



June 28, 2010

Win some, lose some.

President Obama saw one of the signature initiatives of his first term in office, the financial overhaul bill, edge closer to reality this week when Congress finally reconciled the House and Senate versions, keeping the bill on track to be signed into law on the Fourth of July, his target date. And the Chinese government, after much back-and-forth, at long last agreed to let its currency rise against the dollar. However, at the Group of 20 meeting in Toronto, Mr. Obama failed to convince his fellow world leaders that the best way to assure a global recovery was through more government spending, and the Senate, citing deficit worries, refused to pass a bill to extend jobless benefits and offer states some much-needed financial aid. Meanwhile investors, caught in the churn and spooked by more grim news about housing, took all three major indexes down for the week.

The American government has long been after the Chinese central bank to let its currency, which had been tied to the dollar to make Chinese exports more competitive, rise. And the Chinese had long been resistant – until last weekend when the central bank made the surprise announcement that it would do so. Almost immediately, driven by intense criticism at home over giving in to foreign pressure, the Chinese hemmed and hawed and made it clear any changes would be very small and very gradual. While analysts forecast that the yuan would rise 2-to-5% in value by year’s end (it’s thought to be undervalued by 20% to 40%), the cynics dismissed the move

	Key Market Data		
	Week ending...		
	6/25/10	6/18/10	Change
Dow Jones Industrial Average Index	10,143.81	10,450.64	-2.94%
S&P 500 Index	1,076.76	1,117.51	-3.65%
NASDAQ Composite Index	2,223.48	2,309.80	-3.74%
10-Year Treasury Note Rate	3.119%	3.225%	-0.106 pct. pts.
NYMEX Crude Future (Barrel)	\$78.86	\$77.18	+0.77%
Euro/U.S. Dollar	\$1.2386	\$1.2374	+\$0.0012

as a public relations ploy to take China’s currency off the table at the G-20 meeting in Toronto – which it did. In Congress, meanwhile, those clamoring for action from China were far from placated. “It is only strong legislation that will get the Chinese to change and will stop jobs and wealth from flowing out of America as a result of unfair trade practices,” said Senator Charles Schumer (D - N.Y.), threatening punitive legislation. And Treasury Secretary Timothy Geithner, who has spent months trying to quietly persuade the Chinese to act, added that the announcement was “an important step but the test is how fast and how far they let their currency appreciate.”

At midweek, the Commerce Department announced that new home sales had fallen to a record low in May (at least since 1963, when record-keeping began), plummeting 32.7% to an annual rate of 300,000 from 446,000 in April, when the homebuyers’ tax credit was still in effect, and off 18.3% from May 2009. At the same time, 30-year mortgage rates continued to tumble, reaching 4.69%, the lowest point since

Freddie Mac began tracking the data in 1971. Still, despite the historically low rates, fewer people are buying or refinancing, in part because so many have already done so, but also because banks are making it tougher, looking for bigger down payments and higher credit ratings. (The Mortgage Bankers Association said last week that applications for mortgages fell for the fifth time in six weeks and its mortgage index was 36.8% lower than it was in June 2009.) As a result, new home sales are now lower than they were in the 1980s when the rate for a 30-year mortgage was closing in on 20%. The government also reported that foreclosures were up 18.6% in the first quarter, and Fannie Mae said it would move to penalize homeowners who intentionally walked away from underwater homes by not giving them a loan for seven years, though it remained unclear just how intent would be determined.

The Federal Open Market Committee met on Tuesday and Wednesday and, to no one's surprise, agreed to keep the federal funds rate at 0-to-0.25% where it has been since December 2008. However, the overall tone of the FOMC's report was less upbeat than it had been after its last scheduled meeting in April, noting that "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad," while adding that consumer spending continued to be "constrained by high unemployment, modest income growth, lower housing wealth, and tight credit." The one bright point was that business spending on equipment and software "has risen significantly." Echoing that opinion, the Commerce Department said that orders for durable goods (products made to last three years or more) fell 1.1% in May, but the report was nonetheless seen as positive because without orders for aircraft durable goods orders rose 0.9% and overall orders for nonmilitary capital goods excluding aircraft, a key gauge of business spending, were up 2.2% from April, when they fell 2.7%, and 18.4% higher from a year earlier.

While the Senate failed to agree to spend more money, even to help the jobless, there was some good news about the deficit when Mr. Geithner reported that banks had repaid 75% of the Troubled Asset Relief Program (TARP) money they had borrowed along with \$21 billion in interest. He also said that GM and Chrysler would soon be able to repay their loans, though AIG was likely to be a loss. "TARP has helped restore financial stability at a much lower cost than expected," he told the Congressional Oversight Committee.

Leading up to the G-20 summit in Toronto, Mr. Obama had continued to plead his case for more spending to ensure the rebound. "We need to act in concert for a simple reason," he said. "This crisis proved, and events continue to affirm, that our national economies are inextricably linked." But as the week advanced the tide turned against him, especially after David Cameron, Great Britain's new prime minister announced his five-year plan for major cuts in spending and higher taxes, and Germany's Chancellor Angela Merkel rebuffed Obama's call for continued spending. By the end of the meeting, the president had signed on to a plan for G-20 members to cut their budget deficits in half by 2013, though the agreement was non-binding, characterized as being "tailored to national circumstances," and, in a nod to Mr. Obama, described as "growth friendly." The G-20 did not make a decision to tax banks to cover the cost of future meltdowns as had been discussed, and also put off any timetable for new capital requirements for banks. Trying to make the best of it, Mr. Geithner said, "Our challenge, as the G-20, is to act together to strengthen the prospects for growth. This will require different strategies in different countries. We are coming out of the crisis at different speeds." Or, as the editors of *The Wall Street Journal* less diplomatically put the decision to cut back on spending by governments, "The Europeans have had enough and want to swear off the sauce, while the Obama

administration wants to keep running a bar tab.”

The broader view

At home, the lead story was the agreement by House and Senate negotiators, after long hours, harsh words and lots of pizza, on a final version of a bill that was hailed as the most comprehensive financial overhaul since the Great Depression.

As was bound to be the case given the lobbying and impending elections, there was a lot of give-and-take along the way, not only between the two parties but between the House and Senate negotiators. For instance, derivatives will be more closely monitored, but banks will not be forced to spin off their derivatives businesses as the Senate version of the bill had stipulated. And there will be a new consumer protection agency, but it will not police car sales, which had been part of the draft version. All things considered, it's safe to say that only the public's ill will towards the banking and financial services industries kept the bill moving in the face of the political posturing and intense lobbying.

Here are some of the key changes in the bill:

- The regulatory power of the Federal Reserve over large financial firms will be expanded;
- There will be a new systematic risk council of high ranking officials, led by the Treasury secretary, to detect potential threats to the overall financial system and, if necessary, dismantle imperiled firms at no cost to taxpayers;
- There will be a new consumer financial protection bureau covering such financial products as checking accounts, credit cards, mortgages, and student loans;
- The Securities and Exchange Commission (SEC) will have more power to regulate hedge funds and credit rating agencies;

- The ability of banks to invest and trade for their own accounts, “proprietary trading,” will be curtailed (the Volcker Rule);
- There will be a new regulatory framework for derivatives;
- Companies selling certain complex financial products such as mortgage-backed securities will be required to retain a portion of the risk; and
- Executive compensation for companies will be set by independent directors

Of course, as many have observed, even after the bill has been passed, there will be lots of unanswered questions about the fine print that Congress has not yet addressed, the rules and regulations and enforcement – that will give lobbyists a second chance to intervene and politicians a second chance to dither. And the reaction was, predictably, mixed. Some felt that the fact that the stocks of financial firms spiked higher on Friday was a sign that the bill was not tough enough, but others saw it simply as a sigh of relief that the uncertainty about the bill's final form was over. The president of the Business Roundtable, John Castellani, said, “This legislation includes provisions totally unrelated to the financial crisis which may disrupt America's fragile recovery and increase instability and risk.” But Senator Christopher Dodd (D - Conn.), the chairman of the Senate Banking Committee, said, “Never again will we face the kind of bailout situation as we did in the fall of 2008.” As to whether or not it will work, Dodd conceded, “We won't know until we face the next financial crisis.” There is also no certainty that the bill will be passed this week in the Senate where it may be hard for the Democrats to round up the 60 votes needed to overcome a potential GOP filibuster and move the bill to a vote.

A look ahead

In addition to the vote on the financial overhaul bill, should it get that far, this week

there will be updates on personal income and spending; manufacturing, factory orders, and vehicle sales; and mortgage applications as well as the S&P/Case Shiller home price index. Further, the second-quarter earnings season will begin in earnest. Even so, all of that will serve as a mere warm-up to Friday's big story – and the one most likely to move the market as we head into the holiday weekend – the latest unemployment

rate and the nonfarm payroll report from the Labor Department.

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