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Cover Story
Irrational Exuberance
Smoke and Mirrors
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The euphoria Wall Street displayed upon the announcement by the Bush Administration that the government's balance sheet would be used to park illiquid securities was spectacular. On Thursday and Friday, the Dow gained approximately 780 points, after losing as much in the beginning of the week on the news Lehman Brothers was insolvent and Morgan Stanley and Goldman Sachs were seeking suitors/mergers.

The rally over the last two trading days of the week can be appropriately characterized as irrational exuberance, a term coined by the chief architect of this credit bubble we are experiencing. To explain this position, it is essential that we ask three questions: 1) What measures are being taken; 2) What are the intended consequences; and 3) How do we protect ourselves from the failure of another rescue effort by a compromised and beleaguered Administration? Let's address these questions seriatim.

1. What measures are being taken?

The Bush Administration will submit a proposal to Congress for authority to purchase $700 billion in mortgage related securities and bonds. The Treasury will purchase, if necessary, other assets, after consultation with the Federal Reserve. Treasury may buy only assets issued or originated on or before Sept. 17. The Treasury would also have discretion, after discussions with the Fed, to make non-U.S. financial institutions eligible under the program. Treasury Secretary Paulson will have the discretion to act as he deems necessary to hire people, enter into contracts and issue regulations related to a revival of U.S. mortgage finance. The Administration is seeking the authority to implement this plan with insulation from review by the courts. The sunset provision of the proposal requires most components to expire after two (2) years.

2. What are the intended consequences?

The Treasury will remove worthless mortgage related assets from the balance sheets of financial entities unable to comply with regulatory capital requirements. The intent is to restore liquidity and confidence to the capital markets. First, the premise is faulty. Sec. Paulson and other economists have incorrectly identified sub-prime mortgages as the culprit.Unfortunately, the contagion has spread to Alt A, Option ARMS, and prime mortgages, the so-called agency paper (Fannie Mae and Freddie Mae). Hence, the GSE Regulator had to place the two mortgage giants into conservatorship on September 7th.

Paulson, as recent as last week, stated if we stabilize the housing market, we can begin to work our way out of this crisis.Sorry Hank, all classes of assets have been compromised, the exuberance displayed on Wall Street is irrational. The US has $12 trillion in outstanding mortgage debt. According to the Mortgage Bankers Association, at the end of the second quarter of 2008, over 9% of mortgages were 30 days delinquent or in some stage of foreclosure. Interim reports (Case/Shiller Index, National Association of Realtors and Commerce Dept.) indicate the market decline has escalated. Thus the $700 billion may be insufficient to accomplish what the Administration is attempting.

Next, the delinquent and foreclosed mortgages are just one of the symptoms of the much broader credit bubble. Commercial mortgages, credit cards, auto loans, consumer loans, and high yield corporate loans were underwritten to sub-prime guidelines also. Financial institutions originating these transactions merely winked at the underwriting standards because the assets and attendant risk were removed from their balance sheets by way of securitization. The loans were packaged into securities called Collateralized Debt Obligations (CDO). Unlike mortgage-backed securities which have mortgages as underlying assets, CDO's underlying collateral typically consists of several asset classes (a combination of auto loans, mortgages, consumer loans, corporate loans, etc.) with approximately half of CDO's having mortgages as an underlying asset.

According to Bloomberg News (March 13, 2008), there are approximately $2 trillion in CDO's, that are leveraged beyond the value of all the stocks in the US (Wall Street Journal, August 18, 2007).The $700 billion will not cleanup the toxic dump consisting of mortgage-backed securities. How much will the Administration add to that figure to ease the fallout from the CDO's? How will the Administration address the Synthetic CDO's and other derivatives with stratospheric notional values (see International Swaps and Derivative Association)? If you think that proverbial last shoe has dropped, I am here to tell you we are dealing with a centipede. The exuberance is irrational.

The Administration was aware of what they are telling us now, as far back as June, 2007, when two Bear Stearns hedge funds collapsed and certainly by August of 2007, when the markets seized up. To mollify the public, Bush offered a paltry $100 billion stimulus package, $300 billion anemic housing bill, and now this $700 billion bailout - all measures taken are too late and too little, which leads me to my final question.

3. How do we protect ourselves from the failure of another rescue effort by a compromised and beleaguered Administration?

Upon recognizing where we are today, we can decide "where do we go from here". The starting point is to unwind our credit positions and start accumulating cash. On Monday, September 8, 2008, Jim Cramer (CNBC's Mad Money) advised his audience to walk away from their homes if they are upside down. I do not watch the program for several reasons (until recently, Cramer was promoting investments in the equity markets and Cramer believed Sarbanes-Oxley would resolve the transparency issue challenging publicly trade companies) but my wife is an avid fan and she is aware that I have been an advocate of deleveraging since February, 2008, so she called me in a state of shock to announce that Cramer, on national television, encouraged his audience to walk away from a legally binding contract. This position was untenable a few weeks ago but so was the idea that the GSE's (Fannie, Freddie and the Federal Home Loan Banks) would require a bailout, AIG would need to raise $85 billion or Merrill Lynch would be bought for $45 billion in an all-stock transaction.

Deleveraging to some of you might present a moral dilemma. We have been socialized to believe it is unethical and dishonorable to walk away from our obligations. It is not immoral for one to free him or herself from a depraved encumbrance. Employ the line of reasoning in the "clean hands" doctrine of the law. A person (mortgagee/Wall Street) who has acted wrongly will not receive assistance from the court when complaining about the behavior of someone else (mortgagor/homeowner). Also, if Congress did not intend to provide relief to consumers from oppressive debt, the Supreme Court would have not held valid the Bankruptcy Act of 1898. Moreover, it is not economically prudent to remain in a house that will not accumulate equity for years to come due to declining values in that community or because of an inappropriate product used to finance that home.

Homeowners with mortgage balances greater than the market value of their home should re-evaluate the market conditions of their neighborhood and consider whether it is better to rent until the market makes the proper adjustments and save the difference between the mortgage payment and rent. In upside-down circumstances, one-half of the fiscal advantages to homeownership have been eliminated (equity accumulation) the other half (tax deductions) should be balanced against the disadvantages of remaining in the home. Seek advice from a HUD-approved housing counselor or a trained loss-mitigation specialist before you walk away. The same principle should be applied to most debt (auto/consumer loans, commercial loans, credit cards, etc.). Recognize where we are now.

I understand some consumers are fearful of what is behind the doors of foreclosures, bankruptcies and judgments. Many believe they will not recover if either of those credit events should happen to them. These fears can partly be attributed to a lack of information about the markets. Do not give up hope, our economy will not be the same in the future. We can prepare and inform ourselves for the new economy. Take solace in this historical fact, underwriting guidelines of today will evolve to accommodate market conditions of the future. To the extent a fairly large number of consumers will experience one or more of the above events, investors will adjust their guidelines to capture that market.

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