



# BULLS & BEARS

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## HEADLINES

- ISM service index rose to 55.4 in March from 53 in February
- Bernanke: high unemployment and housing troubles are biggest hindrances to growth
- US Airways and UAL Corp. are reportedly in merger talks
- Renewed concerns over the debt crisis in Greece

## FINANCIAL MARKETS

DOW	10,997.35, +0.64%
NASDAQ	2,454.05, +2.14%
S&P 500	1,194.37, +1.38%
OIL	\$84.92, +\$0.05
GOLD	\$1,161.10, +\$36.00
10 YR	3.888%

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## MARKET SUMMARY

Monday April 5, 2010

U.S. stocks closed higher on Monday amid positive economic data. Materials and energy stocks were among the best performers of the day as they moved higher in sync with crude oil. The National Association of Realtors reported that its index of sales agreements rose to 97.6 in February from 90.2 in January. The Institute of Supply Management reported that its service index rose to 55.4 in March from 53 in February. The Dow Jones Industrials Average finished up 0.4% to 10,974, the S&P500 finished up 0.8% to 1187 and NASDAQ finished up 1.1% to 2430.

Tuesday April 6, 2010

Trading was choppy during Tuesday's session, with stocks closing marginally higher at the close of the day. The Fed's most recent meeting minutes were released as the only data point of the day. The Dow Jones Industrials Average finished down 0.03% to 10,970, the S&P500 finished up 0.2% to 1189 and NASDAQ finished up 0.3% to 2436.

Wednesday April 7, 2010

The bears took control during Wednesday's session. Investors fled risk assets on renewed concerns over the debt crisis in Greece. Federal Reserve Chairman Ben Bernanke told the associated press that high unemployment and housing troubles are the biggest hindrances to economic growth moving forward. The Dow Jones Industrials Average finished down 0.7% to 10,898, the S&P500 finished down 0.6% to 1182 and NASDAQ finished down 0.2% to 2431.

Thursday April 8, 2010

U.S. stocks ended slightly higher on Thursday despite selling pressure that plagued global stocks. Bulls took the opportunity to bid up shares on the back of positive retail sales, and M&A speculation. US Airways and UAL Corp. are reportedly in merger talks according to a story published by the New York Times. The possibility of a deal brewing was enough to bid up the shares of both companies, and give a boost to the overall market. The Dow Jones Industrials Average finished up 0.3% to 10,927, the S&P500 finished up 0.3% to 1186 and NASDAQ finished up 0.2%.

Friday April 9, 2010

Major U.S. averages took their cue for their global counterparts as stocks moved higher during Friday's trading session. Dollar weakness throughout the course of the day supported the rally in equities and commodities. Gold closed higher by 0.7% to close at \$1160.90 per ounce on the front month contract and silver closed higher by 1.45% to close at \$18.39 per ounce. The Dow Jones Industrials Average finished up 0.6% to 10,997, the S&P500 finished up 0.7% to 1194 and NASDAQ finished up 0.7% to 2454.

## THE WEEK IN QUOTES

*"We now have proof that Toyota failed to live up to its legal obligations."*  
- Ray Lahood, Transportation Secretary, saying documents from Toyota show that it knew of its problem with sticking gas pedals back in Sept.

*"The merged company will provide customers with a larger combined network."*  
- Willie Walsh, British Airways CEO, on the company's \$7.6B merger with Spain's Iberia. The new company will be International Airlines Group.

*"On the pier, I wasn't seeing anything. I could see only a graveyard of ships."*  
- Ban Ki-Moon, upon touring the Aral Sea; once among the world's 4 largest lakes, it has shrunk 90% ever since the rivers that feed it were largely diverted.

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**2012-2014 DEBT WALL PROBABLY WON'T MATERIALIZE** *By Arnav Guleria, Arizona State University*

**STORY HIGHLIGHTS:**

- Over \$700B in corporate debt and \$2T in US government debt comes due in 2012, and more through 2014.
- Amid scaled back consumer spending and a tepid jobless recovery, this apocalyptic scenario has prompted Kevin Cassidy, a senior credit officer at Moody's, to remark that "an avalanche is brewing in 2012 and beyond."
- Perhaps a smooth sail through 2012 will relax lenders, bringing leverage back onto the buy-out stage.

Over \$700B in corporate debt and \$2T in US government debt comes due in 2012, and more through 2014. HY issuers are different from other types of fixed income issuers in that their credit rating is chronologically local and can thus rise over the course of the debt's life. When previously HY issuers re-finance, they often re-finance in or close to the investment grade market, giving them access to deeper markets than the one the original issue was raised in.

In 2012 will begin a period during which more than \$700B in corporate debt will come due, the hangover from the party of the decade that brought us the largest leveraged buyouts (LBOs) humanity has ever seen. And the private sector isn't alone – the US government will need to borrow over \$2T in 2012. Amid scaled back consumer spending and a tepid jobless recovery, this apocalyptic scenario has prompted Kevin Cassidy, a senior credit officer at Moody's, to remark that "an avalanche is brewing in 2012 and beyond." [1]

First a definition; high yield (HY) debt is debt that is rated below investment grade at time of purchase – it has a higher risk-reward blend than debt rated A or higher. It was popularised in the 1980s by Michael Milken at Drexel Burnham Lambert's Beverly Hills office (read *The Predator's Ball*) and, according to Steven Davidoff in *Gods At War*, set off a wave of debt-fueled buy-out activity that helped create the LBO as we know it today.

The 2012-2014 debt wall scenario makes the assumption that a 2012 HY debenture issued in 2007 will have to be paid off in cash, straining its issuer's balance sheets, or will have to be re-financed in the same market it was issued in. That is, everyone in a single HY maturity space will be re-financing simultaneously, exhausting demand and driving up yields to levels that many issuers won't be able to afford. I am going to argue that this scenario is implausible due to the chronological locality of HY credit ratings.

HY issuers are different from other types of fixed income issuers in that their credit rating is chronologically local. When IBM, for instance, issued its October 2012 5.05 it was reasonable for an investor to assume that it's Fitch A rating in October 2007 would probably be true, with little variance, across the bond's lifetime. In other words, the credit rating for mature issuers is chronologically global, similar across the issuance's life. This makes sense if you look at IBM's position on a growth curve – the point at which it rests exhibits a low first order derivative. This low rate of change begets stability. HY issuers, on the other hand, are a point in the curve exhibiting a very high first order derivative, characterising a high risk/reward deal with significant uncertainty.

For purposes of illustration, let's splice the uncertainty discount for our fictional HY debenture issuer, Acropolis & Co, into the uncertainty for its performance one year after the issuance [0,1] and the uncertainty for its performance after one year [1, ∞). At the point of issuance, t=0, both uncertainty "reserves" are fully weighing down on the value of the bond.

Let's re-visit the company at t=1; assuming the company hasn't blown up, the first year uncertainty reserve should now be zero - its path over [0,1] known at t=1. The [1,2] discount will be less than the [0,1] reserve because it is at a more stable point on its growth curve, implying better cash flow prospects and/or a stronger balance sheet. Thus, [1, ∞) is riskier than [2, ∞). The discount factor should thusly be reduced, with the price rising and yield falling in step.

Let's suppose Acropolis & Co's first debenture was rated CCC at t=0. When issues its new t=1 debenture, the credit rating agencies rate it C. The yield differential between a C and CCC rating are substantial. If the t=0 issue had a call provision, which is not uncommon in the HY markets, it would be in Acropolis & Co's interest to re-finance the t=0 issue with a new t=1 issue, locking in the lower rate. That is, it would pay off the high-interest t=0 issue in full via the proceeds of a lower-interest t=1 issuance. Even if the issue cannot be called, Acropolis & Co will not be in crisis when the bond is due, since it can borrow at its new rate to pay off the principal.

When an issue is re-financed, the new maturity date generally falls after the re-financed debt's maturity. Thus, the 2012-2014 maturity wall should at least be spread over a longer period of time. Additionally, many institutional investors are limited to trading investment grade, that is A or higher, debt. Thus, as issuers approach investment grade, they won't be competing as closely with lower issuers for HY capital, instead having access to deeper waters. The combination of these two trends implies that the 2012-2014 maturity wall has a high likelihood of dissolving away.

This scenario contingent on two things: (1) liquidity in the HY refinance markets at present levels, and, (2) a mild US economic recovery to enable the issuers to continue to service their debt. Additionally, it is assumed that there will be no political intervention in the debt capital markets - that would add a political uncertainty discount factor to the equation, impeding the credit rating rise illustrated above. A common argument against re-financing is that it simply pushes the problem into the future. But by the process demonstrated above, as the issuers' interest rates fall and their cash flow positions strengthen, the impact of the debt on the company will fall. Additionally, any new debt will be taken on, as all corporate debt is meant to be, with the assumption of earning a higher rate of return on the cash from the debt than the interest being paid on the debt. Thus, there is a net value add to society overall.

Taken together, the vanishing of the debt wall fares well for the general economy, though no part more than LBOs. Facing mounting piles of dry powder with limited leverage opportunities, buy-out firms have thus far been forced into all-cash deals, pulling down returns. Perhaps a smooth sail through 2012 will relax lenders, bringing leverage back onto the buy-out stage. In any case, it upgrades recruiting prospects for those interested in the debt capital markets or leveraged finance.



## WARREN BUFFET VS. UNCLE SAM: NO BRAINER FOR INVESTORS *By Jesse Hou, Boston University*

### STORY HIGHLIGHTS:

- Investors at large feel Warren Buffet is a better credit risk than the United States government.
- In general this macroeconomic phenomena is a sign that the market is starting to react adversely to the government fiscal policy.
- The Oracle of Omaha has advised shareholders in several of his famous letters not to invest in treasuries.

On Wednesday, March 24, 2010 Berkshire Hathaway two year corporate bond yields dipped below that of comparable treasuries (by about 3.5 basis points), implying that investors at large feel Warren Buffet is a better credit risk than the United States government. Other brand name bonds for companies like Johnson & Johnson, Lowe's, Abbott Laboratories, and Procter & Gamble also dipped below treasury yields. All of these companies except Procter and Gamble are rated lower than the US Government (AAA) which is contradicted by their respective yields.

### The Auction Leading Up

Treasuries took an enormous hit during a \$42 billion auction of five year notes Wednesday. A separate \$44 billion auction Tuesday also experienced lower demand than usual, and another auction Thursday ended a record-tying \$118 billion week of sales. The bid to cover ratio fell to 2.55, from 2.8 in January (Associated Press). Five year yields rose to 2.59% from 2.42% as a result. Across the board from 3 month to 30 year treasury yields rose sharply. The 10-year surged up 30 basis points.

All this coincided with the passing of a landmark health-care bill that has generated \$940 billion of additional health care spending over the next decade. Sovereign debt around the world has come under fire especially in the euro zone, and municipal debt in the United States is taking its worst beating in decades as California struggles with its seemingly inflexible budgeting system.

A Bloomberg survey of 10 to 18 primary dealers has \$2.4 trillion as the median estimate for the estimated volume of treasuries to be auctioned this year.

### What it Means for the Market

With continued deficits on the near horizon, and a guarantee that the so called "landslide" of treasuries (\$2.59 trillion have been auctioned since 2009) will continue unabated, yields continued rising proving that the market cannot absorb an infinite amount of treasuries. (Marketwatch)

In general this macroeconomic phenomena is a sign that the market is starting to react adversely to the government fiscal policy, and may add fuel to the fires of rumor that the US Government may lose its AAA rating, something long denied by the government as an outrageous idea.

China has been cutting its holdings of US debt for three months in a row, now the second largest debt holder to Japan. The People's Republic shows no sign of slowing this trend. The euro fell to 1.33 against the dollar, its lowest point in 10 months after Fitch cut the rating on Portuguese debt yet again this time to AA-. All of this activity caused confusion in the swaps market, as spreads turned negative last week for 10-year swaps, a technical fluke.

### Buffet's Opinion of US Treasuries

Warren Buffet stated in an interview that "with the US Federal Reserve and the Treasury Department going all in to jump-start an economy shrinking at the fastest pace since 1982, once-unthinkable dosages of stimulus will likely spur an onslaught of inflation, an enemy of fixed-income investors". He strongly doubts the US will retain its AAA rating, and notes that 7% of GDP in 2010 is going towards servicing the federal debt, which will rise to 11% in 2013. The Oracle of Omaha has advised shareholders in several of his famous letters not to invest in treasuries.



**BENTLEY U. ECONOMICS & FINANCE SOCIETY** *By Dylan Ozmore, Carnegie Mellon University*

*An interview with Sherina Khiani, President of the Bentley University Economics & Finance Society*

1. What are the goals of the Economics and Finance Society and can you tell me how the organization got started?

When I first started at Bentley University the Economic Finance Society was not an existing organization. During the Spring of 2009, I took the initiative to establish this organization. Currently, this is our first active year on campus with a general body of about 200 students. Our goal is to bring together students with an interest in Economics and Finance.

2. What type of events does the E&F Society run during the year?

We try to facilitate our goal by holding various networking events, investing competitions, and informational sessions about current economic and financial issues.

3. Sherina, can you tell me about yourself?

I am a junior at Bentley University majoring in economics and finance and with a minor in computer information systems. Besides being president of the Economics and Finance Society, I am also involved in the Bentley Investment Group. After graduation, I plan to pursue a career in Private Wealth Management.

4. With so many universities in the Boston area, do you find that the job environment is extremely com-

petitive?

Yes, the job market has become extremely competitive in the Boston area because of two reasons. Firstly, the financial crisis that the economy is still trying to recover from has caused many firms to substantially decrease the number of jobs available. Secondly, with the decreased number of jobs available, there is great deal of competition because of all the universities in the surrounding area. For example, we are competing with students from Harvard, MIT, Babson, Boston College, and the list goes on. If I were to give advice to anyone looking for a job/internship, my advice would be to start looking as early as possible. Networking is key to landing your ideal job.

5. Where do you think the markets go from here?

I do not think the economy is going to recover anytime soon, I do believe we are going to see a second wave of the mortgage shock.

We are only half way through the bursting of the real estate market collapse. The sub primes are not the only mortgages we need to worry about. We need to worry about the other two types of mortgages that became popular; the Alt-A and Option Arm. In the next 3 years, the default rates are going to increase greatly causing the second wave of the mortgage shock.

6. Where can students go to get more information about the E&F Society or to reach out to you?

To learn more about this organization student can either e-mail me directly at [Khiani\\_sher@bentley.edu](mailto:Khiani_sher@bentley.edu) or email us at [GA\\_EcoFinance@bentley.edu](mailto:GA_EcoFinance@bentley.edu).



APRIL 4 - IO *By Stephen McMannis & Dylan Ozmore*

**1. Poland's President, Central Bank Governor Die in Plane Crash**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a4jStdFKdKTI&pos=1>

**2. The National Housing Survey and the Real Estate Bear Market**

<http://blogs.reuters.com/felix-salmon/2010/04/06/the-national-housing-survey-and-the-real-estate-bear-market/>

**3. The Canadian Banking Fallacy**

<http://baselinescenario.com/2010/03/25/the-canadian-banking-fallacy/>

**4. Credit is Dead. Long Live Cash!**

<http://www.newsweek.com/id/235392>

**5. Bank for International Settlements (BIS) Working Papers**

<http://www.bis.org/publ/work300.pdf?noframes=1>



**6. GM: More Troubles Coming Down the Road**

<http://www.theatlantic.com/business/archive/2010/04/gm-more-troubles-coming-down-the-road/38603/>

**7. David Tepper's \$4B Tops the Hedge Fund Rich List**

<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7546073/David-Tepper-tops-the-hedge-fund-rich-list.html>

**8. Morgan Stanley Bows Out of Atlantic City Project**

<http://www.reuters.com/article/idUSTRE6312H620100402>

**9. First-day iPad Sales Fall Short of Revised Expectations**

<http://www.thetechherald.com/article.php/201014/5463/First-day-iPad-sales-fall-short-of-revised-expectations>

**10. Los Angeles Deficit Shrinks to \$222 Million on Property Taxes**

<http://www.businessweek.com/news/2010-04-09/los-angeles-forecasts-222-million-deficit-for-year-through-june.html>

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

### Our Thoughts:

I just Don't Trust This Market

Everyday I get asked the same question - "Why are you so glum, the numbers point to recovery". Everyone cites several recessions where in it took a long time before people bought into the idea of a recovery. What's different this time - JOBS. On Friday the CEO Report told us that 22% of all polled companies plan to lay off more people. The general public may not know how this economy works but they see: foreclosures, inflation, gas approaching \$3 bucks, taxes rising, houses on the market for 24 months, a lot of bad things. And what is different this time around - it's the Internet!

In 1982 (a previous recession):

- The US was still the worlds largest exporter, and the largest creditor.
- People were looking forward to lower taxes.
- Our nation was fiscally sound.

Comparing that to what's happening presently:

- Greece is doomed - and up to 18 countries could follow in lock step.
- The U.S. is running TRILLION dollar deficits with more to come.
- Wages have been stagnant for 10 years
- All the good paying, blue-collar jobs have gone off-shore.
- Household debt is enormous.
- 49% of all Americans pay NO taxes, leaving the 'other' half to pay the bills.
- Baby Boomers are retiring at the rate of 7,000 per day, yet 51% of them have "no visible means to retire". 70% of them have less than \$50,000 in savings.
- We are scheduled to see 300+ regional banks go belly up.
- And we're waging wars in 2 locations, eating hundreds of billions per year.
- AND - we're no longer dependant upon big newspapers for our news!

If that wasn't enough:

- The U.S. office vacancy rate rose to 17.2 percent
- 149,268 consumer bankruptcies were filed in March - a 34% increase over February - the highest monthly consumer filing total since Congress overhauled the Bankruptcy Code
- California's three largest public-employee pension funds currently face a total shortfall of more than \$500B
- The pension plans at General Motors and Chrysler are underfunded by \$17 billion and could fail if the automakers do not return to profitability
- The Wall Street Journal reported major U.S. banks temporarily lowered their debt levels just before reporting in the past five quarters, making it appear their balance sheets were less risky
- AND over 212,000 could lose unemployment benefits this week.

The difference this time around - is that we all have access to multiple channels of information - and we can separate reality from fantasy. For example: the American Farm Bureau Federation said that Supermarket prices for 16 basic foods were up 6.2% in the first quarter, led by gains in cheese, vegetable oil and eggs. But the Government said that food prices went up just 0.2% in January and 0.1% in February. Now - Who do you believe?

Yes, right now there is a disconnect between what the economy is really doing, and what the stock market is doing. This disconnect is one of the largest we've seen in many years. Despite the trillions in stimulus, despite the rah-rah of the market, we are economically cooked, and until this recess/depression runs it's course, nothing's going to stop it. The Government can slow it - but they can't stop it.

The Market:

The Market has wanted DOW 11K for months - but it's tough when the bulk of the American population doesn't have the means to invest, and most of the foreigners are trying to get money OUT of the US(S) Titanic not put money in. So, for the past 3 weeks we've been running in place. Consider this: 8 million people are out of work and 3 times that are "under-employed" - with the remainder being very scared of touch-

ing the stove - AGAIN. So, Friday (after an incredibly boring session) they circled the wagons and late in the afternoon, pushed and pushed and broke through DOW 11K - to end the day at 10,997.

Okay - now what? This week is the official start to "earnings season" and yes we're going to hear some tremendous earnings. Uncle Sam has spent trillions to keep things moving and companies have cut employees and expenses to the bone. But my guess however is that we are still in a topping phase. It takes a long time to roll over after a year of the biggest financial stimulus and Wall Street push in our history, but roll over we will.

Was Friday the top? I don't think so. I think we still have a climactic "blow off top" coming. I could easily see us gain 150 - 200 points, and then start a long process of stair stepping downward - lose 300, bounce for 200, lose 400, bounce for 300 and so on. After all, history shows us that "stocks" often rise up into their earnings, but interestingly the "market" doesn't have to follow along.

So we will lean long into the stocks that are going to release earnings - usually taking a position 3 to 5 days before the report will reward you - but we never hold over through

a report, we always sell out the day ahead.

Tips:

I would be a lot more optimistic if:

- Uncle Sam wasn't spending the upwards of \$24 trillion in stimulus,
- Banks were marking assets to market, instead of to "model" which the FASB has allowed them to do,
- Taxes were about to go down instead of up,
- There were NOT 7 million homes in a "shadow inventory",
- Good paying jobs were abundant, and
- Companies reported GAAP earnings instead of proforma.

Therefore, I've traded very little this past week and have only two positions open:

- MS purchased at 30.27 - with a stop in at 30.30
- LTD purchased at 26.02 - with a stop in at 25.99

I'll be trading stocks (approximately) 5 days prior to their earnings reports - and then selling the day before their earnings release - as these next several weeks unfold.



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