

# ROHR REPORT

## CAPITAL MARKETS OBSERVER

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**Key Views, Overview,...**

**...Still No Solution, The Taxpayer's Savior, The Fiddler's Notion**

### Key Views

- We begin with a question: What is the definition of a crazy person? One possibility is someone who does the same thing the same way over and over again, yet expects a different result. It is clear that not only are the financial luminaries of the US Treasury and Fed not crazy; they are in fact some of the most serious and intelligent officials in the world. Which leads to question number two: How is it they have chosen to stick with such an incrementally less effective (across time) 'solution' that it has left a demented situation in financial problems flowing from the linked US housing and debt derivative crises? What is not in question is that we will be providing our views on this below, as well as what should have already been done that still needs doing.
- Suffice to say for now the continuing bear trend in equities is at risk of reverting ever more quickly to an active bear market again after the brief hiatus since the Mid-July rescue of Fannie Mae and Freddie Mac. The increasing turmoil tempo is both glaringly apparent and significantly disconcerting, as it presages a potential for the official interventions to prove wholly ineffective at some point; that would be a real problem. Rather than render our own litany of sequential rescue failures, we defer to the attached column from the Financial Times' John Authers. He both guessed right over last weekend that this situation was fraught with risk, and eloquently outlined those incrementally less convincing market responses to official rescues. In case you missed our previous missives, we still encourage anyone who does not already have one to subscribe to 'ft.com' post haste, and take advantage of their daily email alerts.
- Of course, the next significant shoe to fall now that strong sister DJIA has Closed below its 11,100-10,975 weekly UP CPR support (threatening more aggressive activity below the recent stabilized trading range) will be today's highly problematic systemic risk mitigation program announcement. If the DJIA takes it well, there is a chance it will recover back above 11,000-11,100. If not, it is likely to slip back down below the major 10,700 area and retest 10,500-10,450; below that it's 10,150 and the 10,000 area.
- The obvious further question: Why the Congressional at-risk borrower relief program (HERA) seems to have gone MIA since returning from the summer holidays? It was approved under duress by the administration as part of the package that included the GSE reform and funding. You remember that part; the bazooka that Mr. Paulson assured us would not be necessary to actually use if everyone knew it was in place. Messrs. Bush, Paulson and Bernanke, et al. have spent a lot of time articulating a position offering only very limited assistance to at-risk borrowers who wish to remain in their homes, because they wouldn't want to bail out bad decisions after all.

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- However, for firms who either need them to provide (or attempt to arrange) sustained massive infusions of capital to actually write down the losses from the debt derivative portfolios that continue to fail because of the foreclosures that put those folks out of their homes, step right up. As noted previous, we suspect they are rue to admit that the lack of regulation and Fed tightening at key times has left the manic free market Bush legacy (such as it may be) in tatters after the dual credit and housing bubbles burst.
- Of course that bailout/funding focus is not actually available to all comers. There has at least been selective discretion employed based upon both when the problems occurred across the cycle and the business model of the various firms. This answers quite a few of the questions regarding why they rescue some firms, and not others in a seemingly similar condition. In a nutshell, it has to do with whether a particular firm's business model is robust enough to allow for the ability to rebuild capital, and if they were prudent enough to seek shelter if not. That explains a lot about why Bear Stearns' and Lehman Brothers' immersion in shrinking debt derivatives businesses (and major inventories thereof) left them less than viable: No chance they could earn their way out.
- There is also the same cash derivatives counter-party consideration that led the Fed to engineer the Bear merger in March when its failure might have been a shock to the system, while letting Lehman file bankruptcy in September. The shock to the system from a lack of mortgage guarantees from GSE's, and the lack of availability of insurance along with counter-party implications of an AIG failure would have meant a significant increase in systemic risk not attendant to the Lehman failure; or so they hope. More so than 'too big to fail' it is a matter of 'too intrinsically essential for financial system stability to fail' (TIEFFSSTF); not the case for Lehman, in spite of the mess that the Lehman failure and GSE conservatorship have created for other parts of the financial system and general investment confidence. AIG also has a very broad range of viable businesses to help it earn its way out (even if that will surely take quite some time.)
- Yet, even all of the actions taken over the past two weeks have not seemed to restore a strong sense of confidence, as opposed to just the very necessary removal of the most pernicious irritants in a continued bad situation. Which gets us back to the important market decisions for the balance of the week. What is important is not that the US equity markets had failed to hold the near term bottoms generated on Tuesday's rally; it is far more important whether they quickly stabilize and establish weekly Closes back above key supports. That is especially so for the major DJIA 10,700 support, for reasons we will explore further below. The previous July trading lows are also important in the other equities; both in their own right, and for the countervailing influence on fixed income. Those levels are (using the lead contract continuation levels) December S&P 500 future at 1,201, December NASDAQ 100 1,669 (actually the March low), DAX 6,000, FTSE 5,071, and NIKKEI at 11,620 (also the March low) to show they can stabilize.
- The reason all of that is so important along with the DJIA 10,700 area is it will be the test of what sort of downside trend volatility (as opposed to trading volatility) the markets experience from here. We have projected that even if they are going to proceed lower to more major trend supports, that may be more likely to occur as a more gradual 'eroding' bear market after the January and June-July 'terror breaks' so heavily discounted future economic weakness. Whether that remains likely rests with the DJIA ability to hold interim 10,500-450 support as a buffer below the more major 10,700 area (both very significant historic congestion and Fibonacci 0.50 retracement of the entire 2002-2007 bull move.) As 10,150 and 10,000 areas are the next supports below the 10,500-450 range, any failure is more so indicative of a continued vicious bear trend.

▪ Higher DJIA resistances will remain at the interim 11,300-350 technical congestion, with the major resistances at 11,500 or 11,750-800, and even extending as high as the 12,000 area 'big penny' for now. The trend view for the other equities remains exactly the same as Tuesday's **TRENDVIEW GENERAL UPDATE**, which means the technical levels are also very much the same. In that regard it is important that the other equities also held into initial lower supports in spite of being weaker than strong sister DJIA. Those include the December S&P 5000 future at 1,172-65 that has already seen a bit of leakage, DAX 5,875 that has already been overrun temporarily in one of the weak sisters (with not much until 5,735 below that), FTSE 5,000-4,960 (congestion as well as 'big penny') where the market recovered to after yesterday's leakage, and ultimate weak sister NIKKEI only Closing modestly below its March 11,620 low on today's response to yesterday's US weakness.

▪ As we have reviewed it extensively previous, we are not going to waste any space on the continued, erratic counterpoint from the long dated fixed income that is whipping more viciously in response to the erratic equity psychology. The key is still likely to be the December T-note expiration Friday corresponding to its ability (or lack thereof) to escape the 118-00 area resistance Tolerance at 118-12. If so, it can also extend its rally up to at least the next major resistance in the 119-16/120-00 area. Extended resistances are the 120-29 weekly DOWN CPR from back in March, and the 121-22 high from that same period. While that seems very high, it is consistent with weekly oscillator resistance (MA 41 plus 5-00/5-16.) Even more extended resistances on those same oscillator projections could be as high as 124-00 and 127-00. However, those will only likely to be seen if equities enter a serious meltdown instead of going into the more gradual eroding bear we expect. Lower supports remain 117-00, 116-00 and 115-00 area.

▪ Extensive foreign exchange projections are also much the same as noted Tuesday, with an incentive to believe the US dollar might be topping out in the near term for a significant correction even if the overall bottom has likely been seen. It appears especially telling that while Bank of England MPC meeting minutes released yesterday morning were quite a bit more dovish than expected, that only fomented a very mild bout of pound weakness against the US dollar. Along with the commodity economy weak sister Australian dollar holding in around the .7900 area against the greenback, there appears to be a tired tone seeping into the buck, even if that means it can retest higher resistances near term. Major US dollar technical levels are at:

USD Index: RES: .7900 area; .8000-50; .8100 (Fib) SUPP: .7785; .7700; .7600; .7530-00

EUR/USD: RES: 1.4540; 1.49-.150; 1.53; 1.55 SUPP: 1.4380-10; 1.40; 1.3850; 1.3360

GBP/USD: RES: 1.8300; 1.8600-1.8550 SUPP: 1.8000-1.8100; 1.7650; 1.75; 1.72; 1.7050

AUD/USD: RES: .8160; .8265-90; .8430-.8500; .8675; .8750; SUPP: .8000-.7900; .7650

USD/JPY: RES: 105-106; 107; 108.60; 110.00-.50; SUPP: 103.80; 102.50; 100.50-00

USD/CHF: RES: 1.1000-50 (Fib); 1.13; 1.14 (Fib) SUPP: 1.0860; 1.0750-25; 1.0600

USD/CAD: RES: 1.0675-1.0725; 1.0865-1.0920; 1.1050 SUPP: 1.05 (UP Break); 1.0350-00

We refer you back to Tuesday's **TRENDVIEW GENERAL UPDATE** for any additional foreign exchange indications, as well as those for October Crude Oil that had neared extended congestion into interim support at 89.00 and major 86.00 area Fibonacci support into December-February lows, but is now back above 95.50 and has challenged the resistance into 98.50-100.00. Heavier higher resistances remain 110-112 and the 120-122 areas.

## Overview

We will be following recent form of offering extensive outside contributions to expand upon our perspectives. There are some very interesting and compelling ideas from other sources which support our desire to provide the best of what we have seen in the financial press which underpins our own aggressive views on quite a few topics, from why things remains bad for now, and what needs to be done.

The former is amply summed up in **Still No Solution** that revisits the problems with both US housing and other aspects of the economy which are feeling the extended effects of the dual credit and US real estate crunches. Blatant problems for everyone from financial services firms to the average consumer are going from bad to worse, with the authorities pursuing failed solutions.

While the most recent manifestations have been the conservatorships, workouts and interim rescues that are only the most thinly veiled forms of bailouts, those are now associated with a sense of unfairness and imbalance in the process that impugns the basic free market model; and it will take years to repair the damage to the standing of that essential pillar of capitalism long after the dust has settled on the current cyclical downturn.

Unfortunately, that all relates back to the specious positions and lack of effective monitoring and regulation for which the authorities offer very well parsed legalistic and academic excuses. Yet, for any of the well-informed observers, this is transparent blame avoidance, and only foments the worst sort of ineffective approaches at present as we will be reviewing in our analysis of why things are indeed still not achieving the sort of solution that the dire nature of the situation requires.

And as folks who have seen decades of the most bizarre sort of shenanigans in the financial markets (our 'the incredibly dumb things really smart people do from time-to-time' file), the most astounding aspect to us is the current source of hope. While in the past it has often been progenitor of the most highly efficient ways to waste great wodes of US taxpayer money, it seems that the US Congress is the one with the right answers these days, as we explore at some length in **The Taxpayer's Savior**.

As we have noted previous, Congressional at-risk home borrower relief legislation is among the most clever we have ever seen, and potentially effective in addressing the very core of the problem the administration and Fed can not bring themselves to give any serious attention. With due respect for Mr. Paulson's desire to have the purely free market Hope Now program succeed, it has proven inadequate to the task of slowing US home foreclosures to a degree that restores any confidence to debt derivatives tainted by Hybrid Adjustable Rate Mortgages.

Yet, we have not heard much about the Congressional at-risk borrower relief since its much belated passage back into the mid-July FNMA and FHLMC crisis. We have repeatedly noted the Bush administration acquiesced in finally relenting from its threat to veto that legislation due to its pressing need for reform and especially additional funding for the GSE's that was intrinsically tied into the same bill as the \$300 billion at-risk borrower relief program.

That said, there was an unforeseen problem in the rapid implementation of that at-risk borrower relief legislation which might be restraining its progress. In our view it is a surmountable hurdle, and we review both its nature and our suggested solution below.

Last, but not least, very challenging times like these call for very dynamic and focused political leadership. And what do the American people get? The same old soap opera, with even more extensive devolution by both major parties into total anarchic abandonment of any rational foundation for their positions.

That is why our topic in **The Fiddler's Notion** this week is the extreme degree of Pop **Political Delirium**, now dominating the US election campaign. As both parties refuse to spend more than a sound bite of

### Still No Solution

The degree to which the equities have failed to hold even the modest stabilization in the current round of official support attempts is indicative of a situation where expectations of things going from bad to worse are becoming more entrenched. That is at least in part due to the degree to which both the financial community and the general public can plainly see that previous steps which were taken by the powers that be have not brought about a solution to the problems at the core of the financial services meltdown, and that is classically spilling over to the economy at large.

None of which is necessarily inconsistent with previous deleveraging phases; it is more so a matter of degree in both speed and size which is a major concern on this particular cycle. And that relates directly to how little the massive amount of actual money applied to the problem and huge contingent taxpayer liability pledged has accomplished in restoring any sense of normalcy to the markets. At the core is still the inability to effectively price a almost any of the debt derivative portfolios tainted by even a modest component of adjustable rate US home mortgages.

time addressing the serious issues facing the US, we see wholesale contradiction of their historic precepts by aggressive troops in the field for the sake of short term tactical forays. And the generals at the top forego an historic opportunity to heal the national social fabric by providing the bulk of the body politic at the center an opportunity to vote for a more balanced ticket after many years of the sort of highly partisan bickering and animosity that has dominated the US political scene since the political left was shocked and amazed by the election of Ronald Reagan.

While we will return to that further on, first a bit of perspective on how overall economic background for the economy is going to be an intermediate term burden for the equity markets in the is in order. Whether stock markets enter a more gradual 'eroding' bear phase from the periodic sharp debacles seen earlier this year or remain very much more vicious on the downside (see the last two paragraphs on page 2 for more on the specific technical indications), there are good reasons to believe that it will be quite awhile yet prior to any *bona fide* bottom and return to a bull trend phase.

A good part of the reason is that the outlook continues to erode. And part of this has to do with confidence that has dropped just as markedly as some of the valuations of the financial firms of various types. How that plays out consistent with misguided recent encouragement offered by the bills from what is indeed a classical market tendency. The fact that the market is a 'creature of expectations' serves the bulls well during the temporary pullbacks in a bull phase, when they advise that the market will look pass the trough. Fair enough; and it does indeed tend to happen that way.

However, the flip side of that is the bulls sometimes depending too heavily on that ability of the market to trend on anticipation of fairer skies when the storm clouds gather into an extended deleveraging and/or economic contraction which leaves the market discounting sustained weaker economic fundamentals. Ergo the repeated wonderment of the bulls when the equities continued to trend down, especially when the drops were aggressive, in the face of what were seemingly still firm US data.

However, the consistent and significant erosion of credit market conditions always catches up with the general economy, and that anticipatory nature of the equity market has, and will continue, to reflect in the trend. Which leaves the question of whether the coming economic condition has come closer to warranting a potential bottom in the stock markets even as what may much weaker economic news is about to surface over coming months (as is almost always the case for market bottoms and upturns)?

Working from the general to more specific perceptions, in the first instance the average length of bear markets is twenty months. While there are examples of much longer ones (after the late 1960's cyclical peak) as well as far shorter (funny enough 1987 that occurred in a single massive technical dislocation gulp), we consider either the July 2007 or October 2007 (minor new high) peak as good a starting point as any. It is therefore likely that an 'average' bear trend for this cycle (i.e. new lows) should extend to somewhere between roughly the end of either the first or second quarter of 2009.

Due to the degree to which many folks were wrongly assessing the nature of this cyclical downturn with the short term sharp selloffs due to crises in 1997-1998, they expected that the cathartic drops into January and again from June into July might signal a sort of 'climax' bottom from which the market could restore an immediate bull trend.

That assumes those previous selloffs were indeed bear markets. As extensive and vicious as they may have been, neither in duration nor amount of time spent in the temporary downtrends prior to the up trend reasserting itself (as part of the also very overdone Dot.Com Bubble rally) were either of those true bear phases. Nice thought for the bulls that bear markets can be over in a few months; yet that is not the way true bear phases act. This one is more likely to end in a whimper of resignation than a bang.

Yet, as always, it is important to have a fundamental rationale for 'why' a technical view's projection of 'how' the trends will unfold is indeed a reasonable perception. In fact, the lack of almost any possible economic rationale for why the major DJIA Triangle pattern UP Break above 13,665 back in July of last year was going to be able to achieve a massive further move to satisfy the 15,265 Objective of that pattern was the one of the major reasons we became skeptical and then bearish.

That said, there are good reasons to remain bearish now, even if the heavy discounting of future bad news leaves the equities more of the eroding bear trend that we have been hoping it will evolve into from here instead of a continued debacle. The first evidence for this is something that is as forward looking as the anticipatory view which the bulls like to use to reinforce their upbeat expectations during the bull trends. It has been one of the key indications that refuted even the potential ECB and other European leaders were expounding upon for the 'great delinking' from the US that the OECD Composite Leading Indicators have been projecting a weakening economy since the end of last year for all the developed world. We have been confident in our estimation the delinking theory would be debunked by the reality the markets have suggested would instead be the case, and it continues to point to more weakness to come (see attached for the more recent release.)

What is most important about that is the operative term in that analysis: 'leading.' This is not just an assessment of how bad things have been (which is pretty nasty.) It is the sort of projection informed observers understand is an attempt to anticipate the economic activity news and data for the intermediate term future. Until there is at least some sort of stabilization in their projections, we find it hard to imagine how a true trading bottom will be confirmed for the developed economies.

The good news is the OECD is perfectly willing and able to adjust their forecasts according to changing economic conditions, and have done so very markedly when the situation warrants. While that may mean we can look forward to a major upbeat analysis from them once the economic silver lining begins to appear, their most recent major revision was one of significant downside proportions for global growth estimates in its interim economic assessment (an adjunct to the major semi-annual report.) While we have attached the cover note, the extended report was more than we felt appropriate among all of the other extensive attached supporting data and opinion and advise anyone interested to source it directly at: [www.oecd.org/dataoecd/0/51/41229145.pdf](http://www.oecd.org/dataoecd/0/51/41229145.pdf)

That cover page shows the degree to which the OECD is capable of sharp revisions; of course it is unfortunate in this case those are almost exclusively large downward adjustments to previous growth estimates. Of particular interest is the upward revision in the US. Yet that is substantially due to the same sort of economic influence we have seen in the domestic US economic data: the significant contribution from export industries taking advantage of what had been an almost predatory level of exchange rate for the US dollar. While the full report seems a bit lengthy at 19 pages, it is in the typically accessible OECD style of a series of charts with concise blurb titles that go a long way toward describing the implication.

In that regard it highlights quite a few of the other sources of extended weakness that are still going to burden the US and global economies no matter what remedial steps are taken in the near term. Keep in mind the OECD interim update was issued on September 2<sup>nd</sup>.

They highlighted the high degree to which the short-term interbank lending markets remained under extensive strain. That was almost a full month after another of those repetitive calls from the Treasury and the Fed for the banks to raise capital and stress test their models to ensure there would not be a repeat of the Bear Stearns situation. They really did not understand the degree to which throwing money at writing down losses instead of shoring up US housing would not accomplish anything; which is now glaringly apparent.

They noted the extensive tightening of bank lending standards to both industry and the consumers, and a corresponding drop in consumer confidence. No secrets why that was occurring; the multiple graphs on page 8 highlight the accelerated weakness of US housing and the associated spike in home loan delinquencies. Further insights on that came several days later from the Mortgage Bankers Association when they issued their quarterly survey of the delinquency and foreclosure rate. The increases were telling in both scope and nature. Yet, the most telling on the increasingly critical nature of the situation came about two-thirds of the way down page one. According to Jay Brinkmann, MBA's Chief Economist and Senior Vice President for Research and Economics, "The other factor that continues to drive foreclosure rates is loan type,..." and he continued "...the increase in prime ARMs foreclosure starts was greater than the combined increase in fixed-rate and ARM subprime loans. Thus the foreclosure start numbers will likely be increasingly dominated increasingly by prime ARM loans." That's prime; not subprime.

They go on to note “residential construction permits are falling sharply in most countries” as was just confirmed by the US figures yesterday. When even an upbeat group like homebuilders feels that it’s not worth planning on building homes, it is a pretty sure sign the psychology is deteriorating.

OECD goes on to highlight the degree to which “headline and in some cases underlying inflation has surged” and that is in spite of employment costs remaining contained. That gets back to our old axiom about the bosses want to pay the workers only enough so that they don’t quit, while the workers work just hard enough to not get fired. Yet, the fear and greed factor means that workers can demand higher pay when they know times are good, and must take the hit to household discretionary spending when things are bad; that is especially burdensome when there is also inflation in the air, and that means the fear from the falling financial markets and flailing officials has been ladled on top of that.

Then there were the attempted rescues and obvious failures that each spin off their own problems. Lehman Brothers bankruptcy of course triggered scrambling by a series of counterparties and CDS insurers to check their positions, exposures, liabilities and potential payouts, etc. In a quieter way, the fallout from FNMA and FHLMC going into conservatorship was possibly even more troubling from a long term perspective.

The matter of the taxpayer being on the hook for such massive guarantees is a troubling aspect. This is increasingly the default (pardon the pun) choice for the Fed and US Treasury, and is now seemingly commonplace. Yet, even more unseemly was the blatant manner in which Treasury and the Fed implored people to invest to shore up the GSE’s capital base and then moved very quickly to wipe out their investment. Yes, we know, there is a rump equity interest that was preserved. Yet the

market conditions under which that will recover to any significant degree are almost as impossible as driving an automobile to the moon.

And what occurred along the way is a substantial denigration of the confidence in a very useful, long-standing financial instrument: preferred stock. There was a recent very informed column on this by Financial Times contributing analyst John Dizard that is attached for your ease of review. As he notes, a key instrument through which banks were previous able to raise necessary Tier One capital is now under extreme suspicion by investors.

All of the short term fixes are not solving anything because they tend to only treat the symptoms. As our regular readers know, this is a point we have been making since first determining that Mr. Paulson’s Hope Now program was not adequate to the task of stabilizing housing; and that meant that there is not enough capital to prevent serial spreading of the problem without some address of the weakness in the underlying assets. We first suggested direct home borrower assistance would be necessary in **RTC-2008 (CMO III-41** all the way back on December 19, 2007.)

As we noted when revisiting analysis from earlier that Fall, “...US mortgage problems will continue to create commensurate problems with instruments based upon their securitization. As we have noted previous, this is like termites armed with hand grenades, and will only worsen into next year unless a ‘fix’ is found.” Well, maybe it’s finally bad enough that they are actually going to create RTC-2008.

Yet, for all of the sudden reversals by the administration and the Fed (and they have been breathtaking), their version of RTC for this crisis is still an attempt to ‘ring fence’ bad debt instruments to help the banks, not direct assistance to at-risk borrowers!!?

As noted in an article by Saskia Scholtes and Michael Mackenzie in the Financial Times last week,...

*“Richard Bernstein, chief investment strategist at Merrill Lynch, agreed that the government’s actions have amounted to attempts to tackle crises at financial institutions as one-off incidents, rather than tackling the broader systemic challenge.*

*“ ‘The catalyst for the sustained outperformance of financials is likely to be when the government forms an entity specifically designed to facilitate the consolidation of the financial sector – like the Resolution Trust Corporation during the 1989-1991 period,’ he said.*

*“The debate over whether an RTC-style vehicle is needed – perhaps just to ring-fence troubled mortgage assets – also gained traction among central bankers at the Jackson Hole symposium hosted by the Federal Reserve Bank of Kansas City in August.”*

Mr. Bernstein has it exactly right when he notes that the authorities have treated each instance as one-off incidents. While that might have been to put a good face on things and prevent general consternation, it was also wholly inconsistent with no liquidity returning to the interbank lending market due to the suspicion over the unpriceable nature of the debt derivative securities that were causing the problems.

It is also disturbingly typical of the mentality of the administration and the Fed that while the acknowledgement of the problem being ‘systemic’ is finally being accepted, the sort of RTC-style vehicle under consideration is more so to ring-fence troubled mortgage assets than provide the solution to at-risk borrowers that will begin to stem the erosion of value of the underlying housing assets. Maybe a different metaphor (not termites and grenades) can illustrate the problem.

If you scrape your shin, you are likely to treat it by first cleaning it and then applying topical antiseptic. However, if it becomes infected prior to your immune system being able to clear up the wound, then you would shift to an antibiotic to address the infection.

Repeated cleansing and application of meds would hopefully prevent the infection spreading in a low blood circulation area of the skin, possibly into your system. The risk is that any virulent infection in an area like that which can not be cleared up timely risks the potential for it to insinuate itself down through the layers of your skin, and invade the underlying bone.

Then you’ve got a real problem, which is known as osteomyelitis. And if that occurs, you need to shift to much stronger internal antibiotics, because the topical sort can not even affect the infection in that phase. It is not unusual for the surface skin to heal and appear perfectly normal for awhile, and only become inflamed again when the swelling from the internal infection disrupts a lot of body function; including the potential for full systemic infection. Sound familiar?

The initial interbank lockup was like the scrape on the surface which caught the Fed’s attention. When treated with a large infusion of liquidity (antiseptic) it seemed to calm down. And within the context of the administration’s free market ideologue approach, that meant it could be treated as a topical condition. Yet, this is the same as a doctor misdiagnosing a very bad infection. In his book *The Tipping Point*<sup>2</sup>, Malcolm Gladwell cites the psychologists’ term “Fundamental Attribution Error” (FAE) for how the mind simplifies and summarizes. It is now apparent their preference for not extending support to at-risk home borrowers left the Fed and Treasury buying into an FAE that extensive liquidity could cure the debt derivative securities infection.

<sup>1</sup> Malcolm Gladwell, *The Tipping Point* (New York: Little, Brown and Company, 2002), p. 160.

## The Taxpayer's Savior

And so, they have splashed out liquidity, and splashed out liquidity, and splashed out liquidity, and, ... well, you get the point. However, in spite of all that, the infection spread to the bone, because the obvious infection they were treating was a 'binary' virus that was linked to an underlying form which could keep replicating the surface germ in a way that allowed the inflammation to worsen in spite of ever higher doses of the less than effective medicine.

If this goes on long enough, you lose a leg. That's called Bear-Stearns, Fannie and Freddie, Lehman Brothers and AIG. However, by the time the leg goes, the infection has already had enough time to insinuate itself into extended organs (in this case of the investment banking sort) which also require triage; as in Merrill Lynch, money funds that are seeing values drop below the mystical \$1.00 valuation, and possibly some others.

And in the extended phase of what they have been doing over and over and over (crazy, or what?!) coming to a bad end, they constructively abandon their adamant resistance to a bailout for the same reason that Mr. Bernanke abandons tough talk every time the markets melt down: Their manic free market ideology notwithstanding, they would still prefer to not be tagged as the guys responsible for the next Great Depression. There it is: another shock statement from Rohr. But don't think for a minute we really believe that will happen under any reasonable current scenario.

It would take the money funds all becoming suspect, a hint that Treasury might have a problem in the current panicky environment recapitalizing the Federal Deposit Insurance Corporation, and everyone would need to withdraw their money all at once and put it in the mattresses, and swarm to buy zero yield US Treasury bills so as to own the paper of the guys who own the presses.

And in that extremely unlikely scenario there would no longer be capitalism, because all of the capital would be with the government, and not circulating through the businesses. The degree to which the US government now already effectively owns so much more of the private sector (and some very critical pieces at that) is a bit scary, yet also a big giggle in its way. During the post WWII era the West was able to triumph politically, philosophically and economically over the dreaded totalitarian communist movement.

It is often the case in the wake of great geopolitical rivalries that victors fall of their own weight from overplaying a good hand. Isn't it amazing that the financial services Masters of the Universe evolved the system in a way that has the ghost of Lenin grinning from ear to ear? Is the real dialectic give 'em enough liquidity to hang themselves and the state will have to take over?

The saving grace is that our politicians are smarter than the Communist commissars, because they know that management of it comes with taking the responsibility, and that's the last thing they want. While it may take some time, hopefully it will be better regulated and monitored next time (which should not be confused with endorsement of any proposals to turn the Fed into a super regulator.) Just expect it will be spun off to the private sector as soon as possible.

This informs our view of who's going to save the American taxpayer from the predations of the free market ideologues who have messed the whole thing up: Congress! Speaking of crazy people, very many of our fellow citizens would take that thought as a sure sign of aberrant behavior and loss of any mental stability. As we noted above, Congress historically has been progenitor of the most highly efficient ways to waste great wedges of US taxpayer cash. Yet it seems that the US Congress is the one with the right answers these days.

Messrs. Dodd, Frank, Schumer, et al. have been very forward from early on in this financial market crisis about the need to stabilize the situation for the at-risk home borrowers who can still qualify for fixed rate loans at a principal and interest level which they can afford; and that it would be of benefit to the common weal.

Sometimes it is just a matter of trying something different if what has been done already is not working. In this case it is almost a caricature of that sage advice that it has taken the Fed and US Treasury this long to allow that we have a problem that will likely require systemic address.

Mr. Paulson stated at his recent press conference that he is not interested in reviewing what's past; and especially as that was in response to a question that was oriented toward apportioning blame, we can appreciate the sentiment. That said, how many billions of dollars have been lent against securities that can still not be priced because in many cases a portion of them are linked to adjustable rate mortgages that nobody believes borrowers can effectively service? Obviously some of the funds are guarantees against defaults that may never occur, yet are pledged nonetheless.

And the lack of liquidity in those instruments is no less daunting a drag on the capital base of the securities firms and banks, and now the federal government. Let's also look forward and inquire, "What is the plan to re-liequify those securities in a way the firms will want to claim them back from the Fed. What a concept: don't just leave that dross endlessly parked in the public purse. WOW!

If you really want to take a look forward, look for how to start pricing those loans based upon Congressional at-risk borrower relief program adjustments. We discussed that at length in the [CMO IV-8](#), (Thursday, July 17, 2008) discussion of [Stalking Horse](#) (as in low initial funding.)

As we noted at that time, this is not a bailout, it is a temporary US government nationalization of a part the housing stock owned by folks that can qualify for reduced debt service. The government is not even giving the home owner a payment in this clever 'partnership' between the rescued and government in any future upside when the market recovers (which it will at some point in spite of the current dire straits.)

Don't take our word for it; we have once again attached the summary form of the legislation that approved both the GSE reform and funding (clever of Senators Dodd and Shelby to tie that intrinsically into the borrower relief) and the at-risk borrower relief program. We encourage anyone who is interested to review section B beginning on page two, and possibly review our analysis in that previous [CMO](#).

Yet, since the administration relented from its previous adamant opposition, we have not heard much about this program. In the early days we thought some technical reconciliation might be under way. Then we became aware of the 'problem' that might be restraining full implementation of the \$300 billion in relief that just possibly is the additional key needed to unlock the credit and equity markets.

That is the lack of any specific language in the legislation to expedite the adjustment of the interests of those with a stake in the property beyond the first mortgage holder. The bulk of those issues relate to second mortgages that were often used to facilitate the primary mortgage generation in the very topsy-turvy world of high volume mortgage generation during the housing and credit boom. As cockeyed as it seemed to more conservative financial observers at the time, in retrospect it seems even more bizarre. However, there is likely a straightforward cure that might not be liked by everyone, but will most likely address the problems in a manner that allows rapid implementation.

That is the draconian step of forcing all of the subsidiary interests to accept the same discount on their principal amount and the interest rate they will earn as the primary mortgage holder. While that may sound a bit overbearing in the first instance, there are solid practical reasons it is fair, very clear commercial logic that works to the benefit of secondary interest holders, solid historic precedent for its imposition, and current social context for that as well.

It is fair to ask the secondary interest holders to accept the same percentage reduction in their principal on the loan (or other interest) because the bulk of loss of principal being borne by the primary holder means that they are getting the same deal. As long as everyone's principal is going to be subsequently guaranteed by the FHA under the at-risk borrower relief program, the commercial logic reinforces that fairness by elevating the secondary interest holders to an equal standing with the primary, which avoids the possibility the primary exhausts any of the underlying asset value prior to the secondaries being paid.

So much for financial logic and guarantees. The bigger question might become whether the federal government can actually dictate the amendment of a commercial contract in the absence of any negotiation with one or more of parties to the contract, and do so on a grand scale affecting many thousands of investors and institutions? Of course it can.

That was amply demonstrated by the Tax Reform Act of 1986. Due to the intense desire to eliminate what had become a monstrously overblown accelerated tax benefits real estate tax shelter industry, Congress amended the law to not only disallow the accelerated tax benefits that had been denying the Treasury so much revenue; it also prohibited the use of any of the tax shelter benefits from any of the existing syndicated real estate investment that existed at the time.

There were howls of protest from many quarters that this was illegal, as received wisdom at the time was that Congress had never before amended the composition of taxation rules *post facto* for investments made under a previous year's tax regime. As we are not tax law scholars, we can not tell you if that is indeed true. What we do know is two things: that Congress never presented any precedents to justify it, so it is likely the critics were right; and that nobody ever bothered to take Congress to court in order to overturn the legislation that changed all existing deals implications (which ultimately left it being dubbed "The Accountants and Lawyers Full Employment Act of 1986.")

On social context for anything benefitting the common good being well-received by all except some who consider it unfair to their interests is also ripe once again, if the Fed and Treasury are capable (as one example) of encouraging investors to invest in equity at Fannie and Freddie, and a mere several weeks later are forced into zeroing out that investment, why are the interests of second mortgage holders sacrosanct?

Everyone who has invested in almost any form of sophisticated and secondary debt has been getting a lesson in the true risk parameters of creative finance. If the worst case scenario for a second mortgage holder is they are owed money by borrowers who can still qualify for at-risk borrower program loans, and the FHA is going to guarantee the somewhat lower principal, it is probably a blessing compared to the prospect of a default. That would leave them standing behind the primary on a house worth a lot less than the first mortgage principal value, and is sitting empty with not much prospect of being sold anytime soon. If that concern about the niceties of how the secondary interests are going to be addressed is all that's holding back rapid implementation of the at-risk borrower relief, it is past time for a supplemental to slash that Gordian Knot.

Yet, it is astounding to us that we are the only ones up to this point who seem to even be focused on this. It is getting no play in the financial press, as it seems the Fed and Treasury have so bamboozled folks with their consistent focus on just writing down the losses that all of the analysis is on the size of the exposures and what sort of funding in what form it will take to offset them or give everyone confidence in the viability of the organization by guaranteeing them... blah, blah, blah.

It does not seem to occur to the hosts and commentators in the electronic press or the analysts in the print and web platforms to revisit this; except for now, as the latest government capitulations have left them accepting the 'ring fence' version of the RTC-style rescue. It has finally occurred to some of the more enlightened of these folks that if the government is going to be the mortgage holder, then maybe it is a good idea to think about how to stem the tide of foreclosures that have been the problem.

While several folks at CNBC raised the issue of that aspect today, the most telling and pointed preface and question on that came this morning a question from co-host Joe Kernen to highly informed guest Paul McCulley of PIMCO. He said that while you needed the liquidity injections as well, the Congressional at-risk borrower relief should be "put in place and implemented in a big time way." That's verbatim, and you can see the brief interview on their website at: <http://www.cnbc.com/id/15840232?video=859763829&play=1>

Yet, what is most telling and disturbing is that in nine minutes of interview this was only covered for 30 seconds, and because Kernen bothered to raise the issue. CNBC cohort Steve Liesman is among the most talented economic analysts in the electronic press continues to focus on the banking losses and the extension of still more liquidity injections.

And it is not just him. We have seen no meaningful focus on need to stabilize the underlying from any of the other television financial news. Yet, CNBC is a primary source for many folks, including investors, financial services employees, government officials and the political elite. Yet, earlier this week two of host/commentators who are very savvy and aggressive had Senator Richard Shelby on for a chat. As he is the co-sponsor along with Senator Dodd of the Congressional at-risk borrower relief plan, we were hoping they would ask him for an update on that program and why it had not been given a higher profile after waited so long for the administration to relent, and how helpful it might be in the current very troubling situation. Not a word.

Given all of the mortgage backed securities that are at the heart of the problem and any sustainable solution, why aren't PIMCO's Mr. McCulley (and his colleagues), all of the executives at the banks and securities firms, any of the folks in the real estate brokerage business and home building, and a whole lot of others absolutely screaming for action on the stabilization of the underlying assets along with all the huge liquidity operations?

If this were a situation that leant itself to a more private Machiavellian purpose, we might entertain the idea there was some sort of conspiracy of silence at work. Yet it is beyond our intellectual grasp to imagine any operatives who might hold sway over the others that would repress that desire to see the situation right itself.

While the Fed and Treasury might be rue to admit that they have had it wrong, we are well past the point where most folks care about any ego bruising that they might have to suffer from this other approach they resisted for so long being implemented and shown to restore any significant degree of confidence; even if that only means an interim period of greater hope while we all see how it works out.

## The Fiddler's Notion<sup>SM</sup>

The Fiddler on the Roof is part of eastern European folklore. His essence was beautifully captured in the late nineteenth century book by Sholem Aleichem, *Tevye the Dairyman*. Yet, the popular name taken by the musical production is based on the quasi-cubist painting by Marc Chagall. 'The Fiddler' is a metaphor for survival in an uncertain world that is very apt for capital markets participants at all times; especially during the more volatile, erratic phases. As luck would have it, about ten years ago I came across a unique, purple palette print of him. My wife was extremely hesitant to even allow the green-faced man in the house. He ended up on my office wall. I now realize this is just as it was meant to be, as he looks over my shoulder in the rear view mirror on my computer monitor. The Fiddler's Notion<sup>SM</sup> is devoted to observations on risk that may not correlate with some of the typically market trend oriented factors in our other analysis. It is fitting that one involved in such a risky pursuit is looking over my shoulder. Whether or not you like to think about it, he is likely looking over yours as well. So welcome up to the rooftops, where you can share the Fiddler's perspective.

### Pop Political Delirium

The more extreme players constitute an ever growing proportion of both sides of the US political divide; and both sides are nothing less than delirious in their attacks on the other.

According to Webster, delirium is

1. (Med.) A state in which the thoughts, expressions, and actions are wild, irregular, and incoherent;...
2. Strong excitement; wild enthusiasm; madness.

While 'madness' might seem a bit strong, each party's abandonment of at least some significant portion of their core platform is indeed a step toward the political madness that is characterized by sheer demagoguery of cult of personality. Barack Obama is substantially running on the good faith that someone really different can make a major difference, even if fairly inexperienced at the national political level. Mr. McCain is the far more sage yet very much aging voice of experience, who is significantly tainted by all

of the shenanigans that have led the public perception of the free market economy (at least that portion of it which that has not yet been nationalized) in disarray, and fighting to justify the 'good fight' over in the Middle East. And on that basis it might be simply American political business as usual that each of their advertisements are hitting their opponent on his weaknesses.

However, some key aspects of the actions of the Left wing and Right wing supporters of each camp are disturbing in both form and especially content that is inconsistent with some of the most important long held beliefs of their side of the political spectrum.

On the Left, the wholesale disparagement of the accomplishments of Governor Palin is to be expected to some degree. There are indeed questions about her experience that even leave some on the Right wondering whether she was a good choice in light of Mr. McCain's previous disparagement of Mr. Obama on the same grounds.

<sup>1</sup> "delirium." *Webster's Revised Unabridged Dictionary*. MICRA, Inc. 18 Sep. 2008. <Dictionary.com <http://dictionary.reference.com/browse/delirium>>.

Of course, there is also the question of Ms. Palin's judgment in the 'Troopergate' imbroglio, regarding her attempt to pressure Alaska police officials to fire an ex-brother-in-law who was alleged to have been out of line. It seems to us that with each election the Jerry Springer Show becomes a more relevant model for the American electoral process. Besides which, if every official who attempted to assist a close relative were proscribed from holding office, we surmise roughly two-thirds of them might need to resign. Of course, our model is Chicago, so what did you expect?

Yet, the most vicious attacks from the Left (even after misguided statements from their Fearless Leader on lipstick and pigs, etc.) are on a basis we find most astounding: Sarah Palin's success in combining the roles of wife, mother, sportswoman, beauty queen and upwardly mobile political prime mover. Other than their minor (okay, maybe not so minor) disagreement with her strong stand on the 'right to life' issue that flies in the face of women's reproductive rights so important to the Left wing of the political spectrum, she seems to be a classically successful feminist.

The screed directed at her has extended to everything from her being too 'pushy' (as in opportunistic), abandoning her family for the workplace, and in other ways not fulfilling her 'womanly obligations.' Let's take just a moment to clearly say that if she were on the other side of the political divide and a conservative male were saying those very same things he would be immediately castigated for being a chauvinist sexist pig.

In that regard, the Left's current activity all seems a bit delirious to us; and possibly a bit jealous that a woman from the other side of the social and political spectrum could

have achieved in her personal life and public accomplishments some things that often elude the feminists of the Left. That's not a criticism of those on either side, so much as an observation on this proving there is more than one way to achieve things that many folks tend to think it takes more government legislation to accomplish.

In other words, the feminists of the Left are for women 'having it all' (including a very supportive husband who has no problem role sharing), just so long as they are onside with reproductive rights. Otherwise they are happy to abandon all of that to make themselves into single issue feminists that will gladly throw the rest of the women's liberation in the workplace and general equality issues under the bus.

It is notable this is the mirror image of the obsequious response of the Right to the Terry Shiavo affair in 2005. Back then it became a unified, single issue 'right to life' political front. They seemed to wholly and summarily abandon previous 'states' rights' and 'sanctity of marriage' planks of their philosophy to ensure a woman who was (in our view and those of most medical experts) in a permanently vegetative state was kept on life support indefinitely with no prospect of ever returning to any sort of a normalcy.

And that lead us directly to current activity on the Right that also abandons some of their most cherished notions in order to support their candidate in spite of the more contentious aspects that arose during Sarah Palin's VP selection and announcement. Those are, if anything, even that much more astounding. In order to rally around this very creative and aggressive choice of running mate there are role model and family planning related issues being summarily brushed under the rug.

In the first instance, there is the issue of whether the shoot-from-the-hip maverick John McCain really did have his camp as fully review all of Ms. Palin's background as they would like to have us think. One of the best observations on this was in a Financial Times editorial titled "Ready to rule?" back on September 3<sup>rd</sup> that noted developments in this campaign had moved the American electoral process from its typical soap opera to "...laugh-out-loud moments that would grace a top-rated comedy show." Including ... "...that John McCain's team properly vetted the moose-hunting hockey mom before unveiling her as his running mate."

Maybe yes; maybe not. What we know for sure is that nobody inside the campaign has any interest now or in future in letting the rest of us know if they did not. And yet, that does not really seem the point. If they didn't then it is more evidence of the 'gut-feeling', maverick decision making style that a lot of folks question regarding John McCain's temperament being suitable for the highest office in the land; not to mention decisions regarding the use of US military power.

On the other hand, what if they indeed did? It leaves a lot to the imagination about why they would choose someone who would so heavily eviscerate their focus on experience as a qualification for the job of President. Far more disturbing is the implication of her daughter Bristol's 'delicate condition.'

There is so very much wrong with this in classical conservative terms that we are compelled to preface it with a brief note of support and sympathy for the Palin family. Whatever anyone's view on the different approaches to handling this very sensitive area with their children, it is a personal choice. Regardless of whatever might appear to be mistakes, it is a good thing that her family is being so supportive of young Ms. Palin, and that her baby will be born into a warm and loving environment.

That said, the broader issue which a fully vetted selection of Sarah Palin raises is the response of the Right, and especially the religious Right to the obvious contradictions in supporting the candidate by ignoring the serious implications of the situation; as it relates to both campaign positions as well as key components of the classical religious and political Right's ideology.

Undoubtedly Mr. Obama did the right thing by immediately announcing that as a family member and not a direct participant in the campaign, coverage of Bristol Palin should be studiously avoided by the media.

While there were a lot of other reasons he was glad of McCain's VP choice, it buying him cover from any revisit to his own wife's at times controversial comments is surely right up there. Nonetheless, it was the right thing to do, and we have thankfully not seen any close up coverage of Bristol Palin that would amount to media child abuse.

Yet, a couple of obvious points still stand, and the first of these is the degree to which we are in the midst of a teenage girl- and unwed mother-pregnancy/child bearing epidemic in this country. What sort of a role model is a mother who somehow does not manage to sufficiently encourage her teen daughter to not get pregnant?

Again, this is not a criticism of either mother or daughter; people, especially young people, make mistakes. That's a given. But what of the McCain campaign that allegedly knew of this and still decides to move forward in spite of it?

However, the even bigger issue is how the religious Right is on board for a role model who seems to significantly belie the efficacy of their 'abstinence instead of education' model of birth control? Would education and contraception have allowed Bristol Palin to avoid pregnancy? Who knows?

Yet, it is a given that the Palin's are now the poster family for the failure of this prominent bit of conservative religious philosophy on how to handle teenage (and for that matter all premarital) sexual tendencies. And yet there is no comment from the religious Right as to possibly enhancing their program, or allowing limited 'health' counseling that could provide teenage girls enough of the awareness to better avoid a problem.

Yet, in supporting their pro-life candidate to the max they have decided that teenage pregnancy is not the worst thing that can happen, and is probably better than having a bunch of sexually knowledgeable young women running around; even if that has its own problems. Yet, that lack of willingness to entertain the idea a more effective level of sex education might be beneficial leaves the religious conservatives in a bit of a funny position. Is it really the new conservative Right wing paradigm that teenage pregnancy is not so bad if the child plans to have the, uh, child. Interesting.

Yet the real opprobrium is reserved for the men at the top. As noted above, the generals (McCain and Obama) missed an historic opportunity to heal the national social fabric by providing the bulk of the body politic at the center an opportunity to vote for a more balanced ticket after many years of incrementally increasing partisan bickering that has dominated the US political scene.

Due to the need for each to win voters from the center of the political spectrum, and the degree to each was abhorrent to more extreme members of the opposite party, either or both of the candidates could have signaled a centrist approach in their vice presidential candidate selection. They each had an opportunity to neuter their extreme party wings (much as Tony Blair when he gave the labor unions the option to vote Conservative if they did not like his plan.)

After running to the Left of Hillary Clinton in the Democratic primaries, Mr. Obama was already naturally moving back to center as he prepared for battle on the national stage. Mr. McCain has always been known as a bit of a centrist maverick in his own party, and has a strong history of 'crossing the aisle' to collaborate with the Democrats in legislation he considered of benefit to the country.

So, what do the supposedly much sought after political moderates get as their choice? Mr. Obama picks Senator Joe Biden. He is an extremely intelligent and hard working member of Congress, and especially good in the area of foreign relations that is a weak point for Mr. Obama. Unfortunately he is also a very much left of center politician, and is prone to gaffes as he vents his very statist views. Just today he came around to plainly stating that the Obama tax plan is indeed "wealth redistribution." Whatever a tax plan may actually be, that is a phrase most discreet politicians avoid like the plague.

And Mr. McCain? A man who could have most certainly told the religious Right that if they did not like a centrist program, they could go ahead and vote for the left wing approach of Mr. Obama. He might have lost some votes from those who chose to stay home, but not engendered any votes against himself whatsoever. There is the consistent Republican concern about being the party that lacks enough votes to win on the basis of all their adherents showing up, as they are nominally in the minority of the population at large.

However, one must ask what Mr. McCain accomplished by choosing a very much right of center running mate. While there are some Democratic Party members of the fair sex who are livid enough to vote for any woman as part of the Presidential ticket, most will likely come to their senses when and if they digest the nature of Governor Palin's stand on reproductive rights.

As for the rest of the political moderates who were relishing the idea of a McCain candidacy, they are very disappointed; and will possibly vote for Mr. Obama.

That is with all due respect for Mrs. Palin's accomplishments and obvious intelligence and energy. On balance, this is the kind of person with whom moderates would find a common ground in any personal encounter. However, any who are politically either dead center or slightly to the left of center will now likely have some reservations about the reproductive rights issue in the first place, and a series of other issues having to do with individual and privacy rights that might be in flux due to the continued unsettled global political situation.

We look forward to providing further comments as the situation warrants, and hope you have found these perspectives helpful.

-Rohr  
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After all, the next President of the United States is going to appoint at least several Supreme Court justices. While they do not make the laws, their interpretive power as it relates to everything from national security to human rights is daunting.

And that is why this election is being so hard fought on a personal level. It is not just for control of the executive branch; there are major considerations for the future of the judiciary as well. And any of our informed readers knows that gets right back to the reproductive rights issue that is driving so much heated emotion in this campaign; even if the specific content is being kept civil on that issue in deference to young Miss Palin's delicate condition.