



Credit Bubble Bulletin, by Doug Noland

Respite's Over

October 19, 2007

The Respite from Credit crisis came to an abrupt end. For the week, the Dow was hit for 4.1% (up 8.5% y-t-d) and the S&P500 3.9% (up 5.8%). The Transports fell 2.8% (up 5.3%), and the Utilities were clobbered 4.1% (up 7.4%). The Morgan Stanley Cyclical index was slammed for 4.6% (up 16.3%), and the Morgan Stanley Consumer index dropped 3.4% (up 4.8%). The broader market was weak. The small cap Russell 2000 sank 5% (up 1.4%), and the S&P400 Mid-Cap index dropped 3.7% (up 9.3%). The NASDAQ100 declined 2.2% (up 21.3%), and the Morgan Stanley High Tech index fell 3.4% (up 17.1%). The Semiconductors declined 2.5% (up 1.5%). The Street.com Internet Index dropped 3.7% (up 19.1%), and the NASDAQ Telecommunications index sank 3.8% (up 21.3%). The Biotechs fell 2.7% (up 9.1%). Financial stocks were hammered. The Broker/Dealers dropped 7.6% (down 7.4%), and the Banks sank 7.7% (down 14.6%). The HUI gold index declined 2% (up 19.7%).

Crisis dynamics returned to the Credit market. Three-month Treasury bill rates collapsed 38 bps this week to 3.83%. Two-year government yields sank 45 bps to 3.77%. Five-year yields ended the week down 39 bps at 4.02%. Ten-year Treasury yields dropped 30 bps to 4.39%, and long-bond yields declined 21 bps to 4.69%. The 2yr/10yr spread widened 16 bps this week to 61 bps. The implied yield on 3-month December '08 Eurodollars sank 44 bps to 4.145%. Benchmark Fannie Mae MBS yields fell 20 bps to 5.78%, this week significantly under-performing Treasuries. The spread on Fannie's 5% 2017 note widened 4 to 46, and the spread on Freddie's 5% 2017 note widened 5 to 47. The 10-year dollar swap spread increased 2.8 to 64.5. Corporate bond spreads widened significantly this week as Treasuries went into melt-up mode. The spread on an index of junk bonds ended the week 22 bps wider.

Investment grade debt issuers included Wells Fargo \$3.0bn, Covidien \$2.75bn, Vodafone \$1.7bn, IBM \$1.5bn, McDonalds \$1.5bn, American Waterworks \$1.5bn, Yum Brands \$1.2bn, Washington Mutual \$1.0bn, Marriott \$400 million, and Nationwide Health \$300 million.

Junk issuers included First Data \$2.2bn, GTL \$1.0bn, Indianapolis Downs \$425 million, and Bausch & Lomb \$650 million.

Convert issuers included Rayonier \$300 million.

Foreign dollar bond issuance included Pemex \$2.0bn, Taq Abu Dhabi \$1.5bn, and Santander \$1.5bn.

German 10-year bund yields dropped 20 bps to 4.22%, as the DAX equities index dropped 2.0% for the week (up 19.5% y-t-d). Japanese 10-year "JGB" yields fell 10 bps to 1.60%. The Nikkei 225 sank 3.0% (down 2.4% y-t-d) Most emerging equities markets were hit by late-week selling, while debt markets mostly rallied. Brazil's benchmark dollar bond yields declined 9 bps to 5.71%. Brazil's Bovespa equities index declined 2.5% (up 36.9% y-t-d). The Mexican Bolsa gave back 2.0% (up 20.3% y-t-d). Mexico's 10-year \$ yields dropped 11 bps to 5.48%. Russia's RTS equities index slipped 1.0% (up 11.5% y-t-d). Volatility returned to India's Sensex, with this index falling 4.7% (up 27.4% y-t-d). China's Shanghai Exchange declined 1.4%, reducing y-t-d gains to 117% and 52-week gains to 225).

Freddie Mac posted 30-year fixed mortgage rates were unchanged this week at 6.40% (up 4bps y-o-y). Fifteen-year fixed rates added 2 bps to 6.08% (up 2bps y-o-y). One-year adjustable rates increased 3 bps to 5.76% (up 19 bps y-o-y).

Bank Credit ballooned an additional \$32.1bn for the week (10/10) surpassing \$9.0 TN for the first time. Bank Credit has now posted a 12-week gain of \$360bn (18.1% annualized) and y-t-d rise of \$707bn, a 10.8% pace. For the week, Securities Credit increased \$10.8bn. Loans & Leases jumped \$21.3bn to a record \$6.606 TN (12-wk gain of \$283bn). C&I loans rose \$13.3bn, increasing the 2007 growth rate to 22.3%. Real Estate loans increased \$7.9bn. Consumer loans added \$1.9bn. Securities loans declined \$2.2bn, while Other loans added \$0.3bn. On the liability side, (previous M3) Large Time Deposits rose \$22.4bn (5-wk gain of \$100bn).

M2 (narrow) "money" added \$1.0bn to a record \$7.385 TN (week of 10/8). Narrow "money" has expanded \$342bn y-t-d, or 6.1% annualized, and \$458bn, or 6.6%, over the past year. For the week, Currency gained \$1bn, and Demand & Checkable Deposits jumped \$16.5bn. Savings Deposits dropped \$25bn, while Small Denominated Deposits added \$1.2bn. Retail Money Fund assets increased \$7.3bn.

Total Money Market Fund Assets (from Invest. Co Inst) jumped \$11.5bn last week to a record \$2.920 TN. Money Fund Assets have now posted a 12-week gain of \$337bn (62% annualized) and a y-t-d increase of \$538bn (28% annualized). Money fund asset have surged \$659bn over 52 weeks, or 29%.

Total Commercial Paper added \$1.3bn to \$1.866 TN. CP is down \$357 bn over the past ten weeks. Asset-backed CP fell \$23bn (10-wk drop of \$279bn) to \$895bn. Year-to-date, total CP has declined \$108bn, with ABCP down \$189bn. Over the past year, Total CP has contracted \$27bn, or 0.9%.

Asset-backed Securities (ABS) issuance slowed to \$2.3bn this week. Year-to-date total US

ABS issuance of \$486bn (tallied by JPMorgan) is running 31% behind comparable 2006. At \$213bn, y-t-d Home Equity ABS sales are 53% off last year's pace. Year-to-date US CDO issuance of \$270 billion is running 4% below 2006.

Fed Foreign Holdings of Treasury, Agency Debt last week (ended 10/17) jumped \$14.4bn to \$2.018 TN. "Custody holdings" were up \$266bn y-t-d (18.8% annualized) and \$333bn during the past year, or 19.7%. Federal Reserve Credit was little changed at \$858bn. Fed Credit has increased \$5.9bn y-t-d and \$26.6bn over the past year (3.2%).

International reserve assets (excluding gold) - as accumulated by Bloomberg's Alex Tanzi - were up \$1.100 TN y-t-d (28% annualized) and \$1.240 TN year-over-year (27%) to a record \$5.912 TN.

Credit Market Dislocation Watch:

October 19 - Bloomberg (Hamish Risk and Bryan Keogh): "Credit-default swaps rose the most in three months this week as a planned \$80 billion fund to rescue structured investment vehicles failed to stop two funds from being unable to repay debt. Investors are becoming more bearish as losses on SIVs, companies that borrow in short-term markets to buy longer-dated assets, add to concern that the fallout from record U.S. mortgage foreclosures may be worse than analysts had expected. The cost of credit-default swaps, contracts protecting payment on bonds, rises when the perception of credit quality worsens."

October 19 - Bloomberg (Sebastian Boyd and Neil Unmack): "Cheyne Finance Plc and IKB Deutsche Industriebank AG's Rhinebridge Plc, two structured investment vehicles that bought securities backed by home loans, defaulted on more than \$7 billion of debt as the value of their holdings fell. The companies borrow in the short-term debt market and use the proceeds for buying mortgage-backed bonds and collateralized debt obligations. Falling market prices for assets forced the companies to declare all of their debt due this week... 'The fallout from the credit crisis is far from over,' said Jim Reid, head of fundamental credit strategy at Deutsche Bank AG... 'There are probably more skeletons in the closet. The problem is knowing when and where they are going to emerge.'"

October 19 - Dow Jones (Anusha Shrivastava): "The subprime mortgage-based ABX index is under renewed pressure Friday, with its riskiest slice hitting a record low and the less risky slices also trading weaker, amid continued worries over the fallout from the U.S. subprime mortgage crisis."

October 19 - Bloomberg (Bo Nielsen and Min Zeng): "The yen rose the most in six weeks against the euro as a decline in global stocks prompted investors to sell higher-yielding assets funded by loans in Japan. Japan's currency gained for a fifth day versus the dollar, the longest winning streak in almost a year, and posted its best week against the euro in two

months, as the risk of holding corporate debt increased.”

October 17 – Financial Times (Gillian Tett): “A decade ago, when Asia was facing a financial crisis, American bankers and government officials regularly travelled to the region delivering homilies about the best way to exit a banking mess. After all - or so the lectures typically went - America had suffered bank crises in the past, such as the Savings and Loan debacle of the late 1980s. This experience had shown that the best route to recovery was to establish realistic prices for distressed assets, by conducting fire sales if necessary, and then write the losses off. A decade later, however, it seems that some US financiers need to take another hefty swig of the medicine they used to wave at Asia.”

October 19 – The New York Times (Eric Dash and Gretchen Morgenson): “Does the rescue plan for the credit markets need to be saved? The plan is still being developed, but the roughly \$75 billion effort to snap up troubled securities is struggling to get off the ground, days after it was disclosed by the country’s three biggest banks with the support of the Treasury Department. Citigroup, Bank of America, and JPMorgan Chase back the plan but are just beginning to hammer out the details. Bank regulators are aware of the discussions but some say they are out of the loop. And market participants are puzzled, with investors like Pimco and T. Rowe Price balking at buying in... But the plan, which was hatched in August but leaked last week, has been plagued by uncertainties. All three banks agree on the concept but differ on the details. Other questions remain. How will the plan work? Who will participate? How much will its backers put in? ‘Until we know the answers, it is tough to say just how much impact this is going to have,’ said Christian Stracke, a CreditSights analyst who follows S.I.V.’s. At this point, ‘It’s a big mess.’... So far, the banks agree on the larger goal: to restore stability and confidence to a vital pocket of the commercial paper market. They are concerned that if all 30 S.I.V.’s, which hold about \$320 billion in assets, began selling securities at once, prices would plummet and lead to a lending freeze. But each bank has something different at stake in participating... Money market fund managers are also divided over participating. Some say the effort will just delay the inevitable by repackaging bonds backed by mortgages, loans and other assets that investors know little about and that have fallen in value.”

October 19 – MarketWatch: “Former Federal Reserve Chairman Alan Greenspan said the ‘Super SIV’ fund could have serious repercussions, according to an interview with the Emerging Market newspaper... In the article, Greenspan said the ‘Super SIV’ - the \$75 billion Master Liquidity Enhancement Conduit designed to take on the assets of troubled investments - runs the risk of further undermining already brittle confidence in besieged credit markets.”

October 17 – Financial Times (David Wighton): “Big US commercial banks have seen \$280bn of new debt come on to their balance sheets since the credit squeeze, threatening to undermine economic growth by inhibiting their ability to make new loans. The banks have been forced to take on to their books large amounts of commercial paper and leveraged loans after investor demand for such assets dried up in the summer...”

October 17 – Financial Times (Dave Shellock): “Sky-high oil prices, a worrying report on US capital outflows and some disappointing corporate earnings set the scene for another edgy session for financial markets yesterday. The main shock of the day came from Treasury International Capital data showing that foreign investors sold a net \$69.3bn of long-term US securities in August, the biggest outflow since 1990. ‘A truly stunning Tics number, the likes of which I have never seen,’ said Alan Ruskin, chief international strategist at RBS Greenwich Capital Markets. Asian investors sold a net \$52bn of Treasury bonds in August, but Tom Levinson, economist at ING, said the real damage to the headline number came from a near-\$60bn negative month-on-month swing in corporate stock investment... ‘One month never makes a trend, but were Asian Treasury purchases to not rebound in coming months, markets would be left asking whether a key support for the dollar has begun to wane.’”

October 19 – The Guardian (Phillip Inman and Angela Balakrishnan): “Lending by the Bank of England to stricken mortgage bank Northern Rock was increased to £16bn (\$32.bn) over the last week, raising fears that the Newcastle-based bank is running out of funds at a faster rate than expected. Figures released yesterday show that the Bank of England's balance sheet rose by a further £3bn in the week to Wednesday, which suggests that Northern Rock was demanding more funds each week and not less...”

Currency Watch:

October 17 – Financial Times (Peter Garnham): “The meeting of finance ministers and central bankers from the seven leading industrialised nations in Washington this weekend comes amid signs of severe strains in global currency markets. The question is whether they will do anything about it. Ahead of the meeting, the Europeans are fretting over the impact of a strong euro on the region’s exporters, while the dollar’s slide is making a mockery of the US Treasury’s mantra that a strong currency is in the country’s interests. In Tokyo, the yen’s slide rings alarm bells as investors show a new interest in carry trades, in which the low-yielding Japanese currency is sold to finance purchase of riskier assets elsewhere. Meanwhile, China continues to decline persistent invitations from the US and Europe to let the renminbi appreciate faster.”

October 17 – Bloomberg (David Yong and Wes Goodman): “Japan, China and Taiwan sold U. S. Treasuries at the fastest pace in at least five years in August as losses linked to U.S. subprime mortgages sparked a slump in the dollar. Japan cut its holdings by 4 percent to \$586 billion, the most since a new benchmark for the data was created in March 2000, Treasury Department figures...showed. China’s ownership of U.S. government bonds fell by 2.2% to \$400 billion, the fastest pace since April 2002. Taiwan’s slid 8.9% to \$52 billion, the most since October 2000.”

October 19 – Bloomberg (Stanley White and Kazumi Miura): “The dollar may ‘plunge’ in 2008,

prompting the U.S., the European Union and Japan to intervene in foreign exchange markets, said Eisuke Sakakibara, Japan's former top currency official. U.S. economic growth may slow to less than 1% next year...he said... Sakakibara, 66, was dubbed 'Mr. Yen' because of his ability to influence the currency market during his 1997 to 1999 tenure at the Ministry of Finance. 'Should growth fall below 1%, we could see a plunge in the dollar,' said Sakakibara... 'Some form of intervention would be necessary to stop it, and that would require coordinated effort from all three major economies.'"

The dollar index dropped 1.2% to 77.31. For the week on the upside, the Japanese yen increased 2.5%, the Canadian dollar 1.1%, the Swiss franc 1.2%, the Brazilian real 0.7%, the Euro 0.7% and the Danish krone 0.6%. On the downside, the New Zealand dollar declined 1.8%, the Colombian peso 1.4%, the Indian rupee 1.1%, and the Australian dollar 0.9%.

Commodities Watch:

October 19 - Bloomberg (Claudia Carpenter): "Gold headed for its biggest weekly gain in a month as the dollar weakened on speculation the U.S. Federal Reserve will cut interest rates this month, spurring demand for the precious metal as an alternative investment."

October 19 – Bloomberg (Halia Pavliva): "Platinum rose to a record in New York after Anglo Platinum Ltd., the world's largest producer, closed shafts at its biggest mine."

For the week, Gold gained an additional 2.1% to a 27-year high \$765, while Silver dipped 1.9% to \$13.64. December Copper fell 2.8%. November crude surpassed \$90 for the first time, before closing the week with a gain of \$4.91 to \$88.60. November gasoline jumped 4.0%, and November Natural Gas gained 1.0%. December Wheat was little changed. For the week, the CRB index rose 2.0% (up 10.7% y-t-d). The Goldman Sachs Commodities Index (GSCI) jumped 3.1% (up 30.9% y-t-d).

Japan Watch:

October 19 - Bloomberg (Mayumi Otsuma): "The Bank of Japan remains committed to raising interest rates as the world's second-largest economy extends its expansion, Deputy Governor Toshiro Muto said. 'The Bank of Japan will gradually adjust the level of interest rates in accordance with the pace of improvements in the economy and prices and check risk factors,' Muto said..."

China Watch:

October 19 – Associated Press: "China's consumer prices jumped 6.2% in September from a year earlier on higher food costs and the government will consider tightening monetary policy and investment curbs in response... September's inflation rate was down slightly from 6.5% in

August, the highest monthly rate in 11 years... 'To lower prices will be an important task for our economic regulation,' Zhu Zhixin, vice chairman of the National Development and Reform Commission... 'Measures may include exercising a monetary policy of moderate austerity, restricting excessively fast investment in fixed assets and to take measures to adjust prices,' he said."

India Watch:

October 19 - Financial Times (Joe Leahy): "India has pledged to open the 'front door' wider to hedge funds in an apparent bid to bolster foreign investor confidence after a stock market plunge triggered by a proposed crackdown on investment in the country through offshore derivatives. Hedge funds will be given easier direct access to the Indian stock market after the proposed curbs that have raised fears of a rush of selling by foreign investors... Sebi sparked the stock market plunge on Wednesday by announcing the proposed regulations that would curtail the sale of derivatives known as participatory notes that are used by foreign investors, particularly hedge funds, to gain exposure to underlying Indian shares. The market initially fell 9% on the news amid speculation the measures would curb massive capital inflows into India's market."

Asia Bubble Watch:

October 17 – Bloomberg (Josephine Lau): "Asia's ranks of people with more than \$30 million in assets is swelling at a faster pace than in the rest of the world... according to Merrill Lynch & Co. and Capgemini SA. The number of 'ultra high net worth' individuals increased 12.2% in 2006, compared with 11.3% worldwide..."

October 17 – Bloomberg (Seyoon Kim): "South Korea's economy will expand almost 5% this year, topping the government's previous forecast, Finance Minister Kwon Okyu said."

Unbalanced Global Economy Watch:

October 17 – Bloomberg (Fergal O'Brien): "Irish house prices fell for a third straight quarter... as the highest borrowing costs in six years and concern about a property slump deterred buyers, a survey showed. Asking prices for houses fell 0.7% in the third Quarter..."

October 18 – Bloomberg (Steve Bryant and Ali Berat Meric): "Turkey's ruling party plans to increase spending by 10% in 2008 as declining debt levels allow it to loosen budget targets for the first time since coming to power in 2002."

Fiscal Watch:

October 19 - Bloomberg (Michael Quint): "New York State's looming \$4 billion budget gap will

require use of one-time transfers of funds among various accounts and drawing down reserves, Budget Director Paul Francis said."

Central Banker Watch:

October 17 – Bloomberg (Simone Meier and Andreas Scholz): "European Central Bank Council member Klaus Liebscher said the bank remains focused on 'significant' and rising inflation risks, suggesting it may still raise interest rates. 'The message was and is that risks to price stability are clearly pointing to the upside,' Liebscher, who also heads Austria's central bank, said... 'There are significant upside risks' and 'rising oil prices are also increasing these risks to price stability.'"

October 17 – Reuters: "Former Federal Reserve Chairman Alan Greenspan sees no imminent danger in the weakening of the U.S. dollar, a Czech newspaper quoted him as telling a closed-door conference in Prague via a video link... The ex-Fed chairman said inflation was a far bigger concern for the United States than the dollar, which was trading at a tolerable level, the newspaper said."

California Watch:

October 18 – Associated Press: "September home sales throughout California sank to their lowest level in two decades as mortgages became harder to get... A total of 24,460 new and resale houses and condos were sold statewide last month. That was down 45.2% from September of 2006 and 26.8% from August, according to DataQuick..."

October 17 – The Los Angeles Times (Peter Y. Hong and Maura Reynolds): "Home sales in Southern California plummeted in September to a two-decade low, and a rash of grim housing-market assessments Tuesday suggested the worst is yet to come. 'We're on our way down and still picking up speed,' said Christopher Thornberg, a Los Angeles-based economist... In Southern California in September, home sales in six counties -- Los Angeles, Orange, Riverside, San Bernardino, San Diego and Ventura -- fell 48.5% from the same month last year. They were at their lowest since DataQuick...began compiling such statistics in 1988."

October 18 – Bloomberg (Daniel Taub): "San Francisco Bay Area house and condominium sales dropped 40% last month to the lowest for a September in two decades as stricter loan standards kept some homebuyers out of the market, DataQuick...said. Last month's sales count was the lowest for a September since at least 1988, when statistics begin for... DataQuick. Banks and other lenders are requiring homebuyers to make larger down payments and have better credit ratings to qualify for mortgages."

October 19 – Bloomberg (Jeremy R. Cooke): "California and the Port of Oakland sold the

largest of \$7.5 billion in municipal bond offerings as U.S. state and local government borrowing rose to the highest level in five weeks. California, whose bond sales this year already exceed the state's issuance during 2005 and 2006 combined, borrowed \$1.5 billion to fund civic improvements and refinanced \$1 billion of debt..."

Financial Sector Earnings Watch:

October 17 – Bloomberg (Bradley Keoun): "E*Trade Financial Corp... reported its first loss in five years and slashed its 2007 forecast because of rising costs for bad debt at its online bank... Chief Executive Officer Mitchell Caplan's efforts to build E*Trade's online bank over the past three years by tripling loans outstanding backfired as more borrowers fell behind on payments and U.S. home prices dropped."

Mortgage Finance Bust Watch:

October 17 – Bloomberg (Kathleen M. Howley): "The volume of U.S. mortgages will tumble this year to the lowest since the beginning of the housing boom as a 'credit shock' restricts lending, the Mortgage Bankers Association said. The total value of home loans will fall to \$2.3 trillion in 2007, the lowest since \$1.1 trillion of loans were made in 2000, before the real estate market's five consecutive years of record sales and home prices..."

October 17 – Bloomberg (Mark Pittman): "Standard & Poor's lowered ratings on \$23.4 billion of subprime and Alternative-A mortgage securities that were created as recently as June. The cut covers 1,713 classes of bonds sold in the first half of 2007... Some debt with the highest AAA rankings were reduced... S&P's action, in the same year as the securities were created, is its swiftest mass downgrade of mortgage bonds and the first time 2007 bonds have been cut by any company."

October 19 – Bloomberg (James Tyson): "Standard & Poor's lowered ratings on about \$22 billion of securities backed by first-lien subprime home loans because of rising delinquencies. The cut covers 1,413 classes of bonds from the fourth quarter of 2005 through the fourth quarter of 2006..."

October 17 – Financial Times: "After absorbing staggering losses on their land holdings in past downturns, home builders have learned to limit risk by buying options on property instead of purchasing it outright. This time around, they have left other investors holding the bag - and the fallout has only just started. US home builders have taken billions of dollars in write-offs this year after relinquishing deposits on property they no longer need. That land, which is worth far less than book value, is now stuck on the balance sheets of a disparate group of property owners across the country. These investment groups, known as "land banks" and which include GMAC, Acacia Capital, IHP Capital and Hearthstone, are backed by big US institutional investors... In their eagerness to sponsor projects, many investors took extra risk by accepting smaller deposits from builders or looser deal terms. They now have too much

property on their books, paltry deposits to show for it, and lenders breathing down their necks. Some investors will have to sell properties to stay solvent, causing huge tracts of land to hit the market at distressed prices. Discounted properties have already popped up for sale in hard-hit Phoenix, Arizona, and southern California.”

October 17 – Bloomberg (Kathleen M. Howley): “GMAC Financial Services will cut 25% of the staff at... ResCap... ResCap... will fire about 3,000 workers from its 12,000-person staff...”

October 17 – Bloomberg (Takahiko Hyuga and Mariko Yasu): “Nomura Holdings Inc., Japan’s largest securities company, will post its first quarterly pretax loss in more than four years after losing 73 billion yen (\$620 million) on U.S. home loans... ‘This is extremely regrettable,’ Chief Executive Officer Nobuyuki Koga said... ‘The pace of the collapse in the U.S. residential mortgage-backed securities market was quicker than we expected.’”

Real Estate Bubbles Watch:

October 17 – Bloomberg (Shobhana Chandra and Robert Willis): “The two-year U.S. housing recession deepened in September... Builders broke ground at an annual rate of 1.191 million homes... Starts were the lowest in 14 years.”

October 17 – Financial Times (Daniel Pimlott): “DR Horton, the largest US homebuilder by sales, painted a grim picture of the housing market yesterday, revealing that nearly half of its home orders were cancelled in the three months to the end of September. The surge in the company’s cancellation rate was complemented by a 39% drop in sales to 6,734 homes, in spite of an aggressive programme of incentives and price cutting. The dollar value of sales fell by 48%.”

October 17 – Financial Times (Ben White and Eoin Callan): “Hank Paulson, the US Treasury Secretary, warned yesterday that the downturn in the nation's mortgage market would burden the economy ‘for some time’ as several big banks, the largest homebuilder and a major construction equipment maker all highlighted the growing impact of the housing decline... A monthly survey from the National Association of Home Builders and Wells Fargo indicated that confidence among homebuilders had hit its lowest point in more than 20 years.”

October 18 – Bloomberg (Daniel Taub): “Apartment rents rose throughout the U.S. West in the third quarter as home sales slowed and companies boosted hiring... RealFacts said. The largest increases were in the Seattle and San Jose, California, areas. The average monthly rent in nine western U.S. states rose 5.5% from a year earlier to \$1,142... In the San Jose, Sunnyvale and Santa Clara area, the average rent rose 12% from a year earlier to \$1,449. In the Seattle, Tacoma and Bellevue area, it gained 11% to \$955.”

Fiscal Watch:

October 18 – Bloomberg (Michael Quint): “New York State’s looming \$4 billion budget gap will require use of one-time transfers of funds among various accounts and drawing down reserves, Budget Director Paul Francis said. Francis, also a senior adviser to Democratic Governor Eliot Spitzer, said he expects ‘some additional revenue’ even if profits weaken on Wall Street... Francis said budget planners expect to limit state operating expense growth to 5.3% in the year beginning April 1, 2008.”

Speculator Watch:

October 19 – Dow Jones: “Wachovia (WB) CEO Ken Thompson says his biggest disappointment with his investment bank’s weak 3Q performance was that it lost roughly \$300M on securities tied to subprime mortgages. He says WB generally steered clear of subprime exposure, and having those securities in the investment bank represented ‘a little bit of a breakdown.’ He also expressed surprise that the AAA-rated securities lost value so quickly. ‘We didn’t expect that that paper could degenerate that fast,’ he said. Nonetheless, Thompson said he’s comfortable with the investment bank’s risk-management systems.”

Respite's Over:

The autumn respite from summer Credit tumult has run its course. Global central bankers may have succeeded at least temporarily in their aggressive liquidity operations. This liquidity, however, has characteristically avoided post-Bubble risky mortgages and mortgage-related derivatives. Today, a strong case can be made that Monetary Disorder was only exacerbated. To be sure, the unfolding spectacular bursting of the Mortgage Finance Bubble runs unabated. Meanwhile, myriad other global Bubble excesses have gone to only more dangerous extremes – certainly including global equities markets.

It was a week of worrying developments. The degree of mortgage Credit deterioration was confirmed by the dreadfully rapid earnings deterioration being reported by the banking industry. And the housing data out of California suggests an unfolding disaster. If market sentiment doesn't recover soon – and it’s not easy to envision such a scenario in the face of a strangling Credit tightening – we’ll be witnessing a housing bust of historic proportions.

From Wednesday’s Los Angeles Times (Peter Y. Hong and Maura Reynolds): “Home sales in Southern California plummeted in September to a two-decade low... ‘We’re on our way down and still picking up speed,’ said Christopher Thornberg, a Los Angeles-based economist... According to Dataquick, September Southern California homes sales were down 48.5% from a year earlier to the lowest level since at least 1988. Things weren’t much better up north. Dataquick puts Northern California sales down 40% from a year ago. For the entire state, September sales were down 27% from a terrible August to the lowest sales in 20 years. The

lack of jumbo mortgage availability received widespread blame. Credit conditions will likely tighten further.

It is an ongoing theme that I don't expect Credit insurance (in its various contemporary forms) to survive the unfolding downside of the Credit Cycle. Current tumult in the mortgage derivative arena is cause for concern. The rapid deterioration in the mortgage insurance business is quite alarming.

October 18 – Bloomberg (Erik Holm): “MGIC Investment Corp., the largest U.S. mortgage insurer, posted its first quarterly loss in 16 years and said it won't be profitable in 2008 as foreclosures increase from record levels. The net loss of \$372.5 million...was the worst quarter...since it went public in 1991... Costs to bail out lenders tripled to \$602.3 million as home prices in the biggest U.S. markets fell, making it harder for banks to recover when loans go sour. Chief Executive Officer Curt Culver said on a conference call today that real estate prices may drop 10% nationally over the next 18 months... MGIC wrote off its \$466 million investment in Credit-Based Asset Servicing and Securitization LLC, jointly owned with Radian Group Inc., after demand for subprime loans collapsed... Culver blamed much of the surging losses on larger claims from bigger mortgages and fewer delinquent mortgages being returned to good standing as housing markets deteriorated, particularly in California and Florida... The number of borrowers more than 60 days behind on privately insured loans jumped 30% from year-earlier levels in August... The company is forecasting declines in home values of 20% in the Phoenix area, 18% in Las Vegas, 13% in Orlando, Florida, and 7% in Los Angeles over the next two years.”

October 18 – Bloomberg (Erik Holm): “PMI Group Inc., the second-largest U.S. mortgage insurer... said today it will lose \$1.05 a share in the period and withdrew earnings forecasts for the year... The cost to bail out lenders is expected to increase fivefold from the same period a year earlier to about \$350 million...PMI said... Stagnant home prices make it harder for banks to recover when loans go bad.”

There are certainly grounds today to suggest that the unfolding California housing bust will test the viability of mortgage insurance industry. MGIC, in particular, noted increased Credit losses in higher-end homes and in the Golden State. But I don't believe anyone has modeled in the type of housing crisis that is unfolding. This thinly capitalized industry is on the hook for Trillions of insurance exposure. And as the debt market begins to question the ongoing solvency of these insurers, a major additional uncertainty will plague the vulnerable “private-label” ABS and MBS marketplaces. Moreover, the thinly-capitalized GSEs have huge exposure to the fragile mortgage insurance industry. The next stage of the mortgage meltdown is at hand.

Unfortunately, I don't have time this evening to properly highlight what was a very poor week of bank earnings. Almost across the board, Credit deterioration was much worse than had been expected. It will get much worse.

October 19 – Bloomberg (David Milkenberg): “Wachovia Corp. reported its first earnings decline in six years and missed analysts' estimates after a record \$1.3 billion of writedowns for bad loans and mortgage-backed securities... Profit at the five biggest U.S. banks totaled \$18.7 billion for the quarter, the lowest in almost four years, as demand for securities linked to mortgages and leveraged loans dried up... Home foreclosures have forced banks to write down the value of mortgages and home equity loans. Citigroup, Bank of America and JPMorgan together wrote down more than \$2.5 billion in loans for leveraged buyouts of companies.”

October 19 – Bloomberg (David Milkenberg): “Wells Fargo & Co., Regions Financial Corp., and KeyCorp, three of the biggest U.S. banks, posted lower-than-estimated third-quarter profit and said rising loan losses may hurt future earnings.”

October 17 – Bloomberg (Elizabeth Hester and Charles V. Zehren): “SunTrust Banks Inc., Huntington Bancshares Inc. and BB&T Corp. posted third-quarter profits that fell short of analysts' estimates as the worst housing market in 16 years forced the regional lenders to write down the value of bad loans. Net income at SunTrust of Atlanta declined 23% while profit at... Huntington fell 12%... None of the companies had a bigger decline than the second-largest U.S. lender -- Bank of America Corp. of Charlotte, North, Carolina -- which said earnings dropped 32% on \$4 billion in writedowns and trading losses. Record foreclosures and a decline in the value of securities related to subprime mortgages forced the banks to set aside more money to cover future losses. SunTrust, the third-largest bank in Florida, more than doubled its provision for loan losses to \$147 million and said loans no longer paying interest climbed about 70% to \$1 billion.”

From Bank of America's Q3 earnings release: “Unprecedented market disruptions impacted trading results. As a result, Global Corporate and Investment Banking (GCIB) net income fell 93% to \$100 million from \$1.43 billion a year earlier. Capital Markets and Advisory Services, a business within GCIB which includes Liquid Products, Credit Products, Structured Products and Equities, posted a \$717 million net loss compared with net income of \$298 million a year earlier. Included in the net loss for the quarter were \$247 million in markdowns...on leveraged and non-leveraged loans and commitments. Contributing to the loss in Credit Products was a \$607 million trading revenue loss due principally to the breakdowns in traditional pricing relationships, which made hedges ineffective, and the widening of credit spreads. Structured Products, which includes asset-backed and residential mortgage-backed securities, commercial mortgages, collateralized debt obligations (CDOs) and structured credit trading had a net revenue loss of \$527 million. The loss arose from lower investment banking fees and trading declines principally due to the same conditions affecting Credit Products... Provision for credit losses was \$2.03 billion, up from \$1.81 billion in the second quarter of 2007, and \$1.17 billion in the third quarter of 2006. Net charge-offs were \$1.57 billion, or 0.80% of total average loans and leases. This compared with \$1.50 billion, or 0.81 percent, in the second quarter of 2007 and \$1.28 billion, or 0.75%, in the third quarter of 2006.”

From Citigroup's Q3 earnings release: "This was a disappointing quarter, even in the context of the dislocations in the sub-prime mortgage and credit markets. A significant amount of our income decline was in our fixed income business... Fixed income markets revenues declined \$1.64 billion to \$671 million, driven primarily by: Losses of \$1.56 billion, net of hedges, on sub-prime mortgages warehoused for future CDO securitizations, CDO positions, and leveraged loans warehoused for future CLO securitizations. Losses of \$636 million in credit trading due to significant market volatility and disruption of historical pricing relationships... ending revenues declined 14% to \$412 million, primarily driven by write-downs of \$451 million, net of underwriting fees, on funded and unfunded highly leveraged finance commitments... Net investment banking revenues were \$541 million, down 50% due to write-downs of \$901 million... Credit costs increased \$2.98 billion, primarily driven by an increase in net credit losses of \$780 million and a net charge of \$2.24 billion to increase loan loss reserves. In U.S. higher consumer credit costs reflected an increase in net credit losses of \$278 million and a net charge of \$1.30 billion to increase loan loss reserves. The \$1.30 billion net charge compares to a net reserve release of \$197 million in the prior-year period..."

It is worth noting that Citigroup expanded its balance sheet by \$133bn during Q3, a 24% annualized rate. Amazingly, Citi's assets have ballooned \$608bn during the past four quarters, or almost 35%. Despite the poor and deteriorating outlook, Bank of America's Assets increased at an 11.6% pace during the quarter, exceeded by Wachovia's 19.0%. Big Five (Citi, BofA, JPMorgan, Wachovia and Wells Fargo) Total Assets expanded \$243bn during Q3 – a 15.1% growth rate. Big Five Assets have inflated 20% over the past year.

October 19 – The New York Times (Floyd Norris): "'The banking system is healthy.' Ben S. Bernanke, Oct. 15... 'Our bank regulators must evaluate regulatory capital requirements applicable to bank exposures to off-balance-sheet vehicles.' Treasury Secretary Henry M. Paulson, Oct. 16. Out of sight, out of mind. As America's big banks reported poor quarterly results this week, it was hard to know what was more distressing: the news, or the fact many bankers were clearly surprised. They were surprised because banking has evolved to the point where a large part of the revenue comes from things invisible to readers of financial statements, either commitments to make loans, or through vehicles carefully engineered to stay off the balance sheet. A notable illustration came from Citigroup. Its write-offs were half a billion dollars more than the bank had forecast only two weeks earlier, and its optimism about the fourth quarter was toned down considerably. But the most impressive fact was the bank's explanation of why its nonperforming corporate loan total had doubled, to \$1.2 billion, in just three months. Citi explained that the bulk of that came from just one loan — and it was a loan that had not even been made a few months earlier. Citi had taken a fee to provide a backup line of credit to a structured investment vehicle — a line that would be called on only if the S.I. V. could not borrow and a German bank could not meet its promise to make the loan. That happened, so Citi forked over the cash and immediately put the loan on nonperforming status. That's a neat trick. You don't make the loan until you know it will be a bad loan."

It was one of the great myths of this Credit Cycle that the banking system was much healthier and more stable because of the capacity of contemporary finance to dis-intermediate bank

Credit risk to “the marketplace.” It is now becoming clearer to market participants that the major banks in particular have huge exposures to myriad risks market and otherwise, previously having been distributed to various vehicles, structures and market operators. The problem today is that the preponderance of players active in this non-bank risk intermediation have been thinly capitalized and often leveraged. Too many were aggressively writing flood insurance in a drought, without the wherewithal to deal with an eventual flood. There’s now a severe one heading our way whether the Fed cuts rates or not.

It is both fascinating and alarming to witness the wild inflation in the banking system balance sheet in the midst of a rapidly faltering Credit Cycle. Not only are the banks forced now to “-re-intermediate” risk they had previously distributed, they also have no alternative than to take up the slack from an increasingly impaired Wall Street risk intermediation mechanism. The market is beginning to appreciate the great risks associated with such a proposition.

It is today’s inescapable Credit Bubble Dilemma that enormous quantities of new Credit must be forthcoming – which entails intermediating Credits that are at this stage highly risky. For one, they’re of high risk because the Credit system is proceeding toward a major dislocation - one with major ramifications for the entire economic system. Inevitably, the flow of finance will be altered profoundly. Many individuals, market operators, business enterprises, and (local, state, and federal) governments are today poorly positioned and will be forced to adjust. This will amount to a momentous financial and economic adjustment, and we should not expect that it will proceed smoothly.

In the meantime, there is today apparently no alternative than massive banking system inflation. In just 12 weeks, bank Credit has ballooned \$360bn. And as much as the unfolding mortgage debacle will impair the banking system, I fear it has already irreparably damaged “Wall Street finance.” If upper-end jumbo, alt-A and home equity loans are the looming disaster that I suspect (significantly larger in scope than subprime), the viability of the CDO and mortgage derivatives markets may soon be in doubt. The terrible earnings news this week from the mortgage insurers plays right into this debacle. If confidence falters in the GSEs... And the melt-up in Treasury prices only exacerbates MBS instability, while the (not so) quiet run on the dollar further reduces the appeal of U.S. mortgage paper to our foreign Creditors.

Stock market complacency over the past weeks was astounding. But if the markets head directly south from here, market confidence and the Fed’s capabilities will be tested simultaneously. Lower rates are definitely not the answer. Respite’s Over.

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