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Quarterly Investment Outlook

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Sub-Prime 3: It's Payback Time for Banks and Brokers

In our year-end Outlook we stated our opinion that the US economy had tipped over into recession. We also cautioned that mounting foreclosures in the US housing market could further stress the consumer and exacerbate the structural problems that plague the global credit markets. The Fed and the Treasury have made all the text-book moves to provide liquidity to both lenders and borrowers while Congress, not wanting to take second stage in an election year, promptly enacted a fiscal stimulus package. It's too early to tell if these measures will bring relief to the consumer but the credit markets remain, for the most part, frozen. Bernanke and Paulson are occupied on two fronts: averting a severe downturn in consumer spending; and restoring confidence in the structurally impaired credit markets. Accomplishing this will require crafting a plan to reduce the number of foreclosures and stabilize the housing market and, secondly, devising a price discovery mechanism to revalue asset-backed collateral. Restoring confidence in the valuation of collateral will open the floodgates in the credit markets and bring us a significant step closer to recovery.

No Rest for a Weary Fed

As we watch the sub-prime story unfold, we're amazed to see how a small portion of the mortgage market, aided by the miracle of financial engineering, lack of regulatory oversight, greed, and just plain poor business practices, has undermined the structural underpinnings of the financial system. The financial alchemy employed by banks and brokers has created a situation where the "safest" investments have transformed an imbalance in the housing market into a credit crunch that threatens to reach crisis proportions. If there is any good news, it's that the Fed and Treasury have the capacity to bridge the economy and its markets through this period of turmoil. The bad news is that it might come at a significant cost. What, just a few decades ago, would have been a non-event, has boxed in the Fed and the Treasury and left them little to do other than pump liquidity into the system at the cost of a lower dollar and an increased chance for the return of a 70's era stagflation environment. However, restoring confidence and liquidity to the credit markets takes precedence to that longer-term concern.

The Fed and Treasury are fighting a battle on two fronts: They want to shore up consumer confidence, and spending; and they want to restore capital flows to the credit markets. The former is a cyclical problem, the latter is a structural one that could transform the cyclical downturn into something more severe and protracted. While the problems are different, the solution to both is substantially the same: Provide sufficient liquidity when and where as needed and facilitate stabilization of the housing market. Right now, their priority is the financial system. In the past few months, we have seen the Fed make historic reductions in key lending rates in an attempt to both provide some relief to the consumer but, more importantly, to restore liquidity to the banking system. The Treasury stands ready to pour more capital on any fire that breaks out among the banks and brokers as we saw this week with the Bear Stearns meltdown. We wish we could say that conditions in the credit markets have improved as a result of their efforts. They haven't. Inter-bank lending is stagnant and unpredictable and the auction-rate securities markets remains shut down. Ironically, the only segment of the credit markets where capital is flowing is were it all started, mortgage lending.

Bankers Just Wanna Have Fun

One can't escape the fact that the banks and brokers have their hand in every aspect of this impending crisis. Securitizing sub-prime mortgages, backstopping the auction-rate markets, making leveraged loans to hedge funds, reinsuring muni and sub-prime securities. They stretched their on and off-balance sheet lending to the limit in search of fat fees and big bonuses, thinking the collateral they held was "AAA" and that free lunch was being served on Wall Street. Learning otherwise, they have little room to hide in The Great Deleveraging of the capital markets that has just begun. The joke was on them but nobody's laughing. Despite efforts by the Fed and Treasury to lower the cost of capital and provide liquidity, the uncertainty over the underlying value of real estate-backed collateral is pervasive and has undermined all attempts to get capital flowing among banks that are dependent upon short term credit facilities to conduct their business.

Restoring confidence to the credit markets rests upon restoring confidence in the underlying collateral. Though the source of the problem lies in the housing market, there's very little the Fed/Treasury can do, short of a government-funded bailout, to reduce the mounting number of foreclosures. Adding to the problem are walk-aways. These are qualified, not sub-prime, homeowners who can pay but won't since they now have negative equity in their home. With 10 months supply of housing available, the banks don't want to be in the real estate business and are motivated to do "work-outs" with distressed homeowners. Unfortunately, they're limited in what they can do since their capital structure is already under duress from other lending or reinsuring activities where, you guessed it, mortgaged back securities ("MBS") are the underlying collateral.

It's obvious that a pricing discovery process has to be engaged to value the MBS market. Accounting standards require that dealers mark these assets to the market. No doubt, there is tangible value to MBS, but not knowing whether to discount them 25% or 75% renders them untradeable. No trade means no market and that means zero value and big write-downs. It will take time to devise and execute a pricing mechanism. Until then, the Fed can buy time by providing liquidity through channels outside the usual Fed Fund and Discount windows. An example is the recent offer by the Treasury to swap its securities for MBS as collateral for short-term credit facilities. And this past week's event at Bear Stearns is proof that a Fed-brokered takeover of endangered banks by healthy ones is at the ready. Our hope is that a valuation process can be operable within weeks, not months. Since a bottom to the housing market isn't in sight, it's the only way to get the credit markets moving again. Oh yes, it will also allocate losses in the MBS meltdown to where they belong, those fun-loving banks and brokers.

While all eyes are turned to the credit markets, the stock market remains engaged in its process of discounting the current recession. It's been painful for investors who failed to sidestep the carnage in the Financials sector. Resilience in Commodities, high-quality Tech, Staples, and Energy have so far kept the Dow and S & P out of bear market territory. We find it encouraging that the market reacts predictably to the weekly "tape bombs" that cross the ticker and just as predictably to news of the Fed's response. While the outlook for the economy is uncertain, expectations of the Fed's response to events is not. They will do whatever it takes to stabilize the markets and worry about the costs later. We have not changed our forecast for a modest upturn in the market in the second half of this year. With the US market priced at a discount relative to other markets we could see more than modest returns if we see a quick remedy applied in the credit markets.

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