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Expert Advice

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Credit Problems Hit Stock Market

Investors have been jolted lately with a bout of volatility and a sharp, quick correction that knocked the major averages 10% from their peaks. The primary source of this anxiety is the credit markets whose problems began with housing.

The housing bubble has burst

The volume of activity over the last several years was excessive, and well above any normalized trend based on population growth. There was real activity, but it was not sustainable. Moreover, potential homeowners were stretching to buy a home: Industry sources report that **almost half of all loans in 2006 were to non-prime borrowers!** It is becoming clear that many of these loans should not have been made.

The housing boom was fueled by financial innovation

In the past it was typical for a mortgage originator to hold loans on its balance sheet, giving it a financial incentive to make good loans. But in today's world the loan is usually combined with other loans into a mortgage-backed security (MBS) and then sold to investors. The mortgage lender made money based on loan volume, **not** loan quality. As long as there was someone to buy the MBS, the incentives were to do as much lending as possible. Last year many loans were written as "no money down" and "no-documentation" loans, also called "liar loans." Individually these loans had low ratings. But through the alchemy of high finance by combining them into a clever package of MBS, the rating agencies slapped a triple-A rating on upwards of 85% of these loans. With a triple-A rating many institutions, especially foreign investors looking for higher yields for their vast dollar denominated savings, gobbled up these securities.

Signs of trouble first emerged with the subprime lenders. Although these companies sell the mortgages they originate to investors, in most cases they are obliged to buy back the security if the loan quality and their underwriting is poor. Shockingly, many 2006 borrowers didn't even make one payment. **The subprime lenders were forced to buy back many of these securities at the same time their funding source dried up.** The result has been massive bankruptcies.

How did the mess in the subprime mortgage business evolve into a broader credit crunch to the point where banks will not lend short-term money to each other unless it's at a punitive interest rate? The answer is again financial innovation. The benefit of our current system of securitization is that it spreads the risk through the global financial system. The problem we are witnessing today is the complexity of the system. No one is sure how many bad loans there are, how to value the asset-backed securities since in many cases there is no active market where they trade, or even who exactly owns them. Mortgage lending, formerly the business of Main Street has become so dependent on Wall Street that when the buyers of mortgage paper diminish so does the volume in the banking system creating a vicious cycle of illiquidity. Therefore, banks are now reluctant to make even short term loans to each other secured by these exotic securities and credit is freezing up. To bring confidence back into the banking system the Fed has been providing liquidity and lowered the discount rate. Unfortunately, the Fed can't make all these bad loans go away.

One key question for investors is how this saga will play out. There has been a steady drumbeat from the financial community for the Fed to be more aggressive and lower the Fed funds rate and that magically all these problems will be solved. We're not so sure. We believe it will take years to work through the excesses of the last few years regardless of what the Fed does. Just look at the example of Freddie Mac and Fannie Mae, the government-sponsored agencies that owned many complicated securities and had sloppy accounting. It is taking years and billions of dollars to fix their books and value their portfolios, and the job still isn't completed!

Fortunately the rest of the investment landscape is in pretty good shape: interest rates are low, jobs remain plentiful, corporate earnings continue to surprise on the upside, the worldwide economy is strong, and stock valuations are reasonable. Besides a spreading of the credit crunch discussed above the biggest risk is that U.S. housing woes crimps consumer spending to such a degree that it drags down the worldwide economy. Instead of crippling the world economy the more likely effect will be a dampening of global growth from its scorching pace of 5% over the past two years. This outcome is not all that bad because it should keep inflation in check.

We believe the best investment approach is to be cautious with financial companies and those focused on the U.S. consumer while emphasizing companies with global operations, strong balance sheets and attractive valuations. Despite the problems discussed above, companies with these characteristics should continue to please investors with rising profits and stock prices for years to come.

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