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Big Wave Commentary

Sub Prime Risk Grows as the World Leverages Up

A couple of weeks ago, another large sub prime mortgage lender, American Home Mortgage Investors, said it could no longer fund home loans and may liquidate assets, putting its survival in jeopardy. The stock traded as high as \$36 a share in December and today it reopened at \$1 wiping out almost 2 billion dollars in investor funds. As late as July 30, with the stock trading at \$10, two major brokerage firms still had the stock rated as a "buy". Can you imagine being a client of these firms and holding this stock all the way down from \$36 to \$1? Can you imagine being a broker at these firms and advising your client to hold, or maybe even buy more because your firm still recommended the stock?

If there is any example of how out of touch Wall Street is with regards to the negative implications of this sub prime debt mess, it is this one. And let's not just blame Wall Street. Even Fed Chairman, Ben Bernake, testified before Congress last month that there was minimal risk or issues to deal with in the sub prime debt markets.

There is still a disbelief among investors as to how bad this situation is and how it can become worse. The consensus still coming out from analysts is that it will prove to be a nonevent. The rising stock markets worldwide have masked the seriousness of the problem. Always during the last stages of rising asset prices, the consensus view is always right and tends to look smart. As markets continue to make new highs, the naysayers are always discredited. Just look back to the NASDAQ market of the late 90's. The bears saw the overvaluations and were discredited for 2 years while the market doubled in value. Finally the market broke and not until after the NASDAQ lost 75% of its value, did people see the wisdom of the bears warnings. As a great trader once taught me, when dealing with markets, never underestimate how bad things can get.

The culprit now is not just bullish consensus but global leverage. The world is awash in cash and with

this cash comes leverage. The US has literally become a credit addicted economy and any decline in underlying assets tied to that credit, whether those assets are homes or stocks can lead to free falling markets. For leverage is always the monster that kills markets, economies and even individuals. Market history is full of stories of smart people that were ruined in an afternoon because of guessing wrong about a market and being over leveraged and overexposed to risk

The world now is over leveraged. Leveraged buyouts are now close to 5% of our total GDP, an all time record. Global Hedge Funds, which borrow money to trade with using a carry trade, now are leveraged at unprecedented 20 to 1 margins. Loan to value ratios on mortgages, the loan amount expressed as a percent of the property value, have grown to 86.5% last year from 78% in 2000 mainly due to Home Equity Loans.

And the evidence of the US consumer not making ends meet is now present. Nearly 1.2 million foreclosures were reported last year, a 42% rise from 2005. That is a rate of 1 in every 92 US households. Sub prime mortgages issued in 2006 made up 15% of the total as compared to less than 3% in 2000. Countrywide Credit, the largest mortgage issuer, has over 38.5 billion issued in sub prime loans. And evidence is growing that the US sub prime loan mess is spreading worldwide.

In a credit driven economy, a slowdown in credit growth wrecks havoc in asset markets and economies. In the US, growth in credit began to slow in the household sector in 2006 and now is starting to spread to the financial sector. The Fed has not tightened monetary conditions but the markets have for them as a result of losses in the credit markets. Suddenly, the availability of credit has diminished.

This will not be limited to the US. All markets worldwide will be affected. Tighter lending standards

and borrowing costs in the US will spread to other markets around the world. Foreign investment by US investors has increased dramatically in the last few years. They have exposed themselves to these foreign markets in a big way and in a short time period. This growing enthusiasm for foreign stocks and markets is now certainly a reason for concern and taking profits now is warranted.

With summer closing, thoughts turn to school, football and raking leaves. My advice to you would be to use the trees and their leaves in particular, as a signal to the coming direction of stock prices and take action.

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