

# The Pain Report

## From the sublime to the subprime

**‘Too much money was lent to too many people who couldn’t afford it and all of this was predicated on the expectation of ever-rising house prices’**

In 23 years of being in this fascinating, dynamic and wonderful world of financial markets I cannot remember being asked so many questions.

We have had many extraordinary moments.

The Crash of 1987, the Japan Inc bubble of 1989, Orange County in 1994 when the bond bubble burst, the Tequila Crisis of 1995 (Mexico crisis), the Thai baht devaluation in July 1997, the Asian contagion, Long-Term Capital Management in 1998, the Tech bubble in 2000 and today the Collateralised Debt Obligation (CDO) crisis.

All of them have one thing in common and that is the irrational nature of human behaviour. We can go all the way back to “Tulip mania” in 1636 and the South Sea Bubble of 1720 etc. Put very simply: very clever people can do very silly things.

In 1983 I was introduced to the Efficient Market Hypothesis (EMH) while studying a Masters in Finance. My Professor was a loyal devotee of the EMH and he took this extraordinary hypothesis as a given.

After a few months of suffering I couldn’t take any more and declared that I had never heard so much rubbish in my life (Yes. I did graduate). But how did such a clever man believe in such a stupid thing?

How did so many very clever technology analysts believe in the ridiculous valuations on technology stocks in 2000? Why was Enron the most highly rated stock on Wall Street just months before it blew up?

There are many books on this subject and one in particular, *Extraordinary Popular Delusions and the Madness of Crowds*, is probably one of the best. We should also remember that Sir Isaac Newton, who explained to us why an apple falls to the ground and was arguably one of the brightest men of his generation, lost £20,000 in the South Sea Bubble crash. In 1720, £20,000 was an awful lot of money!

Time to talk about today and how we have moved from the sublime to the sub-prime.

In 2004 I was sitting in my hotel room in New York reading a daily tabloid and began to flick through the hundreds of adverts. I was horrified to see the number of adverts for mortgages and one of them said: “Instant finance available over the phone, no job, no income, bankruptcy no problem!!!”

Some of you will hopefully remember me reading from that advert at many talks that I gave through 2005. I then started using the Shiller chart on long-run “real” US house prices in all of my presentations to illuminate the parabolic and, moreover, unsustainable nature of US house prices.

That’s all history now and we need to discuss the recent market turmoil and attempt to determine what it all means. My first big picture observation is that we have moved from a period of credit expansion to one of credit contraction.

It is important to recognise that the sharp rise in US house prices led to a commensurate surge in home equity extraction or Mortgage Equity Withdrawals (MEW). From 2001 to the end of 2006 more than \$2 trillion was borrowed in the form of MEW.

Most analysts agree that approximately 50per cent of this was spent on discretionary items and hence we can agree that the key driver of consumer spending in America was that Americans turned their homes into glorified ATMs.

Now that house prices are declining, MEW is also declining and this will serve to weaken consumer spending in the years ahead.

Most analysts, economists etc. have to date suggested that the weakness in housing was not a real problem since the rest of the economy was strong. I have never followed this logic since it would appear that they are completely ignoring the link between housing, MEW and consumer spending and given that consumer spending accounts for 70per cent of the whole economy I have found this argument quite bizarre.

Similarly, there appears to be this fundamental and all-pervasive belief that US house prices

never fall. Well guess what? This time is different, as house prices are now declining and they are going to decline further.

Let’s now discuss the linkage between housing and the capital market turmoil. According to the National Association of Realtors (NAR), 40per cent of all first time home buyers in 2005 and 2006 put no money down. Similarly, we had an explosion in lending to sub-prime borrowers.

The numbers are as follows: \$110 billion in 2000, \$175 billion in 2001, \$300 billion in 2002, \$474 billion in 2003, \$647 billion in 2004, \$805 billion in 2005 and \$722 billion in 2006. To make matters worse we saw the creation of NINJA loans (no income, no job and no assets).

We also saw a surge in the issuance of option Adjustable Rate Mortgages (ARMs). These are mortgages which have a discounted rate for the first two years and then reset at a higher rate. It is estimated that approximately US\$500 billion of these adjustable rate mortgages will “reset” up by about 2per cent through the course of 2007 and a further \$700 billion will reset next year.

Now the housing optimists (rapidly becoming an endangered species) point out that sub-prime mortgages make up only about 12-14per cent of the \$11 trillion mortgage market and hence the broader mortgage market would be largely unaffected by the inability of the less creditworthy to pay their bills on time. This was the prevailing consensus up until a few weeks ago.

What changed? Hello CDO! Forgive me while I give a very simple explanation of what a Collateralised Debt Obligation is. Let’s start by thinking of a CDO as a mutual fund of various securities.

The CDO manager acquires a range of securities and “bundles” them up into a CDO. The next step will answer your question as to how does sub-prime junk become a AAA security.

This wave of the magic credit wand is due to the process of “tranching”. Some parts

or tranches of the CDO get a higher credit rating than the underlying collateral or securities due to the subordinated structure of the CDO.

Imagine there are three tranches to a CDO: Senior, Mezzanine and Equity. Payments from the underlying bonds go first to the senior, highest-rated AAA obligations and then to the next highest tranches in descending order.

This descending ladder of subordination means that the investors in the senior piece or tranche are protected by the tranches below.

Hence we can see how the sub-prime virus escaped and contaminated the broader capital markets because as defaults rose on sub-prime mortgages, those that had been securitised and held in a CDO and which began to default, were first absorbed by the most subordinated junior/equity tranche.

Now in "normal" conditions CDOs were modeled or structured to a given default level, however, the surge in sub-prime defaults over the last several months was extreme and has led to rating agencies downgrading the credit ratings of many CDOs.

Now we get to the second leg of the contagion. CDOs have no active secondary market and are priced on a "marked-to-model" basis, ie. a theoretical price according to a rather complex valuation model. Then came the Bear Stearns story and this was the "Look the Emperor has no clothes" shock which sent the market into turmoil. Bear Stearns had two funds packed with CDOs which they had significantly leveraged. Various investment banks, which had provided the leverage to Bear Stearns, attempted to sell the underlying collateral (the CDOs) and found that in some cases that they were being offered only 20 to 50 cents on the dollar. At this point Bear Stearns decided to bail out the two funds. An ironic footnote to this discussion is that Euromoney magazine named Bear Stearns as "Best in risk management in the US" in 2006. The Bear Stearns episode led to a contagion of risk reduction across the capital markets.

Credit spreads soared as we saw a massive re-pricing of credit risk and de-leveraging across the entire capital markets.

In some sectors we have experienced serious liquidity issues and in the case of CDOs: no liquidity. We should not forget that the CDO market is \$2.6 trillion in size.

In essence, the capital markets moved from thinking about the "return ON capital" to the "return OF capital".

So let's get back to thinking about what all of this means. The root cause of this current financial market contagion is the NINJA loan and what it represents.

Too much money was lent to too many people who couldn't afford it and all of this was predicated on the expectation of ever-rising house prices.

These sub-prime loans were then securitised and re-packaged, eventually finding their way into the CDO market. If you then add layer after layer of leverage and then someone shouts "The emperor has no clothes" and we find we can't sell the CDOs and no one actually knows how to value them, you have a serious problem.

We must at this point highlight that the securitisation process has led to a significant disintermediation of credit risk and hence the banking system is better placed today to weather the credit crunch than in prior episodes such as the Latin American debt crisis in the early eighties.

Today, however, we face a capital market credit crunch and we must acknowledge that having seen a long and powerful period of credit expansion, we now face a period of credit contraction. The multipliers are now in reverse.

This will lead to an inevitable further slowing in the US economy as consumers look to reduce their levels of debt.

MEW will decline further, house prices will decline further as will housing starts.

In addition, foreclosures will rise and many people will walk away from their homes.

Having been very negative on the US economy, I have as yet not had the courage to forecast a recession, which is statistically defined as two consecutive quarters of negative growth.

At the end of last year, my forecast for US GDP in 2007 was 1.5 per cent with the possibility of a negative first quarter. The first quarter came out at an annualised rate of 0.6 per cent and the recently reported second quarter came out at 3.4 per cent. The current annual or year on year rate of growth is only 1.8 per cent.

Firstly, let me say that we will soon have fond memories of the 3.4 per cent growth rate

achieved in the second quarter.

Growth is set to slow significantly in the months ahead and I now believe an American recession lies ahead in the next twelve months. I hope I'm wrong.

Now what does that mean for the global economy and financial markets?

I know I have said this many times over the last several years but I have to say it again: the global economy can no longer rely on America as its locomotive and it can no longer rely on the American consumer as buyer of last resort. The citizens of Estonia, Vietnam, India, China, Germany etc. now carry that burden.

Similarly, we must emphasize that equity valuations are not expensive and, in fact, with bond yields having fallen sharply in the last several weeks, relative valuations are quite compelling.

We must, of course, acknowledge that the E in the P/E is at risk in the scenario of a recession in the US but we still believe global growth will be reasonable, albeit slower than the markets have been predicting. Equity markets are currently in the phase of re-pricing to this new reality and hence more pain is likely.

Similarly, barometers of the market mood such as the VIX index which measure the implied volatility on the S&P500 show us that fear is rising and there is a much greater degree of uncertainty about the outlook. The US-dollar 10-year swap rate, which is a very good proxy and barometer of credit risk, has similarly risen sharply.

It is these two indicators which will best provide us with an insight into the extent of the capitulation in markets. As of now we have yet to see a complete capitulation.

In summary we see significant volatility ahead and this shall provide some with significant opportunity. We shall, as ever, look to participate in the potential upside and minimise the downside.

All the best



**Jonathan Pain**

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