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An Ongoing Dialogue from
The Delta Group

REVENGE OF THE 1 % LOAN (part II) Oct., 2007

Last March, we spoke of the downside of free wheeling days of Easy Alan: Alan Greenspan's loose credit policies following the 2000-2002 stock market meltdown. Easy credit found its way into the real estate market via lenders, mortgage brokers, realtors, et al, whose personal financial gain superseded their fiduciary duty of responsible lending.

Mortgage loans with interest rates as low as 1%, legitimized by ever rising house prices, drew (read: sucked in) questionable home buyers to purchase inflated property with below market interest rates. Given the circular nature of markets, we expected rising foreclosures and the slowdown in real estate construction, home sales, etc. to have a negative effect on the economy (now estimated at ~1% GDP subtraction over the past year.)

Interestingly, the economic slowdown has not been nearly as damaging as the meltdown in the "subprime" credit market place. Logically, delinquencies and foreclosures substantially reduce the value of these loans. However, the wizards of Wall Street packaged these loans, sold and resold them via the derivative (read leverage) market place, adding risk and volatility to an otherwise mundane security. Consequently, small declines in collateral value cause massive losses in hedge fund (the buyers) asset values, which in turn come back to burden the investment banks who packaged these products. More worrisome, legitimate but increasingly nervous lenders have begun to balk for all types of loans. The fear of rising credit standards and the resulting credit crunch and liquidity crisis is spooking investors.

The stock market panicked accordingly and the sell off and volatility continue. On the positive side, the economy remains resilient and the worldwide growth story remains intact. The Fed will be motivated sooner rather than later to cut rates to preserve home ownership and bailout the Wall Street Wunderkinds. On the negative side, some $600 billion (that's billion with a "b") subprime variable rate loans will reset substantially higher during the next 18 months. The underlying problem can only get worse.

Until then, our investment posture should become more conservative until the credit meltdown is resolved.

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