



## *DT Analysis SAC*

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# **DAILY REPORT** **(02/18/09)** *Strange Math*

I remember sitting at my desk in 3<sup>rd</sup> grade and the teacher comes in and announces that we were going to be the first class to learn the so-called “new math”. I remember thinking to myself “I wonder what was wrong with the old math?” As the years passed I learned the new math and all the other math’s that came after it. Numbers have always fascinated me; in part because they have no meaning, other than the one human beings assign to it. I also learned that the meaning could change over time. For example, when I was younger every day was *one more* and now that I am a lot older it is *one less*. Youth does that, i.e., it creates the illusion of immortality. As I grew older and became more involved in business and the financial markets, I quickly learned that the same number could mean just about anything depending on the mental agility of your accountant. For a perfect example, take a good look at Enron or the Madoff affair. Today the numbers manipulation game has gone to such extreme lengths, that the entire financial system is in danger of collapse. Governmental band-aids have been applied, but it’s the equivalent of trying to cure a cancerous brain tumor with an aspirin.

I want to explain the problem with a real life example. I have a friend who bought a condominium in Miami, Florida in 2004 for US \$1 million. Back in the late 1980's, this same unit sold for US \$245,000. By late 2005, that same unit was appraised at US \$1.5 million, and thanks to the magic of 100% financing, my friend refinanced the condo for US \$1.4 million secure in the knowledge that it would double again in three years. Meanwhile he pocketed US \$400,000 for his trouble and used that to prepay his mortgage and buy a few other goodies like a Ferrari and a Riva boat, all financed of course. Life was definitely good! He even managed to refinance one more time in late 2006 and pocket another US \$200,000. Then along comes the housing/credit crisis in July 2007 and he is saddled with a US \$1.7 million mortgage on the condo, another mortgage on his original house, and four-digit loan payments on both the car and boat. In early 2006 he was making US \$225,000 and felt rich. By early 2008 his income had been cut by 30% as his business declined, and he didn't know where to hide. Life does that sometimes!

My friend's first instinct was to put the condo on the market but he was shocked to realize that it wouldn't sell for more than US \$800,000, and that was if he acted quickly. Since he owed US \$1.7 million, and he didn't have the cash, he decided to wait for the market to turn around. Today that condo is worth just US \$575,000, it goes without saying that he is in default, and the Porsche and boat are both history. Like my friend, there are tens of thousands of individuals out there who are in the same soup. Now, multiply this exponentially because of commercial real estate failures, credit card defaults, car loan defaults, student loan defaults, and so on... Now you get the picture? Millions of people all strung out on way too much credit, shrinking or no income because they are now unemployed, and no way to increase their income over the foreseeable future. The Federal Reserve and Department of Treasury have created liquidity by the boat load, but all to no avail.

It seems incredible to me that no one in power can or will see the problem for what it really is. *The financial institutions made way too many loans to people who can't pay. Without the boom in cheap credit my friend would never have paid more than US \$575,000 for his condo and a responsible financial institution would have required a minimum of 25% down as well as an income to justify the mortgage payment. That never happened. Now*

*this same corrupt system wants to issue more credit to the same fellow who can't pay what he owes, and sure as hell can't pay on another new loan. Cash flow does not now, and never will, support more credit. **What needs to be done is to write down all these loans to amounts that can in fact be paid.** In my friends case, down to somewhere around US \$410,000! Once you do that, then we'll see **real values** and the housing market will once again become attractive. Instead the government continues to pump money*



into banks that are as bad as or worse off than the clients they serve and are mystified that the housing industry fails to rebound. Giving more money to these folks is like giving a typewriter to a monkey; if you wait a

million years he'll type the Bible by accident. My question is who will live to see it?

Unfortunately, the stupidity doesn't end here. The trillions of dollars of worthless assets are slowly being absorbed into the Fed's balance sheet, at or close to face value. The Fed then uses these "assets" as security to print money and channel it back into the banks. These banks do not loan these funds out because no one can qualify, but they do pay themselves nice bonuses and big salaries "for a job well done". Meanwhile the taxpayer is getting laid off and can't pay his mortgage, but he'll get a tax credit for income that already went up the stack. He has no savings, no job, no prospects for a job, and the wolf is at the door. Welcome to the Depression of 2009! The only real solution is to reduce debt down to a level where cash flow will support it, and that will require banks to close their doors and that is as it should be. What happens when that occurs? New and more



solvent banks will spring up to take their place. The government will insure the accounts in the defunct banks to their legal limit and everyone will have learned a valuable lesson. That's how it was played out in 1907, and again in 1929, and that is how it will play out now. Until debt is written down you are just throwing good money away after bad, and you are prolonging the Depression that is already here.

Right now President Obama is a new broom and the country thinks he is resolving a problem left to him by a Republican administration. He is about to sign in a stimulus package that will fail to stimulate the economy. Then in three months he'll be back at the trough looking for more money. Six months will pass, things will get worse, and it will be viewed as *his* problem to clean up. By the end of 2009, assuming he follows the path laid out with the stimulus bill, he will be viewed by the American public as inept and the "wrong man for the job". Things will be a lot worse than they are now. How do I know the stimulus package will fail? *Simply put, all of the stimulus packages to date have failed and this one is just more of the same. Just bigger numbers!* The Fed and the Bush Administration had a very small window of opportunity way back in October 2007 to get ahead of the problem, and they failed miserably. Better yet, they chose to serve a very select and powerful master and let the rest of the country go to hell.

How do I know they are going to fail this time around? The market is telling so. Each and every stimulus package, dating back to September 2007 has had a shorter and shorter shelf life. The first one produced a rally that lasted sixty days, while the last several produced sell-offs that began almost as soon as the details were made public. Obama was elected President back in early November and from that minute on, there was no doubt that a stimulus bill would be forth coming. Admittedly, the bill to be signed is a watered down version due to Republican intervention, but the concept is still the same. The Dow was trading at +/- 9,400 back then and has since fallen to Friday's close at 7,850.41 as you can see in the following four-month daily chart below:



The Dow votes with its money and its money says that Obama is on the losing side. What's more, if the Dow breaks down here as I believe it will, it's saying the future will be a lot bleaker than the present and that is an ugly thought if you ask me! [It's now Tuesday at 9:55 am EST and the March Dow has traded as low as 7,571 and the March S & P has fallen below 800.00 so I am not far off.]

In conclusion it is a shame that President Obama did not take advantage of the situation. He had a mandate from the people but he decided to act like a politician instead of a leader. I know it's early to write obituaries, but I've been around long enough to know a loser when I see one. This market will break down, and soon, probably falling to somewhere around 6,000 before we finally see a decent rebound. Again, I know this because the

market is telling this to anyone who will listen. For a good bottom to occur there must be an exhaustion of the urge to sell. We have seen no such exhaustion or capitulation if you prefer, and that is mainly due to the intervention we've seen. During the 1907 Crash many important names tried in vain to support the market at overvalued levels and they failed. In the end, all many investors had left was their name. J. P. Morgan finally succeeded in intervening, but he had the good sense to wait until the selling exhausted itself. If everyone would just let the Dow find its bottom, things would turn around and you could buy stocks at lower prices. This would not be the end of the bear market, but it would finally offer a reasonable rally you could sink your teeth into.

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