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When Animals Attack

Here's one for you. You're headed out on a two week wilderness expedition and your choice of guide is: Paulsen, Mozilo or Bernanke. Who do you choose? Mozilo seems like the most obvious reject. I mean, having to lug around that tanning bed could get old really fast. Between Paulsen and Bernanke, we'd call it a toss up. Truth is, any of them would probably do nicely. For, while you'd never guess it to look at their bespoke suits, slicked-back coifs and year-round glows, our financial dilettantes know a surprising amount about outdoor survival.

Drawing upon what we can only assume are lessons gleaned from hours spent watching *When Animals Attack*, their initial response to the subprime problem was to "Show No Fear". If we just go about our business and pretend that everything's fine, they figured, the threat would go away. Thus, with unflinching bravado they continued to mark-to-myth, even as the mortgage market went into freefall. The hope being that the Credit Bear would conclude they were *not* its prey and lumber back to his den. Alas, it appears this fella's not going away. Quite the contrary, the financial sector's efforts to conceal its wounds (hiding them behind Super SIVs, etc.) have only served to pique his interest.

Finding themselves drawn into his mortal embrace, his breath warm on the back of their necks, our financial leaders have adopted another Outdoor Survival tactic: *Play Dead.* From Florida freezing withdrawals from its subprime-contaminated state fund, to European banks freezing trading in their covered bond market, to Paulsen's proposal to freeze ARM resets, *playing dead* is the new black. Investors in mortgage-backed securities, and/or the financial institutions that hold them, have curled up into the fetal position with the idea that **if they lay still long enough, the bear will get bored and go away.**

While we admire this respect for the laws of nature, it will come as no surprise to MacroMaven-ites that we're not entirely convinced feigning death is the solution to our problems. (Unless, of course, we're talking about the policymakers themselves. In which case, death—faked or otherwise—has a certain charm). **Judging by the reaction of the folks in the front-row, we're not alone in our skepticism…**

No surprise there. In the case of Paulsen's proposal, it is conspicuously long on promise and short on detail. Having just resolved the looming questions of which loans will qualify and how long they will be frozen, **Hank now faces the challenge of: (1) Identifying who actually holds these loans** (which will require the

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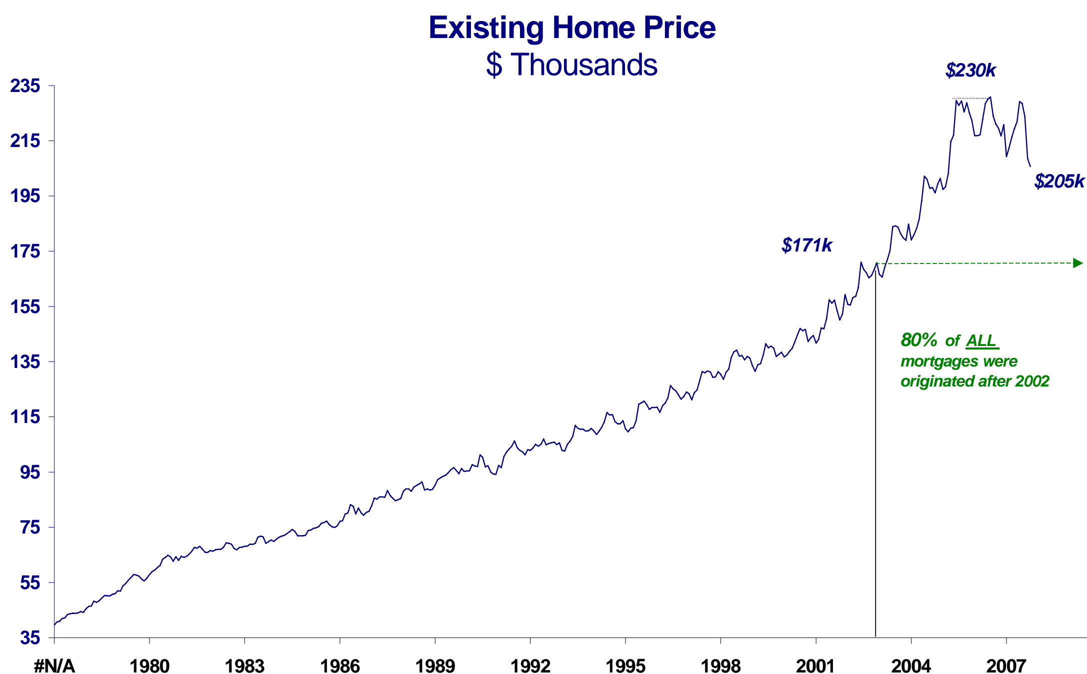
help of Daedalus to navigate the securitization maze). (2) **Cajoling these lenders to accept the modification** (aka, the Goldman mafia "makes them an offer they can't refuse"). And (3) **persuading the bevy of lawyers now salivating on the sidelines** (the Q-election now about to be tainted) **that the proposal is NOT an early Christmas present.** Oh yes, I almost forgot. **At some point they'll have to figure out what happens to all the derivatives** (you know, the CDOs and all that jazz) that are structured on the income streams *no longer being generated* by these frozen ARMs. *Sigh*.

Truth be told, **these are just minor quibbles**. Assuming the Hanky-Panky-Bernanke-Bailout-Crew (try saying that 5 times fast!) figure a way to overcome these obstacles and freeze subprime resets, **they would only succeed in convincing the bear they were dead *temporarily*.** Per the industry's own estimates, **35-40% of modified mortgages end up in default within two years.** That probably explains why only 1% of loans ever end up being modified! One can't but wonder: If the free markets have determined this isn't a viable solution, why should the government hope to enjoy any greater success? The question grows even more pressing when you consider that this grim history is based on NON BUBBLE experience.

This is the key. **In all the focus on the reset minutiae, the *real issue* continues to be ignored. It's called: ASSET DEFLATION.** Sure, rising mortgage rates aren't helping matters. But rate resets haven't been the primary cause of delinquencies thus far. The problem has been **that homeowners bit off more mortgage than they could chew** from the get-go. Most of them, doubtless, **operating on the assumption that within a matter of weeks or months their homes would appreciate by enough that they could refi.** After all, everyone from Greenspan on down assured them that home prices absolutely NEVER decline. So, in the rare case they were even asked such impertinent questions, borrowers took a little license with their reported income and assets. As the WSJ highlighted earlier this week, many subprime loans were actually made to high-quality borrowers who simply didn't want to disclose assets or income...the property flipping crew. Based on what we know thus far, none of these folks will be eligible for help under the Paulsen Plan.

Point is, **even if Paulsen manages to overcome the *considerable* odds and stop subprime ARMs from resetting, he won't have frozen diddly-squat.** As reported last week, the mauling continues, with home prices now back to levels of mid-2005. At the risk of connecting the unpleasant dots, this means, in essence, **anyone who bought an existing property with little or no money down over the last two+ years is now in some state of negative equity.** (Once again, our hat's off to Mr. Greenspan).



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While Paulsen's been busy brokering his non-bailout-bailout, first for SIVs and now for Subprime in general, things have gone from bad to worse. When we first put together the table below, at the beginning of the year, 17% of all Adjustable Rate Mortgages were in some state of negative equity. Thanks to the –6.8% decline in home prices in the 10 months since, **a stunning 33.6% of ARM holders have now been ensnared in this net.** That represents just over $1trillion in mortgage debt. **Outright losses to lenders on these delinquencies are likely to range anywhere from $300-500b.** In other words, estimated losses have *doubled* since just the beginning of the year. Ah yes, **asset deflation and leverage…'tis a lethal combination**.

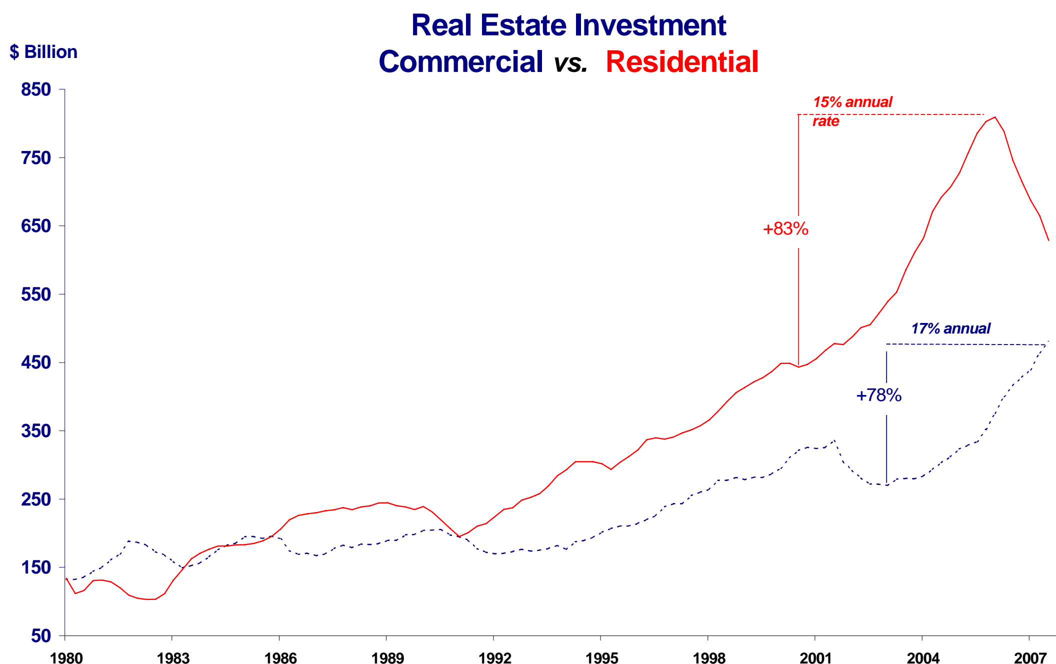
Estimated Mortgage Losses (ARMs only)

Existing Home Price	% of ARMs in Negative Equity	$ amount of ARMs in negative equity	Losses (assuming 70% recovery)	Losses (assuming 50% recovery)
2006	17.0%	$510b	$153b	$255b
Today	***33.6***	***1008***	***302***	***504***
-5%	42.1	1263	379	631
-10%	50.6	1518	455	759

**compiled using data from LoanPerformance (FARES), Fannie Mae*

As further highlighted above, should home prices continue to decline (which, considering that we've yet to make a *dent* in moving the 5+million units of unsold homes, seems inevitable) losses will continue their geometric rise.

You don't have to be Survivorman to know that **nothing ruins a good fake death like uncontrolled twitching.** As housing deflation causes more and more borrowers to writhe in pain, the bear will move in for the kill. *"Mmmm…lunch!"* To say nothing of all the other involuntary spasms that will betray our helplessness. Once again, what we're dealing with here is a bubble and that is, by definition…NOT contained. The reckless lending that took place in the residential mortgage market was equally in force in Credit Cards, Commercial Real Estate and beyond. Indeed, per figures released last week, the **commercial real estate bubble is now inflating even *faster* than its residential predecessor.**



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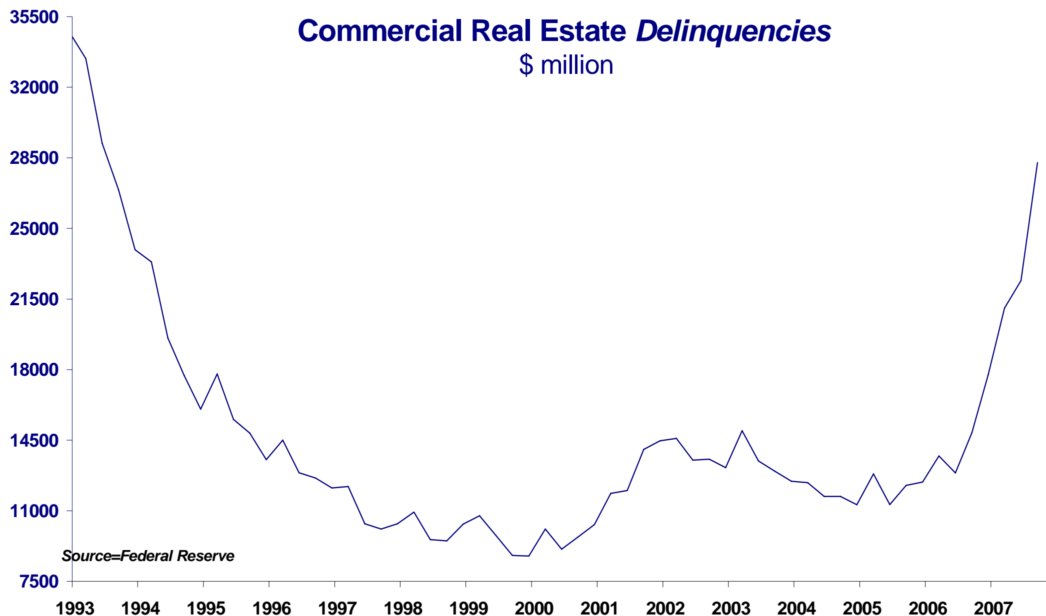
Hold on to your hat, 'cause this is a shocker. After all this aggressive lending, Commercial Real Estate delinquency rates have begun to soar. *Imagine!* In its hot-off–the-press 3rd quarter bank roundup, the FDIC reports that **Real Estate Construction and Development loan delinquencies are up 45.5% y/y, nearly double the 27.2% rate of gain in residential delinquencies.**



Here's another nifty nugget we gleaned from the FDIC's report: at the end of the 3rd quarter, **27% of lending institutions had Construction loan portfolios that *exceeded their total capital*.** YIKES!!!!!!! **Guess we know what'll be next on Paulsen's To-Do list.**

Which brings us back to the larger point. Again, **this is not a regular economic cycle. *It's a bubble*.** Those who persist in analyzing the economic and financial outlook through a standard cyclical lens do so at their own great peril. The comparisons today are to: Dot-Com (2000), Japan (1989-90) and the Great Depression. (Sorry, but that's how we see it). As Paulsen and his pals will soon discover, **subprime is not 'the' problem. It is simply the weakest link in a much larger credit chain.**

Mopping up this mess will take a lot of time ...*and money*. As we've admonished for months, **every dollar lenders are forced to commit to repairing their balance sheets represents *many multiples* that cannot be lent**. A certain mainstream economist recently dared to do the unthinkable—namely, his job. Whipping out his calculator he undertook the basic multiplier math on the mortgage losses thus far. (Math which, by the way, we did two months back in "Mission Accomplished"- 9/7/2007). His findings elicited shock and awe around The Street. As yet it's unclear what had the greater shock value: the estimated $2t reduction in borrowing (virtually identical to our own figures), or the fact that a sell-side institution had the temerity to utter a discouraging word. *It is amazing that the serially-bullish forecasts proffered by this and other institutions failed to arouse any suspicion for the past, call it, 20+years. But the moment they dare impugn the strength of the US economy the media calls a flag on the play and baby-kissing pols (Chris Dodd, we're looking at you) come rushing in. Sorry, just had to vent.*

Having walked into the hay-baler, our intrepid Herr probably has little interest in updating the outlook for loan growth to reflect the new mortgage loss projections. So, here it is. As cited frequently in these pages, **the last time banks were in this type of predicament** (following the Dot-Com bust) they were forced to add $12b to their loan loss reserves over the next year and half. Small though this task seems in hindsight, it was a powerful distraction at the time, **with lending activity declining $450b over the period**. *That implies a multiplier of roughly 40x!* Even if we assume a more conservative figure, like 10x... on the $300b-$500b in losses, that would mean **$3t-$5trillion in lost lending**. *How d'ya like them apples, Mr. Stein?*

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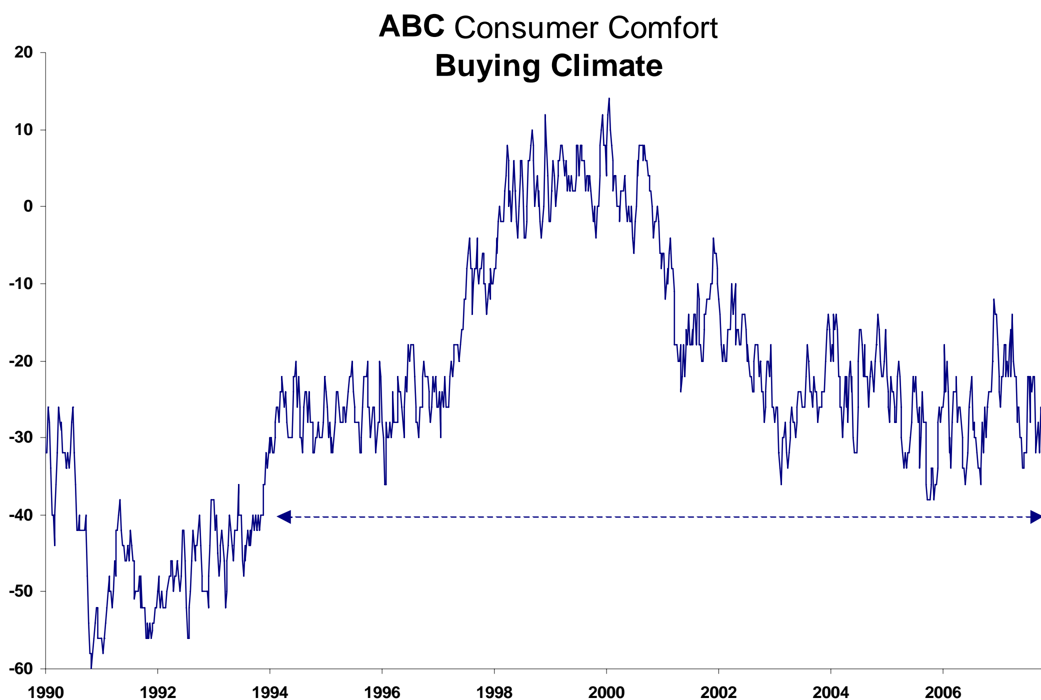
Fact is, these numbers are so huge as to be inconceivable. Literally. Few care to imagine what would happen to an economy which has required $2t in fresh credit just to generate $600b in growth, over the last year, if lending actually slowed by that much. Yet **it seems obvious that the reduction in lending will be many multiples of what it was following the Dot Com bust**. After all, even if we assume that every single $ of Commercial and Industrial loans on bank books in 2000 were to Dot-Com companies (an absurd overstatement) that would only represent 27% of total bank lending. In contrast, 61% of bank loans are tied to the bubble in question--real estate-- today. Not to mention the fact this increased exposure comes at a time when loan loss provisions are at all-time record lows. **At a paltry $87b, the total reserves of all lending institutions are handily dwarfed by the $300-$500b in mortgage losses *thus far.***

Let's **figure they take 5 years to plug this $213-$413b hole, that would require setting aside $42-82b/year. Apply our 10x multiplier and we're looking at $420b-$820b in lost annual lending**. Bad news for consumers, who require ever-increasing amounts of fresh credit just to sustain CURRENT consumption. Do we dare extend the math to include what this all implies for growth??? "Do bears...", *Er,* let's just say 'yes'. We do.

	Annual Loss Provisioning	Annual Credit Creation	Annual GDP growth ($)	Nominal GDP growth (y/y%)
2007 (thru 2Q)	$3b	$2000b	$600b	4.6
Year 1	62	1380	420	3.0
Year 2	62	760	240	1.7
Year3	62	140	60	0.4

As you can see, we've split the difference and assumed lenders add $62b a year over the next 5 years to reserves, reducing total credit creation by $620b/year. Under this scenario **NOMINAL GDP growth would pass thru its 3% recession threshold next year, on its way to 0% by 2010.** That would be the weakest print in 46 years. Basic decorum precludes us from putting it in print. But if we carry the math out to years 4 and 5, nominal growth goes negative. The dreaded 'D' word. If consumers think the buying climate is grim now...



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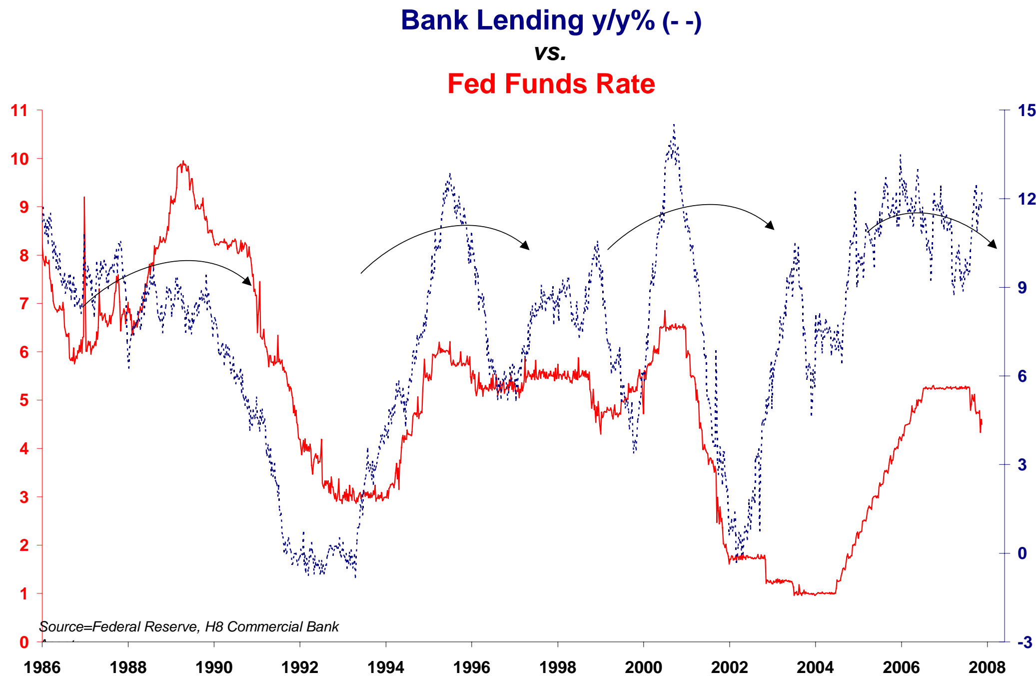
If only we could get it all over with in one shot…like ripping off a band-aid. But policymakers can't let that happen, as it would require taking (considerable) pain before an election. Even if they were willing to do so, **the banks can't begin to focus on repairing their balance sheets right now.** They've got a more pressing problem. Namely, how the heck to make good on all the loan commitments they made to one-time CP issuers. As these borrowers tap their backup lines of credit, the **banks have been forced to resist any logical impulse … and actually INCREASE lending into the credit bust.**



Worse still, they've been forced to BORROW to make these loans (see addenda), thanks to insufficient deposit growth. It is truly a comedy of errors. Only it's not funny. Here are the banks, facing record loan losses at a time when their provisions are woefully insufficient. But rather than begin to repair the damage, **they are being forced to, essentially, lever up their exposure to some of their weakest credits!**

Lest there were any doubt as to how we managed to get into our present predicament, the answer is also revealed in the chart above. Whereas the Fed usually greets the upturn in bank lending as the 'all clear' to lay off the gas, Greenspan continued to gun it for 2 *full years* after lending bottomed in 2002. *"No regrets", eh?* Greenspan's lack of contrition is hardly surprising. Policymakers live to meddle. But, **for all the reasons just outlined, we expect the inefficacies of the current PLAY DEAD policy approach will become clear soon enough.**

Maybe it will be the wheels coming off the CMBS market, which is already starting to happen (see addenda,) or home price deflation causing 'prime' borrowers to have trouble, or spending slowing A LOT. Whatever the ultimate cause, eventually, **policymakers will be forced to dispense with the quaint notion of orchestrating a non-government bailout.** The budget will expand to make room for extended unemployment benefits (to cover all the mortgage brokers, construction workers and CDO traders), homeowner's assistance programs and, who knows, maybe a distressed real estate fund that allows the government to 'invest' in the 5+million units of unsold inventory. (At just over $1t, the price tag on buying up that inventory is about on par with the current subprime losses).

In the meantime, those who haven't done so already should take this chance to run. Run away from anything even remotely tied to credit (housing, financials, consumer discretionary, to name an obvious few) and toward anything the credit bear can't devour (oil and gold). For, **impossible though it may be to outrun the bear, the key to survival is just running faster than Ben.**

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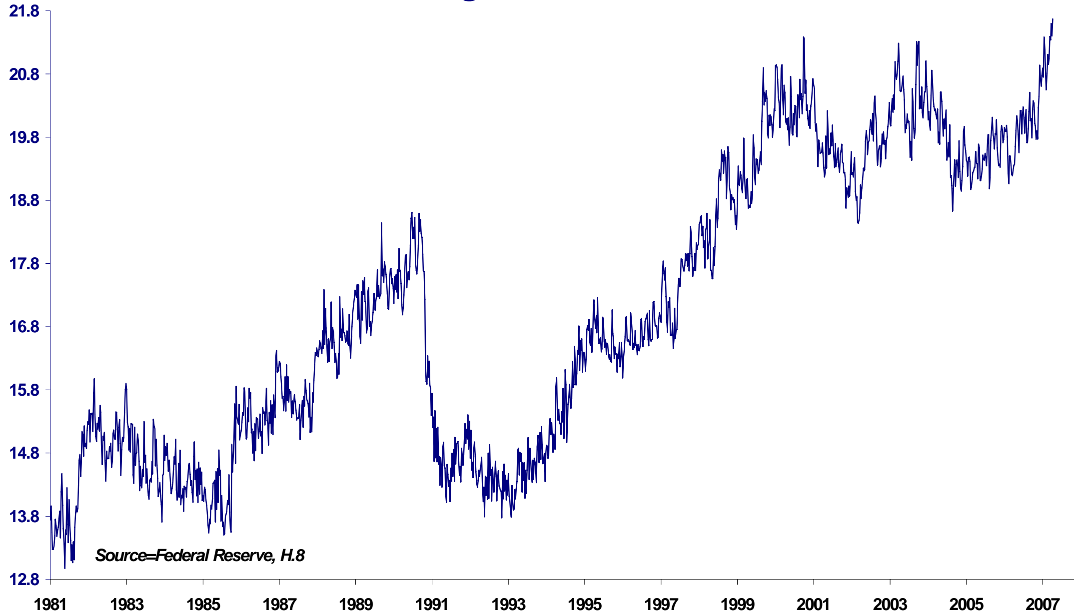

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