

## December 10, 2006 Review

### Summary

### Credit

### Commercial Real Estate

### Commodities

- Dec. 8 (Bloomberg) -- Crude oil gained for a second day as militants in Nigeria threatened more attacks against foreign companies operating Africa's largest producer of oil after kidnapping four workers there yesterday. The attack came a week before the Organization of Petroleum Exporting Countries meets in Nigeria, where it will consider its second cut in production this year. The prospect of more violence in Nigeria and another reduction in OPEC output helped to push Brent crude, the benchmark for two-thirds of the world's oil, to its biggest gain this month. **Crude Oil Gains a Second Day Amid Renewed Violence in Nigeria**  
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aJS1caJbGxYY&refer=home>

### Currency

### Diversification

### Derivatives

- Dec 6 LONDON (Reuters) - In May 2005, ratings agencies cut the debt of U.S. auto makers General Motors Corp. <GM.N> and Ford Motor Co. <F.N> to "junk" after a sustained run of losses. The fall of the once great automotive powers made global headlines, **but among the hardest hit by the downgrades were investors in credit derivatives -- relatively obscure and complex products used to hedge bond and loan risk.** Because **credit derivatives are leveraged, those that contained exposure to Ford and GM debt fell sharply, and some investors lost millions of dollars in a matter of hours.** One institution was reported to be some \$200 million in the red. At the time, the episode heightened concerns that credit derivatives were an unpredictable threat to investors and financial markets, but since then fears have subsided. A credit derivative is like a side bet on a company's ability to pay back its debt. The bet takes the form of an insurance policy where one party agrees to pay the other if a company defaults. The insurance policies rise or fall in value based on the company's fortunes and can be traded or combined in portfolios known as collateralised debt obligations (CDOs), which give investors a choice of exposures to default risk. Such has been the enthusiasm for the products that the market has doubled in size every year this decade, **making it the fastest-growing on the planet. From almost nothing in the mid-1990s, credit derivatives are now worth some \$27 trillion.** But while their popularity is confirmed, there is a nagging concern the investments are untested in an serious downturn, and could

pose a threat to financial stability. Many smaller banks and asset managers in the United States and Europe have bought into the promise of higher returns made possible by leverage, whose investments could be at risk if bond issuers started to default. Even before the 2005 blow up, there were signs of instability. In 2001 and 2002 some investors lost millions of dollars on collateralised debt obligations (CDOs) after taking leveraged exposure to telecoms firms wilting under their debt. **While confidence in credit derivatives has grown, potential problems remain. Even investment bankers admit that the models they use to price the highly complex instruments do not always work.** "The idea that correlation modeling is a reliable indicator is a myth" said Jon Gregory, head of credit derivatives research at Barclays Capital. "It is very difficult to make the models fit and different models lead to different sets of result. **The FSA earlier this year asked banks to use their own internal models to value a particular complex, illiquid portfolio, and was surprised by the results. "We had a wide variety of approaches and a wide range of valuations,"** Huertas told Reuters. "We had an interesting dialogue as to how they came up with that range, and it confirmed the difficulties involved." [tick, tick, tick, tick . . . ]

[http://today.reuters.com/news/articlebusiness.aspx?type=ousiv&storyID=2006-12-06T071049Z\\_01\\_N24366551\\_RTRIDST\\_0\\_BUSINESSPRO-DERIVATIVES-RISK-DC.XML&from=business](http://today.reuters.com/news/articlebusiness.aspx?type=ousiv&storyID=2006-12-06T071049Z_01_N24366551_RTRIDST_0_BUSINESSPRO-DERIVATIVES-RISK-DC.XML&from=business)

- **CRACKS ARE BEGINNING TO SHOW** in the credit edifice. While things couldn't be better on the top floors where the hedge-fund swells reside, down in the basement where speculative-grade mortgage borrowers live, fissures in the foundation are becoming visible. **One of the largest providers of mortgages to borrowers with marginal credit abruptly closed its doors earlier this week. Moreover, derivatives based on the lowest tier of subprime mortgage securities have been plummeting in price in recent days, sending the cost of insuring against these loans' default sharply higher.** Thursday, stocks of major homebuilders also fell sharply as news of these ... **Cracks in the Mortgage Market are Becoming Visible**  
<http://users1.barrons.com/lmda/do/checkLogin?mg=barrons-users1&url=http%3A%2F%2Fonline.barrons.com%2Fbarrons%2Farticle%2FSB116554091799444154.html>
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## Housing

- Dec 6 (NY times) Down in Naples, Fla., a fast-growing city on the Gulf of Mexico, there was an auction of houses about a month ago. Based on the official housing statistics, you might have guessed that the sellers would have made out just fine, despite all the talk of a real estate slump. But that wasn't what happened at the auction. In fact, if you were at the beach club that Saturday, you could have been excused for thinking that the real estate market was crashing. One three-bedroom ranch house with a pool sold for \$671,000. In 2005, the same house sold for \$809,000. Another house, just steps from Naples Bay, sold for \$880,000 at the auction., compared with \$1.35 million a year earlier. On average, the houses that changed hands at the auction had fallen about 25 percent in value since 2005, according to Thomas Lawler, a real estate consultant who analyzed the auction's results. **The truth is that the official numbers on house prices — the last refuge of soothing information about the real estate market on the coasts — are deeply misleading.**

Depending on which set you look at, you'll see that prices have either continued to rise, albeit modestly, or have fallen slightly over the last year. But the statistics have a number of flaws, perhaps the biggest being that they are based only on homes that have actually sold. The numbers overlook all those homes that have been languishing on the market for months, getting only offers that their owners have not been willing to accept. In reality, homes across much of Florida, California and the Northeast are worth a lot less than they were a year ago. The auction in Naples may have exaggerated the downturn in the market there, but not by much. **Tom Doyle**, a Naples real estate agent, estimated that a typical house there, sold in the normal way, would go for about 20 percent less than it did the previous fall. For many homeowners, of course, the decline doesn't much matter. They didn't really benefit from the run-up, and they won't suffer from the decline. And for any renters hoping to buy a home, the fall in prices is downright good news. Unfortunately, there are also a lot of families that took on huge mortgage debts based on the ephemeral peak values of their properties. In effect, they cashed in on the housing boom without cashing out. Then there are the people who bought their homes in the last couple of years and made almost no down payment. Many of them may now be underwater, owing more on their mortgages than their houses are worth. **Most worrisome, growing numbers of these families are falling behind on their mortgage payments, and they won't be able to bail themselves out by refinancing or selling their homes.** "We're now going to combine a high amount of debt with falling home values," said Mark Zandi, chief economist of [Economy.com](http://www.nytimes.com/2006/12/06/business/06leonhardt.html?ei=5087%0A&em=&en=812d7e0e8006dab4&ex=1165554000&pagewanted=print). **What Statistics on Home Sales Aren't Saying**  
<http://www.nytimes.com/2006/12/06/business/06leonhardt.html?ei=5087%0A&em=&en=812d7e0e8006dab4&ex=1165554000&pagewanted=print>

## Housing Finance

- The failure of a small Californian mortgage lender on Thursday increased nervousness in the credit derivatives market about the large number of US "subprime" mortgages extended this year. **The cost of insuring against default on securities backed by subprime mortgages rose after Ownit Mortgage Solutions, in which Merrill Lynch has a 15 per cent stake, closed its doors.** Its failure is the latest in a series of ominous developments in the market for subprime mortgages – higher interest loans made to borrowers who are seen as risky because of payment problems or large debt burdens. There has been a sharp rise in the number of borrowers behind on their payments. The loans are often packaged into securities and sold to investors to help lenders reduce risk. In recent years, this area has been one of the fastest-growing parts of the market for mortgage-backed bonds. So far in 2006, \$437bn of such securities have been issued in the US. The securities have been big business for investment banks which have been buying up mortgage lenders to ensure a continued supply of loans. Merrill last year bought a stake in Ownit, which made \$5.5bn of loans in the first half of 2006. **Ownit closed down this week after JPMorgan Chase, its main lender, cut off its funding.** Hedge funds and big investors have been using the derivatives market to bet against securities that are backed by subprime mortgages. This activity is measured by the ABX home equity index, in which the cost of credit insurance gives an implied price for the underlying bonds. **As measured by the ABX index, the implied price for bonds backed by 2006 subprime mortgages has fallen dramatically in recent weeks.** "Market opinion is

clearly grounded on a fairly negative view regarding the fortunes of the bonds backing the ABX [index],” said Gyan Sinha, mortgage strategist at Bear Stearns. He said problems are pronounced for bonds backed by 2006 mortgages, which cost almost 100 basis points more to insure than bonds that are backed by 2005 mortgages. Other signs of weakness include higher delinquency and foreclosure rates for 2006 vintage bonds. Moody’s put a handful of 2006 subprime deals on watch for downgrade – the first negative ratings activity for bonds originated in these years. HSBC, the third-biggest bank, has announced bad debts are rising in its US mortgage business. **US subprime loans face trouble** By Saskia Scholtes, Michael Mackenzie and David Wighton in New York in New York Published: December 7 2006 22:40 | Last updated: December 8 2006 00:53 [http://www.ft.com/cms/s/2e0393be-8641-11db-86d5-0000779e2340,dwp\\_uuid=f655fe98-30c9-11da-ac1b-00000e2511c8,print=yes.html](http://www.ft.com/cms/s/2e0393be-8641-11db-86d5-0000779e2340,dwp_uuid=f655fe98-30c9-11da-ac1b-00000e2511c8,print=yes.html)

- Dec. 7 (Bloomberg) -- Ownit Mortgage Solutions Inc., a California-based home lender part-owned by Merrill Lynch & Co., closed this week and told more than 800 workers not to return, a former employee said. **Ownit joins Ameriquest Mortgage Co., Countrywide Financial Corp., H&R Block Inc.'s Option One, BNC Mortgage Inc. and other lenders in shutting operations or laying off employees as the U.S. housing market slows.** Delinquencies are rising, home prices are falling and borrowers of adjustable-rate mortgages are facing higher monthly payments. The Los Angeles Times today reported that Ownit ran out of cash needed to meet obligations. The newspaper said Ownit issued a statement blaming New York-based Merrill for cutting off its funding. Merrill spokesman Bill Halldin said today that Ownit's statement was “misleading.” He declined to elaborate. In 2003, Dallas and a group of investors including Chicago-based CIVC Partners bought Ownit. **They expanded the company's annual mortgage issuance at least eight-fold to more than \$8 billion last year. Nonprime News, an industry newsletter, ranked Ownit as the 11th-largest U.S. issuer of so-called subprime mortgages, or home loans made to borrowers with low incomes, untested credit or a track record of default or delinquency. The company issued \$5.46 billion of loans during the first half of the year, 44 percent more than a year earlier, according to the newsletter.** According to regulatory filings, Merrill this year has sold at least \$4 billion in bonds packaged from Ownit home loans. To contact the reporter on this story: Bradley Keoun in New York at [bkeoun@bloomberg.net](mailto:bkeoun@bloomberg.net) . **Ownit Mortgage, Part-Owned by Merrill, Shuts Down This Week** *Last Updated: December 7, 2006 18:03 EST* <http://www.bloomberg.com/apps/news?pid=20601087&sid=aKO4CvD700gI&refer=home#>
- Sebring Capital Partners, a Texas mortgage bank abruptly closed its doors Friday, signaling more trouble in the subprime lending industry. The company posted a message on its website announcing the closing without giving an explanation. Subprime lenders - who cater to borrowers with poor credit - are struggling with rising default rates. **Eight percent of subprime borrowers are at least 60 days late on their mortgage payments, according to a UBS analysis of loans packaged and sold as securities. That's up from 4.5 percent a year ago.** Loans in default often end up in foreclosure, where homeowners may lose their houses. Colorado has had the nation's highest foreclosure rate for eight months, according to California industry researcher Real tyTrac. Banks are responding to rising defaults by closing or trying to sell their subprime operations. Atlanta-based

NetBank last month closed its subprime lending unit and transferred most of its employees to another company. H&R Block is seeking a buyer for its Option One Mortgage Corp., a subprime lender. Key Corp. is selling its subprime Champion Mortgage business. A major investor stopped funding Sebring's loans as a result, forcing the company to seek a buyer, the former employee said. Sebring had to close after a potential acquisition fell through. **Mortgage bank abruptly closes** [Last Updated: 12/05/2006](#)

[http://www.denverpost.com/portlet/article/html/fragments/print\\_article.jsp?articleId=4785136&siteId=36](http://www.denverpost.com/portlet/article/html/fragments/print_article.jsp?articleId=4785136&siteId=36)

- Americans who have stretched themselves financially to buy a home or refinance a mortgage have been falling behind on their loan payments at an unexpectedly rapid pace. The surge in mortgage delinquencies in the past few months is squeezing lenders and unsettling investors world-wide in the \$10 trillion U.S. mortgage market. The pain is most apparent in subprime mortgages, though there are signs it is spreading to other parts of the mortgage market. Subprime mortgages are loans made to borrowers who are considered to be higher credit risks because of past payment problems, high debt relative to income or other ... **More Borrowers With Risky Loans Are Falling Behind 12/5** [\[this story was on the front page of the WSJ – thanks Rob and John\]](#)  
<http://users1.wsj.com/lmda/do/checkLogin?mg=wsj-users1&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB116528735773440781.html>
- Subprime mortgages originated in 2006 could end up having more defaults than any previous year, according to research conducted by investment bank UBS. About 8% of all loans originated this year are at least 60 days delinquent, up from 4.5% a year ago. Foreclosure rates have doubled in the past year as well. Comparing loans of similar age, 2006 vintage loans are performing worse than loans originated in 2004 or 2005, and are on track to match or top the worst years, 2000 and 2001, according to UBS. The problem is especially bad on mortgages originated with less-than-full documentation, which had a 60-day or more delinquency rate of 3.57%. The comparable delinquency rate on fully documented loans originated this year is 2.01%. **2006 Subprime Loan Performance Among Worst Ever: UBS**  
[http://www.banknet360.com/news/NewsAbstract.do?na\\_id=6309&service\\_id=1&bi\\_id=](http://www.banknet360.com/news/NewsAbstract.do?na_id=6309&service_id=1&bi_id=)
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## Macro Economic

### Retail

### Risk

- Dec. 6 (Bloomberg) -- Nicholas Maounis, founder of the Amaranth Advisors LLC hedge fund, made a decision in April 2005 that eventually cost him his firm. His promising natural-gas trader, Brian Hunter, had been offered a \$1 million bonus to join Steven Cohen's SAC Capital Advisors LLC. Maounis, who had built his Greenwich, Connecticut- based fund to \$6 billion in assets, didn't want Hunter to go. Convertible bond and equity prices were falling and oil and natural gas prices were increasing, making Hunter's expertise more valuable. So Maounis named Hunter co-head of the energy desk and **gave him control of his own trades**. Hunter, within 17 months, would be responsible for \$6.6 billion in losses, detonating the biggest hedge fund implosion ever. Since Amaranth's sudden collapse, investors have questioned the unusual trust Maounis put in his star trader, **now 32**. They say Maounis gave Hunter too much latitude and that Hunter, trading more than half the firm's assets, **was blinded by a bet that had worked like a charm for two straight years**. ``Amaranth's demise is not due to some complicated quantitative reason -- **it's about human failing and frailty**," says Hank Higdon, who runs New York-based Higdon Partners LLC, a recruiter for hedge funds and other money-management firms. Hunter declined to comment for this article when contacted Dec. 4, and Maounis, 43, declined to comment through a spokesman. **Billions Lost** Tallying the final days of Amaranth involves huge sums: **During one week in September, Hunter's bet on natural gas lost about \$4.6 billion. By month's end, the losses totaled \$6.6 billion, or 70 percent of Amaranth's assets**. At least one investor saw serious warning signs about the big energy bets and pulled out before the collapse. Some former employees -- who, like others familiar with Amaranth's unraveling, spoke on condition of anonymity because the fund is a private company -- also say they raised questions about the extent of that wager. **When an abrupt market reversal left the fund facing enormous losses**, it was too late to unload positions. **Amaranth's \$6.6 Billion Slide Began With Trader's Bid to Quit** [there really is not a whole lot different between this and LTCM other than the names, the type securities traded and the nature of the pressure. It is primarily for these reasons (human failing and frailty), coupled with my analysis of where the risks stand now, that I am comfortable predicting the credit derivative market will be the source of serious heartburn in 2007]  
<http://www.bloomberg.com/apps/news?pid=20601082&sid=aRJS57CQQbeE&refer=canada>

### Savings Rate

### Tech

### Wall Street

- WASHINGTON, Dec 7 (Reuters) - The U.S. Supreme Court said on Thursday it would hear an appeal by leading Wall Street underwriters and institutional investors of a ruling

that a lawsuit accusing them of illegally manipulating the price of stocks in initial public offerings can proceed. The lawsuit accused the firms **of conspiring to impose anti-competitive charges on prospective buyers in some 900 initial public offerings and to inflate the price of the securities in the so-called aftermarket.** Among the companies appealing to the high court were units of Bear Stearns Cos. Inc. ; Citigroup ; Credit Suisse Group ; Fidelity Investments; Goldman Sachs Group Inc. ; Janus Capital Group Inc. ; J.P. Morgan Chase & Co. ; Lehman Brothers Holdings Inc. ; Merrill Lynch & Co. Inc. ; and Morgan Stanley . **UPDATE 1-US top court to hear Wall St. firms' appeal on IPO** <http://q1.schwab.com/content/rb/2006/12/07/1294059.html>

- Dec. 6 (Bloomberg) -- Stock sales by America's corporate chieftains exceeded purchases last month by the widest margin since 1987, **suggesting they don't share the confidence of investors** who sent the Standard & Poor's 500 Index to a six-year high. Executives including Microsoft Corp.'s Bill Gates, Google Inc.'s Eric Schmidt and Kohl's Corp.'s William Kellogg in aggregate sold \$63.18 of shares for every \$1 they bought in November, an analysis by Bloomberg of data from the Washington Service showed. **That's the highest since at least January 1987.** ``They're pretty savvy market guys," said Wayne Wilbanks, who oversees about \$1.2 billion as chief investment officer at Wilbanks, Smith & Thomas Asset Management LLC in Norfolk, Virginia. ``They see things are slowing down, and they're like, `Man, I'm taking some money off the table.'" **Gates, Schmidt Lead Stock Sales to Highest Since 1987**  
<http://www.bloomberg.com/apps/news?pid=20601084&sid=af9b0Ywcv3mo&refer=stocks>
- Dec 3 (NY Times) - -INVESTMENT newsletter editors are about as bullish as they have been in nearly five years — and that doesn't bode well for the stock market. When investors are wildly optimistic, head for the hills; when they are truly pessimistic, buy stocks. That, at least, is the counsel of contrarian analysis, which derives its name from the idea that the market, in the near term, rarely does what the majority expects it to do. When pessimism and despair reach extreme levels, for example, contrarians believe that the market is at or near a bottom. That's because any short-term traders who are likely to sell their stocks when conditions are unfavorable will have already dumped them — removing potential selling pressure that could drive the market still lower. The reverse is the case, the contrarians say, when optimism is extremely high. **When Wall St. Looks Like Pamplona, Sound an Alarm**  
[http://www.nytimes.com/2006/12/03/business/yourmoney/03stra.html?\\_r=2&oref=slogin&ref=yourmoney&pagewanted=print](http://www.nytimes.com/2006/12/03/business/yourmoney/03stra.html?_r=2&oref=slogin&ref=yourmoney&pagewanted=print)

Article of the week: