

Three market developments that we need to be watching closely

I'm a worrier by nature. I can't help it. My job is to peer around the corner, figure out what's next, and most importantly, discern what can really go WRONG in the economy and the markets.

And right now, I see three troubling developments that are keeping me up at night. These problems aren't front-page news ... yet. But they are circling in the background and threatening to explode into the headlines — derailing the market in the process. I suggest you sit up and take notice. I sure am.

I am not speaking of the vicious cycle between unemployment and the crumbling housing market, or new home sales that are at an all-time low. Nor am I speaking of the nation's banks that have lost \$26.2 billion in the last three months of 2008 or the FDIC regulators that say there were 252 banks in trouble at the end of 2008 and that 14 have closed already in 2009.

These things should be NO SURPRISE to the readers of my emails and letters. In fact, if you pull out my 10 page letter from August '08, it is all there laid out for you on a red carpet. So you shouldn't be surprised that the Labor Department said Thursday that first-time requests for unemployment benefits jumped to 667,000 from the previous week's figure of 631,000. Or farmers had to slaughter 72,000 cows in the last two weeks because milk sales are down and they can not afford to feed and house them.

None of these things are what is now keeping me up at night, it is the following developments:

Troubling Development #1 —

Credit quality is worsening ... and I'm not talking about home mortgages or credit cards

We all know that the private credit markets are in disarray. Delinquency and default rates are soaring on credit cards, home mortgages, auto loans, and more. The cost of insuring bonds consisting of those kinds of loans has risen substantially, and losses on those bonds have been rising smartly.

The U.S. government — and its counterparts overseas — are responding very aggressively with bailouts, bank rescues, interest rate cuts, and rampant money printing. Many advocates of these policies would have you believe there will be no consequences from these actions.

But the market is sending a different message. Indeed, all of the largesse is starting to have a real impact on the perceived credit quality of the countries involved.

In other words, forget about PRIVATE credit quality. SOVEREIGN credit quality is coming into question. Just look at this chart...



If this were a stock, it'd be one you'd want to own ... right? Unfortunately, it's not a stock. This chart actually shows the cost of buying insurance against a U.S. government debt default in the Credit Default Swap (CDS) market.

It now costs professional bond investors 98 basis points to buy that protection, up 14-fold from just 7 basis points in late 2007. That translates into \$9,800 per \$1 million of U.S. debt versus \$700 previously.

Granted, that's pocket change when compared to the cost of insuring the 10-year debt of troubled corporate borrowers, like a General Motors. But again, it's the trend that matters — and the trend here is decidedly bearish.

I started talking about this development months ago. This week, I heard someone on CNBC discussing it ... for the very first time.

Rising default insurance costs were LEADING indicators of last fall's stock market meltdown. And if default insurance costs continue to rise, I suspect it'll be bearish for long-term U.S. bond prices and bearish for stocks as well.

So be sure to watch this trend!

Troubling Development #2 — Eastern Europe melting down

You want to know which other leading indicator told me the U.S. market was in huge trouble last year? The meltdown in Iceland yes, Iceland!

When the rest of Wall Street was looking the other way, I couldn't help but notice this small country's mounting problems. Iceland's currency was tanking, its stock market was coming under severe pressure, and concern about the country's external debt burden — and its ability to pay back those debts — was soaring.

Turns out Iceland was the proverbial butterfly, whose flapping wings helped, set off a credit and stock market hurricane. And these days, those same kinds of troubling winds are starting to blow in the Baltic republics, the former Soviet satellite states and elsewhere in Eastern Europe.

Just consider the following...

In **Latvia**, their currency, the lats, has been losing value against the Euro amid increased credit concerns. Standard & Poor's has cut the country's credit rating down to junk territory, going from BBB- to BB+. The Latvian economy is collapsing at a 10%+ rate, forcing it to seek \$9.6 billion in aid from the International Monetary Fund.

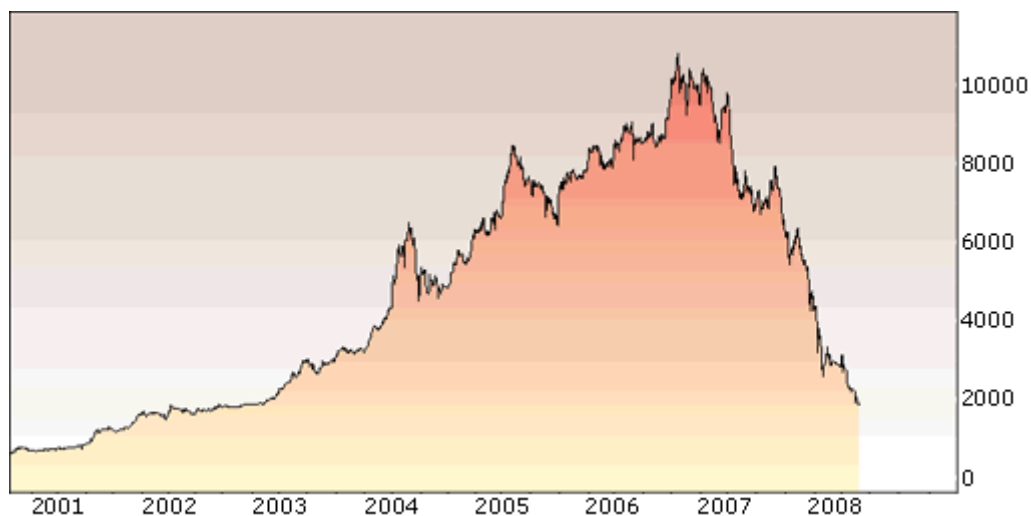
In the **Ukraine**, things are bad and getting worse. The country's currency, the hryvnia, has lost half its value against the dollar in the past several months. S&P just slashed the Ukraine's sovereign credit rating to CCC+ from B, and market participants are worried its \$16.4 billion November bailout from the IMF won't be enough to stop the bleeding.

Meanwhile, **Serbia** is seeking as much as \$2 billion in IMF aid. Concern about **Romania's** foreign-currency debt is driving its currency down. And **Poland's** zloty is plunging amid a sharp economic decline. I'm seeing industrial production fall there at the fastest rate since the country abandoned Communism two decades ago.



Iceland's mounting problems helped set off a credit and stock market hurricane.

Now you might think it doesn't matter that the Warsaw Stock Exchange WIG Index is down 56% from a year ago. Or that the Bucharest Exchange Trading Index has plunged 76% (and 82% from its July 2007 high, as this cliff-diving chart shows).



But considering the interconnectedness of world markets — and the lesson of last year — that kind of thinking could prove dangerous. These budding crises could matter a whole bunch to U.S. investors, and it makes sense to pay close attention.

Troubling Development #3 —

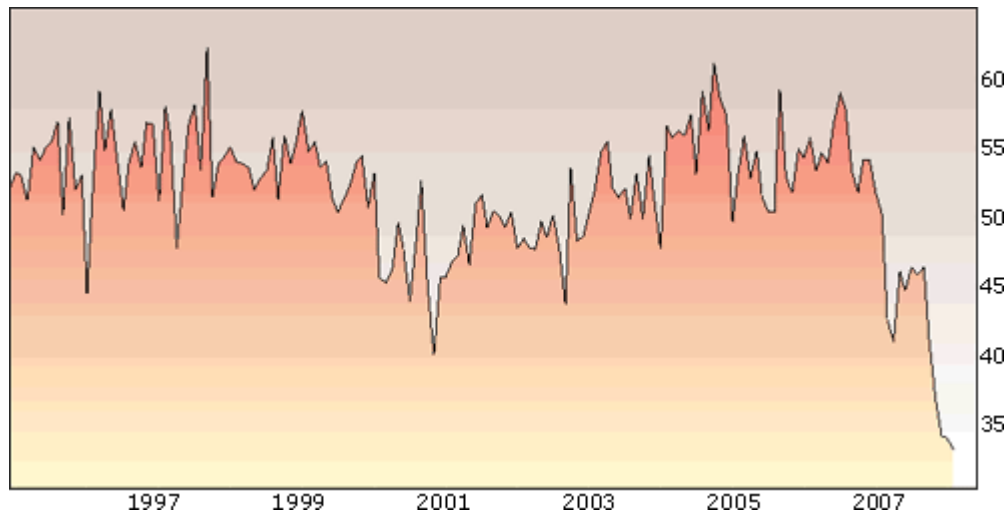
Rapid deterioration in commercial real estate continues apace

Empty buildings; For Sale signs everywhere; Idled cranes, and fenced-off lots. Bright orange eviction notices plastered to front doors. No, I'm not talking about what's going on in the residential real estate market. I'm talking about what's happening in the COMMERCIAL side of the business.

We're seeing commercial property sales dry up. We're seeing issuance of commercial mortgage backed securities (CMBS) plunge — dropping 95% last year. We're seeing CMBS delinquency rates rise quickly, with S&P suggesting they'll triple this year. And we're seeing vacancy rates surge, sublease space being dumped on the market, and rents declining.

Next up: Plunging commercial construction activity...

You can tell that's coming by looking at leading indicators like the American Institute of Architects index. This index, which tracks how much building design and planning work architects are getting, dropped to 33.3 in January from 34.1 in December. That's the lowest level ever for the index, which dates back to 1995.



As construction spending slumps, it's going to be one more force dragging down the U.S. economy. And as commercial real estate loan performance deteriorates, it's going to be yet *another* huge black hole for the banking and lending industries.

Bottom line: Shari and I still think more downside looms. But, "In spite of this impending gloom, it is exactly this type of information that allows Shari and I to keep an open mind, to see down the road a bit, and to make profits . . . I'll have more to say about this in the coming days/weeks" . . .

Until next time,

Valerie Holcomb, President
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Sources: Mike Larson, Money & Markets www.moneyandmarkets.com, MSNBC, MSN money, Marketwatch, chart of the day.

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