Whale Wisdom Commentary

October 2007

Homeownership is the American dream (not surprisingly, people in other countries also desire to own their own homes). It seems like yesterday that interest rates were low and home prices were rising. Growth in residential real estate was boosting the US economy. Investors looking for more favorable yields above that offered by Treasury securities were buying mortgage debt. All was well in the world and Wall Street was paying huge bonuses.

In order to feed the demand for this debt, mortgage lenders lowered their standards in order to squeeze out additional fees and higher rates. Borrowers with spotty credit records or marginal income were encouraged to buy homes with little money down. They signed-up for loans with adjustable interest rates.

The party has come to a screeching halt and Wall Street calls Washington is called for help. The government must do something quickly. The Federal Reserve must lower interest rates and pump liquidity into the system or it will be the end of the world as we know it shouts Wall Street. All those responsible Americans who properly manage their finances will not mind shelling out a few billion dollars to keep the economy strong and help out their less fortunate (i.e. responsible) neighbors. Just get these sub-prime loans (in the 1980s, they would be known as junk bonds, but that term is too descriptive) refinanced and off our books and onto someone else's books. Of course there is no admission of errors from these kings of capital on Wall Street who will likely see smaller bonuses unless the government comes to their rescue. And the media just love crisis, whether it is real or not. Valuable ad time must be sold.

This was a problem just waiting to happen. And in the American spirit of first assigning blame the finger points to the greed of Wall Street investors, mortgage lenders, consumers (not understanding what you are doing is not an excuse), and the media for fanning the flames of a housing mania. However, blame does not solve the immediate problem. The reality is that this will be a three to five year problem. Sure accounting will wipe problems off the books, but the housing market is not as liquid as the stock market therefore resolution will take years.

Here are some ideas that just might fix the immediate problem and prevent this from happening in the future. First, the lenders and borrowers are going to have to figure out a way to work together. Loans can be renegotiated at lower interest rates or with different payment schedules. The homeowner may have to sell their home and accept a loss. If a borrower is in too deep, the homeowner can give the property back to the lender (this is known as deed in lieu of foreclosure) thus saving both parties time and money. Unfortunately for people who bought homes they can no longer afford, they will have to consider homes within their budget or rent until they are in a stronger financial position to purchase a home.

There is zero sympathy for the investors who are being hurt. Investing involves the risk of loss. Loss and risk are necessary ensure markets operate efficiently. These are smart people who should have done their homework and understood these investments better. The lenders too deserve what they get. Lower your standards and increase your risk is an invitation for increased defaults.

The Federal Reserve should stick to its mandate of guiding the US economy and not the whims of Wall Street. It is reassuring to hear that the Fed is monitoring the situation and will respond with the tools at its disposal if and when appropriate. It would be best if the politicians only thumped their chests and took no action. The US has been through market cycles before be it stocks, housing, oil, or any thing else that can be bought or sold. Cycles correctly imply both up and down price movements. Here is a bold prediction. The future is uncertain and we will see markets both rise and fall in the future.