MBS Mantra, LLC

Viewpoint – 8/10/2017

The 10th Anniversary of 'This is NOT a Subprime Crisis'

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The first Crisis Note of 8/10/2007 was originally sent out to my clients over Bloomberg. My employers required me to put it on a Blog - ***Samir Shah's Crisis Notes*** - at **shaeshah.blogspot.com**. You can also access it from MBS Mantra's site: **http://www.mbsmantrallc.com/cn-2007-1.shtml**.

I have also included some additional thoughts below the Crisis Note, that describe the implications today of raising rates and withdrawing QE.

I hope you still find these re-reading interesting.

Crisis Note 2007-1: This is NOT a Subprime Problem.

8/10/2007

It is my opinion that the "market" & the talking heads are WRONG. This is NOT a Subprime or MBS/ABS problem. The creation of Subprime was just a SYMPTOM of what was wrong with the system, and the subprime failure was the first of the Jenga pieces to come out. The fundamental problem is that the bull market in both debt and equity has been driven by global leverage, and I strongly believe this is going to mostly unwind. I've been talking about this since early this summer with some of my (skeptical) clients, but much of it is starting to happen, and I believe it will continue. And, unlike many clients, I don't think the Fed and other central banks will be able to contain it. What we're seeing is just the preview of the Global unwind. The following are the sources of leverages that created the bull market of the past 5 years:

1. Repo & ABS CP (hedge funds, SIVs, SPVs)
2. Levered Loans and bridge loans (private equity - stock markets @ premium)
3. Yen Carry Trade (invested in stocks and bonds, euro, USD, NZ, Aus, Iceland)
4. CDOs & CLOS helped re-leverage a lot of this leverage. Blame Basel.

Many financial products and real assets were created to feed this frenzy of cheap money: homes in orange county and florida, subprime mortages to get people into these loans, levered loans, covenant light loans, highly levered private equity deals, equity bridge loans, etc. Instead of money being raised to invest in cheap assets, assets were created to fulfill the supply of cheap money. And as more money came in, they rose in value, pulling up the prices of everything else.

There is no "real" equity to support this, and not much growth in real assets to support this. Much of the growth in asset values came from rising prices. When the leverage leaves, the price and value of all assets will decline till they stabilise at the value of the true 'equity' in the global balance sheet. Overvalued and unnecessary assets obviously decline the most, if not evaporate in value.

What has happened to date:

1. Subprime blew up, and the rating agencies effectively admitted they had no idea what CDOs should be rated at.

    * Repo haircuts went up. Hedge funds got margin calls and started selling.

    * Levered funds started blowing up. This led CDO and CLO buyers to stop buying as they no longer knew how strong their balance sheets were any more.

    * This started the damage to dealer balance sheets due to stuck CDO warehouses and ABS positions, warehouse loans in the pipeline, prop trading positions, and internal hedge fund problems.

Most people in our market are not looking beyond this, and are praying the Fed will cut rates, and that the liquity it is providing through system repos will bail out the market

2. The levered loan markets shut down, leaving large dealers with stuck bridge loans, and worse, equity loans.

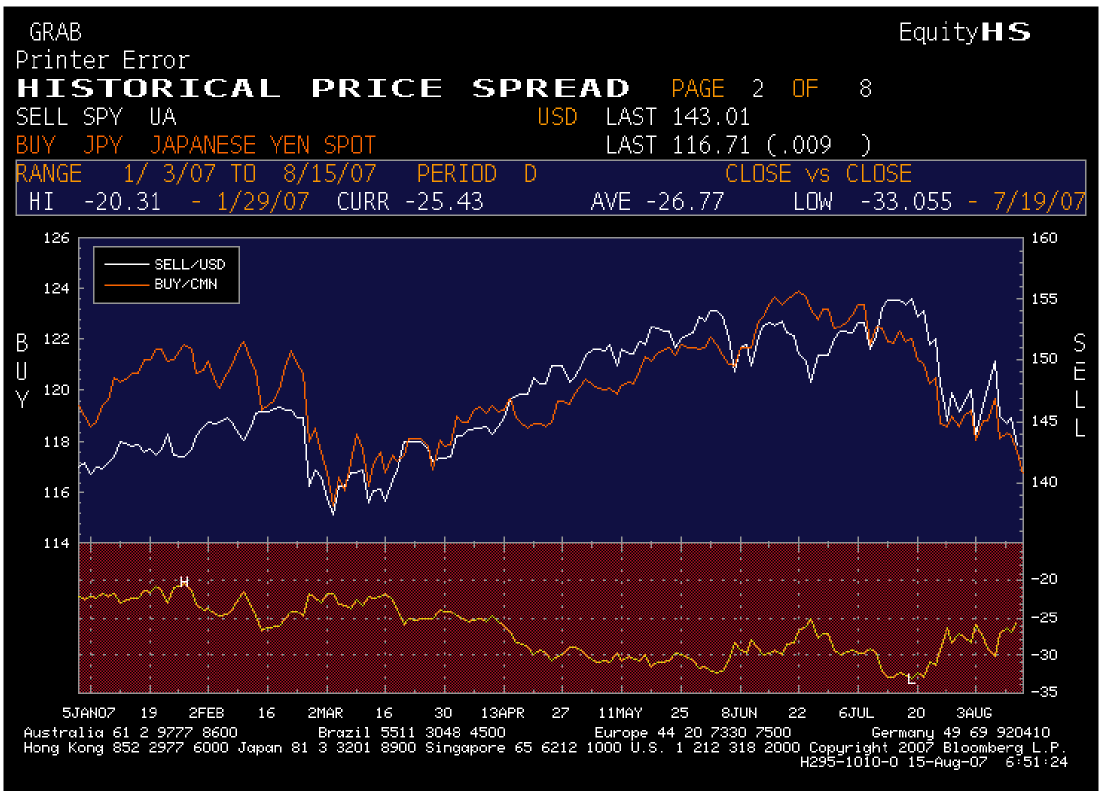
- THIS SHOULD HAVE TOTALLY CLOGGED UP STREET BALANCE SHEETS. WHAT IS THE CAPITAL CHARGE FOR A BRIDGE LOAN, BACKED BY EQUITY THAT WAS TAKEN PRIVATE AT A 30% PREMIUM to its prior market price?
- The street kicks out many repo clients. All hedge funds are now scrambling to sell bonds and delever. Redemptions kick in too. Client marks go into free fall.
- The SEC is investigating whether street is marking internally where clients are being marked.

3. ABS CP market shows sign of stress.

    - 3 ABS CP conduits extend their maturities as they can't roll. Anything funded with CP is a time bomb of supply for the market. They can get 90-120 day extensions in some cases. That means Nov Dec will be ugly with ABS being dumped. Estimates are 1 trillion of ABS funded by this, with the hope that banks will take the hit to money market fund NAVs to keep this contained, and take down the bonds. But, if their balance sheets are clogged by bridge loans, and unsecuritised whole loans, will they be able to?

4. Yen Carry trade - this is the $1 trillian question mark - how much and how rapidly will this unravel?

> * Anecdotal evidence suggests that Japanese housewifes have supported this heavily with retail savings (so called "Mrs Watanabes") everytime the dollar has strengthened, selling more Yen and buying $ and USTs. Will they come to the rescue? Or with USTs rallying, and rates rising in Japan, will they give up and buy back the Yen?
>
> * I STRONGLY BELIEVE THAT THE YEN CARRY TRADE IS THE REASON THE FED CANNOT CUT RATES.
>
> * The system may not be able to handle an additional 1 trillion of deleveraging. The graph below shows an incredible correlation between the S&P and the Yen. I have heard many anecdotal stories about how the US stock markets are dominated by program trading, and I suspect that the programs are funding or hedging their purchases and sales with Yen.



I think Big Ben's position is that he is also not going to bail out bad investment decisions made by investors - thats what markets are meant to fix, and teach. I think they will only intervene seriously if the system is threatened. That means some investment banks and banks will be allowed to fail. They might engineer some mergers. The Warren Buffet option?

Again, I dont think they have the option to cut rates, at least not till the Yen has already rallied. So, maybe 105 or 110 in YEN may signal that they cannot cause further damage by cutting rates.

The only solutions to dampen the effects of this deleveraging will be:

- System repo to provide daily liquidity.
- Raising limits for conforming loans so that high quality home owners in the US that meet agency credit criteria are not penalised by the lack of financing in the jumbo markets.
- Reducing margin requirements.

I don't see how the global unwind can be stopped. While most of these assets are money good, its going to be hard to find enough balance sheet for them. That means prices will need to cheapen.

Samir Shah, 8/10/2007

Additional Comments, 8/10/2017

Most people still incorrectly believe the flawed and incomplete narrative that the Global Financial Crisis was caused by MBS.

My analysis during and since the Crisis has shown that the Crisis was a deleveraging event that shrank the liability side of the global balance sheet, as short duration liabilities (hot money) were called away by their lenders. This resulted in all asset prices declining to fit into a reduced balance sheet size.

Yes, subprime (and other) MBS had been created in prior years to feed the frenzy of growing levered balance sheets that could get unlimited and cheap money to grow, in order to feed the incessant demand for “AAA” assets from banks because of Basel II regulations. And their poor performance had started the process of SIVs failing.

However, plenty of other assets, real and financial, had also been created and inflated, in far greater size than the MBS market, to feed this tsunami of money into the US, primarily stocks.

As I have discussed many times in the past, most of this money was attracted to the US markets from Japan by the interest rate differential between the 2 countries. **With the subsequent cutting of US rates by the Fed starting on August 17, 2007, this incentive went away, leading to the withdrawal of lent money on a massive scale, and converting what should**

have been a localized US subprime credit problem into the Global Deleveraging Financial Crisis.

Understanding this is critical to understanding the subsequent impact of QE, and the risks of reducing QE today.

What QE accomplished was to replace the lost short duration liabilities with lending that had more stability, thereby reinflating the global balance sheet and thus allowing asset prices to reinflate. (Only those with assets benefited from this, leading to increases in inequality.)

Today, with much discussion of drawing down QE, the risks are that money supply (M3) will once again collapse, which will reduce the balance sheet available to house assets and support asset prices.

One solution to this is what the Fed is inadvertently doing - raising rates - which will likely once again attract liabilities/investments back to the US and thus raising US asset prices. If the Fed does both simultaneously - cuts QE and raises rates - the net effect on asset prices should be neutralized.

However, systematic risk will increase if the owners of these liabilities are non-US once again, and could claim their capital at any time, as they did in 2007-2008.

I would love to hear your comments.

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