

## August 12, 2007 Review

### Comments

One day's goat another day's hero?

The same group that on Tuesday did not even know there was a problem became the saviors on Friday. Please forgive any guffaws that might ring out during the course of this commentary, but why anyone would believe the Federal Reserve has any credibility at this point amazes me.

Since I am short on time, having just arrived home from a ten day journey, suffice it to say that I am NOT one of the true believers.

The stakes of the game however have risen appreciably. Now that the Fed is **perceived** to be coming to the aid of the irresponsible yet again, **it had darn well better work**. The sole reason the Dow did not drop substantially on Friday in my opinion is the wishers and hopers now think the Federal Reserve will save the day.

Instead, when it becomes apparent that the Fed is several days late and many dollars short, the fall will be dramatic. Last week I thought within 75 days, now I think within 45 more likely. "Any day now" is also a growing possibility.

Of course, maybe the Wall Street Journal is right and this is the umpteenth greatest BUYING opportunity – see "S & P Looks On Cheap Side Amid Turmoil." The only reasonable explanation I can think of for this article on page B1 of the August 11-12, 2007 edition is that, with the Murdoch takeover, Homer Simpson is now writing for the WSJ.

We will see . . .

### Credit

- Aug. 3 (Bloomberg) -- The U.S. subprime-market rout that wiped out \$2.1 trillion from global share values last week has "got a long way to go," said Jim Rogers, who predicted the start of the commodities rally in 1999. This week's rebound in equity markets hasn't persuaded Rogers, 64, to pull out of bets that U.S. investment banks and homebuilders are heading for further declines. "This was one of the biggest bubbles we've ever had in credit," Rogers, chairman of New York-based Beeland Interests Inc., said in an interview from Hong Kong. "I have been and am still short the investment bankers in America. I'm also short homebuilders." The Morgan Stanley Capital International World Index plunged 5.3 percent last week, its worst weekly drop in five years, on concern defaults among subprime mortgages may be spilling over to other credit markets and hurting earnings and takeovers. Further losses may be in store even after the index, which tracks \$32.6 trillion of stocks, advanced 0.7 percent this week. "Given the stage of the credit cycle that we're in now, we would have to expect more negative news popping up," Beat

Lenherr, who oversees \$7 billion as chief investment officer for Asia at LGT Bank in Liechtenstein AG, said late yesterday in an interview in Singapore. "The market sentiment is a bit nervous to the degree that every bad news is answered with selling." No Big Disaster Some investors say sustained consumer spending and jobs growth may help offset the impact of mortgage defaults. "Subprime will not derail the economy and we're not calling for a big disaster," said Hans Goetti, Singapore-based managing director at Citi Private Bank, which has assets of \$100 billion in Asia. "Consumer spending will not fall off the cliff as a result." [make you wonder about leaving money with Citi?] The MSCI World Index today climbed 0.1 percent, its fourth gain this week, as investors speculated that better-than-forecast earnings will help offset the impact of mortgage losses. The housing slump may extend into 2008 because of stricter mortgage standards and a glut of properties. IndyMac Bancorp Inc. yesterday said it is joining rival lenders in making "very major changes" to home-loan standards and charging higher rates because of a slump in mortgage securities. "This is the only time in world history when people were able to buy houses with no money down and in fact, in some cases, the builders gave them money for a down payment," Rogers said. "So this bubble is the worst we've had in housing and it's going to be the worst before its over cleaning it out." "I'm not of a mood to pronounce the end of the world just yet," said Hans Kunnen, who helps manage \$117 billion at Colonial First State Global Asset Management in Sydney. "You only have to go back three years to see how debt was being priced as if there was no risk at all. Well, there is risk, and it's simply being priced back in." **U.S. Housing Is Among 'Biggest Bubbles,' Rogers Says**  
<http://www.bloomberg.com/apps/news?pid=20601109&sid=a2Rnaf9tZJbA&refer=home>

## **Commercial Real Estate**

## **Commodities**

## **Currency**

## **Diversification**

## **Derivatives**

## **Housing**

## **Housing Finance**

- Aug. 9 (Bloomberg) -- Countrywide Financial Corp., the biggest U.S. mortgage lender, said "unprecedented disruptions" in the U.S. home-loan market may crimp its ability to lend and erode profit. The company may be forced to retain more of the loans it makes to homeowners rather than selling them to investors, Calabasas, California-based Countrywide said today in a filing with the U.S. Securities and Exchange Commission. It also said it may have difficulty obtaining financing from its creditors. "The secondary market and funding liquidity situation is rapidly evolving, and the potential impact on the company is unknown," Countrywide said. "These conditions may continue or worsen in the future." Countrywide last month cut its 2007 earnings forecast after net income

tumbled 33 percent as a growing number of borrowers fell behind on home-equity loan payments. At least 70 mortgage companies have halted operations or sought buyers since the start of 2006, according to Bloomberg data. Shares of Countrywide, which have lost a third of their value this year, fell to \$25 in late trading from \$28.66 at the close today on the New York Stock Exchange. **Countrywide Says 'Unprecedented' Disruptions May Hurt Profit**

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aQcKtPzxhiaw&refer=home>

## Macro Economic

- Aug. 10 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke was wrong. So were U.S. Treasury Secretary Henry Paulson and Merrill Lynch & Co. Chief Executive Officer Stanley O'Neal. The subprime mortgage industry's problems were contained, they all said. **It turns out that the turmoil was contagious.** The \$2 trillion market for mortgages not backed by government-sponsored agencies is at a standstill. **That's just the beginning.** Other types of mortgages are suffering. So are firms and banks that package the debt for investors. The ripples were felt in Europe and Asia, where central banks offered cash to banks amid a credit crunch. And some corporations, from countertop makers to railroads, are blaming the mortgage meltdown and housing slump for earnings that fell short of analysts' estimates. Even a mobile-phone company, Dallas-based MetroPCS Communications Inc., says it's feeling the pinch from customers facing foreclosure. And experts such as William Ford, former president of the Federal Reserve Bank of Atlanta, say the chance of a recession is growing. "Housing created a lot of ancillary economic activity and jobs, and now we are in the reverse process," says Paul Kasriel, chief economist at Northern Trust Corp. in Chicago and a former Fed economist. Fed Intervention The Federal Reserve today provided \$38 billion of reserves to the banking system and pledged further funds "as necessary," **in a statement unprecedented since the aftermath of the Sept. 11, 2001, attacks. [3 days after a meeting in which they made nary a mention of any problem]** The Fed had released \$24 billion in temporary funds yesterday, the most since April. The European Central Bank today made a second loan to banks to alleviate a money shortage sparked by concerns over investments in U.S. mortgages. Today's loan of 61.05 billion euros (\$83.4 billion) brings the two-day total of money lent to 155.85 billion euros (\$212.9 billion). The ECB's **unprecedented** move followed the freezing of three funds managed by BNP Paribas, France's largest bank, **because the bank couldn't calculate how much the funds' holdings were worth due to a lack of buyers.** Today, the Bank of Japan made similar moves to supply cash. "Spreading to Banks" **"The subprime mess is now spreading to banks," [I guess chanting "sub-prime is contained" just did not pay off as hoped]** says Nariman Behraves, chief economist at Global Insight Inc. in Lexington, Massachusetts. "A lot of international banks, especially those in Europe, did invest a lot in the collateralized debt markets, especially the subprime situation here in the U.S., so they're suffering." Peter Lynch, chairman of private equity fund Prime Active Capital Plc in Dublin, said the ECB was "treating this like an emergency." Bernanke told Congress on March 28 that subprime defaults were "likely to be contained." The Fed chief, who declined to comment for this story, changed his assessment last month. On July 18, he told Congress that "rising delinquencies and foreclosures are creating personal,

economic and social distress for many homeowners and communities -- problems that likely will get worse before they get better." Paulson Comment **Paulson said June 20 that subprime fallout ``will not affect the economy overall." [he is one of the guys you are counting on Wall Street????????]** This week on CNBC, he provided a less definitive assessment, saying that markets have been ``unsettled largely because of disruption in the subprime space." ``We've had a major correction in that housing sector," Paulson said. ``**It will take a while for the impact of that to ripple through the economy as mortgages reset." [or maybe not so long]** O'Neal on June 27 called subprime defaults ``**reasonably well contained.**" Merrill spokeswoman Jessica Oppenheim said this week that the company is confident his words accurately reflected the market at the time. O'Neal declined to comment. Among the other executives joining the chorus was Bank of America Corp. **CEO Kenneth Lewis, who said June 20 that the housing slump was just about over. ``We're seeing the worst of it," Lewis said. Within the week, he was contradicted by a team of Bank of America analysts, who called losses in the mortgage market the ``tip of the iceberg" and predicted ``broader fallout" from adjustable-rate loans resetting at higher interest rates.** David Olson, president of Wholesale Access Mortgage Research & Consulting Inc. in Columbia, Maryland, is blunt about his current outlook. He says a third of the U.S. home-loan industry will disappear. American Home Mortgage With last week's collapse of American Home Mortgage Investment Corp., which sold \$58.9 billion of loans to borrowers in 2006, the subprime contagion spread to so-called Alt-A mortgages, which are available to borrowers with good credit who don't want to verify their income with tax forms or pay stubs. American Home couldn't find Wall Street firms willing to buy these mortgages and package them into securities because of rising defaults. The Melville, New York-based company filed for bankruptcy Aug. 6. ``**This is just the first, because all the Alt-A guys are going to go," Olson says. ``This is the most difficult mortgage environment I've seen in my 40 years in the business.**" This grade of loan made up 13 percent of all mortgages last year, according to Inside Mortgage Finance. Combined with subprime, they account for a third of the market. Both types of loan are rapidly disappearing. Housing Prices **U.S. housing prices will fall this year, the first annual decline since the Great Depression of the 1930s,** according to the National Association of Realtors, based in Chicago. The inventory of unsold U.S. homes in May was the largest since the realtors group started counting them in 1999. Defaults and foreclosures may increase because about \$1 trillion of payments on adjustable-rate mortgages are scheduled to rise this year, hitting a peak in October, according to Credit Suisse. Housing and related industries generate almost a quarter of U.S. gross domestic product, according to the Joint Center for Housing Studies at Harvard University in Cambridge, Massachusetts. The mortgage fallout ``ensures the economy will **grow [couldn't possibly say contract, that would be a recession wouldn't it?]** well below its potential through the remainder of the year and next," says Mark Zandi, chief economist for Moody's Economy.com in West Chester, Pennsylvania, who predicts GDP growth of 2.5 percent this quarter and next. Second-quarter growth was 3.4 percent. Lowered Forecast Demand for loans to bundle into mortgage-backed securities came to a halt, crippling the subprime and Alt-A lending businesses. The exception was prime loans conforming to rules set by the biggest government-chartered agencies, Fannie Mae in Washington and Freddie Mac in McLean, Virginia. **[FRE and FNM are the white**

**knights, now that is rich – only 11.8Billion in accounting fraud between those two]**

Doug Duncan, the Mortgage Bankers Association's chief economist, says he's lowering the group's forecast on the total dollar value of new U.S. mortgages. The association said July 12 that the value of mortgages sold would decline 7 percent this year to \$2.6 trillion and 18 percent in 2008 to \$2.3 trillion, from \$2.8 trillion last year. **``Most of the market has shut down," Duncan says. ``This is not a normal event." [no it is not, however, the ratings agencies work is all based on "normal" – that can't be good could it?]**

Peter Hebert, a broker with Houston-based Allied Home Mortgage Capital Corp. in Ellicott City, Maryland, says it's getting tougher to find mortgages for his clients. `Use a Credit Card' For one self-employed borrower in Pennsylvania, with a 626 credit score, just above what's considered subprime, Hebert says he contacted three lenders. Last year, the borrower would have qualified for a 7.99 percent loan, Hebert says. This week, he received one offer for a 10.5 percent loan with a three-year repayment penalty, meaning that if the borrower refinanced during that time he would be required to make six months of payments to the original lender. ``It would have been cheaper to use a credit card to pay for his house," Hebert says. When it came time to lock in the rate, the lender pulled out, Hebert says. ``It was a hard thing to do, an emotional thing, to tell my borrower he was turned down for a rate that was high to begin with," he says. The market is shifting, too, for firms that package loans into securities and sell them to investors. About \$11.2 billion of private-label, or ``non-agency" mortgage bonds -- those not guaranteed by Fannie Mae, Freddie Mac or Washington-based Ginnie Mae -- were sold in July, according to Michael D. Youngblood, portfolio manager and analyst at Friedman Billings Ramsey Group Inc. in Arlington, Virginia. That's down from \$41.6 billion in June and from a monthly average of \$86.6 billion this year. Margin Calls Luminent Mortgage Capital Inc., a San Francisco-based firm that packages mortgages for investors, cited ``a significant increase in margin calls" for canceling its dividend. Such firms borrowed money from banks to buy loans to create securities. When investors stopped buying the securities, the banks that made the original loan demanded their money back. Many such firms that package securities will leave the business this year, says Guy Cecala, publisher of Inside Mortgage Finance. ``If you're an investment bank and you're losing stock value every week because of your connection to the mortgage industry, isn't it easier to cut ties?" Cecala says. Bank Stocks Shares of the top 12 U.S. banks have declined 17 percent since June 1. Yesterday, Countrywide Financial Corp., the biggest U.S. mortgage lender, said in a filing that **``unprecedented disruptions"** in the U.S. home-loan market may crimp its ability to lend. The company said it may be forced to retain more of the loans it makes to homeowners rather than selling them to investors and that it may have difficulty obtaining financing from its creditors. Corporations outside the mortgage industry are taking a hit, too, as housing slumps. Burlington Northern Santa Fe Corp., the second-biggest U.S. railroad, said it shipped less lumber for homebuilding in the second quarter. DuPont Chief Executive Officer Charles O. Holliday Jr. said July 24 that the housing recession eroded demand for Tyvek weather barriers, used in 40 percent of new homes, and Corian countertops. Steak n Shake Steak n Shake Co., an Indianapolis-based fast-food chain, blamed a 4.3 percent decline in same-store sales in the third quarter partly on credit markets. ``Some segments of Steak n Shake consumers continue to be sensitive to high gasoline prices and mortgage interest rates," the company said in a statement yesterday. Shares of MetroPCS, a prepaid mobile-phone service, fell 20 percent

Aug. 3 after second-quarter sales missed analyst estimates. Chief Financial Officer J. Braxton Carter blamed customers' "short-term economic disruptions," such as defaulting on their subprime loans. As for the faulty initial predictions by Bernanke and others, go easy on them, says Josh Rosner, managing director at the New York investment research firm Graham Fisher & Co. "There's no model for what's happening now in the housing and mortgage industries," Rosner says. **"We have to give Bernanke a chance. He is a reasoned and traditional central banker. He knows how to manage crazies." [based on Bernanke's 100% error rate in assessing the situation thus far, Josh might not be the best guy to look to for advice on this]** **Bernanke Was Wrong: Subprime Contagion Is Spreading**

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aygqZPuV0y14&refer=home>

- Aug. 10 (Bloomberg) -- The Bank of Japan added 1 trillion yen (\$8.49 billion) to the financial system, joining central banks in the U.S. and Europe in supplying cash to assuage a credit crunch. The cash injection was the largest same-day operation since June 29, according to Bloomberg data. The European Central Bank yesterday loaned 94.8 billion euros (\$130 billion) in response to a sudden demand for cash from banks. The U.S. Federal Reserve added \$24 billion in temporary reserves to the banking system yesterday, the most since April. "The U.S. and European central banks are trying to make people feel relieved by supplying liquidity, so the BOJ might need to take cooperative action," said Shin Nagai, head of the treasury department at ABN Amro Bank NV in Tokyo. The ECB yesterday said it would provide unlimited cash as the biggest jump in the London interbank offered rate since June 2004 signaled banks are withholding funds as the subprime mortgage crisis spreads. Paris-based BNP Paribas SA halted withdrawals from three investment funds because the French bank couldn't value its holdings. Turmoil in global credit markets may prompt the Bank of Japan to delay raising its 0.5 percent overnight rate, the lowest among major economies. Investors today saw a 32 percent chance of an increase at the Aug. 23 board meeting, according to Credit Suisse Group calculations based on the exchange of interest payments. That's down from 65 percent yesterday. Japan's overnight call loan rates traded at about 0.52 percent after the operation, down from 0.545 percent earlier in the day, according to Tokyo Tanshi Co. The yen rose to 160.98 per euro at 10:08 a.m. in Tokyo from 161.63 yesterday when it climbed 2.2 percent, the most since May 2001. Japan's currency traded at 117.82 per dollar from 118.16. The yield on Japan's benchmark 10-year bond fell 5 basis points to 1.73 percent, according to Japan Bond Trading Co., the nation's largest interdealer debt broker.

[http://www.bloomberg.com/apps/news?pid=20601087&sid=ac\\_0SglnYoHg&refer=home](http://www.bloomberg.com/apps/news?pid=20601087&sid=ac_0SglnYoHg&refer=home)

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**I Disagree . . . and why**

[Article of the week:](#)

**UM EMBA**