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ECONOMIC NEWS UPDATE

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“This Time A Ripple, Next Time A Wave”

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If you are one of those people who doesn't mind worrying, really worrying, think of the High Grade Structured Leveraged Credit Strategies Enhanced Leverage Fund. The hedge fund, run by Bear Stearns, is struggling to raise cash so that it can avoid passing into the dustbin of history. Like another Bear Stearns' fund, the fund's assets consist in good part of bonds backed by subprime mortgages, loans made to borrowers whose histories or incomes make them less-than-good risks. Rising default and late-payment rates have called the value of these mortgages into question, prompting the banks that lent the fund \$6 billion to demand repayment of their loans. Since the fund has only \$600 million in investors' capital, Bear Stearns has no way of repaying its creditors, and at this writing is scrambling to obtain new loans and new equity capital. In short, the fund finds itself in a position not very different

from that of tiny subprime borrowers, only on a larger scale.

This might merely be a matter of no concern to policymakers: bad luck for well-informed and well-heeled investors and lenders such as Barclays PLC, Merrill Lynch and Citigroup who underestimated the risk involved in investing in this fund. But there might be collateral damage, affecting innocent bystanders. If the assets that underlie the fund, now being auctioned off, bring only knock-down prices, similar assets now valued in their trillions, might also be revalued sharply downward. That would hit the earnings of several big banks, reducing their willingness and ability to lend, possibly contributing to the slowing effect on the economy of falling home sales.

But before being becoming consumed with worry, know two things. The financial markets have so far reacted with an indifferent shrug. And the people on top of this situation do not

see any such systemic risk in the economy's future. I base that on talks with key government officials who are paid to watch these things. A composite of that information looks something like this.

The problem of defaults and repossessions is not a trivial one, but neither is it likely to bring down the economy. The mortgage-market turmoil has several causes. The recent rise in interest rates caused monthly payments on adjustable rate mortgages to rise to levels that many subprime borrowers cannot meet. Most of the problems are concentrated in the "rust belt" states, where workers in industries suffering from a combination of mismanagement, rapacious trade unions and imports are finding it difficult to keep their mortgage payments current. Since any candidate who hopes to capture the White House must carry these states, attention must be paid. Also, a disproportionate numbers of the troubled borrowers are black, adding to the political heat generated by the defaults. Most important, key policymakers believe in the social value of widespread home ownership, and are eager to keep credit markets open to subprime borrowers, many of whom prove to be good credit risks.

Still, there is a feeling in some political and pundit circles that if a borrower takes on debt he cannot repay, and his house is forfeit, that is his problem, and not society's. And if lenders are foolish enough not to inquire into the borrowers' ability to carry the loans, they deserve the losses they will inevitably face.

Unfortunately, life is not so simple. Since defaults and repossessions are concentrated in a relatively few areas, the sprouting of for-

sale signs on the repossessed properties drives down the values of the houses owned by families able to meet their mortgage obligations. In addition, families in arrears often reduce expenditures on maintenance, creating eye-sores that adversely affect a neighborhood's appearance and value of properties owned by solvent homeowners.

Such circumstances can breed social problems such as higher crime rates, truancy and neighborhood slovenliness. Which is why Freddie Mac chairman and CEO, Richard Syron, told congress that his organization, which benefits from an inferred government guarantee of its securities, feels it part of its reciprocal obligation to "to develop more consumer-friendly subprime products that will provide stable financing alternatives going forward."

Equally important, the market is working its wonders. Banks are tightening lending standards. Investors have been reminded by the Bear Stearns disasters that if a deal is too good to be true, it isn't. And the rating agencies, wakened to the risk built into bonds that are backed by subprime mortgages, have downgraded hundreds of such securities. The emptors will now have more serious caveats laid before them.

Meanwhile, any collateral damage that might be inflicted on the markets has not yet reared its ugly head in what some call "the real economy". Here's why: despite the turmoil in the subprime market, continued woes in the housing sector, high petrol prices, and higher interest rates, the economy is now growing at a 3% annual rate. Retail sales are up, the manufacturing sector is recovering, exports are rising, earnings remain more than satisfactory,

and -- perhaps most important of all -- jobs remain plentiful. So worry a bit, if that is your bent, but don't overdo it.

Put this all together and you have -- muddle. If the pessimists are right, the housing sector and the associated subprime mortgage market will continue to deteriorate, bringing economic growth to an unemployment-increasing 2% or less, and forcing the Federal Reserve Board's monetary committee to lower interest rates. If the optimists are right, collateral damage from the housing and mortgage sectors will be a ripple, but not a wave, and the Fed will have to raise rates to prevent inflation-inducing growth of closer to 4%. Split the difference -- 3% growth this year -- and you are probably right, which means the Fed can take a vacation at least for the summer. Or at least stand pat when it meets this week.



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