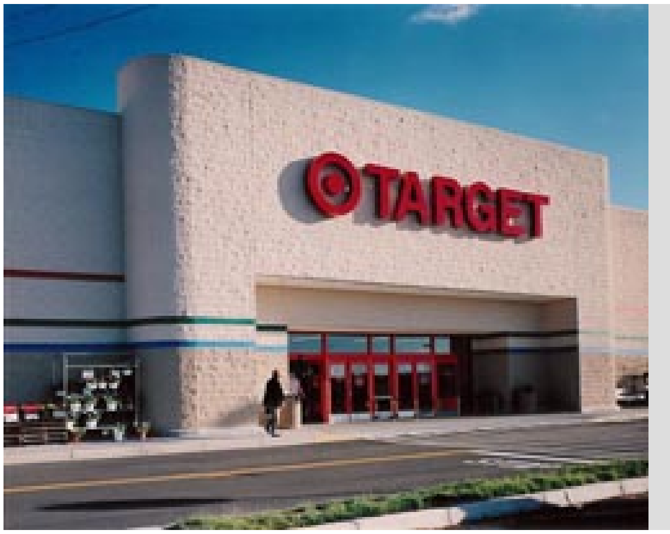
Who's going to take the trophy?

The Case for Economic Recession Grows Stronger Day by Day ...

Is there really any more doubt that we're either in — or on the verge of — recession? Can the bulls really argue that they still have the upper hand?

I don't see how. It seems like every day we get more confirmation of worsening economic conditions ... worsening corporate earnings ... and a worsening credit crunch. Just consider:

➔ A key index that tracks the health of service businesses like restaurants, retailers, and real estate firms plunged to 41.9 in January. That's the worst reading since October 2001, right after the 9/11 attacks. New orders dropped sharply and employment fell to a six-year low.



Retail sales at stores like Target are slumping.

➔ Earnings and sales warnings are popping up everywhere. In just the past few days, I've seen warnings from chipmaker National Semiconductor, construction materials vendor Martin Marietta, consumer electronics company Apple, department stores Macy's and Target, and network equipment vendor Cisco Systems.

➔ And just yesterday, the biggest retailer in the U.S. — Wal-Mart — said its same-store sales gained just 0.5% in January. That was much weaker than the 2% gain that analysts were expecting, and it's proof positive that consumer spending is deteriorating fast.

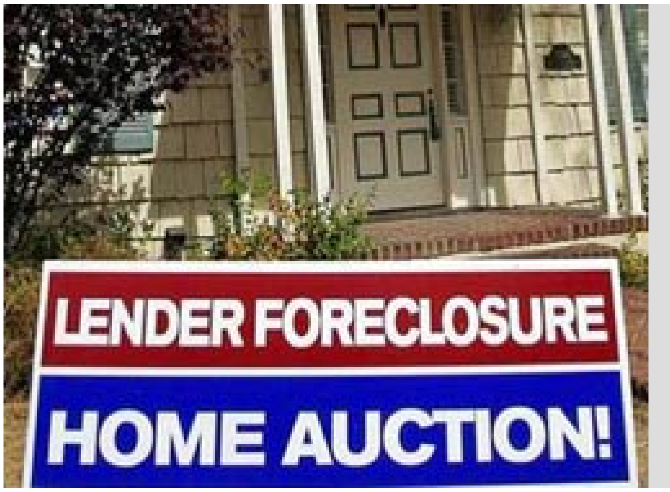
What about the industry that's at the center of this meltdown — housing?

Well, the real estate industry would probably like to forget last year. To briefly recap:

- Housing starts fell 25%, the biggest annual drop since 1980.
- Existing home sales dropped 13%, the biggest decline since 1982.
- New home sales fell 26%, the biggest drop this country has ever seen (data goes back to 1963).
- Meanwhile, the median price of an existing home fell from year-ago levels for the first time since the National Association of Realtors started tracking in 1968.
- Data from S&P/Case-Shiller shows that home prices were falling at an almost 8% rate in 20 top metropolitan areas as of late 2007, the biggest drop on record.

That's causing major problems with residential mortgages. The home loan delinquency rate jumped to 5.59% in the third quarter of last year, the highest since 1986. The percentage of loans in foreclosure climbed to 1.69%, another record. Lenders are adding hundreds of millions of dollars to their loan loss reserves, and charge-offs of souring home mortgages are rising fast throughout the banking industry.

In short, the home mortgage problems are well known. But here's what investors are failing to appreciate: ***It's not just residential mortgages!***



Residential mortgage woes are just the tip of the iceberg!

Commercial Mortgages, Leveraged Buyout Loans, Credit Cards, and Auto Loans Are All Going Bad

There were a record $1.4 trillion of leveraged buyouts in 2006 and 2007. These debt-financed corporate takeovers are now blowing up on the lenders who extended the loans and the junk bond buyers who snapped up the debt.

Get a load of this: More than 25% of the bonds that financed these LBOs are already trading at distressed levels, meaning they yield more than ten percentage points more than Treasuries. That's astounding considering these deals are only a few quarters old. Some of the junk bonds are now worth just 61, 64, or 73 cents on the dollar. Some of the bank loans are worth 90 cents or 91 cents on the dollar.

All told, banks are stuck with a $230 billion pile of high-yield, high-risk debt — $160 billion in leveraged loans and $70 billion in junk bonds. With the price of all this paper falling, banks could be forced to take billions more in write-downs. That's *ON TOP* of the more than $100 billion in write-downs they've already taken.

As for other plain-vanilla consumer loans, the outlook is worsening. The delinquency rate on home equity loans is the highest since 2005. The delinquency rate on home equity lines of credit is the highest since 1997. And the delinquency rate on indirect auto loans — loans you get through a car dealer but that banks actually fund — is the highest since 1991.

This is devastating news for banking stocks. But it also has an *economic* impact. Specifically, rising losses are causing lenders to tighten lending standards dramatically.

The latest Federal Reserve survey of top bank lending officials, conducted in January, found:

- More than 3 in 10 lenders are tightening standards on commercial and industrial loans. That's the most since early 2002.
- More than 80% are tightening standards on commercial real estate loans. That's the tightest banks have ever been — and the Fed has been keeping track since 1990.
- Seven out of 10 lenders were making it harder to qualify for subprime mortgages, while more than 8 in 10 were cracking down on "nontraditional" loans — think Alt-A loans, interest only financing, hybrid ARMs, and so on.
- And more than *HALF* of the lenders the Fed polled are making PRIME mortgages harder to get. That's the most ever!

Will the Government Be Able to Come From Behind and Pull Out a Victory?

Washington is getting more and more involved in the mortgage industry. We've seen several initiatives rolled out since late last summer, including:

1. A program called FHASecure, which is designed to refinance

borrowers with ARMs that are facing resets into a government-insured FHA mortgage.

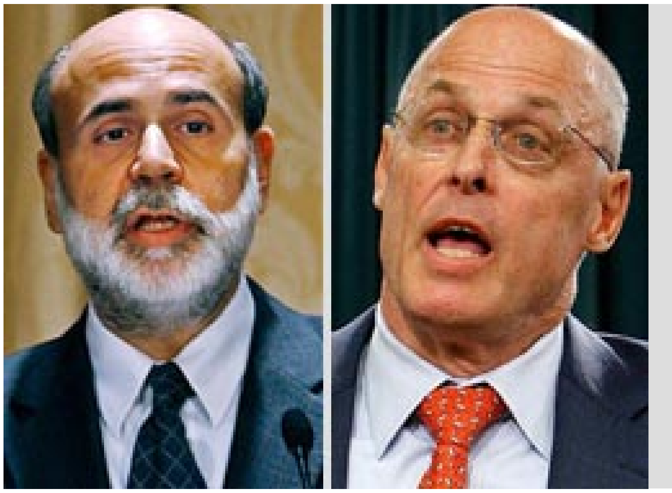
2. The Paulson Plan, which is designed to streamline loan modifications. Borrowers with certain subprime ARMs can qualify to have their interest rates frozen at the loan "start" rate for five years.

3. A proposal from Sen. Dodd to create a government-backed body that would buy crummy mortgages and replace the borrower's loans with more stable, affordable mortgages, perhaps backed by Fannie Mae, Freddie Mac or FHA.

4. A proposal in the economic stimulus plan to increase the size of the loans FHA can insure and Fannie and Freddie can back. They would be able to back loans up to $730,000 — compared with a current jumbo loan limit of $417,000 at Fannie and Freddie and a cap of about $363,000 at FHA.

These moves are designed to reduce the cost of higher-end mortgages ... to help stem the rising tide of foreclosures ... and to fill the financing gap left by fleeing private lenders.

In addition, the Federal Reserve is cutting interest rates sharply. The federal funds rate has been slashed from 5.25% to 3%. The discount rate has also been cut to 3 1/2%.



Bernanke is cutting interest rates; Paulson is planning bailouts.

The Fed has also been trying to flood the banking system with cash. One example: It initiated so-called TAF (Term Auction Facility) auctions that are dishing out $30 billion in funds at a time every couple of weeks.

And you have the federal government jumping in with fiscal stimulus — the House and Senate are hammering out details on a package of tax rebates for consumers and tax incentives for businesses that could total more than the current $145 billion, depending on how many provisions get thrown into the mix.

Unfortunately ...

I Do Not Believe These Measures Will Turn Things Around Quickly

As a nation, we have over borrowed and overextended ourselves in the past several years. We took out too much debt to buy too many homes at inflated values. We bought too many commercial properties at sky-high valuations. And frankly, we made a lot of dumb corporate deals. All of this was financed with high-risk loans and bonds.

Now, home values are coming back to earth. Now, commercial real estate deal volume has dried up. Now, many of the leveraged loans that financed a dramatic M&A wave are sinking fast. And now, the economy is paying the price because lenders are cutting consumers and businesses off as they focus on rebuilding their balance sheets.

As painful as this process is, I want you to remember something very important: This is what *MUST* happen for the economy to ultimately emerge healthier in the long run.

We have to take our medicine. We have to purge the bad debts. We need banks, investors, consumers, and borrowers to be reminded that losses can and do happen when too much risk is taken on.

Once that cleansing process has had a chance to play out, I think our nation and economy will emerge much healthier, and with a more sustainable growth outlook. That's a future I can really look forward to, and I imagine you can too.

Until next time,

Mike

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