

April 2008

Unbearable Crisis

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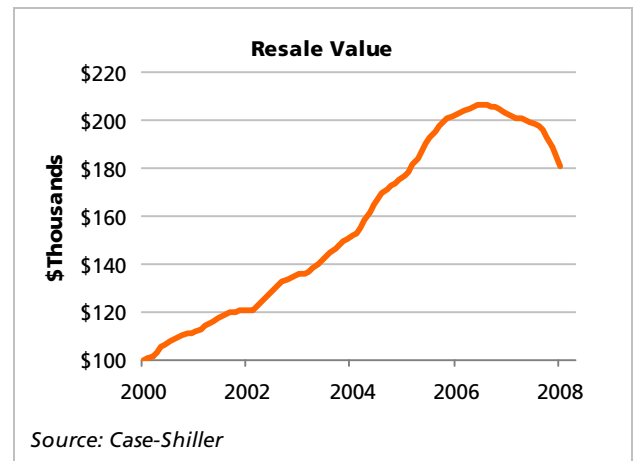
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The managed downfall of Bear Stearns arrested an impending catastrophe. It did not, however, solve the underlying problem. There are numerous forces now at work on the root causes though, mostly devising government responses. Some of these might do some good, but it is going to take a while. From the government perspective, the sacrifice of one Bear (lamb?) on the altar of "moral hazard" was a necessary condition for providing intervention to support the rest of the system.

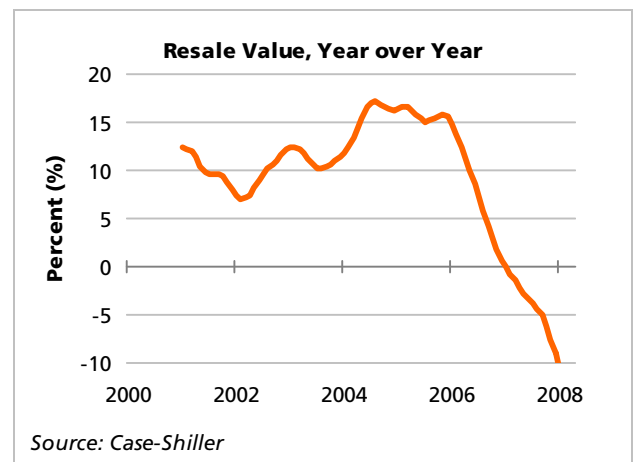
The heart of the turmoil in the financial markets is the rapid decline in housing prices. As measured in the Case-Shiller index of housing prices, a \$400,000 house is now depreciating at about \$1000 per week. For the financial markets, a couple of problems immediately follow. First, there are scary expectations as to the impact of steep price declines on consumer spending and behavior. Second, and more immediately tangible, the markets have limited ability to place valuations on a variety of real estate-backed securities. This has led to a vicious cycle of price reductions, margin calls, and de-leveraging that hit subprime, conventional, jumbo, and commercial mortgages, and then quickly resulted in concerns of counterparty risk. Illiquidity and downward price spirals were quickly extended to asset-backed commercial paper, LIBOR bank and repo lending, leveraged syndicated loans, monoline insurance companies, and auction rate securities. These all remain in difficult circumstances and the list is by no means exhaustive.

Beyond any historical real estate lending crisis, the securitization and tranching of risk has extended the reach of this asset decline to global markets. Investors with limited appetite for volatile assets, such as those that had become omnipresent during a period of excess global liquidity and financial innovation, now find themselves levered to opaque exposures and uncertain valuations.

House Prices Are Declining...



At an Increasing Rate



The Fed and Treasury have responded creatively and aggressively, easing tensions a notch. There is an alphabet soup – TAF, TSLF, PDCF – of measures to provide market liquidity, a lower Fed funds rate, and a host of proposals for regulatory and market reforms. Yet the housing market remains in accelerating decline.

Three things are needed to shift the economic and market outlook. First is a signal that the house price plunge will end. Inventories of unsold homes are still too high. Mortgage rates have not dropped as far or as fast as the Fed funds rate. Supply and demand appear still out of balance.

The second issue relates to consumer health. If spending is reduced, and it is not unequivocally clear yet that it has actually happened, then the economic outlook is worse. The headwinds of inflationary forces in food and fuel also bite here. The next few employment and retail sales figures will be important to ascertain the outlook for the consumer.

The third requirement: the market needs to see an end to financial institutions' write-downs. This purging is clearly occurring. Capital is being rebuilt. Bond prices are responding. Maybe this third piece is falling into place. ■

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