



BULLS & BEARS

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HEADLINES

- AIG sells American Life Insurance business to MetLife for \$15.5 billion
- Boeing shares increase after Northrop announced it would stop battling over a \$40 billion airforce contract
- Labor Department reported workers filing for first time jobless benefits declined by 6,000 to 462,000

FINANCIAL MARKETS

DOW	10,624.69, +0.55%
NASDAQ	2,367.66, +1.78%
S&P 500	1,149.99, +0.99%
OIL	\$81.24, -\$0.26
GOLD	\$1,101.50, -\$33.30
10 YR	3.710%

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MARKET SUMMARY

Monday March 8, 2010

Stocks finished mixed in Monday's session. Dollar strength put pressure on commodities. In company news, AIG entered an agreement to sell its American Life Insurance business to MetLife for roughly \$15.5 billion. McDonalds sales results came in ahead of expectations, which also provided support to stocks. The Dow Jones Industrials Average finished down 0.1% to 10553, the S&P500 finished down 0.02% to 1139 and NASDAQ finished up 0.3% to 2332.

Tuesday March 9, 2010

Stocks ended marginally higher at the close of Tuesday's session, though well off of the highs of the trading session. Boeing shares moved higher after Northrop Grumman announced that it would stop battling over a \$40 billion contract to build the U.S. air forces next generation aerial refueling systems. The Dow Jones Industrials Average finished up 0.1% to 10564, the S&P500 closed up 0.3% to 1140 and NASDAQ closed up 0.4% to 2341.

Wednesday March 10, 2010

Stocks ended slightly higher at the close of trading on Wednesday. The commerce department reported that wholesale inventories dropped 0.2% in January following a 1% decline in December. Sales increased for the 10th consecutive month. Commodities rallied pushing crude oil above \$82.00 a barrel. The Dow Jones Industrials Average closed up 0.03% to 10567, the S&P500 closed up 0.5% to 1146 and NASDAQ closed up 0.8% to 2359.

Thursday March 11, 2010

Major U.S. averages traded higher on Thursday with help from reports out of the Commerce and Labor Departments. The Commerce Department reported that the U.S. trade deficit declined in January as importing of foreign cars, and oil declined. The Labor Department reported that workers filing for first time jobless benefits declined by 6000 to 462000 last week. Financial stocks were among the days best performers on the back of Citi's Vikram Pandit talking about Citi's return to profitability. The Dow Jones Industrials Average closed up 0.4% to 10,612, the S&P500 closed up 0.4% to 1150 and NASDAQ closed up 0.4% to 2368.

Friday March 12, 2010

Stocks were mixed during Friday's trading session in reaction to not-so-great retail sales data. The Commerce Department reported that retail sales rose 0.3% in February; analysts had been expected a decline. The University of Michigan Consumer Sentiment index for March dropped from 73.6 in late February to 72.5, which traders seemed to take as further confirmation of the tenuous nature of the economic recovery. The Dow Jones Industrials Average closed up 0.1% to 10625, the S&P500 closed down 0.02% to 1150 and NASDAQ closed down 0.03% to 2368

THE WEEK IN QUOTES

"The snowstorms couldn't keep consumers away from the cash registers, and neither could the constraints imposed by tightening credit-card terms and near double-digit unemployment"

-CHRISTOPHER RUPKEY, an economist at Bank of Tokyo-Mitsubishi in New York City, discussing the jump in February retail sales in the US.

"I remind them of the danger and risks to the British economy of the disruptive strikes going ahead."

- GORDON BROWN, British Prime Minister, after a breakdown in talks between British Airways and the U.K.'s biggest union. BA crew members plan to strike for at least 7 days.

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CREDIT TRADING STRATEGIES *By Stephen McManis, University of Pittsburgh*

It is one bad time to be a Credit Default Swap trader or even worse a hedge fund that specializes in credit. Politicians across the world, from initially Paul Volcker to now German Chancellor Angela Merkel have attacked speculators and threatened bans. Merkel was quoted yesterday as saying “Credit-default swaps, where you insure your neighbor’s house just to destroy it and make money from it, that’s exactly what we have to curb,” in reference to CDS markets. Yet, as we will address later, swaps have a clientele that consists of primarily of hedge funds and prop desks that pay very close attention to their counterparty risk. Markets are zero-sum and unless in this case Greece banks are buying or selling protection then the CDS market should have no effect on working economies.

Developing a Credit View

Bond traders for years have developed credit views on various entities and priced those accordingly into the prices. Just a review: bonds are usually issued at or around par depending on how close the offered coupon is to current rates; then once in the secondary market they can trade at any price. The price reflects the credit risk inherent in the bond and as a result the yield can be significantly higher than LIBOR. This difference in yield is often referred to as an asset swap spread. So, if traders feel that for example, McDonald’s is expected to have worse performance going forward they might demand higher yields on new issues - which lowers prices on existing bonds. At the same time if a company like AMD continues to surprise you might see the ASW spread starts to tighten as the bonds become “safer” and more attractive. The latter case is more common when companies with negative outlooks turn around and gain traction, with in some cases an improvement in their credit ratings.

The concepts are the same in the CDS market except players in it have found that in many cases it is much more flexible than the bond markets. For instance selling bonds short often proves difficult because it becomes very difficult to borrow cash bonds. Instead, they buy protection via CDS and as the spread widens (bond price falls) they receive a mark to market gain on their swap. Likewise if the spread tightens they would receive a MTM loss on the swap; while in both cases making protection payments to their counterparty. Credit investing in its simplest form is using a CDS on single names to express particular credit views. However, unknown to most people there exist a great number of trading strategies employed in the markets.

Utilizing Credit Indexes

One method that has gained significant appeal is buying or selling protection on credit indices, which is just a basket of single name CDS’s. This has proven to be much easier both in transaction cost and liquidity over developing a bespoke basket. Markit is the primary dealer for such indices and has constructed a host of indexes that include almost all the major geographic zones. Their two most popular offerings are the CDX and iTraxx indices which are broken down into IG (investment grade) and HY (high yield). Interestingly, they also offer a SovX index which is composed of government entities from across the world. This may see some volatility in the months to come as governments debate whether it is legal to “judge their economic impact and performance” through such instruments.

Regardless, the structure of the indices is the same as normal CDS, with protection payments being made quarterly. At the same time new indexes are rolled every six months to maintain liquid instruments while at the same time excluding recently unqualified names (drop in credit rating or mergers). These products have continually proven popular for traders looking to express broad market or sector credit views at low cost, very similar to equity index funds.

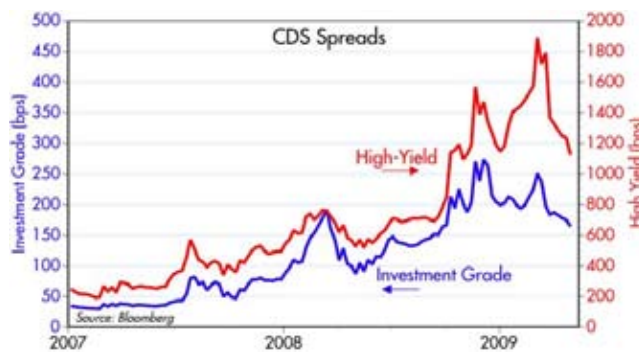
Spread Trading Strategies

Just as with the treasury yield curve you can also have a swap curve across multiple maturities for the same obligation. They usually trade in a similar direc-

tion however you can also have cases of flat, steep, and inversion. This can be brought about by overall deteriorating conditions and higher counterparty risk where traders flock to shorter tenor swaps over longer term. Or when a company issues a convertible bond, it has been shown to drive CDS premiums much higher at the convertible exchange date, while having negligible effects on the cash market. Swap curves also represent supply and demand pictures for protection on a company that which just like a yield curve has a variety of trading strategies.

Arbitrage and CDS Basis

Credit markets are susceptible to arbitrage opportunities just like any other market and the primary strategy is eliminating negative basis. Basis is defined as the CDS premium minus the comparable asset swap spread for identical maturities. In almost all cases the premium is higher, for a host of technical reasons including sell-side demand, than the comparable ASW spread. This is normal, however when a negative basis exists it becomes possible to buy protection in the Over-The-Counter CDS market and purchase the cash bond for a risk free profit. In the event of a default you will receive the full principal at the same time maintaining a positive carry until maturity. These scenarios generally do not last long and the advantage often belongs to the biggest institution; who are able to maximize the small spread thanks to low funding costs and leverage.



Introduction to Correlation Trading

The last strategy we will discuss has to do with default correlation - the likelihood that all assets will default across obligations and companies. In the case of the index example above it is possible to divide it into a host of separate assets called tranches. These are segregated by attach-

ment and detachment points for losses on the entire portfolio. Starting usually at the equity tranche, then the junior and mezzanine tranches, losses will be absorbed completely by these subordinate investors before reaching senior and super senior levels. The subordinated tranches receive a greater portion of the pay out in return for the risk, yet traders try to take advantage of shorter time moves in default correlation.

Say they assume default correlation will increase across the pool of assets; they often purchase equity and junior tranches (Long Correlation) because it becomes less likely that they will experience losses. However at the same time senior tranche holders (Short Correlation) become worried that 1 default with high correlation will lead to multiple and their tranche will also experience losses. Changes in default correlation will result in MTM losses or gains across tranches and these help explain daily price movements.

Correlation trading encompasses a further look into CDS valuation and more complex structured finance topics such as the Synthetic CDO’s and tranching credit risk. In the future it will prove valuable to address the correlation investing and trading strategies available to credit investors apart from the generally macro driven concepts earlier addressed.

Conclusion

This is just a very simplified introduction to credit trading strategies within the Trillion Dollar notional market. Hedge funds and prop trading desks have employed variations of these in the past and continue to be the primary users. However, if politicians can keep their misguided and frankly unknowledgeable reforms to themselves, we will continue to see broader market adoption. Increased exchange clearing, improved liquidity, further standardization, and continued successful auctions may lead to the CDS to eventually being a tool of choice for funds and investors globally.

THE RECESSION- COMPREHENSIVE ANALYSIS (PART 2) *By Daniel Griffith, Carnegie Mellon University*

This is part 2 of a 4 part series covering the recession, its causes, and potential future. This is the first in-depth description of the financial crisis Bulls & Bears has provided.

For years, the Federal Reserve has measured domestic credit with "Private Credit Aggregate". The number measures the total credit issued to the private, non-financial sector (including everything from household debt, non-financial company debt- such as mortgages, auto loans, and corporate bonds) within the U.S. economy. This number is usually measured and compared to nominal GDP, and taken into account to set monetary policies. The theory is this: in a period of steady growth, the Private Credit Aggregate should equal nominal GDP- indicating that non-financial companies are not over consuming, but are still spending (through investments made with debt). One important aspect of this number's relevance is as follows: as more private debt becomes securitized (as I described in Part 1 of the series), it is left out of the monetary aggregates, making those figures less significant- and less useful. Monetary aggregates include checkable deposits, time and savings deposits- all of which make up commercial bank funding, and were traditionally used to calculate inflation as well as monetary velocity. This serves as a valid indicator of bank lending and credit, but as the shadow banking system grew (Lehman Brothers, Bear Stearns, etc), monetary aggregates (i.e. M1, M2, M3) made up less of the total domestic debt. The private credit aggregate remained accurate since it takes into account both securitized and balance sheet debt.



From 1952 to 1984, the private credit aggregate grew at the same rate as the nominal GDP, the figures in 1984 being \$3.5 Trillion nominal GDP and \$3.5 Trillion in private credit outstanding. The problem arises between 1984 and 2007 – in 2007 nominal GDP was \$14 Trillion, while the private credit aggregate was \$25 Trillion. This means the total credit the private and non-financial sector held by 2007 totaled \$25 Trillion (a significant portion of this was due to the increase in home prices), but the country as a whole (financial institutions included) was only producing \$14 Trillion. In hindsight, these numbers are alarming- the relationship represents the amount of credit being underfunded by assets (essentially, the \$11 Trillion of credit above the GDP is seen as unproductive debt- which would never be paid back). This was perceived to be acceptable at the time because housing prices were rising faster than debt levels (thus lulling economists into believing the debt was sustainable), but few expected prices to stop rising. It was only a matter of time before the credit gap closed, and creditors tightened their requirements- the system was hit even harder by the

decline in real estate values. Many ignored the widening gap between credit and GDP, and as a result, omitted the numbers from economic models used to analyze monetary policy.

This significant increase in leverage did not trigger any alarms, primarily because it did not increase inflation. This was due to increasing globalization throughout the 90s. As international markets opened up, a huge demand arose for U.S. fixed income securities. With this inflow of capital, the U.S. was able to sustain huge account deficits, without affecting domestic inflation (since global demand was met by an increasing supply of U.S. debt). And since monetary indicators were more highly regarded than the private debt sector, the increase in shadow banking kept issues under the radar.

In addition to the increase in private sector debt, mergers and acquisition played a minor role in the current financial situation- primarily the auto industry. Although the two terms are normally used interchangeably, there is a key difference between the two actions. Acquisitions occur when a company outright buys another, effecting ending the acquired company's independent existence. It becomes a part of the larger organization (such as when J.P. Morgan acquired Banc One Corp in 2004). The new entity is simply larger, with the same name, and management. A merger takes place when two companies agree to proceed as a single organization, such as Glaxo Wellcome Plc.

and SmithKline Beecham Plc. yielding GlaxoSmithKline in 2000. Another example is the creation of Daimler-Chrysler in 1999 (following Daimler-Benz's takeover of Chrysler).

The 1999 merger of Daimler-Benz and Chrysler led to a restructuring of the worldwide auto industry by bridging the gap between one of the largest car manufacturers in the U.S. and Europe. The combined value after the merger was \$130 Billion, and opened up new markets for the respective brands. Chrysler's sales were relatively flat, but the company hoped to expand into European markets, and Daimler-Benz saw nothing but potential profit from the American market it had just gained access to. The problem which became clear in the mid 2000s was that the company had essentially become too big to fail, and when its sales tanked (and when Benz was unable to improve upon Chrysler models to gain U.S. market share), Daimler sold Chrysler for a massive loss, and company filed for Chapter 11 Bankruptcy in 2009. This fragmenting of the auto industry proves that globalization provided manufacturers with a false sense of security. While globalization served the greater good through the 80s and 90s, here was some of the first major evidence that it may have been detrimental to the global economy.

CALIFORNIA STATE UNIVERSITY, CHICO – FINANCE CLUB *By Dylan Ozmore, Carnegie Mellon University*

An interview with President David Descalso

What are the goals of the Finance Club and can you tell me how the organization got started?

Our official mission is “to explore the finance industry through interaction with those in the finance industry; to expose students to the different aspects of the finance industry; and to enrich the finance degree program by encouraging stimulating discussion of finance topics beyond the classroom”.

Beyond that, we help to connect students with a common interest in finance, regardless of their major. Finally, we’ve helped and continue to help our graduating members start successful careers through the contacts they make with us, and many come back as guest speakers or recruiters.

2. What type of events does the Finance Club run during the year?

We meet once a week, where students can come and talk with our guest speakers. We also hold mixers throughout the year, between new and returning members, and with other College of Business clubs.

Our main event this year will be a trip down to San Francisco in April. We are touring several financial institutions down there, including the Bank of America tower and the Federal Reserve Bank of San Francisco.

3. David, can you tell me about yourself?

When I first came to CSU, Chico, I was an undeclared freshman. I took some business classes, and joined the club my sophomore year. Now, I’m a third year undergraduate with a double major in economics and business with an option in finance. My days are filled with classes, club activities and working part-time, and I love every minute of it.

4. What types of jobs do the finance students receive and at what firms? What is the level of Wall Street recruiting in California?

Chico, unfortunately, is not known for its large presence of financial firms. However, jobs do exist for students interested in banking, insurance, real estate, stock brokerages, and asset management, and we work to connect students with those jobs. Our proximity to Sacramento and San Francisco ensure that firms from these areas come to recruit our graduating seniors and undergraduates seeking internships.

5. What are your thoughts on the economic situation of California?



It’s bad, plain and simple. You look at what Greece is going through, and then you realize California alone is one of the largest economies in the world, many times the size of Greece. Counties and municipalities don’t seem to be in the news as much as the state legislature, but you can bet many of them are struggling too.

However, what I’m really excited about is the level of opportunity this means for our students. Our classes are filled with hands-on learning as we

watch this crisis unfold in real-time, not from a dusty old textbook. Our best and brightest students will have the chance to come out of Chico State, armed with everything they’ve seen and learned, and work to make California a healthy, thriving economy again.

6. Where can students go to get more information about your organization or to reach out to you?

We have our website, <http://www.csuchico.edu/finance/>, which has our calendar for the semester and a lot of information. Our email address is chicostatefinanceclub@gmail.com, and we’re always happy to respond to any questions.

THIS WEEK IN BARRONS... *By r.f. culbertson, Carnegie Mellon University*

Our Thoughts:

Age is strictly a case of mind over matter. If you don't mind, it doesn't matter ... Jack Benny

From a paper called: "Gold and Economic Freedom": "In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. Under a gold standard, the amount of credit that an economy can support is determined by the economy's tangible assets, since every credit instrument is ultimately a claim on some tangible asset. Therefore, gold and economic freedom are inseparable. -Alan Greenspan.

- Last month the government ran up the largest monthly deficit in history totaling \$220.9 billion, 14 percent higher than the previous record set in February of last year.

- The Obama administration is projecting that the deficit for the 2010 budget year will hit an all-time high of \$1.56 trillion, surpassing last year's \$1.4 trillion total.

- The Obama administration is forecasting that the deficit will remain above \$1 trillion in 2011, giving the country 3 straight years of \$1 trillion-plus deficits.

Now isn't that interesting? Alan Greenspan said that without gold you can't be economically free, AND that asset determines the amount of credit a country can support. So we have NO gold standard, and we're running the biggest deficits in the HISTORY of our nation - even Alan Greenspan realized that this would end badly. Our nation is bankrupt - our banks keep two sets of books - our infrastructure is crumbling - our people are either under-employed and/or un-employed - our states can't make budget - our deficits are in the trillions, not to mention the \$80 trillion that we are going to owe for all of our programs - What on Earth do we do about it?

I don't deserve this award, but I have arthritis and I don't deserve that either ... Jack Benny

Well - we can appoint Ms. Janet Yellen as Fed Co-Chair because she believes in "keeping the monetary presses running and dealing with the inflation later". If someone could logically explain to me how we get out of the multitude of messes we are in, I'd gladly sell my gold and silver and go on with life a happy camper. Now - having said that - Jim Taylor wrote me with a fascinating paper which I'd like to take the time to share next week - thanks Jim!

The Market:

The more people I meet - the more people are trying to get OUT of this market at these levels than get IN. Did you know:

- 7,000 Baby Boomers are day are retiring - and for the next 15 years that number is going increase, as the biggest wave of our money making population goes from their earning days to their sustaining days.

- Which means - not only have the baby boomers been responsible for all the economic and financial gains we've seen over the last 20 years, BUT more of them are going to need to take money OUT of the market versus putting money IN.

- 51% of the Baby Boomers are not prepared retire - and have less than \$50,000 in savings

If you add up the ponzi scheme economy, with the demographics, you

come away with something a whole lot less rosy than Wall Street is telling you. It's true that in the short term, they can use the President's Working Group to manipulate the market, and they can also use mark to model instead of mark to market.

BUT what about this news blurb: "07:48 AM The White House turns to short sales to help stem the foreclosure crisis, allowing delinquent borrowers to sell their homes for less than the amount owed and forcing banks to forgive the difference. To speed the process, the government will hand out cash to both mortgage servicers and homeowners." Just so I clear on this - a zillion people got conned into the idea that houses only go up, so they decided to "get in" while they could. During 2004 to 2006 people 4 to 5 TIMES what a house was worth - and started the greatest real-estate orgy of all time. Most couldn't afford it, but figured "Hey it only goes up, so what's the risk?" Let me suggest - IF you were smart enough to hunt down an outfit that would allow you to buy a home you could not afford, and smart

enough to know how to lie on the application - you were probably smart enough to know that your rate would reset higher and you were NOT going to be able to AFFORD IT when that happened. Notice the words "Forcing banks to forgive the difference". As the banks go ahead and "forgive billions" between what the house is now worth and what they paid, doesn't that mean billions just "vanish?" And doesn't that mean that more banks will declare 'bankruptcy'? And isn't the FDIC basically bankrupt? So, who's going to make up the difference? Oh, that would be you and me...again.



It's not so much knowing when to speak, but rather knowing when to pause ... Jack Benny
With all that in mind, the only question is: How far can it go before the wheels fall off? We know their intent is to keep pushing so much stimulus that the people get a false sense of security and actually re-elect Congress in November. I said quite a while back that the market would run up and try and challenge the old highs at 10723, but would probably fall short, stalling out at the 10600 level. Well, we're here and are we building

a new base to push up through the old high and run to 11,500? I still don't think so. We could push thru the old highs - people rush in - and then we sell and the late-comers get crushed.

Honestly - the mutual funds don't have enough money to keep buying. The public isn't jumping in to buy the market. Which just leaves Bernanke and his henchmen - and I'm not sure that there's that much left?

We have been leaning long the market, but at some point in the not too distant future, we'll be buying puts and shorting stocks. But until we roll over and it's proven to me the bear market bounce has ended, we'll be leaning long but keeping our finger near the sell button.

I'm still holding:

CLF at 61.77 - hard stop at 62.50
NTRI at 16.47 - hard stop at 17.00
VDSI at 8.51 - hard stop at 8.60
FSYS at 30.09 - hard stop at 32.00
DRIV at 28.17 - hard stop at 28.65
SPY at 109.55 - hard stop at 114.29

Until next week - be safe.

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