NEW MINERVA REPORT

CDOs Will Hit Us All

Alan Greenspan, former US Federal Reserve Chairman, has placed his successor in the firing line when he suggested that there is a 30% chance that there will be a recession in the US later this year. Ben Bernanke had to reassure listeners to his testimony to Congress that the Fed's view is that economic growth will be moderate, and is likely to pick up later in the year, when he expects the housing market to turn. Why is it that there are questions concerning the US economy? The answer in one word is sub-prime. As we reported last month, the lending practices of the US sub-prime lending companies have deteriorated rapidly over the past three years. These poor lending practices are coming back to bite the lenders. More than 40 lenders have now gone out of business.

There are two ways that the sub-prime lending problems could induce a US recession, one directly, and the other indirectly. Firstly we are already seeing the lending standards tighten. This is not just happening in the sub-prime area. This is effectively reducing the availability of credit. When you have an economy that has a negative savings ratio, (one that spends more than it earns), a reduction in the availability of credit is likely to cause a reduction in consumer confidence, and this can spill over into a fall in consumer spending. This could be exacerbated by a fall in house prices, as defaults push houses onto the market. Falling house prices could affect the way consumers spend, by reducing the wealth consumers have, and feel they have. If the US consumer starts to save again, this will have a negative effect on the economy, which will knock on to the rest of the world.

The second way the sub-prime problems could affect the economy is by creating a shock within the credit markets. One of the reasons why the sub-prime lenders were able to get away with such poor lending practices was because many of the loans made were being securitised, and passed on to others. This meant the lending companies did not feel so worried about what they were doing. Effectively it was someone else's problem. Creators of Collateralised Debt Obligations (CDOs) have been among the biggest buyers of bonds, backed by pools of sub-prime mortgages in the last couple of years. CDOs are basically securities created by packaging together assets like mortgages and loans. The packaging is done by big banks. These CDOs can then acquire a credit rating, sometimes better than the underlying loans, because they are in a package. These CDOs are dealt privately, or over the counter, rather than on a market. This makes details about them rather difficult to gather. It is estimated that CDO exposure to sub-prime mortgages is about $100bn. In recent weeks this has resulted in a $23bn fall in CDO value. There have been quite a few hedge funds cooing about how they were on the right side of this fall in value, but we haven't heard that anyone has suffered. Normally when there is a big fall in a market we hear of some casualties. Why not now?

Valuations

An asset is only worth what someone is prepared to pay for it. When you are looking at assets quoted on a stockmarket, you can normally value the asset quite easily. Although, as you move down the liquidity scale to smaller companies, this is not always the case. If no one has dealt in that share for some time, you would be valuing that share on the last price at which it was dealt. That would not necessarily be the price you would get for the share if you actually sold it. Now, when you are dealing with even less liquid assets, like property or CDOs, the problem gets even harder. In fact, many believe that although $23bn has been wiped off the value of CDOs due to sub-prime mortgages, this will not be reflected in the valuations of funds holding them. As long as there are no defaults, and therefore no reduction in the cash flow, the CDO will be valued at the cost price. It will only be if the fund has to sell the CDO that the true value will be reflected. Therein lies a potentially big problem. Two sources of potential sales could materialise. One source could be that hedge funds holding CDOs get redemptions. A second source could be funds like some pension funds which are only able to hold investment grade assets. If CDOs with sub-prime mortgages are de-rated, these funds could become forced sellers. Whilst this may all seem academic to us mere mortal investors, the type of funds holding CDOs could become forced sellers of more liquid assets, particularly if leverage is involved. That means our investments could be hit as well. We think sub-prime lending will negatively impact our markets again.

Paul Warner
Investment Director
& Editor of the
Minerva Report