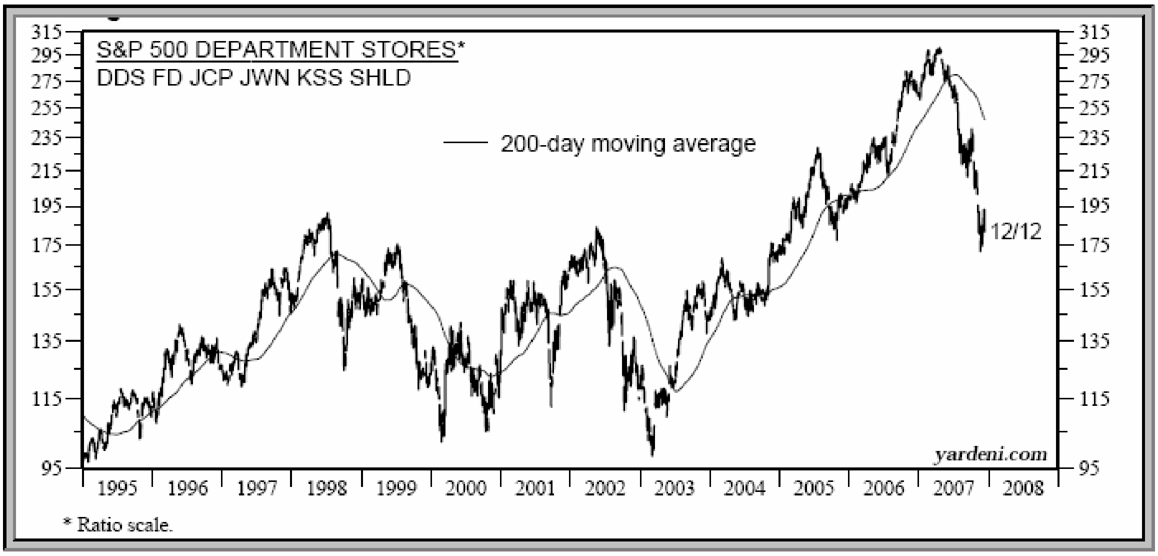
A not so Happy New Year!

Marc Faber

> **"The credit bubble is just beginning to unwind, and while U.S. borrowers are being blamed for the mess, they were really just a pawn in a global game."**
> Satyajit Das, author of a 4,700 page reference book on credit derivatives, and considered a leading expert on the subject.

According to a CreditCards.com poll, for as many as 27 million American adults keeping warm this winter will mean borrowing money and 20 million will use credit cards to be able to afford their heating bills. Nearly 12 percent of Americans say they will need to borrow money to pay winter heating bills; 9 percent will need to use credit cards to be able to afford their heating bills. As I have pointed out before the median US household's financial position is extremely precarious. It is, therefore, not surprising that retail stocks are performing poorly and signaling a recession (see Figure 1).

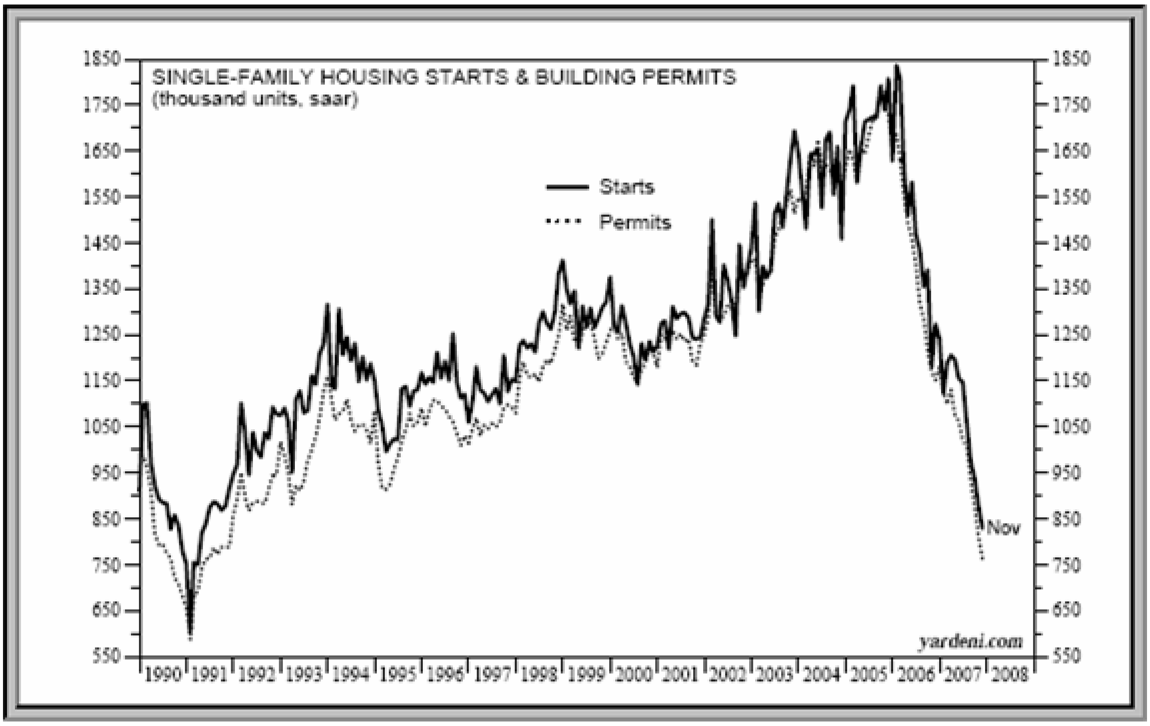
Figure 1: S&P Department Store Index, 1995 - 2007



Source: Ed Yardeni, www.yardeni.com

Poorly performing retail stocks are not the only indicator suggesting a very weak consumption environment. According to David Rosenberg of Merrill Lynch, the housing recession deepened in November 2007, as new home sales plunged 9%, which places the annualized level at just 647,000 – the lowest since April 1995 (see Figure 2). At the same time the supply of unsold homes jumped to 9.3 months in November up from 8.8 months in October, just shy of the 17-year high reached in August 2007 (see Figure 3).

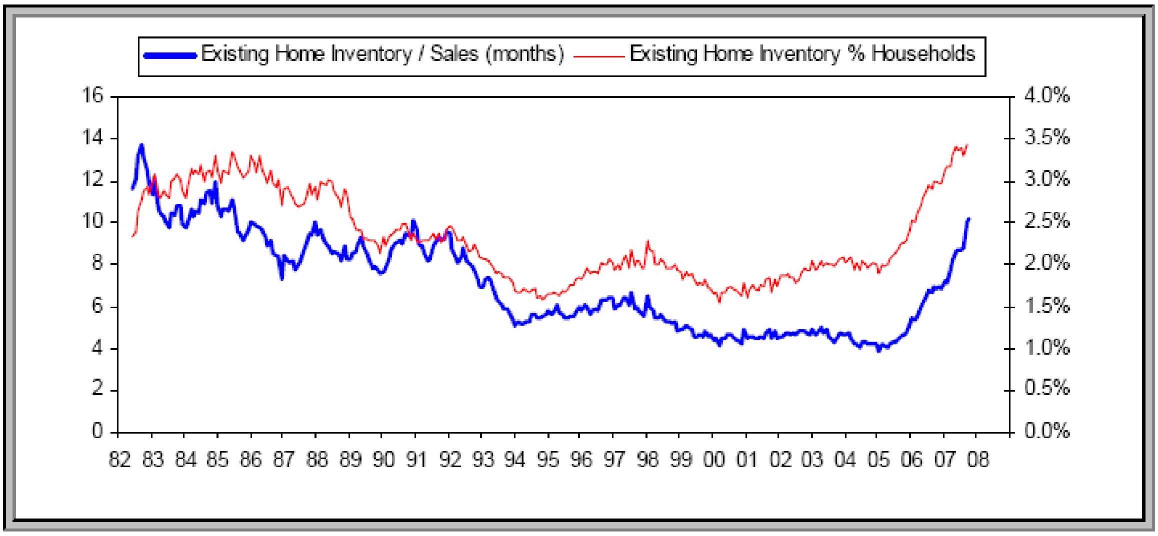
Figure 2: Single Family Housing Starts in a Free Fall!



Source: Ed Yardeni, www.yardeni.com

It should be clear that the high level of inventories of unsold homes will continue to pressure home prices and depress construction activity as we move into 2008. It is evident from the record level of existing home inventories as a percent of US households how severe the housing recession is (see Figure 3).

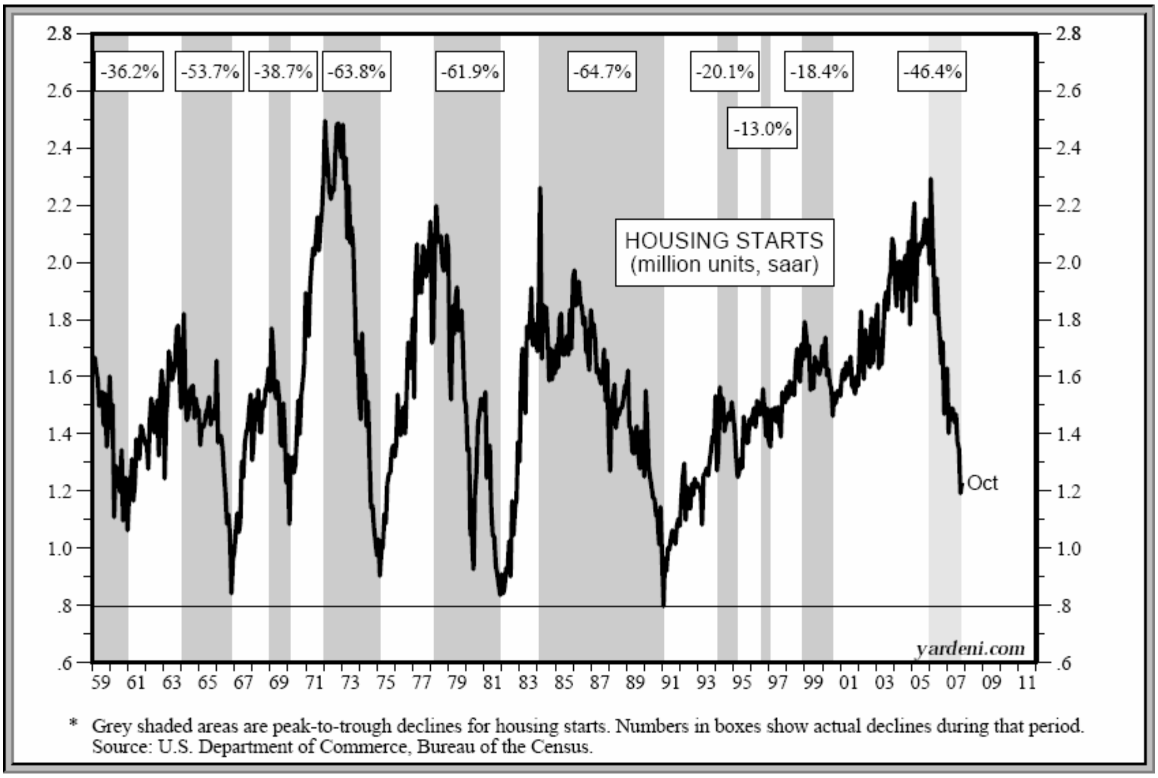
Figure 3: Existing Home Inventories, 1982 – 2007



Source: Bridgewater Associates

It should, therefore, only be a matter of time until housing starts decline further and will also signal the onset of a recession (see Figure 4).

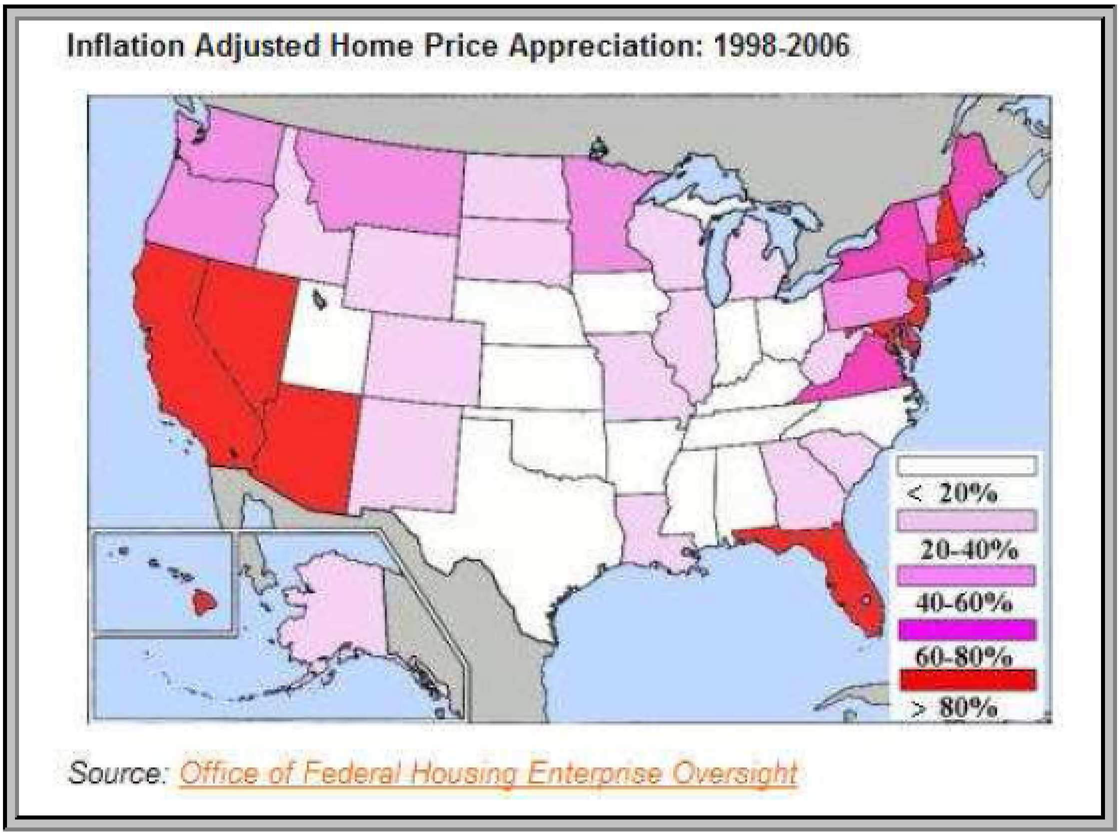
Figure 4: Housing Starts 1959 - 2007



Source: Ed Yardeni, www.yardeni.com

Please note that each time housing starts declined 50% or more, a recession followed, as was the case in 1970, 1974, 1981, and 1990. Given the high level of unsold home inventories both in terms of months' supplies and as a percent of households the housing and construction outlook remains grim to say the least. In last month's report we reproduced a chart showing US median home prices as a percent of median incomes, which indicated that US home prices would have to decline another 25% or stay flat for five years to reach fair value (see Figure 6 of December report). However, it should be noted that in some areas of the US where the home price appreciation was particularly high in the last few years (California, Nevada, Arizona, Florida) housing prices could decline peak to through much further (see Figure 6).

Figure 6: Home Price Appreciation in Real Terms, 1998 - 2007



Source: Fred Richards, Strategic Investing

I am aware that the slump in the housing market is old news and to talk about it may begin to bore my readers. However, what is new is that the credit problems, which first manifested themselves in mortgage backed securities, have now infected also the bond insurance companies such as AMBAC (ABK) and MBIA (see Figure 7).

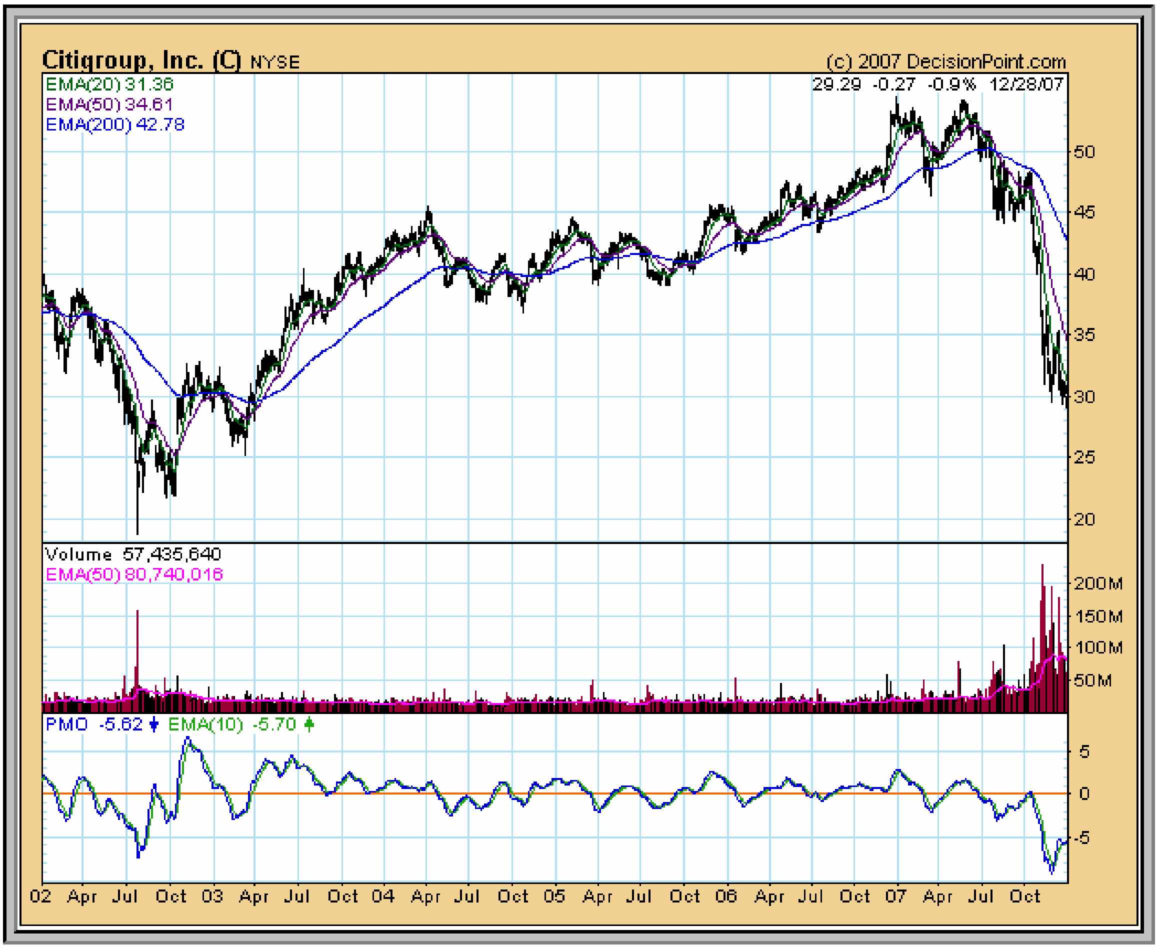
Figure 7: MBIA, 2002 - 2007 – A Total Collapse in the last Three Months to $18!

Source: www.Decisionpoint.com

The problem is that MBIA – the world's largest bond insurer – disclosed on December 21 that it had had guaranteed $8.1 billion of the riskiest mortgage securities, which now imperil its entire net worth (the company's net worth as of September 30 was $6.5 billion). The company said it had guaranteed $30.6 billion of complex mortgage securities in total. Morgan Stanley said that, "We are shocked that management withheld this information for as long as it did."

Well, I am not surprised. First of all if we look at the stock performance of bond insurance companies such as MBIA and AMBAC, we can see that these stocks really started to tumble in earnest in October 2007 and were so indicating some problems. As I have emphasized so many times before, we need to look at the performance of shares, which reflect the market perception of the future value of companies and their earnings, and avoid listening solely to opinions of analysts and so called "sophisticated" investors. As an example I am hearing all the time how great a bargain banks such as Bank of America, JP Morgan Chase, and Citigroup are (see Figure 8).

Figure 8: Citigroup – Almost Cut in Half since July to $29!

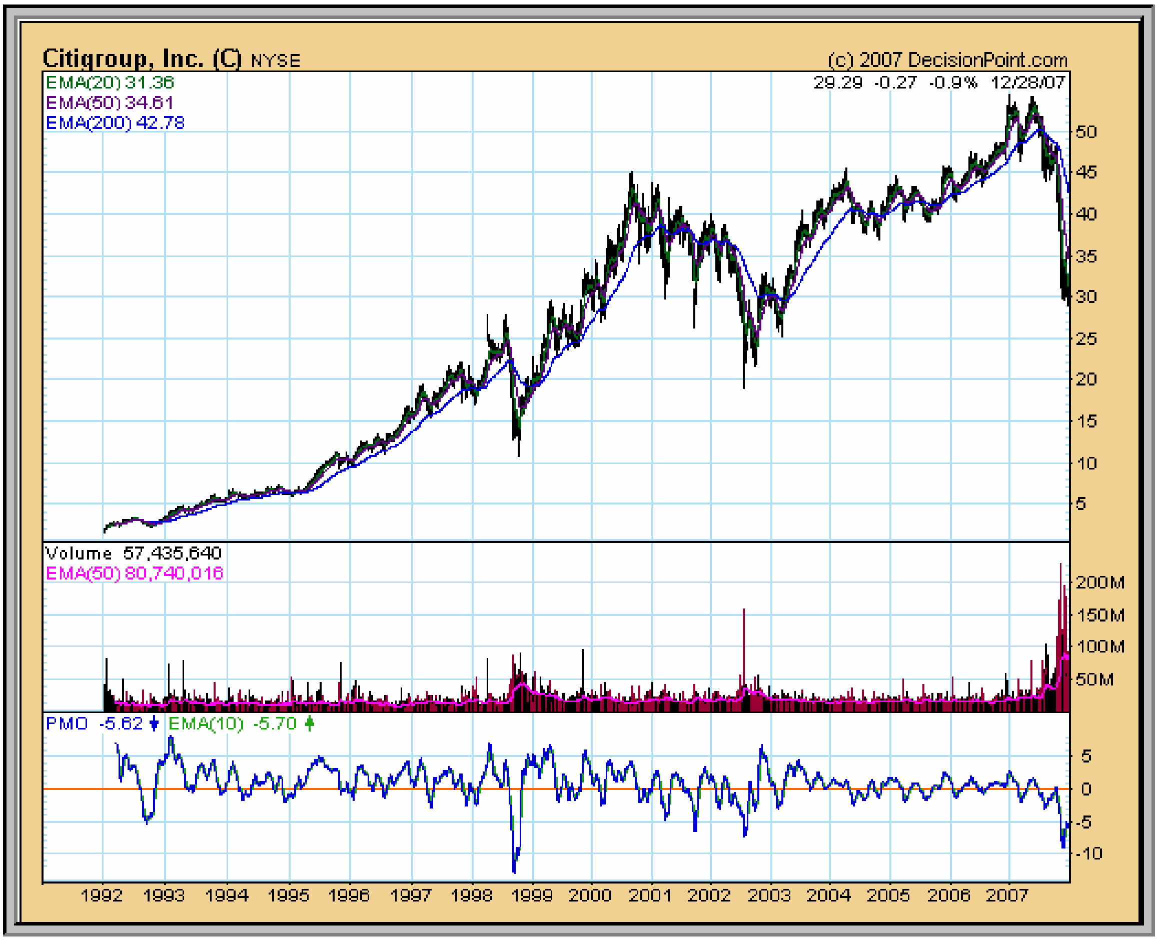


Source: www.Decisionpoint.com

I am not so sure about this view. Consider that in the case of MBIA the buyout firm Warburg Pincus was aware of the exposures to lower quality CDOs prior to making its investment in the company, when it announced on December 10, 2007 that it would initially invest $500 million by purchasing MBIA shares at $31 each! This announcement initially helped restore some investor confidence and pushed MBIA shares as high as $37.50 the day the deal was announced. But, now with the shares changing hands at $18 the deal does not look that great (and may not even be completed). Similarly, Citigroup shares jumped from $30 to $35 after November 27 on the announcement that the Abu Dhabi Investment

Authority (ADIA) would make a $7.5 billion investment in the company. But as can be seen on Figure 8, it has since then given back the entire rebound and some more! Moreover, if we look at long term charts of Bank of America, JP Morgan Chase and Citigroup considerable downside risk still exists (see Figure 9).

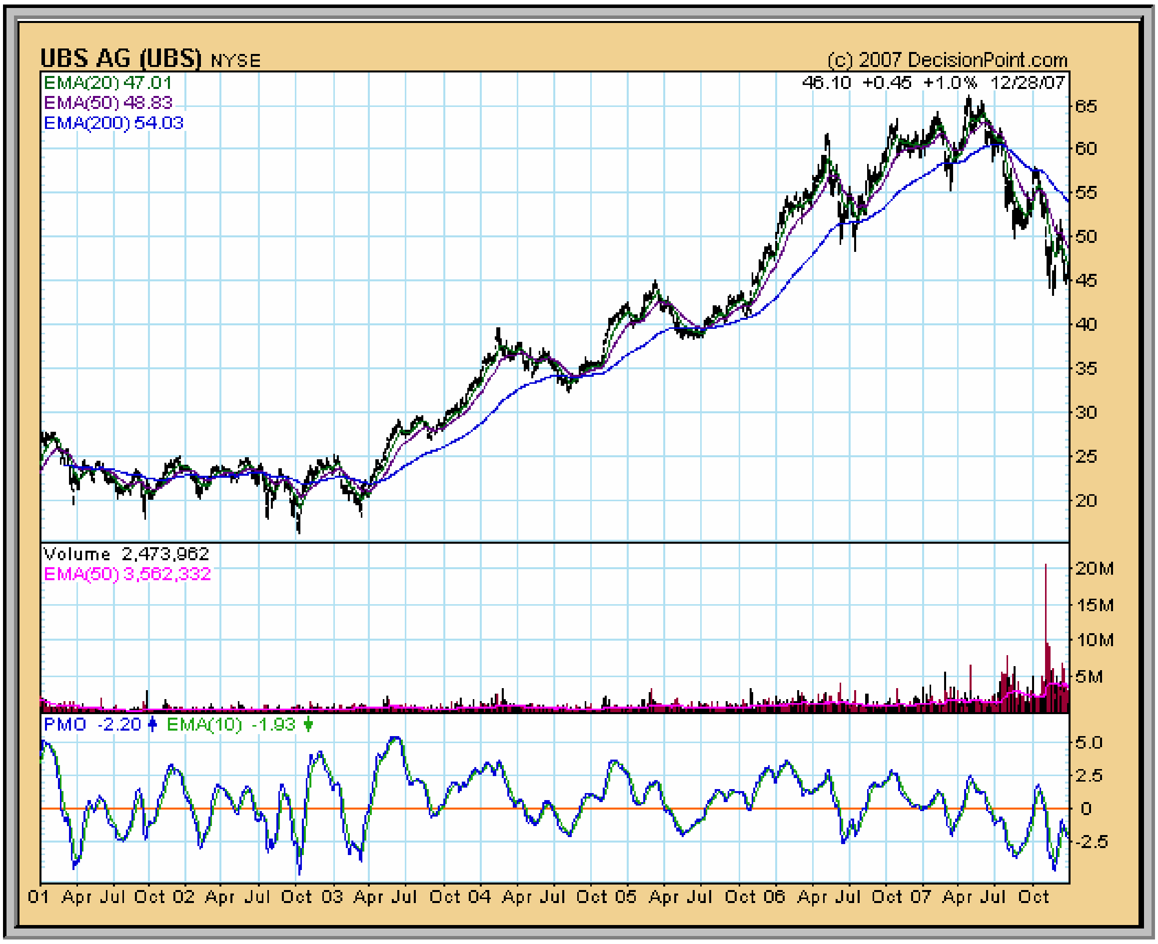
Figure 9: Citigroup – A Decline to Between $20 and $25????



Source: www.Decisionpoint.com

In the case of Bank of America the stock could still drop from $41 to below $30 while JP Morgan Chase could decline to between $20 and $30 from $43. In fact, each time a Sovereign Wealth Fund makes an investment and stocks rebound, they seem to provide excellent exit opportunities. Blackstone Group has declined 24 percent since its initial public offering in June after China Investment agreed to buy a $3 billion stake in the firm. Bear Stearns has declined 26% following its sale of a stake last October to Chinese government controlled CITIC Securities. Therefore, I would consider selling UBS stock here or on any rebound following the announcement that the Government of Singapore Investment Company and a Middle Eastern Investor made a SFR 13 billion investment in some convertible bonds (see Figure 10).

Figure 10: UBS – Sell on a Rebound!



Source: www.Decisionpoint.com

Three observations: a) I have never experienced a bull market in equities without the participation of financial stocks. In addition, when financial stocks across the board collapse it is a very negative sign for the overall health of the stock market (see Figure 11).

Figure 11: Sallie Mae, 2001 - 2007

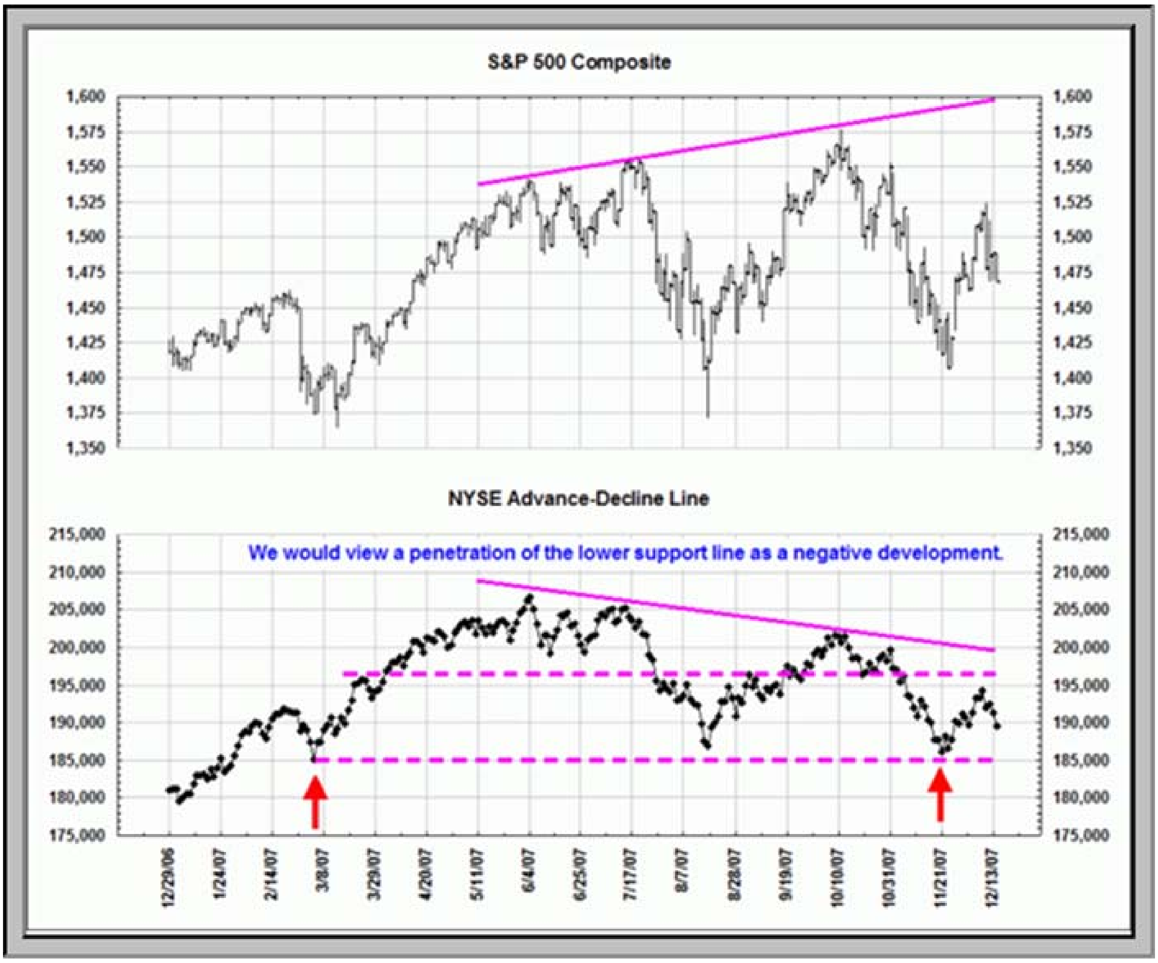
Source: www.Decisionpoint.com

b) The fact that a stock has declined from the peak by 50% or even 90% does not make it necessarily inexpensive. In 1985, I recommended the purchase of a basket of Texas banks, which at the time had declined by 95% from the peak, as a contrarian play. Subsequently, they all went bankrupt!

c) As I have explained before, the financial sector has become disproportionably large over the last 15 years or so. Therefore, I would also expect the reversion to the mean of the financial sector to take several years and not to be completed in just six months!

In short, I would avoid purchasing financial stocks for now and would also defer new commitments to equities. Of some concern to me is that on rallies, the list of 12-months new highs does hardly expand and that the NYSE Advance – Decline Line is trending down (see Figure 12).

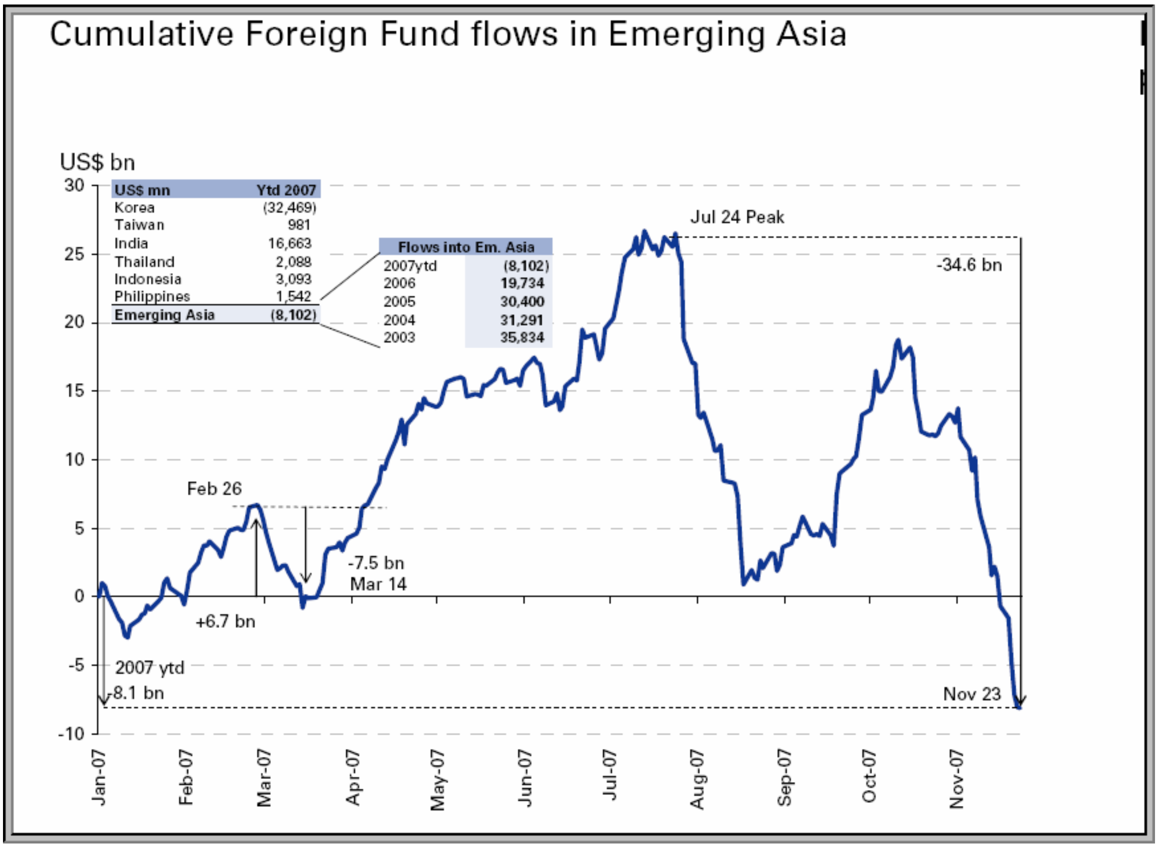
Figure 12: S&P 500 Year-to-Date and NYSE Advance - Decline Line



Source: Ron Griess, www.Thechartstore.com

Also, as explained in previous comments, I would avoid emerging stock markets following their significant out-performance over the last few years. Many institutional investors who 5 years ago hardly had any exposure to this asset class have now up to 50% of their money in emerging economies stock markets. In an environment of relative global tightening of liquidity I am afraid that emerging stock markets could be deserted by foreign investors as seems to have begun in the case of Asia (see Figure 13).

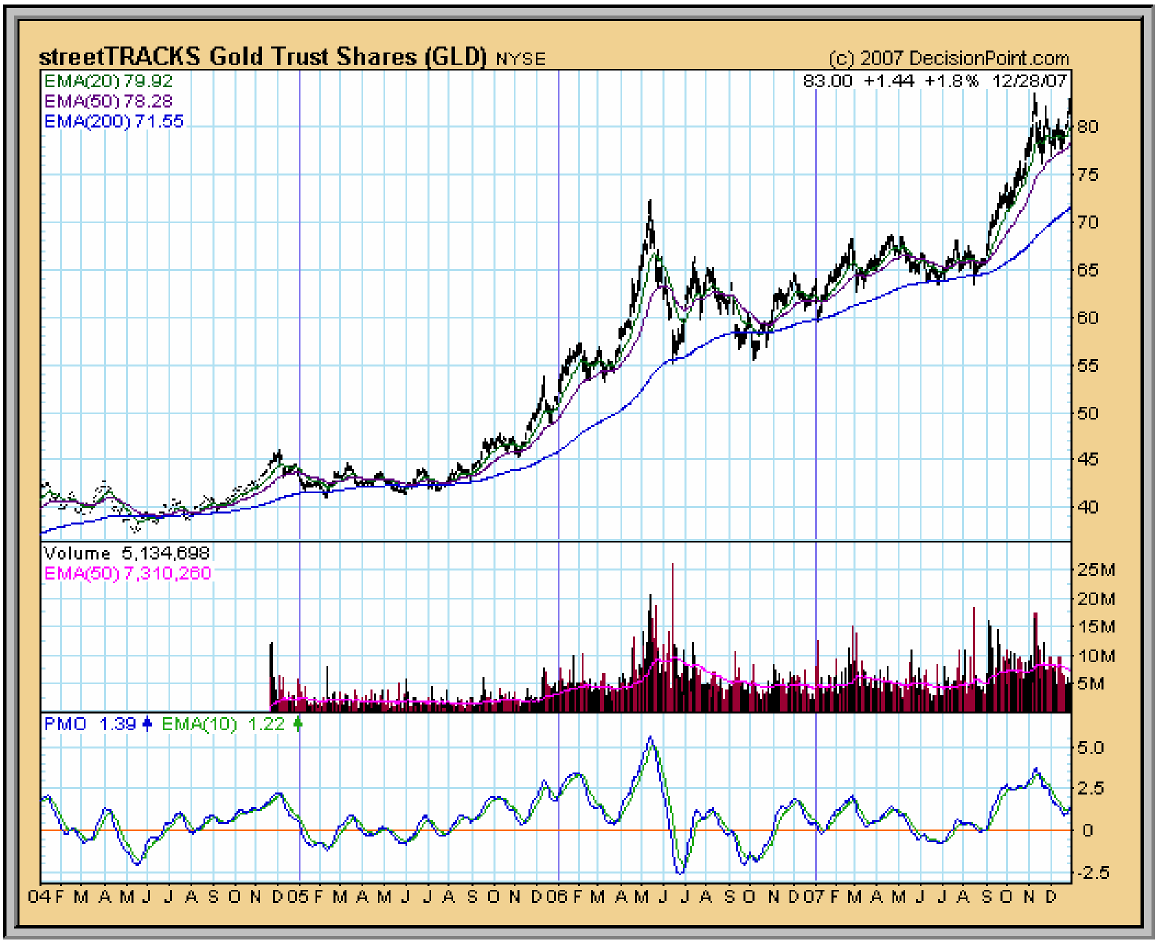
Figure 13: Will Asia Experience Additional Selling Pressure?



Source: Goldman Sachs

I am sorry that the picture I am painting is not particularly favorable for the performance of equities in 2008. So, what would I buy? I like sugar, cotton and I still recommend accumulating gold, which I expect to continue to out-perform equities for several years. Central banks around the world have no other option but to print money and this will lead to a further depreciation in the value of paper money against precious metals. Still, nothing goes up in a straight line and, therefore, investors need to be aware that gold could still correct to around $750 or so. But when we consider the up-side potential of gold compared to its downside risk the biggest mistake an investor could make is not to own any gold at all (see Figure 14). Interestingly, we know a lot of gold bulls who have already sold their positions and pray for a significant correction in order to establish again long positions. In my opinion, the gold bull market will come to an end when Sovereign Wealth Funds - sick and tired of their investments in financial stocks - will finally purchase gold – probably at above $3000 per ounce.

Figure 14: Gold, 2004 - 2007



Source: www.Decisionpoint.com