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Special Report

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May 2007

Updating Our Outlook?

May 17, 2007 Conference Call

(This transcript has been edited)

Operator: Welcome to the Arbor Research and Trading and Bianco Research Conference Call. Your host for today's call is Mr. Jim Bianco, President of Bianco Research. Operator assistance is available at any time during this conference by pressing star, zero. A question-and-answer session will follow the presentation. I would now like to turn the call over to Mr. Jim Bianco. Mr. Bianco, you may begin.

James A. Bianco, President, Bianco Research: Thanks, Jean, and good morning. Thanks to everybody for joining us on our conference call.

Today's conference call is "Updating our Outlook." I struggled a little bit with this topic only in that my natural instinct is to talk about the yield curve and to talk about interest rates, and there is really not much going on there for the moment. They are sideways and look like they're going to continue to be sideways, so there is the forecast. The curve is at –2 basis points (bps) and will stay at –2 bps. Yields on the 10-year are somewhere around 4.70% and are going to stay around 4.70%, give or take a few basis points.

So what I decided to do was to talk about things that are a little less uncertain, and that would be Fed policy, the stock market fiscal policy, and international capital flows. Let's start on Page Two.

Greenspan Is No Longer The Federal Reserve Chairman!

Page 2 is entitled "Greenspan is No Longer Federal Reserve Chairman." This comes from a piece that we wrote last month.

Basically, what I say in this piece is that Greenspan and Bernanke operate very differently, and that we should not confuse the two of them when putting together our forecasts about Federal Reserve policy.

In summary, the Fed has a dual mandate to both keep inflation as low as possible and keep employment as high as possible. Sticking within that framework, Greenspan used to operate on the "keep employment as high as possible. So he would conduct policy or adjust policy in a way that he deemed necessary to instill confidence or to meet the economy's real growth move forward.

Bernanke, on the other side, who is speaking right now in Chicago as I talk, is focusing on the "keep inflation as low as possible." Bernanke's nomination speech was all about the need for inflation targeting.

The Fed talks about core inflation, forecasts core inflation, and hopes that they are right. This is what they mean by data dependency. So in order to get the Fed to move rates, we are either going to need a new up or down in core inflation -- a full stop and that's it, a move up or down in core inflation.

Now, most of the analysis that I read about what the Fed should do or what the Fed will do is all premised on what I have been terming "The Greenspan Playbook" – the unemployment rate is doing this, non-farm payrolls are doing that, the stock market may be doing this, and there might be this happening in China; so, therefore, given any of those or some of those other things along those lines, the Fed needs to move rates up or down, or mostly down is what you get from a lot of these. That is the way that Greenspan operated.

He is not the Fed Chairman anymore. Bernanke operates very differently. And as we have talked about, it has now been 15 or 16 months into the Bernanke term, and Greenspan has cast such a big shadow on the Federal Reserve Chairmanship that people have not yet begun to realize that the game has changed. It is about inflation.

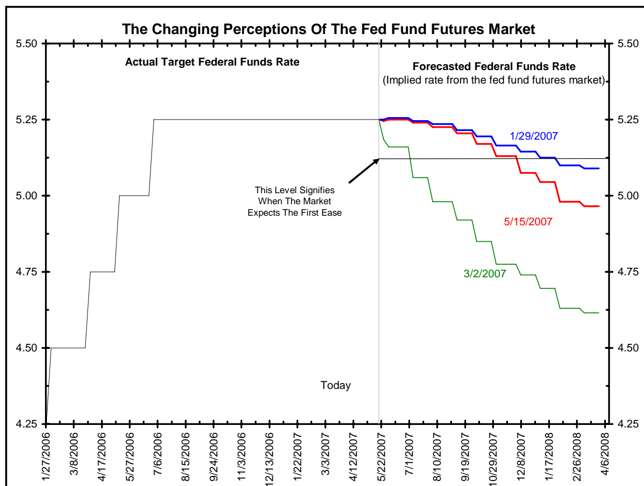
If you want the Fed to ease then you need to make the case that there will be a rapid decline in the core inflation rate, or that the Fed will be so comfortable in forecasting a rapid decline in the core inflation rate that they will ease ahead of that. If you think that the Fed is going to tighten, then you need to make the case that the core inflation rate is going to stay at current levels or move higher because the Fed has already said that it is uncomfortably high.

What you don't need to discuss is the stock market risk premium, employment, consumer confidence, or anything that Greenspan used to focus on; but yet that is exactly what everybody seems to be focusing on.

So I think that it is important to bring up that distinction that we have a new sheriff, he is operating under new rules, those rules are consistent with the mandate of the Fed because they have a dual mandate making them unique in this regard. We need to focus on what Bernanke thinks is important, and then we can get an idea of where Federal Reserve policy is going to go.

Predicting Federal Reserve Policy

On Page 3 is the second thing that I want to bring up because this constantly comes up, although I have tried to dissuade this now in this conference call and in many writings for the last few months – "Predicting Federal Reserve Policy." In the chart on the right, the black line on the left is the actual Fed Funds rate, and the three colored lines – the green, red, and blue lines coming off of that are the predictive paths of the Fed Funds Futures rate on three different dates – January 29, March 2, and two days ago, May 15.

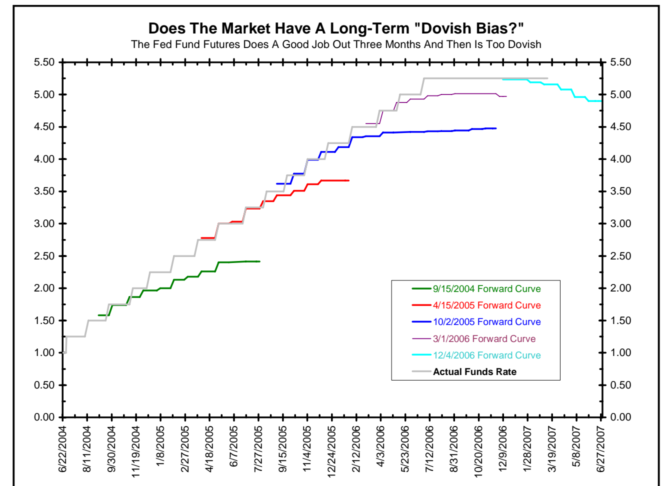


On January 29, the blue line was the most hawkish date that we have had this year, when the market did not expect the Fed to ease until 2008. March 2 is the most dovish date that we have had this year, when the market expected the first ease to come in June. The red line – May 15 – is the current one, which is where the market expects it around October or November as far as the first ease goes.

All of these lines are downward-sloping and, I believe, are coloring a lot of people's opinions while the market thinks that the Fed is going to ease.

As we point out in the bottom chart, the gray line there is the 17 rate hikes that we saw, and then the flat horizontal part at the top is when the Fed held.

The green, red, blue, cyan, and purple lines are the predicted path of Federal Reserve policy on various dates over the last couple of years.



The point is that you can see that the market has a dovish bias. It always thinks that the Fed is going to raise rates less than it actually does or pause sooner than they actually did. The Fed was actually more hawkish.

Now why is it that there is a dovish bias? Remember – I believe that this is clouding everybody's opinion, that the discussion has been when will there be the next ease? And I'm asking, "Who said that there is going to be a next ease in the marketplace?" A lot of times, when I have asked that question, the thing is to look at Fed Fund Futures. They are always predicting an ease way off in the future. As I have pointed out before, as one hedge fund manager asked, "Can you think of an event that would get the Fed to have an FOMC emergency meeting tomorrow?" I have answered, "Yes." If something happened like the stock market crash, a geopolitical event, a terrorist attack, or something along those lines, then the Fed would need an emergency meeting tomorrow.

What would the Fed do? They would probably ease off of such a crisis event. Can you think of any event that would cause the Fed to meet in an emergency meeting tomorrow to raise interest rates? The answer is that that event does not exist. So there is an inherent dovish bias in the Fed Fund Futures. The unknown that we cannot foresee will only result in the Fed easing rates. There is no unknown that we cannot foresee that would cause them to raise rates. Hence, a built-in premium towards falling rates. That is why the market is constantly more dovish than they thought during the 17 rates hikes and it is now. I have argued that, in looking out beyond three months on Fed Fund Futures, you have to adjust for that dovish bias. And if you adjust for that dovish bias, what you will find is

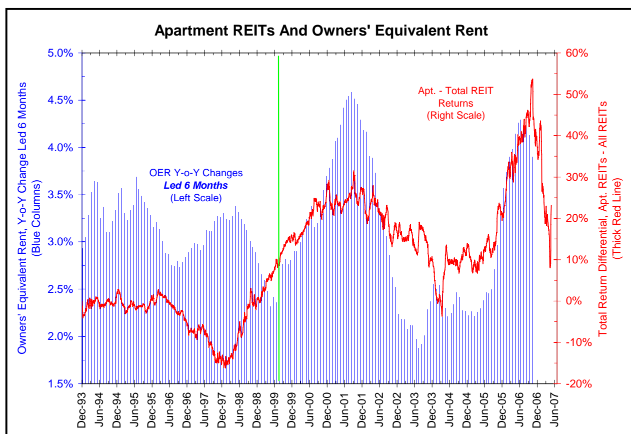
that the market thinks that the Fed is on hold for quite a long time.

Is OER Rolling Over?

Page 4 – why does the market actually think that the Fed is on hold? Again, the Fed focuses on core inflation. By focusing on core inflation, you take some of the things in core inflation and magnify their importance because you have taken food and energy out. The more things that you take out, the more that you magnify the importance of what's left.

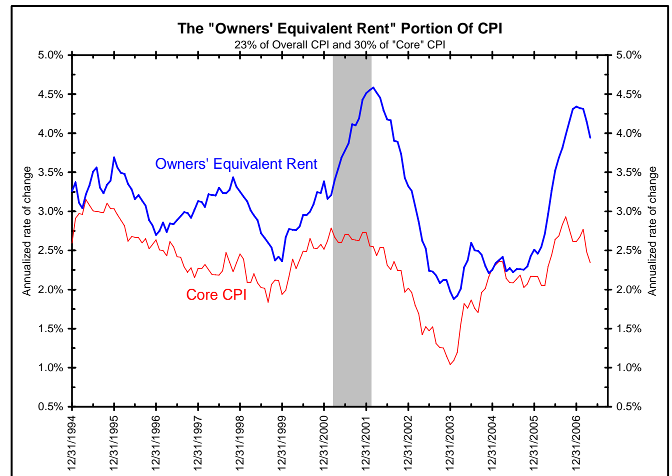
We have argued that what is being magnified in the core inflation rate right now is owner's-equivalent rent because it is something along the lines of 30% of core CPI and about 14% of core PCE. So as I wrote here, we do not think that it is a stretch to say that implied rental values of homes matters more to the Federal Reserve than the price of gasoline when setting Fed policy.

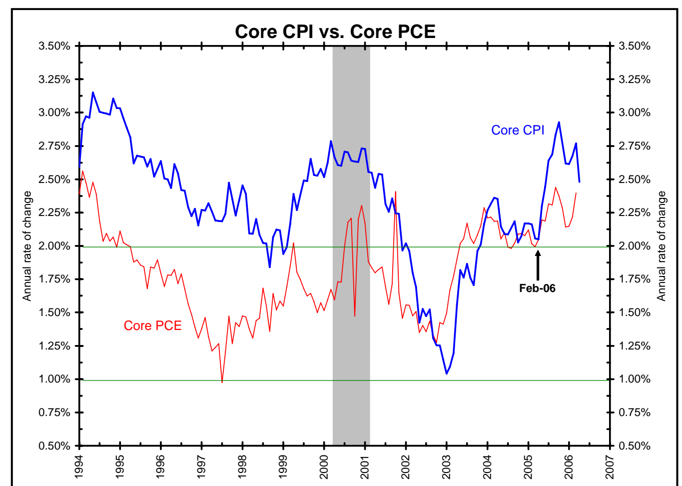
As far as where we are is concerned, again, the top, right chart – the blue bars are year-over-year change in OER, and the red line is the excess return of apartment REITs to total REITs shifted forward to six months.



So what is happening to apartment REITs relative to total REITs now, we believe, is an excellent indicator of where OER is going to go in six months, and OER drives core inflation, which drives Fed policy. What you see is that the red line has taken a big dive in recent months. It peaked on Halloween, October 31, and it has gone down quite substantially, although it started to rebound a little bit in the last couple of days. The fact is that you should be looking for OER to start downward from here forward.

If you look at the chart underneath it, that is exactly what has been happening. The blue line shows that OER is starting downward for the first time in quite a while, and that should bring the core inflation rate, which is the chart on the left, down back into the Fed's comfort range, which we are somewhat defining as about 1% to 2%, maybe 2.25%, but it's going to bring it down. And if it brings it down, and the Fed is on hold, then the Fed is on hold throughout the balance of this year and into next year.





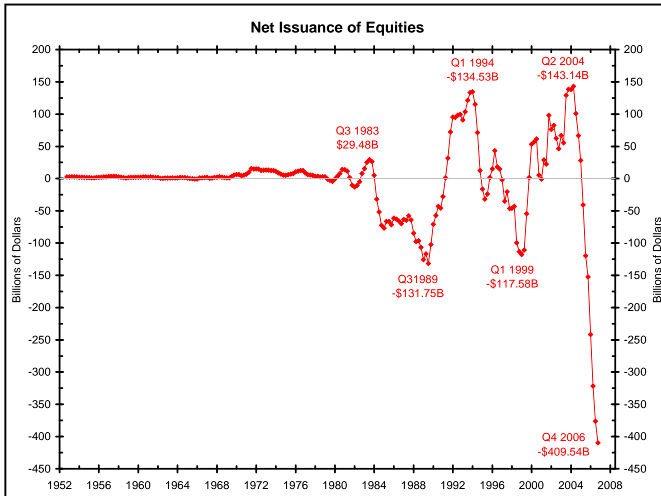
If it brings it down substantially, then we can talk about easing. If it doesn't bring it down enough or we're wrong, and OER turns up, or core inflation just defies OER and the other components overwhelm it, then the Fed will react accordingly. That is what drives Fed policy.

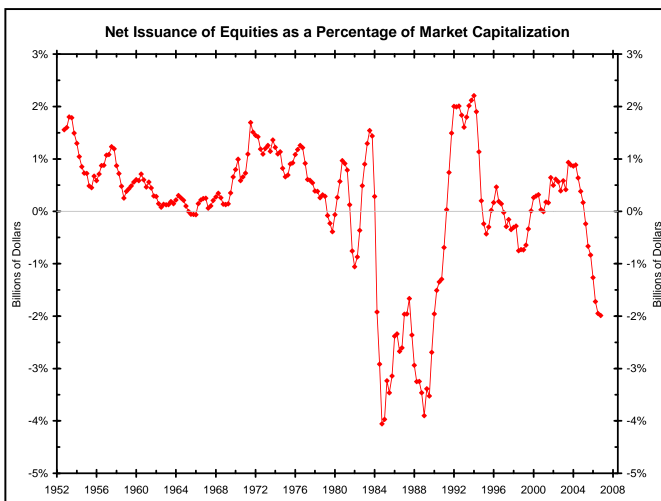
Supply Shrink

OK, Page 5 – let's talk a little bit about the stock market because I think that the stock market is probably the most interesting story out there right now.

And the stock market story is about supply shrink. The chart on the upper left shows the net issuance of equities through the first quarter from the Federal Reserve Flow of Funds Report. In about three weeks, we'll get an update on this for Q1. I suspect that it will be a little bit larger, but you can see that we net reduced this float of the U.S. Stock Market by $400 billion in all of 2004, through the year ending in Q4 2006. That means that the combination of

buybacks and companies going private shrunk the stock market by more than $400 billion when you add back to it secondary offerings and initial public offerings. As a percentage of the market's capitalization, the chart below it, you can see that we are at the most extreme level since the 1980s. The 1980s as a percent of market caps was a much bigger level.





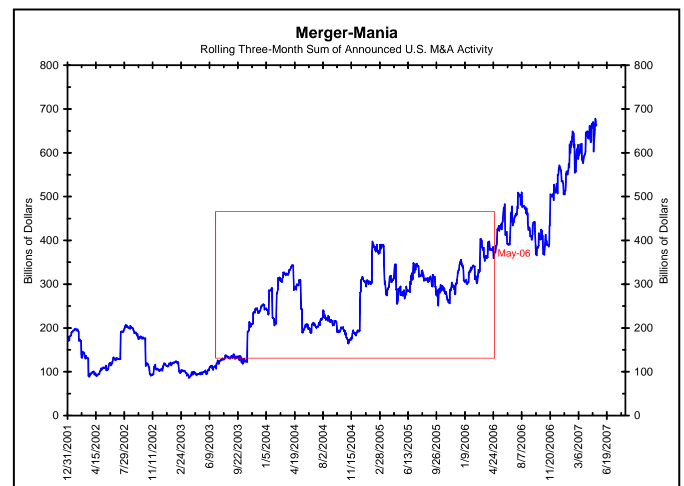
What is interesting about this chart, especially the "Percent of Market Cap" chart – is that the returns in the stock market do line up very well with this chart.

When the net issuance of equities as a percent of market cap is highly negative – negative 2%, 3%, 4% – the stock market returns around 19% versus 11% for the entire period shown. When it is above 1% like it was in the 1970s and early 1990s, the market returns about 8%. So it's less than average when it's above 1%, and it's better than average when it's around -2% or lower. We're at -2% right now. So the idea here is that, as the pool of stock shrinks, the amount of money in the market stays the same, and that has to get reinvested back into an ever-smaller pool of stocks.

Now, what does that really mean? We wrote a piece about this a couple of weeks ago, and we said that stocks can be priced for one of two reasons – they can be priced for ownership, which is what we do, as we own the stocks – or they can be priced for control, which is what Sam Zell and Rupert Murdoch do. They control companies. There is usually a premium for control. That's why mergers are done at a premium to current ownership pricing. If the marketplace believes that this merger wave is going to be huge, then they are going to start to price the entire market for control. The entire market cannot be bought. And at some point, when it ends, we are going to have to go back to pricing all of these stocks for ownership, which is a fancy way of saying that they will go down.

By the way, I will throw out a very interesting statistic that I heard yesterday. I haven't had a chance to confirm it, but I have no reason to believe that it is wrong.

It was from Jim Cramer on CNBC. He said that the amount of money in private equity right now is enough to buy and take private the 350 smallest companies in the S&P 500. So the bottom 350 companies could go private right now with the amount of money in private equity, according to Jim Cramer. Like I said, I haven't been able to confirm it, but I have no reason to believe that is wrong.



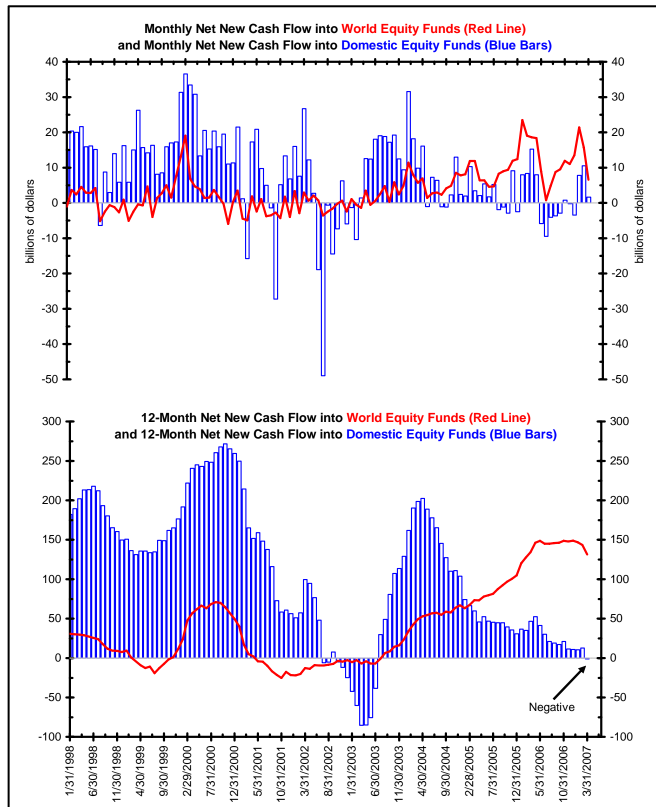
To give you an idea of how the mentality of this market is, that means that, in this market's mind, all 350 of them should be priced for control. Does that mean that they are all going to bought and taken private? No, but that's the way that they are going to be priced, and that is why this market has gone up 10% in the first six months of this year. And as you can see on the chart to the right -- the merger mania that we're talking about here – here is a rolling three-month sum of announced M&A activity that is at a multiyear high right now. We don't have data back into the 1980s, so I can't say if it's an all-time high, though it probably is on a nominal basis,

but maybe on a percentage-of-market cap basis it isn't; but it is at, at least, a several-year high.

Equity Mutual Funds Flows – Domestic v. World

Again, on Page 6, I do want to point out that it is the merger thing that seems to have caught the market's attention, although that's a dangerous game to play because, when it ends, it usually ends badly. It's not necessarily that money is flying into the market.

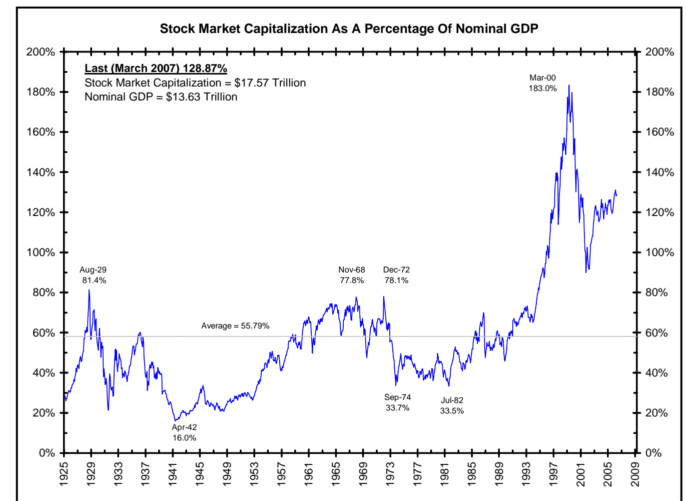
The chart on the bottom, again, shows the rolling 12-month sum of money into equity funds. Domestic equities are the bars. The red line is domestic equity. You can see that we're negative for the first time since 2003. The public is not putting money into the stock market even though it's up over 10% in the last six months. It has been up 10% or more in 2006 and in 2005, and already, halfway through 2007, they are not participating in this market. It is quite extraordinary to see the public not interested in the market.



Mutual funds own 25% of the U.S. stock market, and that owner – that 25% owner – is not participating by adding more money to the market; it's just the big supply shrink that it taking the market higher. That supply shrink is looking like there is no sign of its slowing down right now, and so there is no reason to believe that the market is going to stop going up; hence, why we have had only a handful of down days this quarter. It's about as common as the sun going up, or at least that's the perception that we have in the marketplace. For the moment, I don't see that ending. But when it does end, I do think that it will be rather unpleasant.

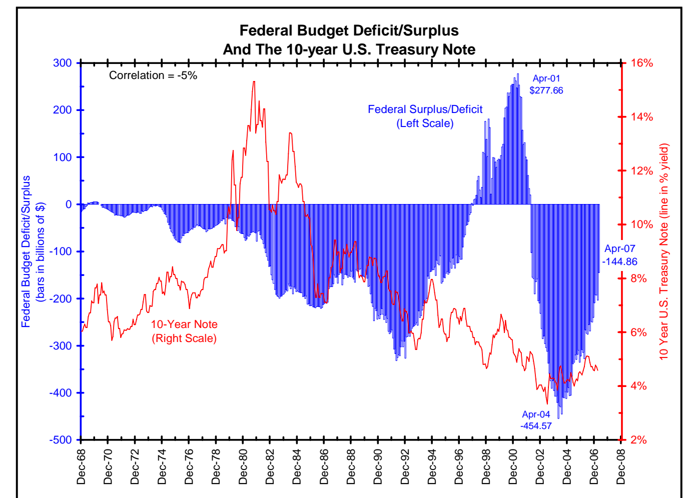
The Wealth Effect

Page 7 – The Wealth Effect – I do want to talk a little bit – if you're not a stock trader, again, that this is an important point to bring up, that the stock market so dominates things beyond just the stock market itself. The chart on Page 7 shows the stock market's capitalization as a percent of nominal GDP, and it shows that it's currently at 130% – or 128.8%. Again, we have a $17.5 trillion stock market against a $13 trillion nominal GDP. I believe that this is an important statistic to understand so that, when you look at the charts on Page 8, they make a little bit more sense.



Do Capital Gains Drive the Federal Surplus/Deficit?

Let me start with the chart on the lower right on Page 8. I am surprised that this chart has not gotten more attention than it has, or the statistic.



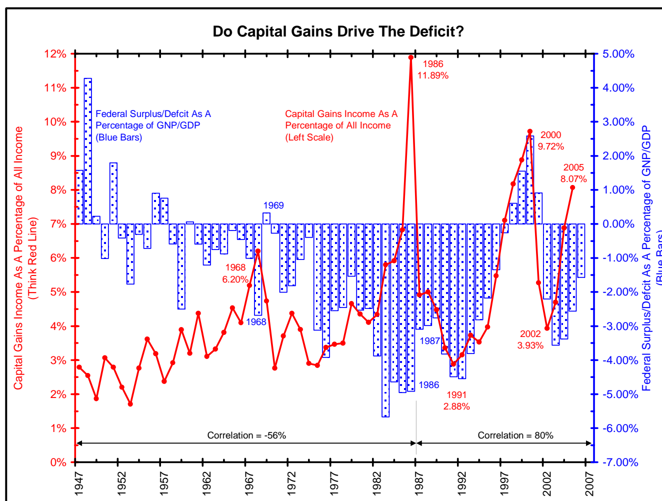
The Federal Surplus Deficit – the Federal Deficit, which, according to political polls, the American

public lists as the number one economic problem facing the Country right now is the large federal deficit. It has collapsed in the last few months.

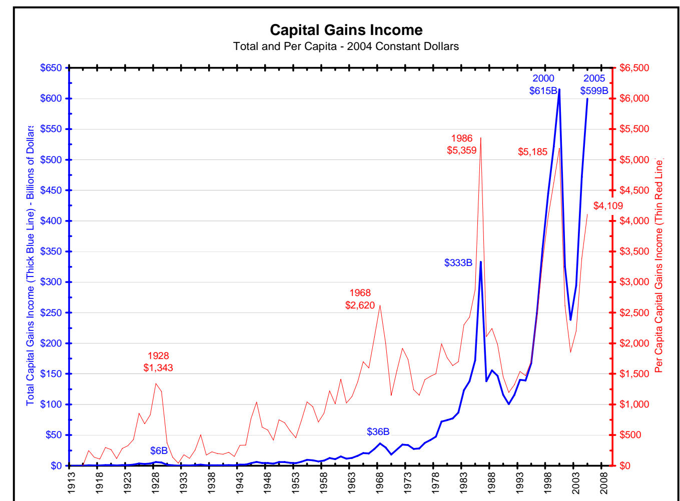
Now, I am showing it here on a year-over-year basis so that it incorporates all seasonality into the numbers because the revenues and the outflows are lumpy and don't go in and out at the same time, so year-over-year incorporates it.

We're down to, in April of 2007, a $144 billion deficit from $209 billion in the year ending March of 2007, a $50 billion swing in one month. Thank you, capital gains, for flying into the Treasury and giving them, on April 17, a $48 billion one-day inflow from just cashing all of the checks that came in right at the end on tax filing. Just three years earlier the deficit was $455 billion and now it is $145 billion - a $300 billion swing. And yet, if anybody has been watching politics, they know that we have been spending a lot of money on Iraq; we've been spending a lot of money in cleaning up after Hurricane Katrina, and a lot of conservatives are crying that Congress has an inability to rein in spending. Even after all of that, the deficit has gone from $455 billion to $145 billion.

It's within shouting distance of being balanced before the 2008 election. Now why is that? Look at the chart above. It shows capital gains as a percent of all income. The data is current only through 2005 because that is the last data that we have, as we won't get the 2006 data, probably, until the early part of next year.



But what it shows is that, since the 1986 Tax Act, there has been an 80% correlation between the deficit and capital gains. Right now, 8% of the average taxpayer's adjusted gross income is due to capital gains. If you look at the chart on the right, basically, what it shows is that total capital gains on the average tax return, adjusted for inflation, was $4,100; so the average tax return is showing $4,100 of capital gains.



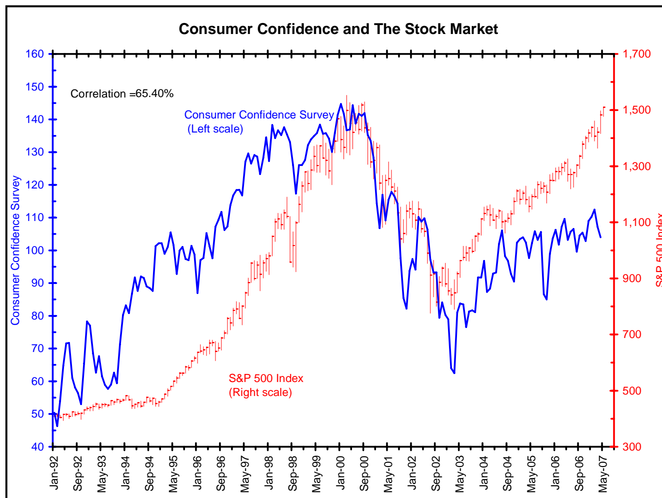
Now, of course, people at the top end of the income scale are showing a lot more than $4,100, maybe even into the several-hundred-million dollar range if you start getting into the wealthy hedge fund managers or even $1 billion; and there is a lot of people in the bottom end that are showing zero or some nominal amount from interest in their checking account. But the average out is $4,100 per person. The blue line is just the nominal number of non-inflation adjusted, which was $600 billion. So capital gains – the stock market goes up. The byproduct of the stock market going up is that it balances the budget or gets the budget closer to balancing.

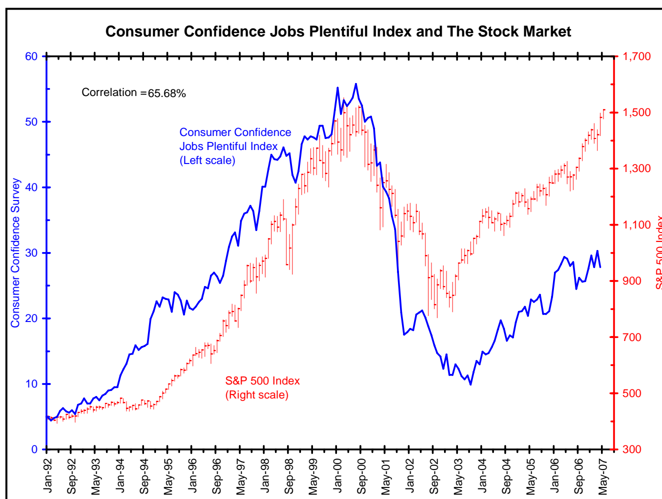
I have seen analysis and have no reason to believe it is wrong, and it makes sense – that if the stock market were to go up another 10 to 15 percent – I used to say 15% to 20%, but we've already had a 10% gain, so it's now another 10% to 15% -- by the end of next year – 18 more months – and were to hold that level through the end of 2008, and you have no major change in spending patterns in Washington – no other big hurricane to spend $100 billion in cleaning up, or a terrorist attack, or some other move in Iraq or anything else that would require a lot of money, or Congress just starts spending money like drunken sailors. Let's assume that everything that we know about spending stays steady, and you get another 15% gain in the stock market and hold it through the end of next year. George Bush can leave office with a balanced budget, which a lot of people think is still impossible to happen. But we have already whacked $300 billion off of it. Thank you, stock market. So the stock market is very, very important to Washington, and they are just now starting to understand that.

The Stock Market's Influence on Consumers

Page 9 – just to kind of talk about the stock market's influence one more time, I just want to point out that we have been very critical of the consumer confidence surveys because we don't think that they tell anything new as these indices line up very closely with the stock market. The question is too abstract. People don't understand it. So when you ask them, "What do you think that the state of the economy is," that's like asking somebody, "What is the weather like in the United States?" "I don't know. It's raining in some places, and it's sunny in other places." So they look out the window and tell you what the weather is.

When you ask them what the state of the economy is, they don't know, so they just describe what the stock market did last month, which is why consumer confidence indexes line up with the stock market.



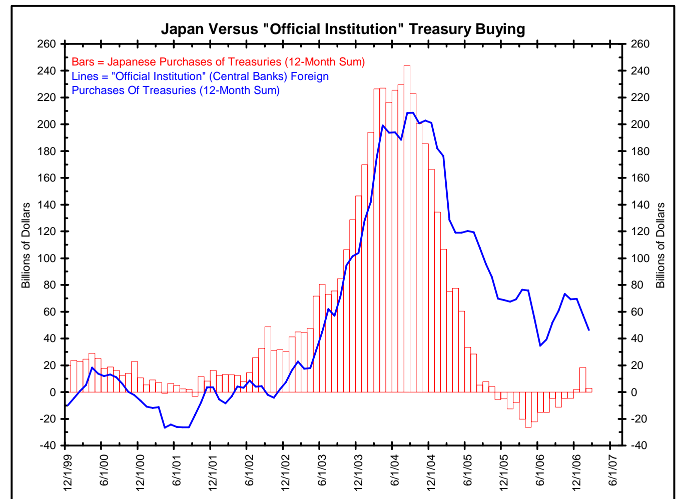


So if you're watching the stock market go up and you don't trade stocks, it still affects the budget deficit, it affects consumer confidence, it affects what people think about the economy, and, therefore, it affects interest rates.

Foreign Activity In Treasuries

Finally, on Pages 10 and 11, I just want to make a few comments about foreign activity and treasuries.

This is another one of those stories that seems to be on the tip of everybody's tongue. There was a *Business Week* story two weeks ago – "What If Foreign Money Shunned the U.S." It was interesting because the story brought up a point that we have brought up in the past, that is let's look at the example from 2003 and 2004 with Japan.



If you look at the top chart, the red bars represent net purchases of Treasuries from Japan, and the blue line represents net purchases of Treasuries by all official institutions or central banks. So the blue line is all central banks, and the bars are Japan.

They don't break it out by central bank per country, so I can't give you Japan's central bank alone. But what you can see in this chart is can we make the assumption – and I think that it's a very safe assumption – that the big bulge in Japanese buying that corresponded with the big rise up and down with central bank activity was largely the Bank of Japan.

Everyone worries if there is a massive shift in foreign activity; say a $200-billion shift. Well, it happened a couple of years ago so we have a roadmap as to its potential consequences.

Remember that the 10-year yield bottomed at 3.11% in June of 2003. Find June of 2003 on this chart, and you will see that the Japanese were net buyers in a year-over-year basis of about $50 billion worth of treasuries. Then by late summer 2004 they bought about $250 billion annualized or, in total – in other words, their buying reached a peak of $250 billion year over year and, in total, bought almost $400 billion worth of treasuries by the end of 2004. What did interest rates do during that period? They rose. They rose because the economy was heating up. They rose because the Fed was raising rates,

and there was a rise, at least in early 2004, in anticipation of that.

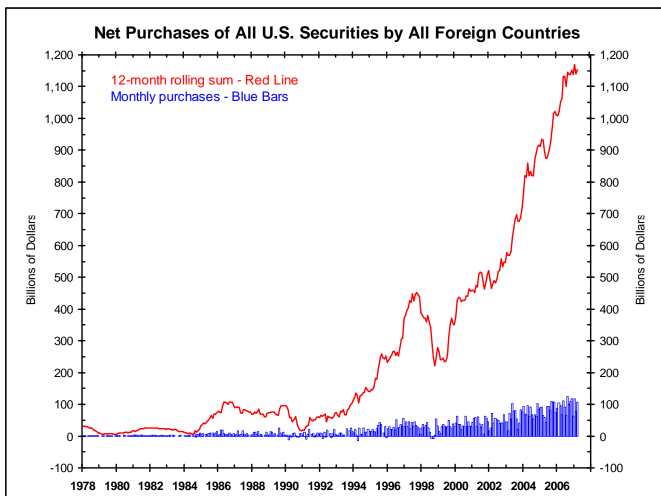
So, they rushed in and threw $400 billion at our market a couple of years ago and rates went up. Then you could see the Japanese went from a year-over-year basis of $250 billion by November of 2004 to early 2006, about a year ago, they became net sellers of $30 billion.

So, what happened to interest rates when the Japanese stopped buying? They went down! So one of the things that we have been talking about with this obsession of what happens when the Chinese stop buying treasuries, or what happens when the Chinese economy slows is that they own only $400 billion to begin with. The Japanese added and subtracted those kinds of numbers just a few years ago and we didn't see any movement out of interest rates because of it. So I think that we vastly overestimate what the effects of foreign buying on our market.

I agree and have been on the case that foreigners own about 50%t of our Treasury market. That means that, all things being equal, they are depressing our interest rates. There is no doubt about that. But to look at jiggles in the margins about whether or not they are buying here or selling there, and saying that is going to have a profound impact on interest rates, I think, vastly overstates the case. We can use as an example just a couple of years ago with the Japanese.

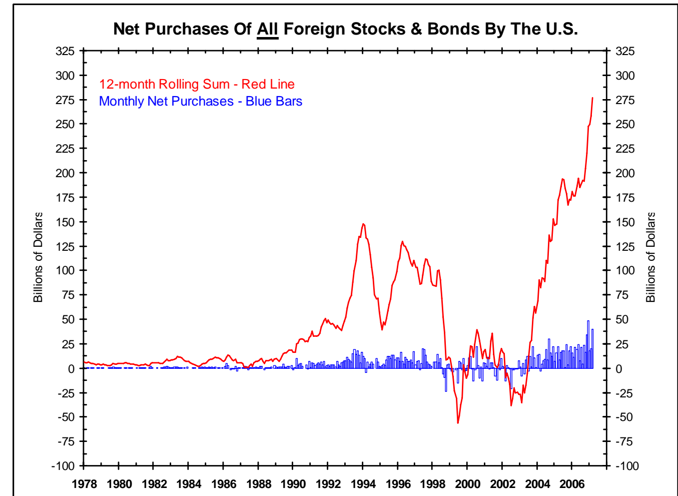
Two Way Foreign Flows

Page 11 – This is a chart that we put together for a report that we put out a couple of days ago called our "Treasury International Capital Update." I found it fascinating. I didn't know this.



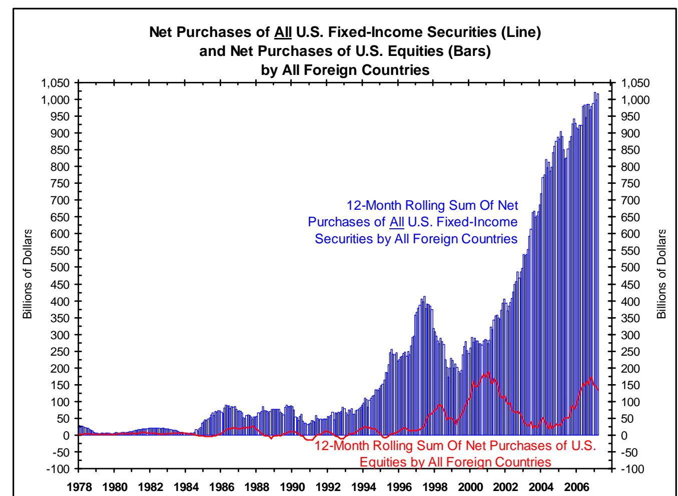
Net purchases of U.S. securities by all foreign countries – the top, left chart – is at a new record of about $1.1 trillion on a year-over-year basis. So in the last year, foreigners bought about $1 trillion worth of U.S. securities. They have not actually had a *monthly* net outflow of U.S. securities since September of 1998, so all of that fear about what happens if they sell – they haven't actually had one month of outflows for about nine years now.

But if you look at the chart on the right, this is the opposite – the net purchase of all foreign stocks and bonds by the U.S. – so how much are we buying of foreign securities – that's at a record, too.

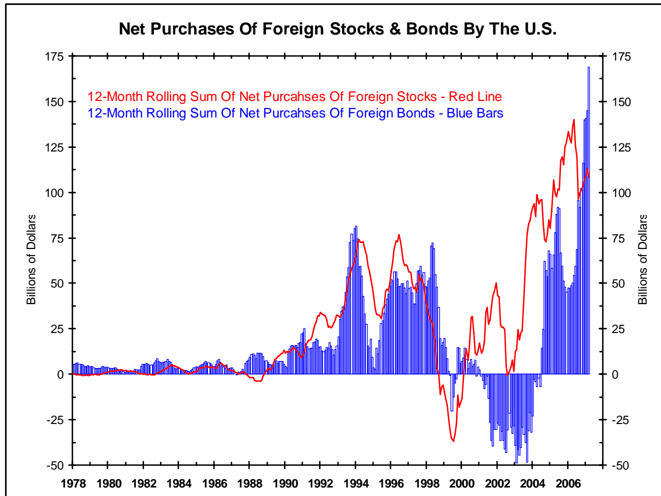


So the amount of money coming into the country by foreigners is at a record, and the amount of money going out of the country by Americans is a record. Admittedly, the U.S. numbers are much smaller, as there are only about $275 million on a year-over-year basis. But, nevertheless, we're both heading higher – money coming in, money going out, big two-way flows when it comes to foreign activity.

If you look at the bottom charts, it breaks it down into stocks versus bonds. If you look at what foreigners are buying of the U.S. -- the bars are fixed-income assets – it's almost all fixed-income assets, so up to $1 trillion in fixed-income assets, it's about $150 billion worth of equities.



If you look at what U.S. investors are buying of foreign securities, it's about evenly split. I say "about" because the red line shows equities, and the blue line shows bars. Up until two months ago, actually, there was more equity buying than fixed-income buying, and that's kind of flip-flopped, but it's about equal numbers, roughly, whereas it is not about equal numbers the other way.



So foreigners buy $1 trillion worth of U.S., almost all fixed-income; that's a record. The U.S. sends $275 billion overseas, and that's a record, about evenly split between fixed-income and equities.

So, when we look at flows, I just thought that it was interesting to note that the flows are records going both directions. And we were talking about what if foreigners shun U.S. securities, what if the Chinese start selling – you could not possibly pick a more incorrect time to ask that question because exactly the opposite is happening, that more money is coming into the U.S., and U.S. investors are sending more money overseas – the confidence in the global financial system has never been higher.

So before we start fretting about what it means if it stops, then give me a credible reason for why you think that it will stop now because the trends – if you look at these charts – have been unmistakable for years that the two-way flows have been increasing. So just from history, now is not the time start looking for those flows to change and go the other way.

With that as a backdrop on Fed policy, the stock market, and international capital flows, I will stop there. I will ask Jean, the Operator, to come back online and give you directions on how to ask questions. So, Jean, are you there?

Questions and Answers

Operator: Ladies and gentlemen, at this time, we will conduct the question-and-answer session. If you would like to state a question, please press star, one on your phone now, and you will be placed in the queue in the order received, or press pound at any time to remove yourself from the queue. Please listen for your first name only to be announced, and be prepared to ask your question when prompted.

Bianco: All that I was going to say was, as usual, you can also email me questions at jbianco@biancoresearch.com. For some reason, that seems to be a popular way, also, for people to ask questions. I've already got my first emailed question, which actually came in before the conference call. So while people are getting into the queue, let me answer that question. I also remind you that we use first names only on the questions because we feel that, by keeping it somewhat anonymous, it encourages questions.

So Jason asked a question about the VIX and the MOVE. "The recent trend in the MOVE has been to continue downward while the VIX has been up-trending since mid-April. Do you think this has any significance?"

First of all, let me give a quick description of what we're talking about. The VIX – the Volatility Index of the stock market – shot up when the stock market went down in late February/early March. The VIX has stabilized around 13.5 or so. I would probably tend to describe what it has done since mid-April (or the last month) as more sideways action around the 13 level or so as opposed to having moved a level up or down. The MOVE Index – the Merrill Option Volatility Index, or implied volatility in the bond market – has collapsed in recent days, and it's now at a new all-time low.

Volatility is the price of insurance. You need insurance when there is uncertainty. Let me take the MOVE first. It's at an all-time low. Does that mean that the market is very comfortable with the level of interest rates? I think that it does. I think that just like I started off the conference call -- why am I not talking about the curve, and why am I not talking about interest rates – because the curve is –2 and has been –2 for a year. Sometimes it gets the +7, and sometimes it gets the –12, and we are now to the point where we think that there is a difference between –2 and +3, that, somehow, -2 means one thing for the economy, and +3 means another thing for the economy. Ridiculous as that sounds, that is exactly the analysis that we're getting because we're counting the basis points one at a time, thinking that there is some kind of importance there.

The 10-year note is at 4.73% right now. It has been at 4.70%, 4.60%-something now for weeks. I think that is going to continue to be at those levels. The curve is going to be slightly negative. The 10-year is going to be somewhere around 4.70%. Everybody knows what the Fed is doing. Everybody knows what the Bank of Japan is doing. The economy is

running at around 2%. Nobody is making a case for an upward or downward move in the economy. Why do we need insurance in this market when everything is known and nothing is happening? Hence the MOVE index is at an all-time low.

You are correct if you're thinking, "Well, then that means that there is going to be a surprise somewhere because we've built in too much complacency. That is a valid way to look at it. But to answer the question of why the move is so low, I think that it's because everybody knows what is happening, and nothing is moving. It is kind of hard to get all excited about the curve unless you really want to say, "I forecast that the curve will go to +3 or –8" as opposed to being two/10s at –2, as if that is a different number.

With the VIX, there is an investor skew in stocks because, naturally, investors are long stocks, which is not the case in currencies or in fixed income. Given this skew, there is a high degree of correlation between the stock market and the level of the VIX. Rallying stocks tend to get lower VIXs, and declining stocks get higher VIXs. We saw that in late February when the market went down and the VIX shot up. So why isn't the VIX returning to that 10-level or so that it was at before February 27? Why is it settling at 13? Uncertainty. Is everybody comfortable with the rally in the stock market? I would argue that they're not as comfortable with this rally as they were with the rally that we had prior to February 27, hence, the need for insurance and the higher levels of the VIX Index.

Sometimes, the simplest answers are the best.

Operator: Yes, our first question comes from Michael. Please state your question.

Michael: Hi, Jim, I have several questions, actually. I'll just ask one question for now. The point that you make that net purchases of your securities, although less of about $1 trillion, and net purchases of foreign securities by U.S. investors of about $275 billion, it seems to me that the difference between those two is just about equal to the trade deficit. My question to you is, "Isn't that an identity?" In other words, if the trade deficit is $800 billion or some such number, isn't it necessarily so that those dollars have to wind up in somebody's hands and are temporarily invested in, for example, T-bills or T-notes and, therefore, show up as if they were investment. But is it maybe going too far to take that as confidence in the U.S. systems by our trade creditors?

Bianco: The answer to your question is, "Yes." Ultimately, these are the numbers that you would look at – that net and various other nets like it to say that that's why the large current account balance of the trade deficit has frustrated those that think that the dollar should be collapsing off of that news, because we could run the big trade deficit or current account deficit forever as long as everybody continues to give us money.

Like I said in the comments, I agree with you that it would be a mistake to say that this means that there is total confidence in the system forever. There is confidence in the system now, hence the big two-way flows. That does not mean that something cannot happen to upset that confidence.

I think that those that want to talk about what if foreigners shun the U.S. have a valid question. But instead of talking about the consequences of their shunning the U.S. -- let's leave that as the second part – why would they shun it now that the year-over-year flows (according to the TIC data, which goes back to 1978) have never shown a year-over-year outflow by foreigners, all the way back to 1978. They have never net-sold the market, for 30 years. Why do we think that is a concern now? That is a better question to ask.

So, yes, whenever I see people saying, "All right, there is a lot of confidence in the system," I understand that there is now, but I also understand not to assume that it will be that way forever.

Michael: Well, again, I am a little hung up on the identity issue here. Even if foreigners did not have confidence and were changing dollars wholesale into euros, for example, at central bank levels or elsewhere, somewhere, there would be dollars that would be forcibly invested short-term into a yield-bearing instrument and, presumably, show up as investments in the U.S. for those who want to interpret it that way. But in a sense, I'm not sure what to read into that other than that we export huge amounts of paper, and it comes back in some form because the holders have to do something with it.

Bianco: I guess. I agree with you that you could see that in the bottom charts, that the vast majority of foreign investment into the U.S. is in fixed income. There's no doubt that it's being parked in yield-bearing instruments while the resolution of what to do with that money is decided elsewhere. With a U.S. investment, you can actually argue is a little bit more what we would consider investment because it's more equity-driven and more speculative-driven – not more speculative, but meaning that they are investing in capital and in plant equipment – the U.S. investors overseas – by buying more equities – 50 percent, almost, is being bought of equities; whereas we are seeing the numbers, at least from foreigners, being parked in treasuries, and we're seeing it being parked in short-term instruments.

Like I said, I'm not going to say that the system is perfect and that there is not a problem. I'm just saying that no one perceives a problem now, and

these high flows are evidence that no one perceives a problem right now that the flow is both in and out of the U.S.

Bianco: I've got another emailed question from Ben. Ben gives me an interesting statistic here: the bottom 350 companies in the S&P 500 account for $3.6 trillion – or 26 percent – of the $13.8 trillion market cap of the S&P 500. So that kind of gives you an idea of when Cramer makes that statement that there is enough money in private equity to buy the $350 bottom companies in the S&P 500 that that would mean about $3.5 trillion. The total amount of private equity – with the total amount, I assume that Cramer's statement is that the total amount of private equity, assuming that they apply leverage numbers like the typical private equity firm, have the capacity to buy about $3.5 trillion worth of equities, which would be the 350 bottom S&P 500 firms.

Thanks, Ben, for that stat. It's very interesting.

Operator: If you would like to state a question, please press star, one on your phone now. Yes, our next question comes from Richard. Please state your question.

Richard: The first-quarter GDP, I guess, was 1.2. -- maybe it will be revised down to 0.7 -- and yet the unemployment rate is at 4.50%. You said that the Fed is looking at inflation and employment. Are they looking at employment as a proxy for GDP? I mean, if we had two or three quarters of 2 percent GDP growth, but inflation remained where it is for whatever demographic reasons, would that be acceptable to them?

Bianco: Well, that gets into a philosophical debate about where the Fed is in its thinking. I would argue this – 1.3% growth first-quarter GDP, stock market is at an all-time high, the employment rate is very low, the inflation rate is a little bit above their target range – I would say that, in order of importance, I would probably give you a guess that the inflation rate being above their target range is the most important thing in influencing them so that they are on hold. The next most important thing that is going to influence them is going to be their forecast on the core inflation rate, which they believe is going to moderate, which then puts them on hold. I would argue that the third most important thing would probably be a sign of confidence in the economy, in the financial system; and the stock market being at all-time highs puts them on hold. And the fourth most important thing would be lousy GDP, which would suggest an ease.

So if the GDP numbers continue to run weak like we saw in the first quarter, then I would argue that, in order to get the Fed to get off of this move, they would need to see the inflation rate come down a lot. They would need to forecast – and Bernanke would tell us because he tells us in his speeches, as he is very clear-spoken on this – that they are forecasting big drops in the inflation rate, maybe a weakening in the equity market. Then GDP would start to affect Fed policy. But, right now, it's just being overwhelmed. It's being overwhelmed by the unemployment rate. It's being overwhelmed by the stock market. It's being overwhelmed by high core inflation. It's being overwhelmed by a Fed that is only predicting modest declines and high core inflation. So there is really nothing out there.

Just to reiterate my point at the beginning, your argument is exactly the way that Greenspan looked at it, but I am arguing that this is not Greenspan. This is a different guy who looks at it in a different way. And the personality of the Fed Chairman indeed does matter, and his personality and his way of looking at it is very different.

Bianco: OK, we've been on this call for 46 minutes. I will wrap it up unless somebody hits one to give us a question in the next seconds. I will be available in the office afterwards for anybody who has any other questions or comments.

Thank you all for attending this conference call. We will see you at next month's call.

Operator: This concludes today's conference call. Thank you for attending.

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