

What's Wrong With This Picture?

January 26, 2004

Financial Company	4th Quarter 2003	4th Quarter 2002	% Increase
Fannie Mae	\$ 2.20	\$ 1.00	120%
Citigroup	\$ 4.80	\$ 2.50	92%
JP Morgan Chase	\$ 1.90	\$ (0.40)	N/A
Wells Fargo	\$ 1.60	\$ 1.50	7%
MBNA	\$ 0.70	\$ 0.50	40%

The financial bubble goes on unabated. Why does the fact that the huge banks and other financial institutions making such great profits give us reason for concern? The answer is two fold. First and foremost, financial institutions are not a part of the real economy. What we mean by that is that they allocate funds to those areas of the real economy that they believe will be profitable for them as well as worthy of their trust that principal will be returned. In most all cases, we are talking about the allocation of credit not equity, but of course it takes equity (income) to repay. Therein lies the problem. Economic fundamentals are not allowing much in the way of income (profits for business and salaries and wages for individuals) while the Fed is promoting huge increases in credit through the banking system.

Twenty years ago or so the U.S. economy operated on a large equity base with a relatively small debt assumption. Now it is becoming the opposite. Leverage is great in good times, but asking for trouble in times not so great.

Secondly we are concerned, as we believe the marginal actors in the business community are bankers. They have an uncanny way of discovering and lending to the "white elephants" particularly at the top of a cycle. Is now the top? We don't know, but it sure feels like it.

Our assessments of the various markets are as follows:

1. Stock Market Overvalued
2. Housing Overvalued
3. Bond Market (BBB and less) Overvalued
4. Government Bond Market Undervalued

When will this become the consensus? We wish we knew, but that does not change in any way our evaluation.