

The Other Side of the Street
23 September 2007

Comments

This Session's Proof We're Ready to Rally

9/21/2007 3:42 PM EDT There should have been a real clocking today. **Masco** (MAS) blew up. **Nike** (NKE) reversed. The banks got a series of downgrades. But it didn't happen. Too much money wants in and needs to be in.

<http://www.thestreet.com/p/pf/rmoney/jimcramerblog/10380858.html>

“The worst is definitely behind us,” Bear Stearns Chief Financial Officer Samuel Molinaro said today in a conference call with investors. Sept 20, 2007

“don’t fight the fed”

“I believe in a strong dollar” – Paulson

OR

Saudi dollar situation **There is now a growing danger that global investors will start to shun the US bond markets. The latest US government data on foreign holdings released this week show a collapse in purchases of US bonds from \$97bn to just \$19bn in July, with outright net sales of US Treasuries.**

Jim Rogers, the commodity king and former partner of George Soros, said the Federal Reserve was playing with fire by cutting rates so aggressively at a time when the dollar was already under pressure.

In an effort to shake the “little boy who cried Wolf” role, I will not reiterate my views. Suffice it to say nothing has changed.

We will see . . .

Credit

- Sept. 21 (Bloomberg) -- R.H. Donnelley, the biggest independent publisher of Yellow Pages telephone directories, and CompuCom Systems Inc. led U.S. companies selling \$1.83 billion of junk bonds this week after the Federal Reserve's interest rate cut spurred demand for high-yield, high-risk debt. Borrowers issued the most speculative-grade securities since July, according to data compiled by Bloomberg. Corporate bond sales

overall total \$27.7 billion, compared with \$26.6 billion in all of last week and the average this year of \$23.4 billion. Cary, North Carolina-based R.H. Donnelley sold \$1 billion of bonds to repay debt, increasing the offering from \$650 million. Junk-rated companies sold bonds for the first time in three weeks as the Fed's half-percentage-point reduction in its benchmark rate on Sept. 18 helped lower the yield premium that companies pay to borrow over similar maturity Treasuries by the most in four years, Merrill Lynch & Co. index data show. "The market's open for business, particularly in terms of refinancing," said John Fenn, a high-yield strategist at Citigroup Inc. in New York. The yield premium on high-yield bonds narrowed 37 basis points, or 0.37 percentage point, to 421 basis points this week, the biggest weekly decline since August 2003, according to Merrill Lynch index data. The securities are rated below Baa3 by Moody's Investors Service and BBB- by Standard & Poor's. [i.e. moral hazard] **R.H. Donnelley, CompuCom Sell High-Yield Debt as Demand Returns**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aHNcXSWmEyiY&refer=home>

- Sept 19 - Forget **Northern Rock**. The UK bank most damaged by the credit crisis may actually be the Bank of England. After Wednesday's announcement of further market interventions, its actions resemble a series of concessions ending in capitulation. Back in August, the Bank emphasised its formal framework for the money markets, which allowed banks to borrow from it, overnight, on penal terms, using risk-free collateral. On September 5, facing interbank rates, it relaxed its aggregate reserve targets, in effect injecting cash into the overnight market. On September 14, it extended a credit line to Northern Rock of unlimited duration and with mortgages eligible as collateral but insisted these concessions would not apply to the market overall. Finally, on Wednesday, it unveiled three big interventions at three-month maturities, with mortgages allowed as collateral. It is possible to applaud operational flexibility – Jean-Claude Trichet, president of the European Central Bank, has made a virtue of it while sounding hawkish on base rates. And the terms of the latest action are similar to those that the Federal Reserve and ECB already offer. But, unlike his peers, governor Mervyn King nailed his colours to the mast in an uncompromising way. Only last week, he seemed to, in effect, rule out on grounds of moral hazard precisely the action the Bank has now taken. There are two possible explanations for the *volte face*. One is that the Bank has decided that its stance was wrong. Whether open market operations can really save struggling lenders or alter interbank rates, especially at longer maturities, is open to debate: the ECB and Fed actions have not made much difference. Nonetheless, after the Northern Rock debacle and with other smaller lenders possibly still at risk, the Bank may have decided it was vital to give anything a try. This would be a courageous choice but still an admission that it misjudged the situation. The second explanation is that the Bank has yielded to pressure from the Treasury. In either case, the governor's position looks exposed.
<http://www.ft.com/cms/s/1/e8bc6d80-66af-11dc-a218-0000779fd2ac.html>
- **Sept 19 CIT Group**, a leading US commercial finance company, said on Wednesday it would sell its subprime loan portfolio to **Freddie Mac** in a move to quit the home-lending business, triggering a sharp rally in its shares. CIT, the largest independent finance company in the US, has been badly hit by the turmoil in the credit markets and by the **shake-out in the subprime sector**. The company said it planned to sell between \$3.5bn and \$4.2bn of triple-A rated securities backed by \$6bn of residential mortgages. The

announcement came on the same day that Fannie Mae and Freddie Mac, the US government-sponsored mortgage lenders, welcomed a regulatory decision to allow them to buy more home loans. CIT will change the accounting designations of the underlying loans from “assets held for sale” to “assets held for investment”, according to a statement. The New York-based company also received a \$2bn credit line from Morgan Stanley to finance its operations until the sale closes. CIT to sell subprime portfolio to Freddie Mac <http://www.ft.com/cms/s/0/ca250e94-66dd-11dc-a218-0000779fd2ac.html>

- Sept. 19 (Bloomberg) -- **The Bank of England abandoned its opposition to emergency three-month money auctions and loosened lending standards, a week after Governor Mervyn King said such steps would encourage “risky behavior.” [i.e. a further abdication of responsible behavior in favor of bailing out speculators and increasing moral hazard]** “This measure is being taken to alleviate the strains in longer-maturity money markets,” the bank said in a statement today. The Bank of England said it will accept “mortgage collateral” at the auction of 10 billion pounds (\$20 billion) in loans next week. It will have a penalty rate of 6.75 percent. “It’s a significant departure,” said Ross Walker, an economist at Royal Bank of Scotland Group Plc in London. King “**will have to demonstrate that the risks to the wider financial system were such that they justified these steps**” [they are obviously huge] when he briefs lawmakers. The three-month London interbank offered rate in pounds, or Libor, dropped 0.2 percentage point to 6.55 percent today in London. The overnight rate declined 0.25 percentage point to 5.89 percent. The gap between the three-month Libor rate, which reached a high this year of 6.9 percent on Sept. 11, and the bank’s benchmark had reached the widest in at least two decades. **BOE Reverses Policy, Lends Three-Month Emergency Cash** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aPfnrYPF6dXs&refer=home>
- Sept 18 - Moody’s Investors Service is considering overhauling the way it rates complex financial instruments to analyse for the first time how these products might behave in a liquidity shock. Such measures of so-called “liquidity” and “market value” risk could be issued alongside the traditional ratings, which currently just indicate the risk that an instrument will default. **“One of the issues we are currently talking to regulators about is the possibility of creating tools to address liquidity and market value issues,”** Brian Clarkson, president and chief operating officer of the ratings agency, told the Financial Times. “The sudden lack of liquidity due to the lack of transparency is currently the biggest problem in the market – can we develop a product that speaks to this risk? It is something we are certainly working on,” Mr Clarkson added. The move, which is also being mulled by the other two rating agencies, would potentially mark a significant shift in direction of this industry, which has hitherto focused primarily on measuring so-called “credit risk”, or the chance that an issuer will not repay a bond. However, the reforms come as ratings agencies are scrambling to offset mounting criticism from regulators and investors that they have been too slow to warn investors about the potential risks in structured finance. **This criticism has been sparked by the fact that some investors have been deeply shocked to see the value of some complex products collapse in recent weeks – even though these had previously been given a top-notch credit rating.** Writing in Tuesday’s FT, Mr Clarkson denies that the rating agencies are at fault. “Moody’s has a strong historical record of correctly ordering relative risks across diverse asset types and markets,” he writes. **“But recent events with**

regard to the US subprime mortgage market demonstrate that markets do change, sometimes rapidly and dramatically." Moody's, together with its two main rivals, Standard & Poor's and Fitch, is now meeting with regulators to discuss how to restore confidence in the structured credit sector. All three agencies have floated the idea of introducing liquidity ratings in these discussions, and this concept has been welcomed by some regulators. However, some policy makers are now pushing for a much broader overhaul of the ratings industry, and analysts warn that the industry could face lawsuits from disgruntled investors in the coming months. **Moody's looks at ratings reform**
<http://www.ft.com/cms/s/0/abade426-654e-11dc-bf89-0000779fd2ac.html>

- Sept. 17 (Bloomberg) -- Chancellor of the Exchequer Alistair Darling said the U.K. government will guarantee all deposits held by savers at Northern Rock Plc, a measure aimed at bringing to an end a four-day crisis of confidence in the bank. "Should it be necessary, we and the Bank of England would put in place arrangements that would guarantee all the deposits in Northern Rock," Darling told reporters in London today. **The guarantee will be extended to any bank in similar circumstances, so long as it is solvent, a Treasury spokesman said.** [less than a week ago, the central bank said there was no way it would bail out any entity, now it is all entities. Yet another example of how badly behind the eight ball the central bankers find themselves] The change in policy is also an attempt to limit the political damage from Northern Rock's trouble, as opposition politicians said Prime Minister Gordon Brown's policies during a decade as finance minister were to blame. "This government has presided over a huge expansion of public and private debt without showing awareness of the risks involved," Conservative leader David Cameron said in a speech earlier today. "Under Labour, our economic growth has been built on a mountain of debt." **Northern Rock customers ignored repeated assurances from Chief Executive Adam Applegarth and Darling that there is no need to withdraw money after the U.K. central bank provided emergency funding last week.** [none of this will stop the exodus. Ask yourselves if you would find comfort in a government claim it would make sure you got paid one day as a reason to not remove your funds today. If you would go get your money, why won't everyone else?] Savers lined up outside the banks to draw about 2 billion pounds (\$4 billion) of deposits, or about 8 percent of the bank's total, since Sept. 14, according an estimate by JPMorgan Chase & Co. The company's 1.4 million retail customers had about 24.4 billion pounds in deposits at the end of June, according to its Web site. **The stock, which fell 31 percent on Sept. 14, has slumped 77 percent from the all-time high in February.**[down 77% in a little over six months. This will become standard fare shortly across the equity markets. It is as foreseeable as was this disaster.] Vince Cable, treasury spokesman for the Liberal Democrats, said Brown ignored warnings of a "looming debt crisis" for the past four years. "The water is now pouring through the defenses after the near collapse of Northern Rock," Cable told delegates at the Liberal Democrats' annual conference in Brighton, England. It is "a product of greed and reckless gambling by over-paid executives, lax, indulgent banking regulation and a complacent government." **Darling Guarantees All Northern Rock Bank Deposits**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aHEJoWQHjiCY&refer=home>
- Sept. 17 (Bloomberg) -- Credit Suisse Group, Citigroup Inc. and JPMorgan Chase & Co. are taking losses on leveraged buyout loans to keep transactions alive and get debt off

their books. Credit Suisse pushed the buyout of First Data Corp. forward on Sept. 14 when it and other lenders agreed to lower the amount of loans that they'll initially sell to \$5 billion and cut the price to 96 cents on the dollar, said three people with knowledge of the talks. Bankers will meet with investors today in New York, according to the people, who declined to be identified because loan terms are private. The decision to sell debt at a discount follows similar moves by lenders, including New York-based Citigroup and JPMorgan, in the takeovers of Alliance Boots Plc and Allison Transmission Inc. Banks are trying to lure investors back to high-yield loans and limit losses on an estimated \$320 billion that they have committed to fund LBOs. **Credit Suisse, Citigroup Take Losses on Debt to Keep LBOs Alive**
http://www.bloomberg.com/apps/news?pid=20601087&sid=a_Q2YxvwRf4&refer=home

Commercial Real Estate

Commodities

- Sept. 17 (Bloomberg) -- Crude oil in New York rose to a record \$80.70 a barrel in New York on signs that the Federal Reserve will lower interest rates at its meeting tomorrow to bolster the economy of the U.S. "This is going to reassure folks about the economy and ease fears about a pullback in demand," said Rick Mueller, an analyst with Energy Security Analysis Inc. in Wakefield, Massachusetts. "This comes on top of the realization that OPEC's production increase isn't that large and the barrels won't be hitting the U.S. for months anyway." **Crude Oil Rises to Record \$80.70 on Signs of Interest-Rate Cut** [like this from the "it's all good" camp? \$80 per barrel oil is great because it shows the economy is strong. How about it would be insane to cut interest rates in the face of the rampant inflation inherent in \$80 per barrel oil?]
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a7tGvf7Swsx4&refer=home>

Currency

- WASHINGTON (Reuters) - U.S. Treasury Secretary Henry Paulson said on Friday he is "a big believer in a strong dollar" but reiterated that China's yuan currency needs to appreciate more against the greenback. In a transcript of an interview with Public Broadcasting Service business commentator Charlie Rose airing on Friday night, Paulson said a strong dollar was good for the United States. "**As I think you know, I believe very strongly that a strong dollar is in our nation's interest,** and I'm a big believer in currencies being set in a competitive, open marketplace," Paulson said. He said the dollar's value is set in a competitive marketplace based on underlying U.S. economic fundamentals. But he added that China needs to allow more appreciation and flexibility in the yuan's value in the short term as it moves "to a point in the intermediate term when the currency can be set in a competitive marketplace." "It's a bit of an unnatural act to be as integrated as they are, as I said in terms of goods and services, and not be there yet

with the currency," Paulson said. **Paulson's strong dollar comments echo a message that other participants in a meeting of Group of Seven finance chiefs said he had delivered when they met a week ago in Washington.** European Central Bank President Jean-Claude Trichet also on Friday commented on the U.S. strong dollar policy in Berlin at a meeting of euro zone finance ministers. "My last remark -- We have noted with interest that the Secretary of Treasury and the U.S. authorities have said a strong dollar is in the interest of the U.S. economy," Trichet said. **Paulson: Strong dollar in U.S. interest [this is pathetic. Having orchestrated the collapse of the dollar, the government is now trying to jaw bone support. Another fitting data point in a very disgusting week of market manipulation]**
<http://www.reuters.com/article/businessNews/idUSN2033450120070421>

- Saudi Arabia has refused to cut interest rates in lockstep with the US Federal Reserve for the first time, signaling that the oil-rich Gulf kingdom is preparing to break the dollar currency peg in a move that risks setting off a stampede out of the dollar across the Middle East. **This is a very dangerous situation for the dollar,"** said Hans Redeker, currency chief at BNP Paribas. "Saudi Arabia has \$800bn (£400bn) in their future generation fund, and the entire region has \$3,500bn under management. They face an inflationary threat and do not want to import an interest rate policy set for the recessionary conditions in the United States," he said. The Saudi central bank said today that it would take "appropriate measures" to halt huge capital inflows into the country, but analysts say this policy is unsustainable **and will inevitably lead to the collapse of the dollar peg.** As a close ally of the US, Riyadh has so far tried to stick to the peg, **but the link is now destabilising its own economy. There is now a growing danger that global investors will start to shun the US bond markets. The latest US government data on foreign holdings released this week show a collapse in purchases of US bonds from \$97bn to just \$19bn in July, with outright net sales of US Treasuries.** The danger is that this could now accelerate as the yield gap between the United States and the rest of the world narrows rapidly, **leaving America starved of foreign capital flows needed to cover its current account deficit - expected to reach \$850bn this year, or 6.5pc of GDP.** Mr. Redeker said foreign investors have been gradually pulling out of the long-term US debt markets, **leaving the dollar dependent on short-term funding. Foreigners have funded 25pc to 30pc of America's credit and short-term paper markets over the last two years.** [this inevitably removes the ability to "lower rates" as the market will refuse to provide capital at lower rates. It also means inflation will explode.] **"This is nothing like the situation in 1998 when the crisis was in Asia, but the US was booming. This time the US itself is the problem,"** he said. **Jim Rogers, the commodity king and former partner of George Soros, said the Federal Reserve was playing with fire by cutting rates so aggressively at a time when the dollar was already under pressure.** The risk is that flight from US bonds could push up the long-term yields that form the base price of credit for most mortgages, the driving the property market into even deeper crisis. **"If Ben Bernanke starts running those printing presses even faster than he's already doing, we are going to have a serious recession. The dollar's going to collapse, the bond market's going to collapse. There's going to be a lot of problems,"** he said. Kuwait became the first of the oil sheikhdoms to break its dollar peg in May, a move that has begun to rein in rampant money supply growth. **Fears of dollar collapse as Saudis take fright**

<http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/09/19/bcnsaudi119.xml>

- Sept. 20 (Bloomberg) -- The dollar sank to a record low against the euro on speculation Federal Reserve Chairman Ben S. Bernanke will tell a congressional hearing that the U.S. housing slump threatens to slow economic growth. The dollar fell against 15 of the 16 most-active currencies as traders bet the Fed will cut borrowing costs again after the first reduction since June 2003 on Sept. 18. The U.S. currency was also pushed lower by speculation that Saudi Arabia and some of its neighbors may abandon their pegs to the dollar following the Fed decision. "One thing that should be clear is that this is not a dollar-friendly Fed," said Jim McCormick, the London-based global head of currency research at Lehman Brothers International. "The biggest focus going forward is going to be the monetary policy expectations." The U.S. currency fell to \$1.4065 against the euro, the lowest since the European single currency's inception in 1999, and traded at \$1.4039 as of 7:31 a.m. in New York. It was at \$1.3957 late yesterday. McCormick predicts the dollar may tumble to as low as \$1.45 in the next few months. The dollar was also lower against the yen at 115.16, from 116.10 yesterday. Saudi Arabia may drop its dollar peg, London's Daily Telegraph newspaper reported today, without citing anyone. The country failed to lower its interest rates in line with the Fed, which may pave the way for the desert kingdom and its neighbors to scrap their currency pegs as a weak dollar stokes inflation. 'Hammered' The dollar was "hammered" against other major currencies by the speculation, Adam Cole, global head of FX strategy at the Royal Bank of Canada in London, said in a note to clients. Pressure on Saudi Arabia's peg will intensify "if the Fed continues to reduce rates, adding to already strong arguments for the dollar to fall." The currencies of commodities exporters also rose as the price of oil reached a record and the dollar's decline caused gold to surge to a 27-year high. The U.S. currency dropped to C\$1.0045 versus the Canadian dollar, a 30-year low, from C\$1.0151 yesterday. Against the Norwegian krone, it declined to 5.54, the lowest since September 1992, and to 86.23 U.S. cents versus the Australian dollar, the lowest since Aug. 9. The dollar also fell against the British pound, to \$2.0071 from \$2.0008 **Dollar Falls to Record Low Against Euro Before Bernanke Speaks**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aoGcju1ekBtM&refer=home>

Diversification

Derivatives

- Sept. 17 (Bloomberg) -- **U.S. regulators are questioning mutual fund managers who bet on home loans before the subprime mortgage market collapsed, concerned they may overvalue the stakes when selling shares and making payouts to investors.** The Securities and Exchange Commission canvassed the nation's 25 largest mutual fund companies last month on their holdings of mortgage-linked securities, according to Douglas Scheidt, an associate director in the SEC investment management division. Demand for bonds backed by home loans **evaporated** this year as U.S. borrowers with poor credit histories fell behind on payments at a record pace. "We have talked to several about whether they are having difficulties in valuing" subprime debt and about

how they're coping with "significant redemptions" by shareholders who want out, Scheidt said in an interview. **"If they sell off the more- liquid securities to satisfy redemption requests, then the valuation of the remaining portfolio becomes even more critical.** In questioning mutual funds last month, the SEC found that some managers have struggled to determine the value of subprime holdings, Scheidt said. **That's a concern because funds are required to calculate the net value of their assets each day to set the price at which existing investors can sell shares back to the fund and new investors can buy in.** Failure to record losses on mortgage-backed assets would leave net asset values too high. "Let's say instruments were overvalued; that means any redeeming investors are getting out of the fund with more than their appropriate share," said Barry Barbash, a former head of the SEC's investment management division. "Investors staying in the fund could be shortchanged," said Barbash, now a partner at Willkie Farr & Gallagher LLP in Washington. With markets for subprime securities clamped shut, funds that need money for shareholder redemptions might have to sell assets that are in demand, such as U.S. Treasuries, leaving remaining shareholders saddled with hard-to-sell and hard-to- value mortgage-backed debt, Scheidt said. The struggle to get "fair" prices has cropped up at Morgan Keegan & Co., the Memphis, Tennessee-based brokerage arm of Regions Financial Corp. 'More Extensive Process' **Morgan Keegan, with more than \$7.4 billion in assets under management, said in an Aug. 30 SEC filing that three of its bond funds would delay semi-annual regulatory reports because "recent instability" in fixed income markets required "a more extensive process" to verify the values of certain securities.** Of the three, Regions Morgan Keegan Select High Income Fund and Regions Morgan Keegan Select Intermediate Bond Fund have "experienced significant net redemptions," according to an Aug. 13 notice to investors. Should they need to sell securities to pay departing shareholders, getting a "fair" price "may be difficult," the notice said. **Within the \$11.3 trillion U.S. mutual fund industry, the biggest subprime-debt investors are taxable bond and money market funds, which together had assets totaling \$3.44 trillion as of July, according to the Investment Company Institute.** Chuck Freadhoff, a spokesman for Los Angeles-based American Funds, the largest U.S. fund company with about \$1.1 trillion in assets under management, said the group has been able to actively trade its subprime holdings, which are "overwhelmingly" rated AAA. **"Given the high rating of the subprime bonds we had, valuing them was not a problem,"** [given that none of the underlying debt is in fact AAA, the structured finance rating was based on pre-2005 default rates, and the complete lack of an active liquid market, there may have been no problem coming up with a value, the question is how inflated that value was, is and will be.] he said. Bond and money market funds trying to gauge the value of investments in turbulent markets typically try to get price quotes from three Wall Street dealers, according to Peter Rizzo, a senior vice president at Standard & Poor's. Dealers stopped providing prices on subprime bonds when trading dried up during July and August, Scheidt said. According to Rizzo, the firms are reluctant to give low quotes that suggest clients have lost money and are even more hesitant to give high estimates that they would then have to honor as market-makers by purchasing the securities. "The dealers are finding themselves away from their desks a whole lot more," Rizzo said. "No one is willing to put out a quote." [as noted last week, if you would like to know how this turns out, read Den of Thieves and then understand this will be exponentially worse] Advisers

<http://www.bloomberg.com/apps/news?pid=20601087&sid=awofPc5KItpc&refer=home>

Housing

- September 20 2007 - Fresh economic shocks on the scale of the present credit squeeze will occur if US house prices continue to fall, one of the country's leading housing experts warned yesterday. Robert Shiller, a Yale university economist, told a US congressional panel that he feared "the collapse of home prices might turn out to be the most severe since the Great Depression". [Professor Shiller is too busy thinking for himself to watch CNBC and therefore gets a pass on not knowing the "you can't fight the Fed"] "The decline in house prices stands to create future dislocations, like the credit crisis we have just seen," he told the Senate's joint economic committee. The warning underlines an increasingly widespread view that the turmoil in financial markets and tightening lending conditions are early consequences of a slump in the US housing market that is gathering momentum. Mr. Shiller, who designed the respected Case-Shiller house price index and predicted the bursting of the dotcom bubble in a bestselling book, [let's see predicted the dot.com bubble versus Maria Bartalomo who could not even answer the finance category questions when she was on Jeopardy. I'm going with Dr. Shiller but I'm a risk taker] said that while there had been a focus "on lax and irresponsible lending standards, I believe that this loss in housing value is the major ultimate reason we see a crisis today". Alan Greenspan [Shameless Shill who appears everywhere to hawk his book], former Federal Reserve chairman [whose irresponsible behavior caused the upcoming destruction of trillions of dollars of retirement savings], told the Financial Times this week that double-digit falls in house prices from their peaks would not be surprising. A fall in house prices on that scale would be unprecedented in US history and would have an economic cost several times greater than the meltdown in the subprime mortgage market that triggered the current financial crisis. [Maybe the Fed can cut to minus 4.75 percent???] The joint economic committee heard from experts who said a 15 per cent fall in house prices would wipe out \$3,000bn of household wealth. [A 15 percent fall would probably not even bring us down to 2000 prices. What is not mentioned is that the RISE in prices was extremely abnormal and a significant drop would merely be reversion to the mean] Alex Pollock, a fellow at the American Enterprise Institute, said: "Residential real estate is a huge asset class, with an aggregate value of about \$21,000bn, and is of course the single largest component of the wealth of most households." A year ago it was common to say that while house prices would periodically fall on a regional basis, they could not on a national basis . . . Well, now

house prices are falling on a national basis," he said. Mr. Shiller said it was "difficult to predict the depth, duration and all of the consequences" of the worsening housing slump. "The Federal Reserve will undoubtedly take aggressive actions, which will mitigate its severity. But, if home price deflation persists or intensifies, they may discover that the Achilles' heel of this resilient economy is the evaporation of confidence that can accompany the end-of-boom psychology," he said. "Despite all the reassuring statements we've heard from the administration that the impact of this mess would be 'contained', it has not been contained, but has been a contagion that has spread to all sectors of the economy," he said. **But investors were cheered by the prospect of future interest rate cuts, as consumer price figures suggested a moderate inflation trend. The government's consumer price index fell last month by 0.1 per cent as prices at the pump dropped by nearly 5 per cent. Core prices increased by 0.2 per cent. But the annual underlying inflation rate edged down to a 17-month low of 2.1 per cent from 2.2 per cent. [a great article but they just could not resist adding something stupid at the end]** US housing expert sees fresh shocks <http://www.ft.com/cms/s/0/97bcd100-6712-11dc-a218-0000779fd2ac.html>

- Building permits in August were 1,307,000, down 5.9% from July and down 24.5% from August 2006. Housing starts were 1,331,000, down 2.6% from last month and down 19.1% from last year.
- Sept. 19 (Bloomberg) -- Builders in the U.S. began work on the fewest homes in 12 years in August, raising the risk the real-estate recession will spread to other parts of the economy. The 2.6 percent decrease to a lower-than-forecast annual rate of 1.331 million followed July's 1.367 million, the Commerce Department said today in Washington. Building permits dropped 5.9 percent to a 1.307 million pace, also the lowest since 1995. The housing slump may deepen after borrowing costs rose and lenders shut off access to credit, causing growth to slow even more, economists said. Federal Reserve policy makers yesterday lowered the benchmark rate by a half point to prevent a broader economic slowdown. **``The housing market deteriorated significantly in August,** Brian Bethune, an economist at Global Insight Inc. in Lexington, Massachusetts, said before the report. **``Housing activity will continue to be a significant drag on overall growth through 2008."** Consumer prices unexpectedly fell 0.1 **percent in August as Americans paid less for gasoline [in September crude hit a record \$84 per barrel wall street ignored this data because a Fed cut that had been one of the most widely anticipated in history occurred, but apparently was not "priced in" – as if \$84 crude has been]** and housing costs moderated, the Labor Department also reported today. The first decrease this year followed a 0.1 percent advance in July. Core prices, which exclude food and energy, climbed 0.2 percent as forecast and were up 2.1 percent from a year earlier **More Foreclosures Lenders sent notices of default or the equivalent to 108,716 homeowners in August, up from 42,144 in August 2006, Irvine, California-based research company said. It was the most since record keeping began in 2005.** Builders are turning more pessimistic as a result. The National Association of Home Builders/Wells Fargo index of builder sentiment dropped to 20, matching the January 1991 reading as the weakest ever, the Washington-based association said yesterday. Construction companies are sweetening incentives to get rid of inventory. Hovnanian Enterprises Inc. held a three-day blitz Sept. 14 to Sept. 16, with discounts worth as much as \$100,000 in some California developments. The company said the event led to gross

sales of 2,100 homes, as more than 1,700 potential buyers signed contracts and 400 gave deposits. **The housing market is seeing `more rapid descent," Ara Hovnanian, chief executive officer of the Red Bank, New Jersey- based builder, said yesterday at a conference in New York.** Economists predict the drag from housing is far from over. Declines in residential investment subtracted 0.6 percentage point from growth in the second quarter. **The National Association of Realtors last week cut its home- sales forecast for the ninth time this year [why should this one be considered to be reliable – 9 cuts, 9 months are we seeing a lack of credibility trend here?]** and predicted the housing slump will extend into 2008. New-home sales may drop 24 percent on top of an 18 percent fall in 2006, the group said. **U.S. Housing Starts Fell in August to 12-Year Low**
http://www.bloomberg.com/apps/news?pid=20601087&sid=aSRLR4mzz_QA&refer=home

Housing Finance

- Sept 20 - **The risk of moral hazard must be considered in designing government-backed programs; such programs should not bail out failed investors, as doing so would only encourage excessive risk-taking. [hollow rhetoric when this is exactly what the Fed has done the past decade]** One must also consider adverse selection; programs that provide credit to only the weakest eligible borrowers are likely to be more costly than those that serve a broader risk spectrum. Risk-based insurance premiums or tighter screening and monitoring by lenders can mitigate adverse selection. But ultimately such mechanisms have their limits, and no government program will be able to provide meaningful help to the highest-risk borrowers without a public subsidy. Whether such subsidies should be employed is a decision for the Congress. Most recently, as I am sure Committee members are well aware, subprime mortgage losses that triggered uncertainty about structured products more generally have reverberated in broader financial markets, raising concern about the consequences for economic activity. As I noted in a speech last month at the economic symposium hosted by the Federal Reserve Bank of Kansas City, **the turbulence originated in concerns about subprime mortgages, but the resulting global financial losses have far exceeded even the most pessimistic estimates of the credit losses on these loans. [This is absurd. The “resulting financial losses” have been easily ascertainable for years by anyone who care to look under the hood. Further the losses are currently mild compared to where they are headed.]** These wider losses reflect, in part, a significant increase in investor uncertainty centered on the difficulty of evaluating the risks for a wide range of structured securities products, which can be opaque or have complex payoffs. **Investors also may have become less willing to assume risk. [“Investors” still have a complete disregard for risk versus reward as evidenced by the stupidity this week on Wall Street, although on a relative basis because their ability to take on risk has dropped, there is in fact some decrease in some areas]** Some increase in premiums that investors require to take risk is probably a healthy development on the whole, as these premiums have been exceptionally low for some time. However, in this episode, the shift in risk attitudes combined with greater credit risk and uncertainty about how to value those risks has created significant market stress. **On the positive side of the ledger, past efforts to strengthen capital positions and**

financial market infrastructure places the global financial system in a relatively strong position to work through this process. [a period of historically abnormal interest rates and default rates is no comfort now that the trek to reality has begun] In response to these developments, the Federal Reserve moved in early August to provide reserves to address unusual strains in money markets. On August 17, the Federal Reserve Board announced a cut in the discount rate of 50 basis points and adjustments to the Reserve Banks' usual discount window practices to facilitate the provision of term financing for as long as thirty days, renewable by the borrower. The purpose of the discount window actions was to assure depositories of the ready availability of a backstop source of liquidity. The Federal Reserve also took a number of supplemental actions, such as cutting the fee charged for lending Treasury securities. Earlier this week, Federal Open Market Committee lowered its target for the federal funds rate by 50 basis points. The action was intended to help forestall some of the adverse effects on the broader economy that might arise from the disruptions in financial markets and to promote moderate growth over time. Recent developments in financial markets have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth. Bernanke Testimony **[I still can't believe he sold out the future without a substantial belief that things were so bad even a certain to fail long term strategy was worth trying. And yes I think things are at that point and that it will not work in the short term either]**
<http://www.federalreserve.gov/newsevents/testimony/bernanke20070920a.htm>

- Sept. 19 (Bloomberg) -- As many as half of the 450,000 subprime borrowers whose mortgage payments increase in the next three months may lose their homes because they can't sell, refinance or qualify for help from the U.S. government. "Short of the cavalry riding in over the hill, a lot of these people are just stuck," said Christopher Cagan, director of research and analytics at Santa Ana, California-based First American CoreLogic, the risk management unit of the biggest U.S. title insurer. **The number of borrowers whose mortgage payments jump in the next three months will be the second-highest ever for a quarter**, according to Credit Suisse Group, Switzerland's second-biggest bank. Twenty-seven percent have already missed a payment, said First American LoanPerformance, which owns the largest database of U.S. mortgages. That makes them ineligible for the Federal Housing Administration bailout proposed last month by President George W. Bush. **There's no lifeline in sight for subprime borrowers, who face an average increase of 26 percent, or \$400 a month**, according to CoreLogic. Falling prices and a rising inventory of unsold homes make it difficult or impossible to sell or refinance without losing money and government programs aren't designed to aid the most desperate. **That leaves foreclosure as the only alternative, and one that will deepen and prolong the worst housing downturn in at least 16 years.** About 48 percent of subprime borrowers wouldn't qualify to refinance into a mortgage that conforms to the underwriting rules established by government-sponsored agencies Fannie Mae in Washington and Freddie Mac in McLean, Virginia, according to a report by New York-based analysts for UBS AG, Switzerland's largest bank. **There are a number of people who have mortgage debt that's more than the value of their house, and a lot of those people are going to walk away,** said David Olson, president of Wholesale Access Mortgage Research & Consulting Inc. in Columbia, Maryland. **That**

will put more homes on the market, which already has too many." **The Federal Reserve's half-point benchmark interest rate cut yesterday will have little impact on borrowers whose mortgages are adjusting,** said Ed Leamer, director of the UCLA Anderson Forecast in Los Angeles. "It's not going to alter the housing situation, or clarify defaults and delinquencies," Leamer said. **U.S. home prices fell by a record 3.2 percent in the second quarter,** according to the S&P/Case-Shiller Index. Lawrence Yun, chief economist for the Chicago-based National Association of Realtors, has warned that year-over-year prices will fall for the first time since the Great Depression of the 1930s. **'Painful for People' It would take 9.6 months to sell off all the existing homes on the market, the longest amount of time in at least eight years,** according to the Chicago-based realtors group. Listings in the Orlando, Florida, area show 26,300 homes for sale, **a 20-month supply,** said Gary Balanoff, a real estate broker with ReMax Select in Oviedo, Florida. **"There is no silver bullet from Washington that will prevent home prices from falling further," Laperriere said. "A lot of people are operating on a mistaken impression."** The fact that more than a quarter of subprime borrowers default on their adjustable loans before the rates reset makes a political solution less likely, Laperriere said. "The myth here is that the resets have been the driver of payment delinquencies, but the fact is if the borrower can't afford the teaser rate payments, then they can't afford to ever pay back the loan," he said. **The Federal Reserve Bank pumped \$62 billion into the banking system on Aug. 9 and Aug. 10 in an effort to soothe a credit crisis. Murray said the Fed should do the same for borrowers. "If they gave us that money, we'd be able to be out of this predicament," he said. [the foregoing is in fact one of many reasons why there should never be bailouts. Mr. Murray bought a house he could not afford and now thinks the government should pay for it for him. Really quite sick, but that is life in a society that refuses to take any pain today if it can foist it off until tomorrow.]** The number of adjustable-rate subprime mortgages rose to 72.5 percent, or \$1.26 trillion, of all adjustable-rate loans outstanding in the first quarter, a 17-fold increase over 2001, UBS said. About 57 percent of mortgage broker customers with adjustable-rate mortgages were unable to refinance into a new loan in August, according to a study by Campbell Communications, a market research firm in Washington. Adjustable-rate mortgages to subprime borrowers account for 44 percent of all new foreclosures, according to the Mortgage Bankers Association in Washington. "A lot of the folks who are in trouble are in trouble even before their mortgage rate resets," said Bert Ely, a banking consultant in Alexandria, Virginia. **"They can't refinance because they shouldn't have gotten their mortgages in the first place."** Adjustable-rate mortgages of all kinds worth \$139.2 billion, the most ever, are scheduled to reset at higher interest rates in the next three months, according to First American LoanPerformance in San Francisco. Subprime adjustable-rate mortgages make up \$84.4 billion of that total. In the third quarter, \$136.7 billion of mortgages were slated for reset, with subprime comprising \$87.4 billion. About 2.91 million subprime borrowers have adjustable-rate mortgages, about 90 percent of which will have reset at higher interest rates by the end of 2008, **LoanPerformance said. Subprime Borrowers to Lose Homes at Record Pace as Rates Rise**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=akOEPec30TR4&refer=home>

- Sept. 17 (Bloomberg) -- E*Trade Financial Corp., this year's worst performer in the Amex Securities Broker-Dealer Index, cut its 2007 profit forecast by at least 25 percent because of bad home loans and said it will quit the wholesale mortgage business. Earnings per share will be \$1.05 to \$1.15, compared with an earlier estimate of \$1.53 to \$1.67, the New York-based online brokerage said today in a statement. Profit will fall to between \$450 million and \$500 million, from \$628.9 million in 2006. E*Trade cited ``significant deterioration in the mortgage market in August," with home-equity loans among the poorest performers. E*Trade, which made the announcement after U.S. stock exchanges closed, fell to \$13.30 as of 6:15 p.m. New York time in extended Nasdaq Stock Market trading. The stock has lost more than 36 percent this year, compared with a 6.2 percent average decline for its peers in the 12-member Amex index. The brokerage, which expanded its online bank to become less reliant on commissions from day traders, assured investors a month ago that three-quarters of its home-equity loans were made to borrowers with credit scores of at least 700 on a scale that ranges from 300 to 850, and that the mortgage-backed securities it owned were top-rated. The revised earnings forecast includes costs of \$245 million in the second half for bad loans and \$100 million to write down asset-backed securities. E*Trade also will record \$32 million in severance and restructuring costs. The company plans to get out of the wholesale mortgage business, which involves making loans through a network of independent mortgage brokers. E*Trade said it will now focus on retail lending, or issuing loans directly to customers. At least 110 U.S. home lenders have halted operations or sought buyers since the start of 2006, according to Bloomberg data. Mortgage companies are running short of cash as falling home prices hurts demand and overdue mortgage payments make bankers reluctant to extend more credit. E*Trade said its funding sources ``remain sound" and that the company is ``well capitalized" based on regulatory standards. **E*Trade Cuts Earnings Estimate 25% on Mortgage Losses**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=afVrj5FJgO48&refer=home>
- Sept. 17 (Bloomberg) -- NovaStar Financial Inc., the subprime home lender trying to survive by conserving cash, scrapped plans to pay a dividend on 2006 profit and will forfeit its tax status as a real estate investment trust as a result. The mortgage company, one of more than 110 that have halted lending or left the business since the start of 2006, said in a statement that the loss of REIT status will have a ``significant adverse impact" on third-quarter results. Kansas City, Missouri- based NovaStar is reviewing its listing requirements with the New York Stock Exchange. Auditors raised doubt about NovaStar's survival earlier this month as cash ran short and a plan to raise more than \$100 million from private-equity investors collapsed. REITs, which can invest in property or mortgages, pay no federal taxes on most or all of their profit provided they pass most earnings directly to shareholders in the form of dividends. NovaStar rose 14 cents during regular trading hours to \$8.24 in 4:02 p.m. New York Stock Exchange composite trading. During extended trading after the announcement, the shares fell as low as \$7.55. The stock has declined more than 90 percent this year. **NovaStar Can't Pay Dividend, Forfeits REIT Status**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=agAMlcjd.GPo&refer=home>

Macro Economic

- September 20 2007 03:00 Even one of the London market's best days of the year could not prevent a further heavy fall for **Northern Rock**. Shares in the troubled mortgage lender dropped a further 16 per cent to 257p, taking losses since Friday to 60 per cent, as rumours swirled in the City that **Lloyds TSB** and **HBOS** had made low-ball offers. The rumoured HBOS approach was said to have been pitched at just 100p. Traders said Northern Rock shares had also been pressed by rumours of write-downs in its £8bn "available for sale" portfolio. Northern Rock's poor performance was in marked contrast to the rest of the banking sector. **Northern Rock plummets again despite bank rally** <http://www.ft.com/cms/s/0/849668f8-6711-11dc-a218-0000779fd2ac.html>
- Hank Paulson, US Treasury secretary, **on Monday sought to reassure European governments that the financial turmoil sparked by the US subprime mortgage crisis would not have a lasting effect on the world's markets.** [yes this was the day **BEFORE** the Fed cut rates because things were so grim in those markets.] Fears have been heightened by scenes in Britain of savers queueing outside branches of Northern Rock, the bank forced to call on the Bank of England for a rescue loan as shock waves from the subprime crisis spread. Speaking on a visit to Paris, where he met President Nicolas Sarkozy and the French finance minister Christine Lagarde, Mr Paulson said that although **it would "take a while to work through this turbulence in the capital markets, we are doing so against the backdrop of a strong global economy".** [reconcile this with the Fed needing to cut 50 basis points with the US equity markets near all time highs – you either have a shameful bailout of cronies who over speculated or an implosion about to happen and a last ditch effort to avoid it. Neither is very palatable] There were already signs of "modest reductions in the strains in some markets But Mr Paulson, a former banker from Goldman Sachs, defended the hedge fund industry, the target of frequent political attacks both in France and Germany. **The crisis had been fuelled by bad lending practices and not the development of new financing techniques;** changes in regulation should be carefully considered. "We want to get the balance right. **The whole world and the US has benefited from innovative financing techniques and innovation in terms of securitisation and credit availability, [this will be a wonderful quote to run back out in about a year – much like the 2005 Greenspaon quote about how wonderful sub-prime was]** and so we need to make sure we think this through carefully and don't rush to judgment and overreact," he said. **Paulson seeks to assuage subprime concerns** <http://www.ft.com/cms/s/0/dda792b6-6557-11dc-bf89-0000779fd2ac.html>
- Sept. 17 (Bloomberg) -- Bank of England Governor Mervyn King has spent the past month trying to stay above the fray as the U.S. subprime-mortgage collapse roiled credit markets. Now he's getting dragged in, whether he likes it or not. **Two days after King, 59, told lawmakers on Sept. 12 that central banks should avoid giving the impression they will help lenders that made bad decisions, the Bank of England**

provided emergency funds to Northern Rock Plc in the biggest bailout of a British bank in three decades. "It's a crisis of confidence, and the bank is confused," said Patrick Minford, an economics professor at Cardiff University who advised former Prime Minister Margaret Thatcher. "They want to be hands-off, but in this situation they can't be. I don't think this has done King any good." King's credibility is in question for his refusal to emulate other central banks and take early action to help cash-strapped lenders. With Northern Rock's failure, he is finding himself subject to the same charge of excessive caution being leveled at U.S. Federal Reserve Chairman Ben S. Bernanke, whose office adjoined King's at the Massachusetts Institute of Technology in the 1980s. King, a former London School of Economics professor whose five-year term ends June 30, initially underestimated the threat posed by rising defaults on mortgages to U.S. borrowers with poor credit histories. **It was "not an international financial crisis," he said Aug. 8; the next day, credit markets seized up as concern about exposure to subprime losses made banks reluctant to lend to each other.** The European Central Bank has loaned cash to banks in seven special auctions since then, and the Fed responded to criticism its response was too slow by cutting the rate at which it lends directly to banks on Aug. 17. Economists predict the Fed will reduce its benchmark rate tomorrow by at least a quarter point. **King held back until markets forced his hand. Last week he said that too much help "encourages excessive risk-taking, and sows the seeds of a future financial crisis."** With three-month money-market rates close to a nine-year high, the bank on Sept. 13 made its first additional cash loan to banks. The next day, it rescued Newcastle, England-based Northern Rock after rising credit costs left the U.K.'s third-largest mortgage provider unable to make new loans. Hard Line "Is this the right environment to be so sanctimonious and to take such a hard line?" asked James Knightley, an economist at ING Financial Markets in London. "If you play this moral high ground, it could backfire." **Northern Rock's customers have ignored assurances that their deposits are secure.** While Chancellor of the Exchequer Alistair Darling said today their deposits are "backed by the Bank of England," customers have removed at least 2 billion pounds (\$4 billion) since Sept. 14., the British Broadcasting Corp. reported. While Brown and the Bank of England have overseen Britain's longest period of economic growth in two centuries, **consumer debt has also surged over the last decade: Households are now shouldering a record 1.3 trillion pounds in debt.** In addition, the Bank of England's benchmark rate of 5.75 percent is the highest among the Group of Seven nations, and London house prices fell the most in three years in September, a report from Rightmove Plc showed on Sept. 14. Now Brown presides over an economy increasingly vulnerable to rising credit costs just as he considers whether to call an early general election to capitalize on the improved prospects for his Labour Party since he succeeded Tony Blair as prime minister in June. Former Federal Reserve Chairman Alan Greenspan said in an interview with the Daily Telegraph published today that the U.K. "is more exposed than we are" to tighter credit conditions and that the housing market is "going to turn." **[I guess Greenspan is just pimping out to sell his book, although his attention grabbing is pretty pathetic] King, BOE Face 'Crisis of Confidence'**

After

Rescue

http://www.bloomberg.com/apps/news?pid=20601087&sid=awZ1VuQi_zyc&refer=home

- Sept. 17 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke is grappling with what predecessor Alan Greenspan might call a conundrum. At issue is whether today's U.S. economy most resembles 1998, when Greenspan may have been too eager to cut interest rates, or 2000-2001, when he may have been too slow. The trouble is, the situation now resembles a bit of both. That increases the danger as the Fed's Open Market Committee meets tomorrow to decide on interest-rate policy. If Bernanke and his colleagues aim to avoid the mistake of 1998 and opt for caution, they risk a recession. If they push ahead with big rate cuts and growth proves resilient, they could find themselves with rising inflation, fueled by record oil prices and a slumping dollar. "This is a critical time for the Fed," says Peter Hooper, who worked at the central bank during the financial crisis in 1998 and is now chief U.S. economist for Deutsche Bank Securities in New York. "The stakes have risen." The Fed today faces a financial-market-driven increase in borrowing costs, as in 1998, and a weakening economy comparable to 2000. The central bank responded to the former with three rapid-fire rate cuts, which some officials now think helped inflate the stock-market bubble. In 2000, it made the opposite mistake after the bubble burst, waiting too long to cut rates and allowing the U.S. to fall into recession. **Template for Action** Which model the Fed latches onto will help determine whether it reduces the federal funds rate tomorrow by a quarter or a half percentage point. If 1998 is the guide, policy makers may settle for the smaller cut. Taking a cue from the 2000 episode would suggest a half-point drop in the rate, which is charged on overnight loans between banks. Judging by their public comments, policy makers are divided over which path to follow. Futures trading indicates investors expect at least a quarter-point cut. For J. Alfred Broaddus Jr., who helped fashion policy in both 1998 and 2000 as Richmond Fed president, today's situation "is more comparable to 2000 and 2001. There is a clear risk to the economy." **Greenspan's Miscues Haunt Bernanke as Fed Weighs Cut**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=ao4CfiB0Of1w&refer=home>

Retail

- Sept. 20 (Bloomberg) -- FedEx Corp., the world's largest air-cargo carrier, said first-quarter profit rose to \$494 million. It cut its full-year earnings forecast as much as 4.3 percent, citing "financial volatility and high energy costs." Net income was \$1.58 a share in the period ended Aug. 31, up from \$475 million, or \$1.53, a year earlier, the Memphis, Tennessee-based company said today in a statement distributed by Business Wire. Earnings per share for the year will be between \$6.70 and \$7.10, down from a range of \$7 to \$7.40, FedEx said. **[Apparently did not get the memo that the world has been saved by the other "Fed". Sad they are putting business expertise ahead of mindless hype.] FedEx Posts Higher 1st-Quarter Profit, Cuts Forecast**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aWH6e8ld.1hs&refer=home>

Retirement

Risk

Savings Rate

Tech

- Sept. 17 (Bloomberg) -- PHH Corp., the mortgage lender and vehicle-fleet manager that agreed to be bought by General Electric Co. and Blackstone Group LP, said the sale may unravel after Blackstone failed to get \$750 million in loans. **[who couldn't see this coming? Only those ostriches who believe that nothing bad could ever happen]** Blackstone, which planned to buy PHH's mortgage business, told GE in a letter that JPMorgan Chase & Co. and Lehman Brothers Holdings Inc. "revised interpretations" about whether enough debt financing would be available to complete the \$1.8 billion purchase, according to a statement by PHH today. General Electric intends to exit its own subprime mortgage business, WMC Mortgage, the company said on July 13. Subprime home loans, which have the highest risk of default, are made to people with the lowest credit scores. At least 110 mortgage companies have halted loans, closed or sold themselves since the start of 2006, including 90 this year. Buyouts of mortgage companies including Accredited Home Lenders Holding Co. have collapsed as overdue payments rose and U.S. housing sales slumped. **PHH Sale to GE, Blackstone May Collapse as Banks Balk**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aZVFuRDOKOqg&refer=home>
- Ouch. Microsoft's bruising nine-year battle with the European Commission has ended in stinging defeat. The Court of First Instance ruled firmly against the software giant's legal appeals and backed the Commission on every issue of substance. There seems little point in Microsoft taking the main elements of its case any further. What does the defeat mean? **[nothing to US equity markets – YET]** First, the Commission has emerged with strong precedents, when it comes to dominant technology companies, on the key issues of interoperability and bundling of new products. That is likely to mean more pressure on Microsoft itself. The Commission will continue to push for Microsoft to ensure interoperability for rival server products with its Windows operating system. It might also be emboldened to pursue more vigorously a complaint from rivals about Microsoft's dominant – and highly lucrative – Office software. More broadly, though, the ruling appears to cement the Commission's position as regulator-in-chief of the global technology industry. It has taken a more combative approach than US regulators in recent years. The European market is so important – technology companies clearly have to do business there. And the global nature of the industry means decisions in Europe have ramifications for products around the world. **Microsoft ruling**
<http://www.ft.com/cms/s/1/1f0e61ce-6519-11dc-bf89-0000779fd2ac.html>
- Sept. 17 (Bloomberg) -- Microsoft Corp. lost its appeal of a European Union antitrust ruling, forcing the world's biggest software maker to pay a record 497 million-euro (\$689 million) fine and help rivals connect their products to the Windows operating system. The European Court of First Instance in Luxembourg today backed the EU's 2004

decision that ordered the U.S. company to disclose proprietary data and strip music and video software from a version of Windows. **The ruling bolsters probes by Competition Commissioner Neelie Kroes of Intel Corp., Rambus Inc. and Qualcomm Inc.** "This is deeply troubling for business, the state of the law and trans-Atlantic relations," said Philip Marsden, a competition lawyer and senior research fellow at the British Institute of International and Comparative Law. "The ruling shows a total diversion between the U.S. and Europe." The EU's Kroes said today's ruling is "bittersweet" for consumers because Microsoft remains dominant in PCs. There is "no doubt" that Microsoft's market share will change as a result of the EU's order, she said at a briefing in Brussels. "A market share of much less than 95 percent would be a success," Kroes said. "A significant drop in share is what we would like to see," she said. "That 2004 decision set an important precedent in terms of the obligations of dominant companies to allow competition, in particular in high tech industries," Kroes said. "The decision upheld by the court is particularly important because so many people use computers, be they individual consumers, schools, businesses or governments." "It's a big loss for Microsoft," said Nicholas Economides, a law professor at New York University. "It will make Microsoft sell some products with different functionality in the U.S. and Europe." Intel, Rambus The EU is examining whether Intel granted illegal rebates to customers to wrest sales away from rival Advanced Micro Devices Inc. Rambus is accused of illegally obtaining patents on an industry standard for memory chips. Both deny the allegations. Qualcomm, the second-biggest maker of chips that run mobile phones, is facing allegations by Nokia Oyj, Ericsson AB and other handset manufacturers of overcharging for patent royalties for third-generation mobile phones, which allow users to access the Internet and play videos. The EU hasn't decided whether to open a formal probe. San Diego-based Qualcomm has said the charges "are factually inaccurate and legally meritless." "The decision means that the commission will approach these cases with renewed confidence," said Michael Reynolds, a partner at Allen & Overy LLP in Brussels who represented Sun Microsystems, referring to complaints against Rambus, Intel and Qualcomm. "Other companies that feel they're harmed by dominant companies will seek reviews in Brussels because there are now court-enforced rules that support them. The U.S. will take account of that." **Microsoft Loses Appeal Against EU Antitrust Order** <http://www.bloomberg.com/apps/news?pid=20601087&sid=aoBgMsLNah3k&refer=home>

Wall Street

- September 20 2007The government is casting a wide net in its scrutiny of Wall Street banks, investors, credit-rating agencies and others in the role they played in the subprime mortgage crisis. **"We look at all the players" to determine whether there were missteps in accounting and possible insider trading**, says Walter Ricciardi, deputy enforcement director at the Securities and Exchange Commission. **[they will find plenty and be busy for years]** In a telephone interview Wednesday, Ricciardi said the SEC is asking mutual fund managers, lawyers, company executives and credit-rating analysts for

details of their involvement in trading of securities that came from bundled mortgages. Amid financial market turmoil that has raised the specter of stalling economic growth, federal securities regulators and Congress are probing the **\$3.5 trillion market** [one of many reasons why the Fed move is one of “confidence building not substance – the governments of the world do not have the capital to buy their way out of this mess] of globally traded securities made from home loans. As housing market conditions worsen, regulators are realizing how hard it is to track the trail of transactions from home borrower to lender to investor, and that it may be even harder to determine blame and liability on some of the players. Here are some of the areas the SEC is focusing on: **Collateralized debt obligations, which are complicated pools of mortgages purchased by investors around the world in recent years. In June, two hedge funds at Bear Stearns nearly collapsed after making bad bets in CBOs, especially those that include subprime loans made to borrowers with tarnished credit.** Major Wall Street investment banks and their vulnerability to mortgage defaults, an inquiry that is described as a routine part of the SEC's oversight. The securities and operations divisions of Bear Stearns (Charts, Fortune 500), Goldman Sachs Group (Charts, Fortune 500), Lehman Brothers (Charts, Fortune 500), Merrill Lynch (Charts, Fortune 500) and Morgan Stanley (Charts, Fortune 500). "Given the recent events in the mortgage and credit markets, and their potential impact on financial institutions," the SEC staff is monitoring the five firms' cash positions and balance sheets "with greater frequency than during periods of normal market stress," Erik Sirri, director of the SEC's market regulation division, told Congress recently. Evaluating regularly whether large securities firms are adhering to policies on the pricing of subprime mortgage debt. In August, SEC staff queried by telephone managers at 25 of the biggest mutual fund companies about their holdings of mortgage-backed securities. **The regulators are concerned that fund companies invested in the securities before the springtime collapse in subprime mortgages may overvalue them when they sell fund shares as investors press to cash out,** [there is no question these assets are grossly overvalued] Douglas Scheidt, an associate director of the SEC's investment management division, said Wednesday. **SEC probes Wall Street on subprime mess** http://money.cnn.com/2007/09/20/news/companies/subprime_sec.ap/index.htm?source=yahoo_quote

- September 20 2007 - Morgan Stanley reported a 7 per cent fall in third-quarter profits yesterday after unexpectedly taking a relatively bigger hit from credit market turmoil than rival Lehman Brothers. The Wall Street bank suffered heavy losses in trading structured credit products, such as collateralised debt obligations and credit default swaps, which contributed to a \$1bn (£500m) fall in credit revenues compared with the second quarter. Two credit traders, Colin Stewart and Joe Facchini, have left the bank, insiders said. Morgan Stanley marked down the value of its loan commitments to private equity buy-outs by \$726m, net of fees. It marked down other loans to clients by \$214m. The bank suffered losses of \$480m in quantitative equity trading. The result was a worse-than-expected fall in income from continued operations to \$1.47bn, or \$1.38 a share. Return on equity was 17 per cent, in line with Lehman. Colm Kelleher, incoming chief financial officer, **said it would take "another quarter or two" for the credit markets to return to normal.** [go back and look at the identical comments early in the housing collapse – there is simply no way to know when or how this “gets back to normal” or what normal is

– in fact the past five years have been very abnormal but on the “good side” so no one cared.] But he said Tuesday's Federal Reserve interest rate cut would "help the healing process".

Profits fall as turmoil hits Morgan Stanley
<http://www.ft.com/cms/s/0/da7df380-6711-11dc-a218-0000779fd2ac.html>

- that its third-quarter results would be hit by a €250 million (£174 million) charge after rogue traders in New York built up a huge unauthorised credit position. The French bank said the charge, and turbulent trading conditions this month, would mean its third-quarter earnings would come in “significantly below” the same period a year ago. Calyon said that on the evening of September 4, the bank’s senior management was told about the existence of an unusually large market position on the books of its proprietary trading desk in New York. The bulk of the position had been built up at the end of last month and was centered on certain credit market indices, which Calyon did not name, although it stressed that none of the trades was linked to the US sub-prime mortgage sector. The position was built by its proprietary trading desk, which uses the bank’s own balance sheet to take bets on stocks, bonds and indices. In recent years banks have been making greater use of proprietary trading to drive revenue and profits. In this instance, however, the trade was executed above the authorised limit and without the authority of the bank. As of yesterday, the position had been brought back within the bank’s normal trading activities, it said. **Calyon hit by €250m charge after rogue trade in New York**
http://business.timesonline.co.uk/tol/business/markets/united_states/article2485365.ece?E MC-B1tn
- Sept. 19 (Bloomberg) -- Absolute Capital Management Holdings Ltd. halted withdrawals from eight hedge funds with \$2.1 billion of assets after co-founder Florian Homm quit. The firm will seek to extend a lock-up on redemptions for a year while it restructures the funds, Absolute Capital said in a statement today. Seven of the pools hold over-the-counter U.S. stocks that can't be sold at the prices the firm has on its books, affecting as much as \$530 million of assets. Absolute Capital clients tried to withdraw more than \$100 million after Homm quit yesterday in a dispute over pay for the firm's fund managers. Homm, 47, managed three of the funds affected, and oversaw the others as co-chief investment officer. Shares of the company, which has its main offices in Majorca, Spain, slumped 84 percent in the past two days. **Discord Over Pay Homm said yesterday he quit after directors declined to follow his lead by turning down bonuses and contributing shares to support the funds during market turmoil. [the Street at its best – who cares that clients lost their shirt - GIVE us OUR bonuses]**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aybs9pm0wLn0&refer=home>
- Sept. 18 (Bloomberg) -- The U.S. Securities and Exchange Commission is examining hedge funds for signs of insider trading, demanding information about relationships between managers, employees, family members and public companies. SEC officials told hedge funds to list clients and workers who serve as officers or directors of publicly traded companies, along with the names of any relatives who hold such posts, according to a 27-page letter to industry executives obtained by Bloomberg News. The SEC confirmed its authenticity. “The SEC is really drilling down, trying to get very specific information that might give them leads on insider trading,” said Nora Jordan, a lawyer at New York-based Davis Polk & Wardwell who represents hedge funds in SEC examinations. “Some of the information that they have asked for has never been asked

for before, and many clients are not keeping it." **Unusually high trading in shares and options before takeover announcements by companies including TXU Corp. and First Data Corp. has intensified scrutiny of how market-moving information spreads among hedge funds, investment banks and leveraged buyout firms.** [this could have been quoted out of Den of Thieves about Milken and Bosky] The SEC's office of compliance and inspections referred 223 cases of potential securities violations to the agency's enforcement division in the latest fiscal year. **SEC Scrutinizes Hedge Funds in Insider-Trading Probe**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a4X6HpmeL9no&refer=home>

- Celebrated securities lawyer William S. Lerach, who recouped billions of dollars for defrauded shareholders and collected billions in legal fees, has agreed to plead guilty to one count of conspiracy in an alleged kickback scheme and could serve as long as two years in prison, people familiar with the situation said Monday. Lerach, who resigned last month from the San Diego law firm that he founded in 2004, will pay a fine of several million dollars under the terms of the deal he made with federal prosecutors in Los Angeles, these people said. They said that he had refused to cooperate with the government in its case against Milberg Weiss, the firm where he made his name, but that he could be called to testify at a trial scheduled to begin in January. [Mindless greed.] **Top class-action lawyer may plead guilty in kickbacks**
<http://www.latimes.com/business/printedition/la-fi-lerach18sep18,0,6442421.story?coll=la-headlines-pe-business>
- Sept. 18 (Bloomberg) -- Bonuses in London's banking industry may drop more than 15 percent this year as rising borrowing costs paralyze leveraged buyouts and mergers, the Centre for Economics and Business Research said. The total value of payouts may drop to 7.5 billion pounds (\$15 billion) from a record 8.8 billion pounds in 2006, said Jonathan Said, an economist at the 15-year-old, London-based consulting firm. The decline in pay "could be larger if activity continues to drop," Said said in an interview. A decrease would have a knock-on effect on the "higher end" of London's housing market, where prices have surged in the past year, he said. **London Bonuses May Drop More Than 15% on Credit Woes, CEBR Says**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aOSChVF6V2hQ&refer=home>
- Sept. 17 (Bloomberg) -- Wall Street's third quarter would be the worst since 2001 if it weren't for the timely sale of a power company by Goldman Sachs Group Inc. [this will get MUCH worse. Of course no reason for anyone to do anything but buy buy buy because the Fed has cut right???] **Worst Wall Street Quarter Since 2001 Tempered by Goldman's Gain**
<http://www.bloomberg.com/apps/news?pid=20601109&sid=a3e60HBySgPk&refer=home>
- Sept. 17 (Bloomberg) -- Goldman Sachs Group Inc.'s Global Equity Opportunities hedge fund lost 1.8 percent in the first week of September, extending the slide that led to last month's \$3 billion cash injection. Global Equity, with \$7.5 billion in assets, fell 23 percent in August, its steepest monthly decline, as rising credit costs roiled stock markets, said two Goldman investors, who declined to be identified. Goldman, the second-largest U.S. manager of hedge funds, shored up the investment pool after it dropped more than

30 percent in the first two weeks of last month. Goldman pumped \$2 billion into Global Equity and lined up \$1 billion from investors including Maurice "Hank" Greenberg, the former chairman of American International Group Inc., and billionaire Eli Broad. August also was the worst month for Goldman's Global Alpha hedge fund, once the New York-based firm's biggest, which fell 22.5 percent and received \$1.6 billion of redemption notices. "People aren't going to keep suffering losses," said Brett Barth, a partner at New York-based BBR Partners, which invests in hedge funds. "These funds are supposed to do well with risk management. Something has gone badly awry." Goldman managers -- Robert Jones at Global Equity, and Mark Carhart and Raymond Iwanowski at Global Alpha -- use computer models to determine what securities to trade and when. Other so-called quantitative managers fared better. James Simons's \$29 billion Renaissance Institutional Equities made up the 8.7 percent that it lost in the first eight trading days of August. **Goldman's Global Equity Fund Lost 1.8% at Start of September**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=aR2iQbA07YhQ&refer=home>

- Sept. 17 (Bloomberg) -- The U.S. economy will avoid a recession and a "psychology of fear" in equity markets has caused some share prices to fall too much, investor Laszlo Birinyi said. **[Are we likely to hear from him again when these same stocks get much cheaper, cut dividends and commercial RE follows its inevitable down turn (which by the way is clearly already underway)? My guess is no. So Laszlo congratulations on your 15 minutes of fame. Don't worry about how many little guys lose their retirement following your "buy now" advice.]** "All the bad news is being magnified," said Birinyi, who helps manage about \$600 million as president of Birinyi Associates Inc. in Westport, Connecticut. "Good, solid companies which have nothing to do with finance, which **are really immune** [little is immune from a recession if only because valuations as a whole drop in recessions] from all these other issues, are being punished just as severely as stocks which are really tied to the issues." The Standard & Poor's 500 Index has declined 4.4 percent from a July 19 record amid concern a rise in borrowing costs sparked by defaults on subprime home loans will stifle growth in the world's largest economy and erode companies' earnings. Birinyi said shares of some companies that pay relatively large dividends **including commercial real estate investment trusts** [most certainly thought the same thing about residential REITs last fall. **How much NEW did you have Laz?????**] may be good investments. "Commercial building is still strong," he said. The market has "been throwing the baby out with the bathwater." Birinyi is known for pioneering money flow analysis, which compares the dollar amounts moving into or out of a stock or index to establish whether it is being more aggressively bought or sold. "The markets are OK," Birinyi said in an interview. "The problem is that we have a lot of smoke and a lot of noise going on. Right now, we have that psychology of fear." **Birinyi Says 'Psychology of Fear' Has Left Some Stocks Cheap**
<http://www.bloomberg.com/apps/news?pid=20601087&sid=a0lbQYZNePys&refer=home>

I Disagree . . . and why

[Articles of the week:](#)

How We Got into the Subprime Lending Mess

Published: September 19, 2007 in Knowledge@Wharton
This article has been read 5,942 Times

When mortgage default rates started to climb earlier this year, many experts thought the damage would be confined to the minority of issuers that had binged on subprime lending.



It's turning out much worse. Consumer spending is off, the credit crunch is spreading, the housing market is in a slump and the stock market has been shaken.

The economy is so threatened that the Federal Reserve set aside its worries about inflation and on September 18 cut short-term interest rates by half a percentage point for the first time in four years, hoping a shot of stimulus would head off a recession. The Fed pointed to worries about "tightening of credit conditions" that could deepen the drop in housing prices and the recent pullback in homebuilding.

Six or eight months ago, few experts thought the subprime fallout would be this bad. "It's the realization of my worst nightmares, the extent of the negative impacts on the rest of the economy," [Susan M. Wachter](#), professor of real estate and finance at Wharton, said in an interview several days before the Fed action. "The degree and the extent of the harm done were not expected. It surprised me. But the fact that this would end badly was *not* surprising."

Downturns in the mortgage and housing markets have caused economic problems before, but the current situation is the first of its kind, underscoring the profound changes in these markets, she said. "In the past, these kinds of events have led to downturns in the overall economy through a credit crunch in the banking sector. This will be the first time it is through a credit crunch in the non-banking sector of finance, if it happens."

At the root of the subprime problem is a new class of specialized mortgage lender that has emerged in recent years to operate free of the regulations affecting traditional banks. In the mid-1970s, traditional institutions such as savings and loans had nearly 60% of the mortgage market. Now that stands at about 10%. Over the same period, commercial banks' share has grown from virtually nothing to about 40%.

Many of the new lenders specialize in loans to borrowers who could not qualify for traditional mortgages because of poor credit or low incomes. And they have passed the risk on to investors around the world who are eager to buy mortgage-backed securities carrying higher yields than those offered by safer investments such as U.S. Treasury bonds.

Mortgage-backed securities are created by assembling thousands of loans into bundles and creating a series of bonds that pass borrowers' principal and interest payments on to the bond owners. Typically, there is a series of bonds of increasing degrees of risk reflecting the borrowers' creditworthiness. The riskier bonds pay the highest yields but are the first to lose value if borrowers fall behind in payments.

Many subprime loans have adjustable interest rates: They typically change every year by adding a fixed margin to an underlying rate such as the yield on one-year U.S. Treasury bills. Between 2003 and early 2007, one-year Treasury rates rose to about 5% from just over 1.25%. As a result, borrowers are now facing steep increases in monthly payments as prevailing interest rates rise. That has led to growing defaults and losses for bondholders.

"Things are unraveling faster, and to a degree that we did not expect," Wachter said, adding, "It is clear that nobody knows who owns the toxic waste portion" -- a reference to the riskiest bonds. "The fact that it is so widely dispersed has made it even worse because many investment funds are suspect."

In a new paper, "[The Housing Finance Revolution](#)", Wachter traces the evolution of the home-financing market over the decades, explaining how technology, deregulation, globalization in financial markets and a world-wide decline in interest rates have produced the current crisis. Her co-author is Richard K. Green, professor of finance and economics at George Washington University.

A Global Tour of Mortgage Lending

Worldwide, the trend has been to move away from government control of mortgage lending and toward various systems of financing through the capital markets, Wachter and Green say.

Prior to the 1980s, for example, mortgages in the United Kingdom were provided through heavily regulated "building societies" which drew on depositors' savings and offered mortgages at below-market interest rates, shielding the mortgage market from changes in market rates. That changed with the Building Society Act of 1986, which leveled the playing field between the building societies and commercial banks. By 2000, building societies provided only 15% of mortgages, down from 70% in 1980.

Many other European countries opened their mortgage markets to competition in similar ways during the 1980s. "From heavily regulated and rationed systems, modern housing finance emerged with funding increasingly supplied through market-oriented commercial banks..." Wachter and Green write. "The result has been an explosion of mortgage growth throughout Europe...."

Falling interest rates contributed to the boom in mortgage lending by making homes more affordable. From 1980 through 2004, the average prime interest rate for 13 industrialized countries fell from 15% to 4.4%, Wachter and Green say. Low interest rates also allow people to borrow more, allowing them to bid up home prices.

Change has reached even the most undeveloped economies. Wachter and Green note that in Bangladesh, mortgages were generally available only through the government-owned and funded Housing Building Finance Corp. until five or six years ago. Bureaucrats issued mortgages with little thought of borrowers' ability to pay, and typically 20% of borrowers were behind in payments at any given time, a very high rate.

A few years ago, the government stopped funding the BHBFC, and now three-quarters of the market has been taken over by private institutions that use underwriting standards and other modern loan-management techniques.

Similarly, mortgage lending stayed in government hands in South Korea through the middle of the 1990s, despite that country's growing economic size and sophistication. Loans were hard to get and usually covered only a portion of the cost of buying a home. Reform after the Asian financial crisis of 1998 introduced some market-driven features and led to a rapid growth of the mortgage market, though the system still has undesirable features. "Loans generally have very low loan-to-value ratios, variable rates of interest and balloon payments," the authors write. Some Korean policy makers think the solution is securitization -- creation of mortgage-backed-securities for sale to investors -- rather than relying on savers' deposits to fund mortgages.

That is the approach developed over the past decade in Australia. Lenders flooded into the market in the mid-1990s because they could borrow money cheaply and lend it out through mortgages at substantially higher rates. Mortgage-backed securities were a good bet because Australian borrowers had very low default rates. And there was a big appetite for these securities from pension-fund managers who had large sums to invest after a late-1980s law required employers to provide pensions.

Balloon Payments and Bailouts

The United States has been the leader in the move to securitization to provide mortgages, but it is a system that has taken decades to develop.

Before the 1930s, American mortgages featured variable interest rates and down payments of at least 50%, and homeowners generally renegotiated their loans every 12 months. Borrowers' payments covered interest only, with principal paid off with balloon payments, usually after less than five years. Most loans were funded by savings and loans, which drew on savers' deposits, or by mortgage bankers using funds invested by insurance companies.

As unemployment rose during the Depression, many homeowners could not make their balloon payments, causing a wave of sales and foreclosures. The federal government stepped in, creating the Federal Housing Administration (Fannie Mae) to insure long-term mortgages, and the Home Owners Loan Corporation to sell government-guaranteed bonds to purchase non-performing mortgages. This was the beginning of the securitization that is a central feature of today's mortgage market; lending risk is passed on to investors in mortgage-backed bonds rather than being held in the institution that originates the loans.

Essentially, the government bailed homeowners out by replacing their old mortgages with fixed-rate, 20-year loans they could afford. Borrowers could now borrow most of the money needed to buy a home, and instead of facing balloon payments homeowners amortized, or paid down principal gradually.

Under this system, savings and loans were the primary source of mortgages into the 1970s. S&Ls were federally insured and heavily regulated. The government set ceilings on interest rates paid

to depositors, and S&L lending was limited to mortgages. Most mortgages carried fixed rates. In 1968, Fannie Mae was divided into The Government National Mortgage Association, or Ginnie Mae, and the new Fannie Mae, which was privately held and could buy and sell non-government-backed mortgages.

The system worked well so long as short-term interest rates paid to depositors were lower than long-term interest rates charged to borrowers. But in the late 1970s, interest rates soared and the yield curve inverted -- i.e., short-term rates were higher than long-term ones. Many S&Ls became insolvent because they were paying more to borrow money than they received on the long-term, fixed-rate loans they had previously issued. This kind of interest-rate risk can be avoided by issuing adjustable-rate mortgages, but the federal government had barred that to protect homeowners from "payment shock" when interest rates rose.

In response to the S&L crisis, Congress in 1980 lifted a regulation that had put a ceiling on the interest rate paid to depositors, helping S&Ls compete with the relatively new money market funds for the deposits needed to make loans. And regulators lifted the ban on adjustable-rate mortgages.

Technology and academic insights also helped the market evolve. Starting in the late 1970s, the mortgage industry and investors who bought and sold its securities began to use more powerful computers to analyze prices and risks in much the way sophisticated investors analyze the options market. Thus they could better predict the number of borrowers who would default if interest rates went up, and how many would refinance if rates fell -- events that can undermine the value of mortgage-backed securities.

The 1990s saw the development of "private-label securities" issued by commercial banks and other entities generally free of the regulations governing ordinary banks. These were similar to the mortgage-backed securities sold to investors by government-authorized entities like Fannie Mae, but they did not carry the same implicit government guarantee that investors would be protected against unexpectedly high default rates.

Initially, private-label securities involved only "prime" mortgages issued to low-risk borrowers, but then lenders used them to back jumbo loans that the government-authorized lenders were not permitted to make. Finally, lenders used them to back subprime loans to borrowers with poor credit histories and Alt-A loans to ones deemed safer than subprime but not as good as prime.

The private-label market mushroomed from \$586 billion in 2003 to \$1.2 trillion in 2005, as subprime and Alt-A loans grew from 41% of the private-label market to 76%, Wachter and Green say. Investors were eager to buy these securities because the higher mortgage rates charged to riskier borrowers meant higher yields on the mortgage-backed securities.

"For a time, capital markets seemed to have an appetite for almost any kind of risk, so long as it received sufficiently large yield in exchange," Wachter and Green write. But, they add, there was little understanding of the credit risk -- the risk that borrowers would stop making payments -- in the new, fast-growing market. "Many subprime loans had essentially no underwriting, and insufficient data were available to calibrate default risk for subprime mortgages."

Because home prices had soared between 1997 and 2005, homeowners who ran into financial trouble could easily sell their homes for more than they owed, avoiding default and foreclosure. That period therefore provided no insight into what would happen if home prices leveled off or fell while rising interest rates saddled homeowners with bigger payments -- the situation that has developed in the past year or so.

'No Skin in the Game'

The looser credit standards of the past decade brought a mortgage boom, with Americans holding 2.5 times as much mortgage debt in 2005 as in 1997, a period when gross domestic product grew by just 50%, Wachter and Green say. Subprime mortgages made up 22% of new loans in 2005, compared to 8% in 2003, and in 2004 more than 30% of all mortgages carried adjustable rates, up from about 10% in 2001.

"At the same time, the subprime market developed new products whose features had never faced a market test," Wachter and Green write. This included 2/28 and 3/27 loans, which have 30-year terms but begin annual rate adjustments after the first two or three years. They carried prepayment penalties making it prohibitively expensive for borrowers to refinance when their payments got too high. Buyers qualified based on the initial low "teaser" rate, even though they might not be able to shoulder the higher payments that could come if the rate adjusted upward.

"The apparent mistake the industry made was to offer a loss-leader price in the early years of a loan in order to get borrowers into the market, in the hope that they would make up the difference in later years," Wachter and Green write. "They attempted to enforce the higher price in the future through the use of prepayment penalties. Prima facie evidence suggests that this did not work."

Many borrowers, Wachter and Green say, did not understand how high their monthly payments could rise if interest rates went up. They note that "even under the best of circumstances, disclosing true costs and risks to even well-informed borrowers is difficult; to a borrower without financial literacy, it is nearly impossible."

Investors who bought securities backed by subprime loans apparently did not understand the risks either. "Mortgage originators had powerful incentives to originate loans, regardless of quality: every mortgage that was successfully originated and sold to an investor produced a fee for the originator." These firms often assured investors that loans met minimum standards, and they often promised to make good in case of unexpectedly large number of defaults. But they did not have the capital to honor those promises.

It is puzzling, Wachter and Green say, why investors did not understand this. Nor did they seem to understand the risks inherent in the housing market; from time to time, prices have dropped in various regions of the U.S.

The evidence from the U.S. and around the world clearly shows, Wachter and Green say, that the public benefits when market-based mortgage systems replace ones controlled by government: Loans become easier to get and homeownership rates rise. Investors benefit as well, from access

to new types of securities. It is not so clear, they say, that any one way of providing market funding is best -- through savers' deposits, bonds guaranteed by government or securities that have no guarantees.

Wachter and Green argue, however, that there is a way to minimize a repeat of the problems recently experienced in the subprime market: Make sure that the firms that originate these and other loans continue to have a financial stake in the loans even after they are securitized and sold to investors.

That could be done by requiring that they keep enough funding on hand to cover a portion of investors' losses if borrowers default at higher-than-expected rates. "The problem is that the originators have no skin in the game, or there's some misunderstanding about whether they have skin in the game," Wachter said. "It needs to be made explicit that they do." <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1812#>

CDOs teeter on the edge of precipice Duncan Kerr 20 Sep 2007 Collateralized debt obligations have been structured and traded in various forms for more than 20 years. But it is only in the past five years their use has soared and their impact felt throughout the capital markets. From sales of \$82bn in 2002, investment banks last year sold more than \$500bn of CDOs, underscoring the rapid growth of this opaque and highly complex market amid the bull run on credit.

But it has not always been such a bullish story and cracks have emerged to undermine the intricate CDO technique, which in turn has raised questions about their risk and reward.

In May 2005, after the downgrades of [Ford](#) and [General Motors](#) to junk, CDO managers faced their first true stress test amid the so-called correlation trading crisis that ensued.

Observers say the CDO market is on the edge of a precipice after three months of tumult in the capital markets, caused largely by the fallout from the sub-prime mortgage crisis in the US. But while the turbulence has led to losses in some funds and the closure of others, the CDO market remains standing, at least for now.

Here *Financial News* profiles 10 of the largest managers of CDOs ranked by their assets under management.

1) TCW

CDO assets \$64bn+

Top managers [Jeffrey Gundlach](#), chief investment officer; [Louis Lucido](#), group managing director; [Roland Ho](#), managing director

Flagship CDO funds Davis Square, Everest, South Coast Funding, Salt Creek High Yield CSO

Established in 1996, TCW's structured finance CDO business has grown to make it the largest CDO manager and issuer by number of deals and assets. Its CDO platform is a natural extension of the company's fixed-income asset management experience.

TCW's Credit Mortgage Group was formed 11 years ago to meet structured product investors' demand for CDOs within the ABS, commercial mortgage-backed securities and subordinated residential securities markets.

The leading manager of cashflow, market value and synthetic CDOs also manages one of the broadest pools of collateral types of any manager, including MBS, ABS, corporate credit, high-yield bonds, commodities, bank loans, emerging markets debt and global project finance.

A renowned innovator, TCW last year broke ground in the commodities sector, working with [Barclays Capital](#) to introduce the first managed collateralized commodity obligation. The transaction, dubbed Everest 1, offers investors exposure to an array of commodities which are in turn referenced by swaps that are triggered if the commodity falls below a certain price.

The strengths of TCW as a manager are its investment management infrastructure and depth of experience and its network of contacts across markets and issuers. TCW is a wholly owned subsidiary of The [TCW Group](#) Incorporated, and an indirect subsidiary of [Société Générale](#).

2) [Ellington Management](#) Group

CDO assets \$30bn

Top managers [Richard Brounstein](#), managing director; [Michael Vranos](#), founder and chief executive; [Richard Daley](#), managing director of Ellington and chief operating officer of [Duke Funding Management](#)

Flagship CDO funds Duke Funding series

US hedge fund and alternative investment house Ellington Management Group hit the headlines in May when it finalised the acquisition of mortgage lender Fremont General Corp's sub-prime mortgage business for \$32.3bn (€23.3bn). At a time when institutions were reducing their exposure to the troubled sub-prime mortgage market, the deal was a bold move by the firm, one of the leading mortgage-backed securities specialists.

Ellington was set up in 1994 by five partners who had been the nucleus of [Kidder Peabody](#)'s MBS trading and research group in New York. The CDO business, run through Duke Funding Management, focuses primarily on managing cashflow-based mezzanine and high-grade ABS transactions, but it also runs synthetic and hybrid CDO structures.

Last year it branched out with a novel €1.1bn (\$1.5bn) cross-currency synthetic CDO with issuer Bear Stearns.

Duke Funding's asset manager rating is CAM1, the highest of five that are awarded by rating agency [Fitch](#). It reflects Ellington's investment and portfolio management expertise, the strength of Duke's CDO technology and administration, and the quality of trading, research and technology staff.

It will need all of these attributes if it is going to navigate the turmoil in the US sub-prime market.

3) [Cohen & Co](#)

CDO assets \$43bn

Top manager [Christopher Ricciardi](#), president and chief executive

Flagship CDO funds Alesco, Alesco Financial, Dekania, Dekania Europe, Stategos (Kleros & Libertas)

Cohen & Co made a shrewd move in February last year appointing Christopher Ricciardi, Merrill Lynch's head of CDO origination and structuring, as its chief executive.

Ricciardi, one of the most respected bankers in structured finance, has been the chief architect behind Cohen's asset growth and international expansion over the past 18 months. This included opening a London office to help broaden its European origination activities and double issuance of its flagship Dekania Europe CDO series.

The CDOs are backed by hybrid capital securities, similar to trust-preferred securities in the US, and are primarily from the insurance sector.

Known for its structural innovation, Cohen created the first transaction backed by non-profit municipal securities (non-profit preferred funding), and launched Alesco Financial, a real estate investment trust which uses CDOs as its primary financing method.

Cohen's management team has a strong record and its history in bank insurance investments means it has developed longstanding relationships with regional and local bank and insurance broker-dealers.

4) [Vanderbilt Capital Advisors](#)

CDO assets \$13bn+

Top managers undisclosed

Flagship CDO funds [Lakeside](#), Dunhill, Bristol and Millennium Park

[Pioneer Investments](#), the investment management arm of Italy's [UniCredit](#), bought Vanderbilt Capital Advisors last April in an acquisition that highlighted the trend of mainstream investment managers moving into hedge funds and structured finance.

The acquisition of Vanderbilt, which is one of the largest cash ABS CDO managers in the US, extended Pioneer's diversification into specialised investment products. Vanderbilt combines an active and quantitative approach, using small specialist teams of specialists rather than committees or stars.

In March, [Goldman Sachs](#) and Germany's [HVB](#) co-led the sale of Vanderbilt's synthetic arbitrage CDO, Millennium Park.

The deal marked a new development for Vanderbilt, which had previously focused on issuing CDOs backed by structured products or ABS.

5) [ACA Capital](#)

CDO assets \$17.9bn

Top managers [James Rothman](#), senior managing director, structured credit; [Brad Larson](#), managing director, structured credit

Flagship CDO funds ACA ABS, [Zenith Funding](#), Lancer Funding, ACA CDS, ACA CLO

ACA Capital has had a tougher time than most over the past few months amid the turmoil in the sub-prime mortgage crisis.

ACA Capital Holdings this month reported a net loss of \$93.3m during the second quarter, after heavy scrutiny from equity and bond investors over its exposure to sub-prime mortgages.

The company, parent of the market's only single-A bond insurer, ACA Financial Guaranty, blamed its loss for the quarter on impairments it took on parts of its CDOs, along with mark-to-market losses on its structured credit portfolio.

Housing market deterioration in the US, especially among second-lien and sub-prime mortgages, was the main cause of both, the company said.

In all, the firm's CDO exposure, including sub-prime and instruments backed by corporate and commercial mortgage debt, totals \$61bn of value – on a capital base, or shareholder net worth, of only \$326m.

However, in a recent presentation to bond investors, ACA said liquidity remained robust, rating agency [Standard & Poor's](#) had affirmed its single-A investment grade rating, and that 99.8% of its structured credit risk was rated AAA.

6) [BlackRock](#)

CDO assets \$22bn

Top managers [Sacha Bacro](#), head of structured products; [Ron D'Vari](#), asset-backed securities; [Chris Milner](#), commercial real estate and commercial mortgage-backed securities

Flagship CDO funds Anthracite euro CRE CDO, Kimberlite, Carbon Capital, Tourmaline, Galena, Palladium, Valleriite, Magnetite, BlackRock Senior Income Series

BlackRock has leveraged its experience and clout as one of the largest investment management groups in the world to create a leading and innovative CDO business.

In both ABS and commercial real estate, BlackRock has devised some ground-breaking CDO transactions, including the introduction of a hybrid structure that changed the way mezzanine ABS CDOs are done. The \$750m Tourmaline CDO I was the first hybrid cash/synthetic deal not to use a guaranteed investment contract or reserve account to pay for unfunded synthetic potential loss payments.

It was also the first hybrid backed by mezzanine asset-backed securities. Until Tourmaline, CDOs had been either synthetic or purely funded. BlackRock's Kimberlite commercial real estate CDO was another first, allowing a manager to replace credit default swaps with total return swaps. BlackRock's strengths include a disciplined investment decision-making process, its CDO platform and investment management technology and a strong performance record.

7) [Bear Stearns Asset Management](#)

CDO assets \$14bn+

Top managers [Raymond McGarrigal](#), senior portfolio manager

Flagship CDO funds Klio, Stone Tower, High Grade Structured CDO

Bear Stearns Asset Management's reputation was hit hard by the collapse of two of its dedicated structured credit hedge funds in June.

[Ralph Cioffi](#), a former bond salesman at Bear Stearns, led the CDO division. However, after the fund collapsed he stood back from day to day operations to act as an adviser.

Cioffi was involved in the initial structured credit efforts at Bear Stearns. With [Raymond McGarrigal](#), senior managing director of fixed-income credit structured products and [Matthew Tannin](#), senior managing director on the CDO structuring desk, his management team was one of the most highly regarded on Wall Street, with more than 40 years' experience between them.

Hedge funds had flocked to Bear Stearns's high-grade CDO business for financing. The team's extensive capital markets experience and its commitment to the CDO platform, was marred by Fitch's warning last year that its centralized decision-making process may create key-man risk. Fitch said complex initiatives, running concurrent with CDO issuance, could prove problematic.

Fitch placed BSAM's CAM 2 CDO manager rating on negative watch on June 22 as a result of the implosion of the High Grade Structured Credit Strategies hedge funds and the "uncertainties" related to its business strategy and capacity of the team.

8) [Brightwater Capital Management](#)

CDO assets \$35bn

Top managers [Graham Light](#), vice-chairman and global head of investment management; [Neil Colverd](#), president and chief executive

Flagship CDO funds Blue Heron, Whitehawk and Osprey

Brightwater Capital Management is an alternative investment manager owned by German lender [WestLB](#). In the past four weeks, Brightwater – which manages CDOs, CLOs, structured investment vehicles and asset-backed commercial paper conduits – has come under intense scrutiny over its exposure to the sub-prime mortgage crisis following heavy losses and funding problems at other German banks, particularly [IKB Deutsche Industriebank](#).

The bank has, however, strenuously denied market speculation that it faces mark-to-market losses.

A spokesman told [Dow Jones Newswires](#) that WestLB's situation "doesn't in any way compare" to the crisis at IKB. He said: "98% of our collateralized debt obligations are rated AAA or AA by the rating agencies."

WestLB has not disclosed the amount of capital invested in CDOs.

Brightwater's Blue Heron Funding V is a cashflow CDO backed primarily by a portfolio of highly rated investment-grade commercial mortgage-backed securities, residential mortgage-backed securities, and home equity securities, according to rating agency [S&P](#).

9) [Vertical Capital](#)

CDO assets \$10bn

Top managers [Alissa Eason](#), CDO surveillance and investor reporting; [Thomas Pearce](#) and [Brett Graham](#), managing partners

Flagship CDO funds Vertical CRE CDO, Vertical ABS CDO, McKinley Funding and Pampelonne

Vertical Capital, established in 2002 through an alliance with [Bank of America](#), is an independent fixed-income asset manager that has closed 11 individual CDO funds invested in asset-backed securities, [RMBS](#) and [CMBS](#) among other assets.

At launch, the company focused on the high-grade structured finance markets, with its first high-grade CDO of CDOs closing in October 2003.

It diversified into mezzanine-quality ABS collateral in June 2005.

Last year the firm launched its first commercial real estate CDO, dubbed CRE CDO 2006-1, through Bear Stearns.

Fitch, which rates Vertical CAM2, warned about the rate of CDO issuance from the firm, which hit a record last year, and its further expansion into mezzanine-rated and commercial real estate-related collateral.

The agency also raised concerns about Vertical maintaining a transparent control environment because it is not yet under the oversight of the US [Securities and Exchange Commission](#). Vertical plans to register with the [SEC](#) this year.

10) [Aladdin Capital Management](#)

CDO assets \$17.1bn

Top managers [George Marshman](#), chief investment officer; [Joseph Moroney](#), senior portfolio manager

Flagship CDO funds Landmark, Greyrock and Hudson

Established in 1999, Aladdin's business focus is non-traditional fixed-income-based strategies across a broad range of sectors.

The firm is an adviser and manager for two relative value global credit funds, 10 collateralized loan obligations, three investment-grade managed synthetic CDOs, seven structured credit funds, one floating-rate bank loan fund and one single-investor fund.

Aladdin Capital broke into the European CLO market this year, launching its €13m Hudson CLO through Bear Stearns. The transaction is at least 90% backed by senior secured loans from 13 countries.

Its CLO business started in 2001 under four specialists, including Joseph Moroney, whose bank loan experience dates back to 1998, where he co-managed \$11bn in bank loans at [Merrill Lynch Investment Managers](#). At [MLIM](#), Moroney's team was one of the largest buyers of bank loans in the world.

The firm believes its competitive advantage lies in its participation across both the high yield and investment-grade markets.

It is active in hedge funds and structured credit, and while there are different information flows, the information is beneficial to multiple businesses.

* CDO asset values are based on Creditflux data <http://www.financialnews-us.com/?page=ushome&contentid=2448754969&printview=true>

UM EMBA

- [The ghost of macro economics past? Companies really might collude?] Sept. 14 (Bloomberg) -- SanDisk Corp., the world's largest maker of flash memory cards, said it received federal grand jury subpoenas indicating a U.S. Justice Department investigation into possible antitrust violations in the industry. Chief Executive Officer Eli Harari got one of the subpoenas, the Milpitas, California-based company said today in a regulatory filing. It provided no further details about the U.S. probe. Canadian authorities are also investigating, SanDisk said. The Justice Department has spent more than three years conducting a criminal antitrust probe of makers of another type of memory chip, known as DRAM, charging four companies and 13 people and levying fines of \$731 million. In October, U.S. authorities opened an investigation of the SRAM market. Flash memory chips are used in consumer electronic devices, including Apple Inc.'s iPod, to save digital music and pictures. SanDisk spokesman Michael Wong didn't return telephone calls before business hours seeking comment. SanDisk and 23 other flash memory companies are defendants in a proposed class action filed Aug. 31 in federal court in San Francisco that claims they conspired to fix the prices of flash products in violation of U.S. and California law. ``Defendants' collusive behavior artificially inflated the price of flash memory," consumer Stuart Go said in the complaint filed on behalf of himself and other purchasers of products containing flash chips since 1999. Go wants a court order enjoining the alleged misconduct, plus unspecified damages. **The companies were able to collude because their executives went to the same trade shows, had offices on the same street and even ate in the same restaurant, Go's suit alleges. SanDisk Subpoenaed, Sued Over Flash Memory Practices** http://www.bloomberg.com/apps/news?pid=conewsstory&refer=conews&tkr=SNDK:US&sid=aYI_84xAewlk