

Big Wave Commentary

What is really driving The Credit Crisis?

When looking at the markets, it is not hard to see the visible signs of wreckage caused by the credit crisis. Falling prices of structured securities, massive write offs and losses at Bank and Brokerage firms and the various ill conceived solutions from the governments are all out in the open. Even though there may be more losses unearthed and consequences of this toxic debt have yet to play out, the markets still seem to be unable to accept the magnitude of the problem. The credit markets are still locked up, banks are unwilling to lend to other banks and there are a goodly amount of mortgages and investments coming due in 2008 that many believe will outright default.

What is driving the crisis? What is the common cause of all these losses? The cause of this crisis, in my view is simply falling real estate prices. The falling prices of structured debt, massive bank write downs and a weakening economy is the result of the average price of homes going down.

During 2003 and 2004, housing prices were in a bubble. Prices were being driven higher due to low interest and mortgage rates. This "ultimate teaser rate", a 1% funds rate was historically low. It enabled sellers to price their homes and ultimately sell them at prices based on financing and not fundamentals. Even Fed Chief Alan Greenspan encouraged homeowners to take out adjustable rate loans instead of conventional. Homeowners simply did things backward. They figured out how much money they could afford each month for a mortgage, shopped around to find the most "creative" one that fit their payment schedule and then bought the most expensive house they could. Prices kept rising, homes kept being built and the bubble was formed. Bubbles, no matter in what market all adhere to the same rules. It doesn't matter if it is homes or dot com companies, they all share irrational up swings and they all end very, very badly. Take the NASDAQ bubble. It topped out at 5132 in March 2000 after a spectacular rise throughout the late 90's. It bottomed in October

2002 at 1108, an astounding 78% collapse in a little over 2 years.

According to the Case Shiller home price index, the average home price topped out in 2005 and has fallen almost 20% since then. Fannie Mae figures, while not as harsh, are showing a 13% drop since February of 2006. The worst housing price drop on record was recorded during the great depression when home prices dropped 30%. That happened over a period of 8 years topping in 1925 and bottoming in 1933. The price of a home did not exceed that old index high set in 1925 until 1947. If you bought a home at the top in 1925, and sold it 22 years later, you probably broke even. Housing declines take years to turn around, not months.

Bubbles also create the illusion of the inevitability of rising prices. It was clear over the past couple of years that housing prices could never go down. This belief of the ever rising home price led to the illusion of automatic risk free returns. As housing prices soared, affordability became a problem. Creative mortgage products such as ARMS and teaser rate and sub prime were invented so more people could qualify. The belief that you could never buy too much house was in vogue as was elevating your lifestyle by borrowing against the equity of your home. Home Equity debt hit an all time high.

Now, the bubble has burst. All of the assumptions made in later stages of the bubble have burst as well and billions have been lost. Home prices do drop and low interest rates do encourage leverage and excess risk. We are a credit addicted society and low interest rates feed our addiction, not stop it.

This crisis can not be cured by lower interest rates. To find the cure, you must look at the causes and here are mine...

- 1.) Home prices were too high. The affordability index was at its worst in July 2006. Home

prices at this time were never as unaffordable to the average buyer than then.

- 2.) The amount of structured securities, tied to mortgages was staggering.
- 3.) Debt and leverage was at an all time high. Derivatives and securitization in the mortgage market spread bad loans around the world like a plague. Investors who bought these did not know that they were assuming such huge risks if housing prices fell.

This credit crisis is the result of a nationwide decline in home prices. For this crisis to end, home prices need to stop falling. The prices of homes need to

become affordable to the average person using conventional mortgage terms. If ARMs and teaser rates still need to be used to buy a home, then prices are still too high. Until this happens, you can expect further losses and strain in the credit markets and downward pressures on the stock markets as well as the economy. Remember it took 8 years for real estate prices to bottom during the last housing crisis. We are in the second year for this one. Excessive expectations lead to negative surprises. Don't expect housing to turn up so quickly.

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