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UPDATE

September 2007

"Faith gone from your eyes
Each word it flies
Straight to the heart and I know
Watching you go
There ain't no easy way to cry

-David Gray, Easy Way to Cry

Played Out

We've all heard the story of a relationship built on abused trust that tests the limits of patience. The pattern is as familiar as the rain. The offender's indiscretions are patiently endured until their cumulative weight becomes too great to bear. Once confronted, there is a specious offer to repent. Hip to the game, the scorned declines the offer and a relationship once promising and healthy is now soiled.

Currently, the serial credit offenders on Wall Street are on bended knee. "If you could just find it in your heart to forgive us," they are saying, "we will never do it again." "It," in this case, is financial frivolity on a scale so grand that asset and credit markets the world over have succumbed. In the old days of former Federal Reserve Chairman Alan "Easy Al" Greenspan, all would likely have been forgiven and forgotten. Now, however, these indiscriminate lenders and investors are courting a Federal Reserve Chairman with seemingly higher standards. Perhaps seeing how investors used and abused the accommodative policies of his predecessor, current Fed Chairman Ben Bernanke is intent on trying to make sure his monetary policy doesn't let these "players" off the hook for their past transgressions.

The notion that the subprime mortgage debacle is contained has been discredited. With regards to failing asset management funds and central bank liquidity injections, we have learned that in a flat world, credit dislocations have long tentacles. "It is remarkable how strains are spreading both here and abroad," says Ed Hyman of ISI Group, Inc. "This financial crisis, due to its breadth and complexity, doesn't seem likely to end quickly. And we doubt it has seen its extreme."

What is truly jaw-dropping at this stage of the game is that we still do not have a good idea who the cheaters are. According to a recent UBS Securities, Inc. report, there is over $1.2 trillion (with a T) subprime and Alt-A mortgage-backed securities (MBS) and a trillion more or less dollars of outstanding collateralized debt obligations (CDOs) held in the marketplace today. Despite the poor performance of these "investments," a relatively small number of investors have 'fessed up to their holdings. Perhaps they just don't know what they own. After all, one week after assuring investors that his company had no subprime credit exposure, the CEO of BNP Paribas, a French asset manager, had to explain why he was halting redemptions on some of his funds due to losses in subprime MBS.

"The significance of proper disclosure is, in effect, the key to the current crisis," said Bill Gross, managing director at PIMCO Global Advisors. "Financial institutions lend trillions of dollars, euros, pounds, and yen to and amongst each other. When no one really knows where and how many [bad mortgage loans] there are, the trust breaks down, and money is figuratively stuffed in Wall Street and London mattresses."[1] In what is called a flight to quality, investors today are accepting sharply lower yields in exchange for the safety of government bonds. "We're having a crisis of confidence, and investors with the cash have no risk appetite at all," said James Kauffmann, head of fixed income at ING Investment Management.[2]

The new-found reality of the true value of mortgage securtities, coupled with increased risk aversion, has sapped liquidity and sent assets around the world down in lockstep. Stocks, corporate bonds, emerging-market debt, commodities such as gold and other metals (which investors turn to precisely because their prices typically don't move in sync with other assets) dropped…in late July.[3] "Simply put, there has been a sea change in the availability of credit," says Tom Gallagher of ISI.

On Thursday, August 16, 2007, the credit market dislocation rocked the short-term commercial paper market many companies depend on to finance their daily activities. In London, $45.5 billion in short-term [commercial paper] could not find a buyer. The largest mortgage lender in the U.S. was unable to raise money in financial markets and was forced to tap an existing bank line of credit to remain solvent. Then, the Japanese yen suddenly surged against the dollar, rising 2% in just minutes and crushing currency market players who hadn't anticipated such a sharp move. These shocks reflect one of the most perilous days for global credit markets - the circulatory system of the international economy - since the 1997-98 Long-Term Capital Management crisis.[4]

Chart 1

Chart courtesy of ISI Group, Inc.

Yet, with financial pain being distributed wholesale, the holders of the toxic debt remain silent (aside from their pleas for mercy from the Fed.) "Many institutions including pension funds and insurance companies argue that accounting rules allow them to mark subprime derivatives at cost," said

[1] Bill Gross, *PIMCO Investment Outlook*, September 2007.
[2] Serena Ng, Greg Ip and Shefali Anand, "Fed Fails So Far In Bid to Reassure Anxious Investors," *The Wall Street Journal*, August 21, 2007.
[3] Justin Lahart, Allistair MacDonald, and Joanna Slater, "Braving the Subprime Storm," *The Wall Street Journal*, August 6, 2007.
[4] Randall Smith, Carrick Mollenkamp, Joellen Perry and Greg Ip, "How a Panicky Day Led the Fed to Act," *The Wall street Journal*, August 20, 2007.

Gross. "Defaulting exposure therefore, can hibernate for many months before its true value is revealed to investors and importantly, to other lenders"[5]

It takes some chutzpah to mark your subprime holdings at cost given the performance of the ABX index that tracks the value of subprime assets (see Chart 1). Proponents of this security valuation methodology argue that these illiquid securities must trade before they can be priced. However, accounting rules mandate that investors value their holdings to appropriately reflect the realities of the marketplace. If there are no buyers to be found, "then the price is zero," says Jack Ciesielksi, editor of the Analyst's Accounting Observer newsletter. "If there's a bid out there, then there's a price. Take your pick."[6]

As cheaters conceal and obfuscate, the economy suffers. "The events of the last few weeks were much more than a financial markets event: a severe and abrupt credit crunch in the mortgage market has occurred," said Tom Gallagher. "The near destruction of the subprime and Alt-A markets, which last year represented 40% of the mortgage originations for purchase, will not be reversed anytime soon. Whatever your assumption for the housing market was in late July, it should be much more pessimistic today as major companies have exited the Alt-A market and others have tightened standards such that few borrowers qualify. Real consequences will follow. Expect this to dramatically reduce the demand for housing." Daniel Oppenheim, housing analyst at Bank of America Securities expects demand for new homes to fall 35% versus 2006, or an additional 20% beyond the estimated impact from the subprime fallout made earlier this year. "We think new home sales could fall as low as 700,000 homes annualized, down from 1.28 million in 2005," says Oppenheim. "We have seen traffic fall sharply in August with further pressure on pricing. Our market checks point to a recent spike in cancellations as lenders pull loan commitments and buyers fail to qualify." In short, the credit crunch is drastically reducing demand for housing.

At the same time, inventory data from the National Association of Realtors (NAR) shows the supply of existing homes for sale rose to 4.59 million in July, or about 9.6 months of supply, the largest glut of housing inventory in this country since the 1990 recession. Given this outlook, it does not come as a shock that ISI's house price survey showed the biggest decline in its history (see Chart 2). Ed Hyman believes that house price declines are now the key drag on future economic growth, and given the fundamental backdrop, these prices are likely to continue to decline for some time.

Chart 2

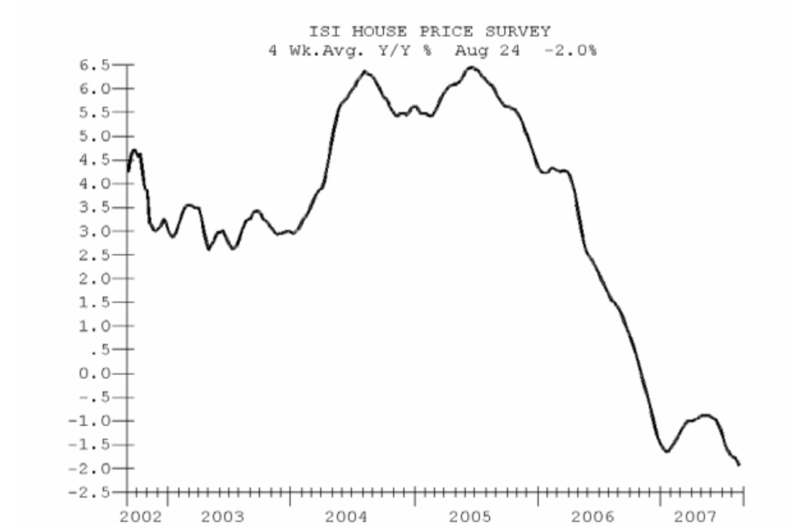

Chart courtesy of ISI Group, Inc.

[5] Gross, September 2007.

[6] Ian MacDonald, Carrick Mollenkamp and David Reilly, "When Buyers Snub Sellers," *The Wall Street Journal*, August 15, 2007.

Strains on economic growth have spread beyond the housing market as tighter credit conditions pressure consumer spending. According to Ed Hyman, real consumer spending is on track to be the weakest since the 2001 recession. Indeed, the trade report for the month of June (before the credit crunch showed its teeth) showed imports of consumer goods fell 2%, a potential sign of slowing consumer demand.[7] Further signs of waning demand come from the auto sector, where ISI's auto dealer survey showed its weakest reading since 1998. In addition, auto dealers report that traffic remains slow at dealerships, and new incentives have not created much interest from buyers. The dampened consumer spending environment is evident in the ISI trucking company survey as well (see Chart 3). Trucking companies say their customers warn not to expect a big surge in volumes because of expectations for softer consumer spending in the second half of 2007.

Chart 3

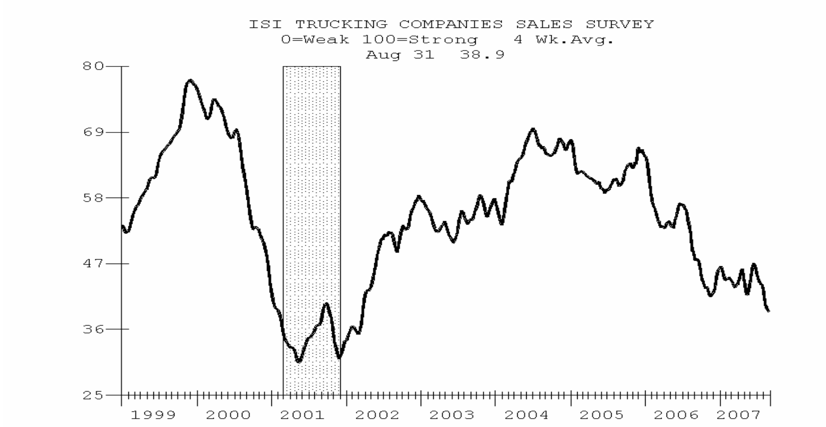

Chart courtesy of ISI Group, Inc.

The retrenchment of the consumer is also reflective of a softening labor market. Specifically, mortgage finance and residential construction employment are on the decline (see Charts 4 & 5), Ed Hyman estimates that housing-related employment overall is likely to decline -12% year-over-year (see Chart 6). The result: consumer income expectations have declined to a level not seen since the 1990 recession (see Chart 7).

What strength there is in the U.S. economy has come from overseas. Foreign economic growth contributed to strong second-quarter operating results for U.S. corporations as the percentage of profits from international operations has grown from 5% in the 1960s to roughly 25% today.[8] Interestingly, however, many of our friends overseas are dealing with real estate property bubbles of their own. The British property market is suffering from stretched valuations and subprime mortgage arrears (like delinquencies only it sounds cooler). Ireland's housing starts have declined sharply, and June home price increases there slowed to a record

Chart 4

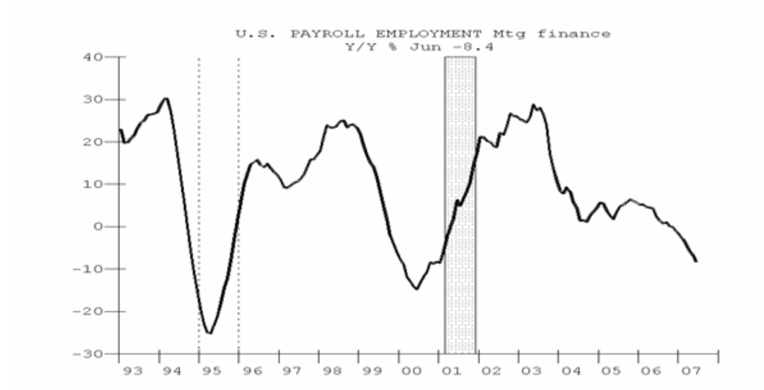

Chart courtesy of ISI Group, Inc.

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[7] Jeremy W. Peters, "Producer Prices and Trade Data Give Fed Little Reason to Cut Rates," *The New York Times*, August 15, 2007.

[8] Timothy Aeppel, "Overseas Profits Provide Shelter for U.S. Firms," *The Wall Street Journal*, August 9, 2007.

Chart 5

Chart courtesy of ISI Group, Inc.

low. And, as we have seen over the last few weeks, the credit crunch is having global economic implications. Just as the fallout from this crisis is sure to slow economic growth at home, so too will it have its impact abroad. In fact, Japan's second quarter gross domestic product (GDP) grew a weaker-than-expected 0.5%. Across the other pond, Eurozone GDP disappointed on the downside with just 1.4% growth in the second quarter of 2007.

Given the significant amount of pressure on the U.S. economy, the drumbeat for Federal Reserve monetary policy stimulus is likely to grow. However, based on his actions to-date, Chairman Ben Bernanke has shown a great deal of ingenuity and decidedly more tact than his predecessor in dealing with this crisis. According to John Hussman, President of Hussman Investment Trust, "The Fed has an interest in stabilizing the banking system and the real economy. It has no interest in taking the private sector's loss for the irresponsible lending practices of recent years, nor in saving overly aggressive hedge funds from the losses on their leveraged bets…There will inevitably be enormous losses taken as a result of mortgage defaults – but don't assume it will be the Fed that takes them."[9]

Fed policy makers are extremely reluctant to re-introduce moral hazard into financial markets by jumping to the rescue with an interest rate cut simply to relieve the woes of investors or to bail out hedge funds and others that many blame for the current problems. That means an imminent reduction in the Fed's key policy tool, the federal funds rate, is still far from a sure bet.[10] "For some 10 years now, the Fed has jumped in pretty aggressively on any minor problem that has arisen causing a moral hazard as investors took on greater and greater risk and debt, assured the Fed would always bail them out with

Chart 6

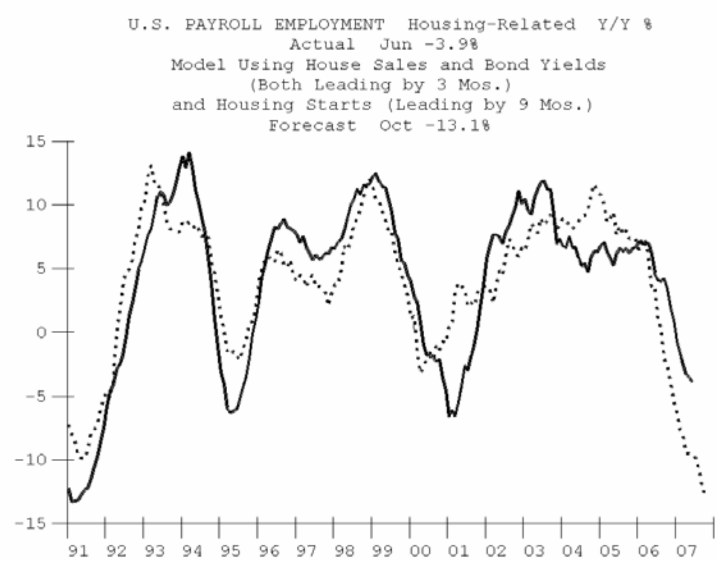

Chart courtesy of ISI Group, Inc.

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[9] John P. Hussman, Ph.D., "Hardly a Bailout," *Hussman Funds*, August 13, 2007.
[10] Edmund L Andrews, "Fed Seeks Balance as Investors Clamor for Action," *The New York Times*, August 22, 2007.

the…Greenspan 'put' insurance," said Ned Davis of Ned Davis Research, Inc. "So-called pseudo 'free market capitalists' always praise the system on the way up, but when excesses [are] being corrected, they call on "Big Brother" to help them out."[11] Adds Jan Hatzius, chief domestic economist for Goldman Sachs, "The argument is people did risky things [and] they are getting punished now, and if you ease interest rates, you reduce the punishment."[12]

Chart 7

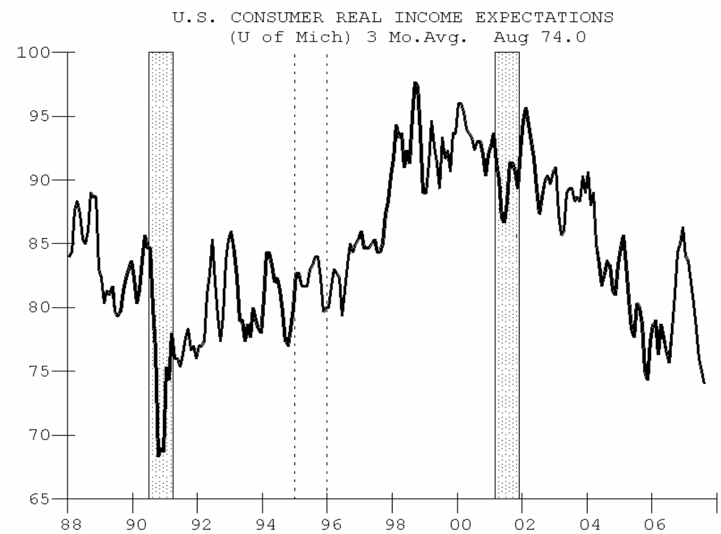

Chart courtesy of ISI Group, Inc.

While the arguments for moral hazard are valid, Tom Gallagher believes that Bernanke and crew will be compelled to cut the Fed funds rate not to aid investors in distress, but in an attempt to save the economy from a recession. (Remember that the banks' prime rate, home-equity loan rates, credit card rates, etc. are all tied to the cost of money – the Fed funds rate.) The risks of a recession seem clear enough. Market forecasters currently project over two million mortgage defaults leading to a -10% decline in housing prices, an asset deflation in the U.S. not seen since the Great Depression.[13]

Unfortunately, at this late stage, we wonder how quickly a cut in the Fed funds rate can help the economy. For the housing market at least, the die has already been cast. Remember, consumers with adjustable rate mortgage (ARM) loans are facing a pending tsunami of rate resets. When we inquired about the mechanics of these resets, what we learned was troubling. The 2/28 subprime ARMs (loans with rates that adjust after 2 years) originated in late 2005 have interest rates of 7.5%. The pending resets on these loans will be based on a spread above LIBOR (London Interbank Offer Rate) of, on average, 600 basis points (bps) or 6.0%. (For Alt-A resets the spread averages 300-400 bps.) So, if the Fed cuts the fed funds rate by 75 basis points to 4.5% (and assuming the LIBOR rate follows the Fed funds rate as it generally does), the subprime loans will reset to a 10.5% interest rate. Just to offset the reset adjustment and keep interest rates on these subprime loans from rising, the Fed would have to take the Fed funds rate down a whopping 375 bps to 1.5% this year.

Even if the Fed were to ease to that level, they can't "guarantee that the private mortgage market – flush with fears of depreciating collateral – would follow the Fed down in terms of 15-30 year mortgage yields and relaxed lending standards," says Bill Gross.[14] This increased risk aversion can be seen in the

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[11] Ned Davis, "Institutional Hotline," *Ned Davis Research, Inc.*, August 24, 2007.
[12] Louis Uchitelle, "Opinions Are Plentiful, as Bernanke Faces His First Crisis," *The New York Times*, August 11, 2007.

[13]Gross, September 2007.
[14] Gross, September 2007.

recent decline in Treasury yields in conjunction with a rise in mortgage rates that has lifted the spread between the two credit instruments to the highest level in five years (see Chart 8). "It is one thing to have cheap (free) money," said Art Cashin, a floor trader for UBS. "It is another to lend it to someone who is unlikely to pay you back. Throwing money at a situation does not automatically cause a surge in demand. It is, some say, like pushing on a string."[15]

Chart 8

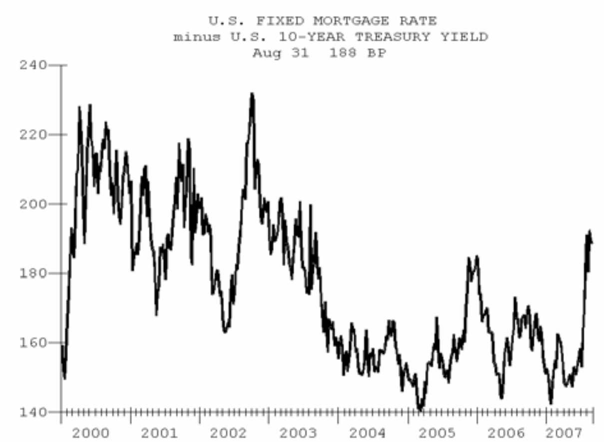

Chart courtesy of ISI Group, Inc.

And so we have reached a great paradox. Undiscerning investors are clamoring for assistance from the Federal Reserve, but the new Fed chairman is not as easy, nor as forgiving, as his predecessor. His valiant effort to teach these investors a lesson is likely in jest. One can't help but conclude, seeing the pain about to be wrought on main street America, that his hand will ultimately be forced by the prospects of economic fallout – a recession. Unfortunately, the credit excesses built by the risk enabling policies of his predecessor would likely limit the positive impact his stimuli could have on the economy. Thanks Easy Al.

It took too long for policy makers and investors alike to realize that they had done wrong as they casually ignored countless and clear warning signs. Sadly, for several million Americans facing the very real prospect of foreclosure, Ben Bernanke's monetary stimuli can do little to help. Even a massive subprime borrower bailout, as many have begun to call for, likely would only help a fraction of those facing pending resets.

For the majority of these homeowners, whose economic prospects are bleak, there will be no easy way to cry. One can only hope that future monetary policies will ensure that the market "players" that wreaked this havoc will be shedding tears of their own. Their game, after all, is played out.

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[15]Art Cashin, "Cashin's Comments," August 15, 2007.