



Market Weekly

Commodities, Forex, Futures and Options

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Managed Account Research, Inc. 929 Santa Barbara Street, Santa Barbara, CA 93101
www.ma-research.com research@ma-research.com 800.308.1495

HEADLINE OF THE WEEK: "Bailout tab: \$700,000,000,000" (Los Angeles Times, 9/21/2008)

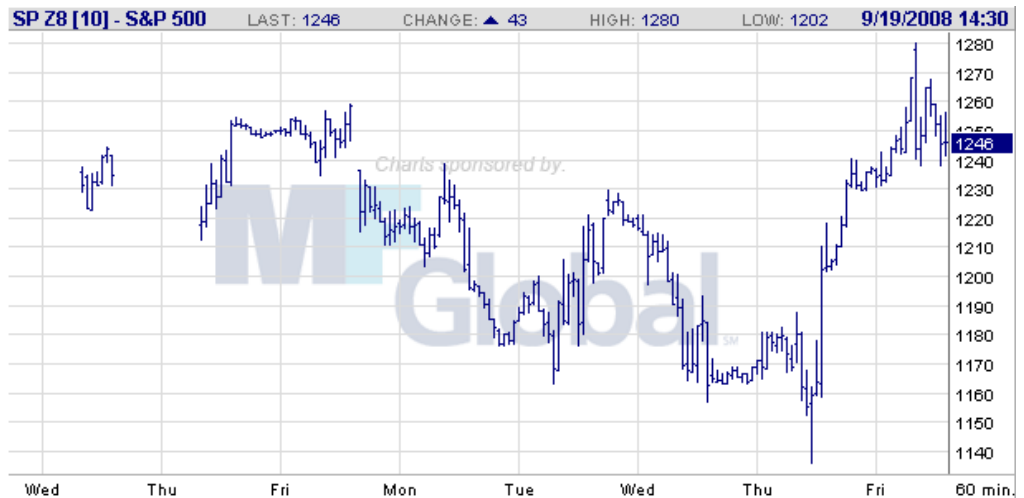
Compiled by Mack Frankfurter, Chief Investment Strategist

WEEKLY RECAP

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Based on Thursday's and Friday's response, we can gather that the equity and credit markets approved of US Treasury Secretary Paulson's plan to use taxpayers' money to try and quell the credit crisis. Problem is that reaching an agreement on a RTC-type vehicle is not going to be easy. Markets in the next few weeks are going to respond according to how the deal gets done, and where ultimately the bid price is going to be placed for the toxic assets that are poisoning the banking system. Pimco's Bill Gross thinks that the price should be 65 cents on the dollar (he also nominated himself on CNBC to be one of the proposed trust's managers), while hedge funds have been known to consummate deals which values these assets at 22 cents on the dollar. The saying goes, "buy when there is blood in the streets." If pulled off correctly, and taxpayers receive an equity interest in the outcome, it could turn out to be the greatest trade ever. Already AIG has made \$15 billion on paper since Tuesday when the government took an 80% stake in exchange for an \$85 billion dollar line of credit. But this is all pie-in-the-sky musings while the sky is falling. Conventional wisdom is that this action will ultimately prove inflationary. However, current fundamentals reflect more of a deflationary environment than an inflationary one. So even while the Fed might be creating liquidity (ie, printing money), since credit markets are effectively locked up, the multiplier effect is minimal in a crisis whose closest comparison is 1929.

"The saying goes, 'buy when there is blood in the streets,' and if pulled off correctly, it could turn out to be the greatest trade ever."



Gold is off its highs from April '07, and since July '08 is breaking down to lows not seen since a year ago.

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Headlines from page 1

“What Hamilton did in 1792 is just like what Paulson and Bernanke are doing now.”

In times like these one needs perspective. Truth is, Government bailouts is a U.S. tradition dating back to Alexander Hamilton, the country’s first Treasury Secretary. In 1791, the federal government assumed obligations that states such as Massachusetts and South Carolina owed from the Revolutionary War (part of a larger deal that included moving the capital from New York to Philadelphia to Washington). Taking on the states’ obligations added about \$18 million to a total U.S. domestic debt of \$65 million—debt securities that proved attractive to financial speculators. Speculators tried to corner the market on government 6% bonds, so-call Sixes. Hamilton, the founder of BONY, watched the developments with alarm. After the price for Sixes burst, Hamilton, working without a historical blueprint engineered an innovative response. The Treasury borrowed money from the banks and used it to buy government bonds, lifting the market price. He also told banks to accept bonds as collateral for loans to securities brokers, with the government guaranteeing the collateral. What Hamilton did in 1792 is just like what Paulson and Bernanke are doing now. In the 1930s about 1,000 American homeowners a day were losing their houses to the bank. President Franklin Roosevelt and Congress created the Home Owners’ Loan Corp., an ambitious government agency designed to prevent foreclosures on an enormous scale. The agency bought defaulted mortgages from banks, then refinanced them at lower rates for fixed, 15-year terms. The current mortgage crisis involves securities backed by subprime home loans. But during the 1930s, there was no secondary market for securitized mortgages. So the agency had to hold the mortgages for the full terms. It finally closed up shop in 1951, with about 80% of borrowers having paid their loans off on time or early. In fact, the agency earned the government a small profit.



Crowds panic in the Wall Street district after the stock market crash in 1929.



Gold had its biggest one day change as measured in dollars on Wednesday, and another Thursday.

“What assets will the government-backed entity accept? Will it only take simple credit securities or more complex ones, too?”

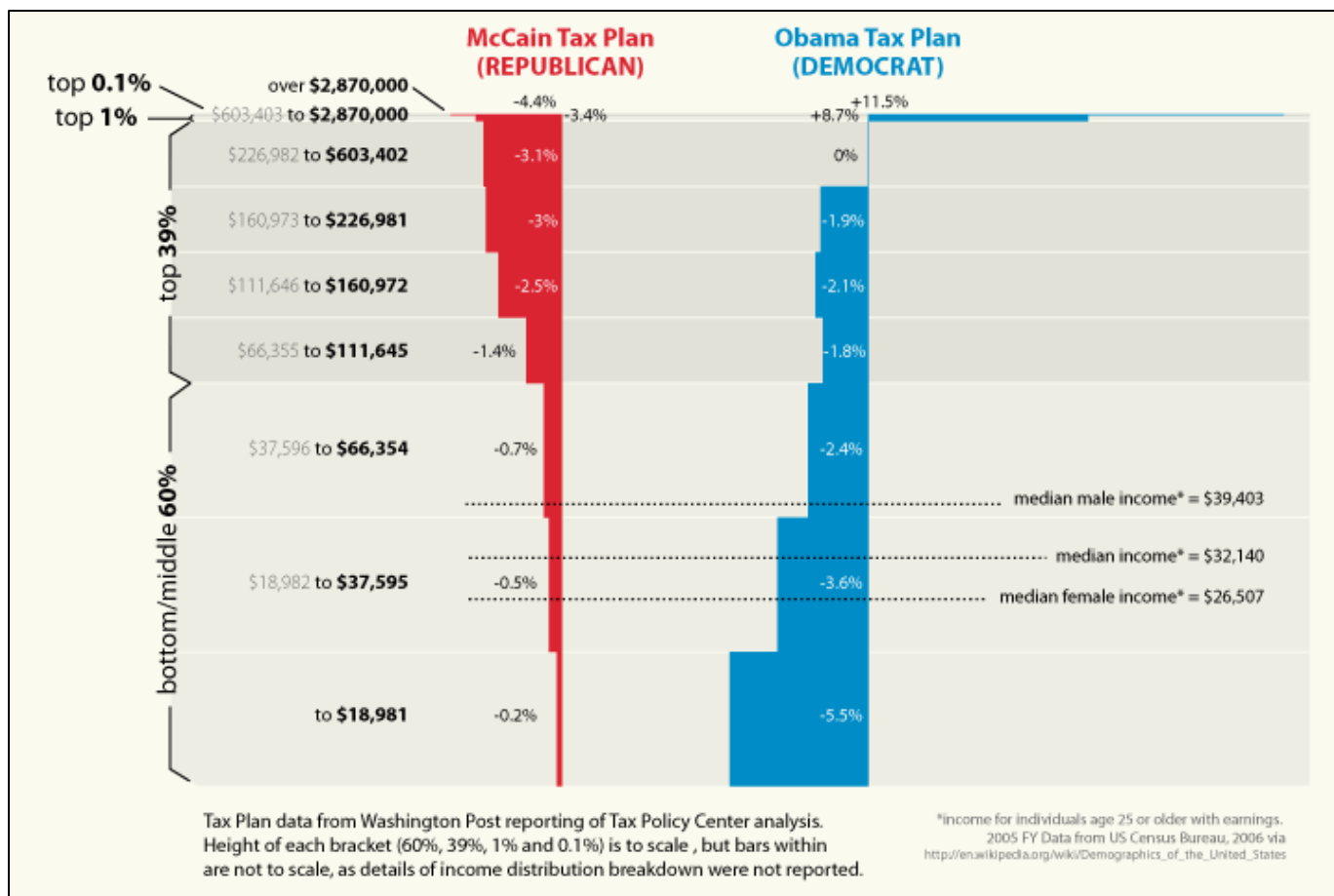
The above history lesson provides a perspective regarding the current situation. A government-sponsored vehicle can help deal with a situation in which investors fear banks do not have enough capital to cover credit losses. The entity can address this by buying problem assets from banks, and by giving them more capital to finance portfolios of problem assets, or both. The basic questions are the same in both instances. What assets will the government-backed entity accept? Will it only take simple credit securities or more complex ones, too? At what price? And will it invest to hold or sell on the assets? It’s all speculation at this point.

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ECONOMIC REVIEW

This graph compares McCain's and Obama's tax plans, and was redrawn from Washington Post data by Viveka Weiley. The graph is an effort to correlate tax cuts/increases with income distribution across population. The bottom three brackets equal 60% of the population, the next four are 39%, followed by the top 1% and top 0.1% brackets.



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Next Week's Economic Calendar

Execution of the RTC II deal is going to be the main focus next week, with all economic statistics taking a backseat.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
24-Sep	10:00 AM	Existing Home Sales	Aug	4.95M	4.93M	5.00M
24-Sep	10:35 AM	Crude Inventories	20-Sep	NA	NA	NA
25-Sep	8:30 AM	Durable Orders	Aug	-0.7%	-1.3%	1.3%
25-Sep	8:30 AM	Initial Claims	20-Sep	NA	NA	NA
25-Sep	10:00 AM	New Home Sales	Aug	520K	518K	515K
26-Sep	8:30 AM	Chain Deflator-Final	Q2	1.2%	NA	1.2%
26-Sep	8:30 AM	GDP-Final	Q2	3.4%	3.4%	3.3%
26-Sep	10:00 AM	Mich Sentiment-Rev.	Sep	74.0	N/A	73.1

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~~Op-Ed~~ MANAGED FUTURES NEWS

Mack Frankfurter, Chief Investment Strategist

The largest financial bailout in United States history, which some traders are starting to call the ‘Securitized Housing Investment Trust’ (hint: think acronym), is causing an existential crisis amongst those who hold to purest free market ideology. Senator Jim Bunning, Republican of Kentucky, echoed this sentiment when he said, “The free market for all intents and purposes is dead in America.” These ideologues doth protest too much, methinks.

Since the 1929 crash, the last time the nation faced an economic train-wreck of this magnitude, the U.S. Government has effectively been in the insurance business and it has generally served us well. The vast majority of laws and regulations are designed to mitigate risk. Drunk driving laws minimize the number of car wrecks, and the short uptick rule (until recently eliminated) prevented unfettered short-selling from forcing solvent companies into insolvency.

Government institutions enforce these policies. What is the purpose of the military but an insurance policy against attack from other nations? What is the key purpose of a central bank other than insurance against a run on banks?

In fact, the present-day capital market system, which has been responsible for raising living standards to the highest in world history, relies upon laws and regulations: the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act of 1936, and the Investment Advisers Act of 1940. Although not perfect (and definitely requiring an overhaul), these laws have served Wall Street and LaSalle Street very well over time.

The problem with fundamentalist free market ideology is that it is only theoretical, and ultimately not pragmatic. Truth is, without government establishing the premise of private property enforced through law and justice, contract markets would soon devolve and be quickly replaced by gangster capitalism akin to Putin’s Russia. There is a term for the unfettered combination of concentrated power, ideological adherence and capitalistic greed, it is called “fascism.”

There is another term “beta,” which defines the systematic return/risk of assets. This concept is related to Modern Portfolio Theory and underlies the oft-stated investment strategy of buy-and-hold. What is not well-understood, even by many sophisticated investors, is that this theory is flawed. The issue is portfolio construction. Accordingly, the definition of “true beta” or “true market portfolio” must be extended to encompass other economic factors.

What academics came to recognize was that approximately one-third of non-governmental tangible assets in the U.S. are owned by the corporate sector, and only one-third of these corporate assets are financed by equity. As a result, Jagannathan and Wang concluded that assumptions underlying the concept of beta must be altered in order to resolve anomalies in the model. In other words, “true beta” or the “true market portfolio” must include the “aggregate wealth portfolio of all agents in the economy.” This is a revolutionary view with both political and economic ramifications.

Business balance sheets do not in practice reflect public infrastructure assets which businesses are dependent on. For example, a trucking company’s greatest asset is not its fleet of trucks, but the U.S. Highway system. Likewise, public liabilities such as the cost of pollution are also not reflected on corporate balance sheets. This is beginning to change with the idea of integrating regulations into “cap-and-trade” contract markets involving emission allowances.

It is time for a new economic ideology to take hold which adheres to a progressive view. Government and free enterprise are actually joint partners in promoting economic growth and well-being. Certainly, political will effects a constant tug-of-war between interests, but this is not unlike the struggle between a sales-trading desk which drive revenues for an investment bank, and internal compliance/risk managers who ensure balance between risk and reward.

The problem with the prevalent populist stream of conversation regarding free markets versus socialism is that such dialogue is anachronistic. Rather, the conversation needs to shift to good versus bad governance, and public policy which enhances the value of the aggregate wealth portfolio of all agents in the economy.

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Managed Account Research, Inc. 929 Santa Barbara Street, Santa Barbara, CA 93101
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