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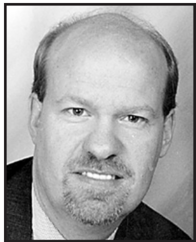
Rosy market scenario turns to darkness

The sub prime loan crisis is about to become a lot bigger. Not only will Wall Street and major financial markets be driven lower by its unraveling, but Main Street USA could catch the worst of it.



Bears & Bulls

David Nielsen

It could substantially affect the economy as no other event has in the last 70 years. It may be Wall Street's dirty little secret now, but one that it will not be able to hold under wraps for much longer. Its effects will mark the end of this bull market in stocks and the beginning of the new bear market.

We are going to look at this crisis over the next few columns. We will take the time to define the investment culprits, look at the dangers and risks and draw some possible conclusions.

Before we begin, a word to the wise. The Wall Street media blitz is in full force. The massive marketing campaign aimed at sliding this mess under the carpet is up and running. Don't believe it. The only way Wall Street makes money is for everyone to be happy and bullish.

The asset gathering machines called brokerage firms are running at full steam. Trotting out expert after expert, they tell us all to be calm, that this is a small piece of the debt market and that the economy is doing great and will not be affected.

"Go ahead and buy stocks."

"There is no end in site for this bull run."

"Think long term, not short term."

They are calling this sub prime mess a "speed bump" along the way to higher stock prices and stronger economic growth.

Well, I beg to differ from the Wall Street crowd. This is not a speed bump. It is a sink hole. This is the type of financial accident that can come along and cripple an economy, market or even a country for years.

Its consequences are unknown in that these sub prime obligations are brand new securities where a market is not even in existence to price or trade them. On most institutional buyers' ledgers, their value is listed at the price they paid for them, showing no loss on the books because no one knows what they are worth.

One major Wall Street firm loaned almost $4 billion to a hedge fund to rescue it from default because of its sub prime obligations. Over 40 major sub prime lenders have already closed their doors. And this is just the tip of the iceberg. Home owners themselves are the next to feel the fire.

Within the year, Bank of America estimates that about $500 billion of adjustable rate mortgages are scheduled to come due and reset their rates. Most of these mortgages were called "teasers" because their initial mortgage rate was set at a low 1 to 3 percent. Today, these mortgages will be reset at an average rate 2 percent higher.

This means substantially higher monthly payments for homeowners, and 2008 holds even more surprises when another $700 billion comes due. Of these ARMs, more than 75 percent or $500 billion are rated sub par.

Currently, over 7 percent of sub prime loans are in default and as credit spreads widen, lending standards are tightening, leading Bridgewater Associates to estimate that sub prime defaults could explode to 20 percent by 2008. Bloomberg Creditsights shows sub prime arm delinquencies, the precursor to default is running at a 15.9 percent rate, up from 9.9 percent in winter 2005.

This sub prime crisis is not an isolated event and no matter how hard Wall Street tries to tell us otherwise, will not go away overnight.

The rosy market scenario is turning to darkness. The dark path coming is that these delinquencies we are seeing now will lead to defaults which will lead to lower home prices which ultimately will lead to a weaker economy, lower corporate earnings and finally a much lower stock market.

This sub prime crisis is not an isolated event and no matter how hard Wall Street tries to tell us otherwise, will not go away overnight. It will be the headlines for months to come.

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