

Economic Commentary



Central Plains Advisors, Inc. • 100 N Broadway Ste 130 Wichita, KS 67202-2212 • Economic Consulting & Investment Management

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Risk and Leverage in Every Nook and Cranny

Here come the lawyers! The cracks in the financial markets are beginning to show. Bears Stearns, one of five big investment bankers on Wall Street, is facing serious trouble with two of its sponsored hedge funds. It already has borrowed \$3.2B to shore up one. What will come next? We understand that the sub prime mortgages are what have brought the company grief. There have been several smaller hedge funds to bite the dust earlier in 2006 and 2007. However, this is the first to draw the attention of the markets. We believe there will be many more to come. The strength in the economy has been the financial sector all along. Their belief that the Fed will come to their rescue if trouble rears its ugly head has led them to take on leverage and risk in every nook and cranny. It has been nothing more than an old-fashioned Ponzi scheme dressed up in "new era" clothing. Please analyze the following blog on Bear Stearns' problem taken from Mish's *Global Economic Trend Analysis*.

The Mark to Market Iceberg
Earlier this year I was struggling to figure out exactly what I was missing with respect to Collateralized Debt Obligations (CDO) structur-

ing. Specifically, I wanted to know why is the market so sanguine in the face of deteriorating collateral values in the mortgage market? One of my firm's theses has been that as the mortgage market deteriorates, investors holding CDO as an investment would realize losses and this would feed into other risky asset classes. Why aren't losses being seen when the market is so clearly deteriorating?

So I asked a large broker firm to send over its smartest math person on CDO structuring. The team that came over was headed by a very smart gentleman. He was very good at math and very straightforward. Working for a broker, I was prepared for some sugar coating. I didn't get any.

The answer is simple and scary: conflict of interest.

He explained that due to the many layers of today's complicated credit products, the assumptions used to dictate the pricing and outcome of CDO are extremely subjective. The process is so subjective, in fact, that in order to make the market work, an "impartial" pricing mechanism must exist that the entire market can rely upon. Enter the credit agencies. They use

their models, which are not sensitive to current or expected economic activity, but are based almost entirely on past and current default rates and cash flow to price the risk. This, of course, raises two issues.

First, it is questionable whether "recent" experienced losses over the last few years really represent the worst of the credit market (conservative). But, even more importantly, it raises a huge conflict of interest: the credit agency's customers are the very issuers of the tranches they rate. The credit agencies, therefore, need to compete for business based in part on the ratings they are willing to give these tranches. As a result, they will only downgrade when forced to by experienced losses; not by rising default rates, not a worsening economy, but only actual, experienced losses. Even more disturbing, they will be most reluctant to downgrade the riskiest tranches (the equity tranches), since those continue to be owned by the issuers even after the deal is sold.

So even though the mortgage market has deteriorated substantially, mark-to-market losses by those holding the CDO paper have generally

not been realized, simply because the rating agencies have not changed their ratings for all of the above reasons. Accounting rules only require holders of the paper to mark prices according to the accepted model, not actual prices.

I asked them what would force the rating agencies to change their ratings. The response was, "it's just a matter of time. If the market continues to deteriorate, the agencies at some point will be forced by the cumulative losses to acquiesce." Because these losses have been compressed, any re-adjusting of ratings by these agencies is likely to result in a massive repricing of risk. We may be there now.

Three Words: Mark to Market

* CDOs are so illiquid—meaning they trade so infrequently—there is no market to mark them to.

* OK, then how are they valued?

* With models that the major credit agencies use based on past and current default rates and cash flow.

* Wait a minute, if the models are based on past and current defaults, what happens if there is a sudden surge in defaults... like we are experiencing right now?

* Nothing.

* And doesn't this raise conflict of interest questions between the credit agencies and their cus-

tomers?

* Yes.

* In fact, this is an issue Minyanville Professor John Succo wrote about more than a month ago and again today.

* The bottom line is that even though the mortgage market has deteriorated substantially, mark-to-market losses by those holding the CDO paper have generally not been realized because accounting rules only require holders of the paper to mark prices according to the accepted model, not actual prices.

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\$3.2 Billion Margin Call at Bear Stearns

Bear Stearns has a \$3.2 billion rescue plan [read margin call] in the works that could spur a takeover of Bear Stearns itself if it fails.

If Bear Stearns Cos. loses a lot of money trying to bail out one of its struggling hedge funds, the bank could be acquired by a rival, an analyst at Merrill Lynch & Co. said on Friday.

Bear Stearns (BSC) unveiled a \$3.2 billion rescue

plan for its in-house High-Grade Structured Credit hedge fund after it was hit hard by mortgage-derivatives trades that went awry.

Before that, Bear had only invested \$35 million in the fund and another more leveraged vehicle called the High Grade Structured Credit Enhanced Leveraged Fund and it hadn't lent any money to them.

But now the bank has "meaningful exposure," to one of the funds, analyst Guy Moszkowski wrote in a note to clients of Merrill Lynch. Bear Stearns is one of the leading players in the mortgage market, so the bank should be able to extract value out of the fund's assets, given enough time, the analyst said.

However, Moszkowski estimated that if Bear Stearns loses half the amount of its loan, that would knock roughly \$7 a share off its net earnings in a year. That's about half this year's forecast profit, the analyst noted.

He added that if such losses mount, Bear Stearns could become vulnerable to a takeover.

"If the firm is not able to resolve its position without a meaningful loss, we think the likelihood of a sale rises materially," Moszkowski wrote in the note.

The manager of Comstock

Funds had the following to say about the Bear Stearns.

The near-collapse of two big Bear Stearns hedge funds heavily invested in highly-speculative packages of subprime mortgages indicates that the severe housing recession is spreading to the financial arena and is threatening the occurrence of systemic fallout. It is estimated that various institutions own about \$6 trillion of mortgage-backed securities of which about \$800 billion are subprime. About 13% of subprime mortgages are currently in default, and foreclosure rates on these loans are soaring.

In addition about \$2 trillion of mortgage securities are backed by adjustable rate loans (ARMS) that have been or will soon be reset at higher rates. An estimated 29% of all mortgages issued in the last three years were ARMS. Home buyers who took out ARMS in 2004 have already seen their rates rise by about 40%, adding about \$290 a month in additional payments on a \$300,000 mortgage. Many of these buyers will not be able to refinance at fixed rates as a result of higher mortgage rates and stricter regulations that will disqualify would-be borrowers.

There are undoubtedly a large number of other hedge funds with portfolios similar to those of Bear

Stearns, and it appears that, in the vast majority of cases, the securities have not been marked to market. The big fear is that any auction of the Bear Stearns holdings will expose the true price of all these holdings and result in immense losses with an unknown, but potentially dangerous chain reaction throughout the financial system. The ratings agencies have generally given these securities high ratings and have only recently started to slash their grades. Last week Moody's cut ratings on 131 bonds backed by pools of subprime loans and are reviewing 247 others, including 111 it had recently lowered. This could force the sale of bonds that were cut to "junk" from "investment grade" and result in significant portfolio write-downs.

The problem is that what we've seen to date is probably only the tip of the iceberg. David Viniar, Goldman Sachs CFO, and former head of firm-wide credit risk, states that "I continue to believe that we haven't seen the bottom in the subprime market. There will be more pain felt by people as that works through the system." Ara Hovanian, CEO of big builder Hovanian Enterprises said, "There isn't a recovery about to happen." SEC Chairman Christopher Cox stated that "Our concern is with any potential systemic fallout." In our view the potential effects of the falling

housing market on both the economy and the financial arena puts the stock market in an exceedingly risky period ahead.

One can easily see what the problems will be. The lawyers are sure to go after the bond rating agencies, fund sponsors, and the brokers who sold them. Also look for Congress to hold endless hearings, etc. It is our opinion that when this is over, Enron will look like child's play.

Since the recession of 2001, this entire recovery and expansion has been built on the false signal of low short-term interest rates engineered by the Fed. Why do we say that? Before the Fed came along, supply and demand was the dominant factor in determining interest rates, along with—of course—*inflation*. No more. Holding short-term rates at 1% for a long period of time allowed the financial engineers on Wall Street to develop all forms of instruments that appealed to borrowers and lenders alike. Keep in mind it was a *false signal*, not based on the "true" economic conditions. All such endeavors at the margin never come to a good end.

Armed with low cost loans, the financial engineering party began. As markets continue to advance, all is well. When they begin to decline, all is not well. One cannot be sure that a ma-

major decline in asset values is underway; however, homeowners will testify that they have. And, as we have suggested many times before, common stocks, housing values, commodities, and less than top quality bonds remain very much overvalued.

Earlier we talked of the Federal Reserve coming to the rescue. Please note the following chart depicting such rescues in the past. After each one of the stated problems, the Fed did its work. The problem is that it is now expected, so that market participants take more and more risk. We wonder—has the hole been dug so deep even the Fed cannot help? That, my friends, is the \$64,000 question. There will be a time it won't work.

Slow to No Growth
At the same time that sus-

pect mortgage loans are placing pressure on financial intermediators and investors alike, the consumer is lowering his use of borrowed money. This is occurring for various reasons, maybe the most important being the stiffening of lending standards, as well as the need for the consumer to replenish his liquidity. Please note the following seasonally adjusted annual levels of total household borrowing.

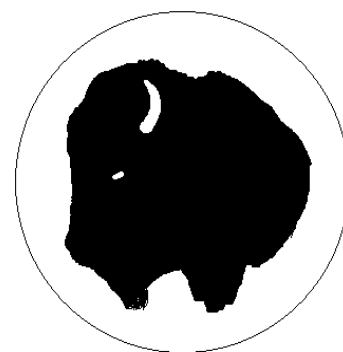
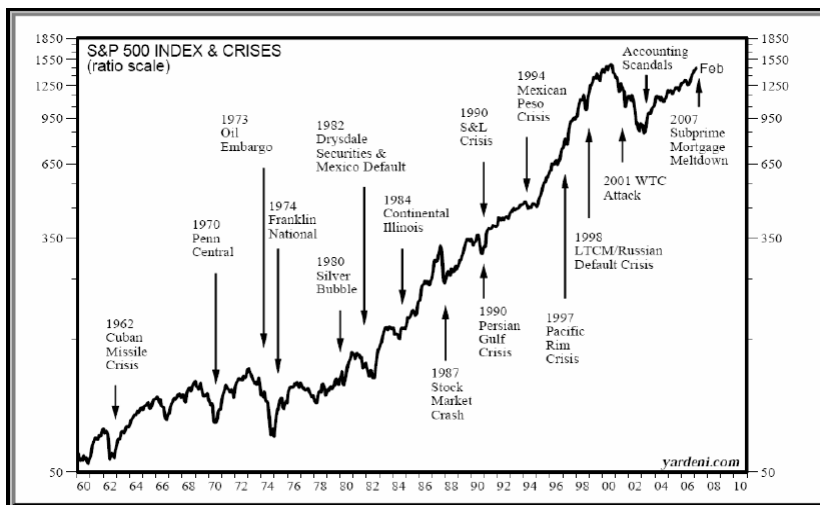
1Q 2007	\$770.7B
4Q 2006	\$906.8B
3Q 2006	\$973.9B
2Q 2006	\$1,111.2B
1Q 2006	\$1,094.3B

*2.1 Federal Reserve
Flow of Funds Report*

Within these numbers, mortgages have declined sharply while consumer credit has increased. One need only look at the retailers to understand that the consumer is facing

money problems. Retail sales on a year-over-year basis have declined for three months in a row. Wal-Mart sales are nearly flat. Target announced its year-over-year same-store sales would be at the low end of their recent forecast. Those in the household furnishings area are experiencing slow sales. Just ask Bed Bath & Beyond, among others.

The hope remains that business capital spending will pick up the slack that the consumer is creating; however, recent durable goods orders seem to indicate that this may not happen, at least to the extent Wall Street expects. Slow to no economic growth appears to be in the cards, despite the fact that the second real GDP will likely be somewhat better than the first quarter.



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