Fed’s Move Is Positive, But Not a Cure for Credit Markets

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From a perspective of investor confidence, yesterday’s move by the Federal Reserve to allow banks and brokerages to temporarily swap mortgage-backed bonds for U.S. Treasuries was important. Stock market reaction was broad based and could be the beginning of a sustained rally. However, previous moves by the Fed aimed at restoring investor confidence were quickly counteracted by more announcements of credit writedowns in the banking and brokerage sector. Therefore, to call a long term bottom in stocks with any degree of confidence you have to believe the Fed’s actions will address the root cause of the problem in the credit markets.

The declining value of mortgage-backed bonds is the real problem. Mortgage-backed bonds, or a stake in a pool of mortgage payment streams, “pass through” the homeowner’s monthly payment to the bond holder. When you own a mortgage-backed bond, the home’s value gives you some protection against default since the asset can be sold if needed. Holders of mortgage backed bonds are facing two problems:

(1) Home values (the collateral backing the mortgages & bonds) are falling.
(2) More homeowners are defaulting which means the number of monthly payments being made within mortgage pools is falling.

This is not good news for mortgage-backed bond holders. These problems make mortgage-backed bonds less attractive to investors, which results in declining bond values. It is the declining value of the bonds which causes the writedowns. Writedowns reduce the willingness and ability of banks to lend. Since the global economy and financial markets are highly dependent on the continued availability of credit, any negative news related to credit is negative news for stocks.

The Fed’s actions will in no direct way stem the fall in home prices. Nor will allowing banks and brokers to temporarily (28 days) exchange undesirable bonds for Treasury bonds suddenly enable John Q. Public to pay the mortgage. Home prices are falling as a result of too much supply and less demand driven by the end of a speculative frenzy. Allowing a 28-day swap of bonds will not reduce the supply of homes for sale or prompt Johnny and Sally to return to speculation in real estate.

The basic problems are home prices are falling and mortgage default rates are climbing. If you believe home prices will continue to fall and mortgage default rates will continue to rise, then you should be skeptical of the sustainability of any rally in stocks. The Fed has succeeded in boosting investor confidence for now. The real tests will come when more writedowns are announced, or when numerous AAA-rated mortgage backed bonds are downgraded by the rating agencies. When asked about the Fed’s latest action in a Bloomberg interview, Kevin Flanagan, who oversees Morgan Stanley’s fixed income trading, said “There’s a lot of unwinding that still needs to go on. This is going to take some time.”

S&P 500 Remains in Downtrend

Even after yesterday's impressive move, the S&P 500 remains firmly in a downtrend. If we have hit a long term bottom, it will show up on the charts in due time. Yesterday's rush to buy stocks is barely discernable in the chart below.

More Bond Downgrades Are Coming

"Moody's, S&P Defer Cuts on AAA Subprime, Hiding Loss" was the headline of yesterday's important story from Mark Pittman of Bloomberg. The main points of interest to investors:

> "Even after downgrading almost 10,000 subprime-mortgage bonds, Standard & Poor's and Moody's Investors Service haven't cut the ones that matter most: AAA securities that are the mainstays of bank and insurance company investments."
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> "Sticking to the rules would strip at least $120 billion in bonds of their AAA status, extending the pain of a mortgage crisis that's triggered $188 billion in writedowns for the world's largest financial firms. AAA debt fell as low as 61 cents on the dollar after record home foreclosures and a decline to AA may push the value of the debt to 26 cents, according to Credit Suisse Group."
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> "Most of AAA subprime bonds in the ABX indexes will be cut by an average of six or seven levels within six weeks."

The Bloomberg story goes on to quote Kyle Bass, a hedge-fund manager based in Dallas:

> "The fact that they've kept those ratings where they are is laughable. Downgrades of AAA and AA bonds are imminent, and they're going to be significant.''

If bond rating downgrades and announcements of new writedowns can be kept in the closet for a few more weeks, stocks may continue to rally. For the reasons given above, it is prudent to continue to remain selective and cautious when placing any new investment capital at risk.

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