

What, Why, What Next?

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March 10, 2009

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Topics

- **What**

- Housing Bust
- Stock Market Sliding in Turmoil
- Credit Crisis

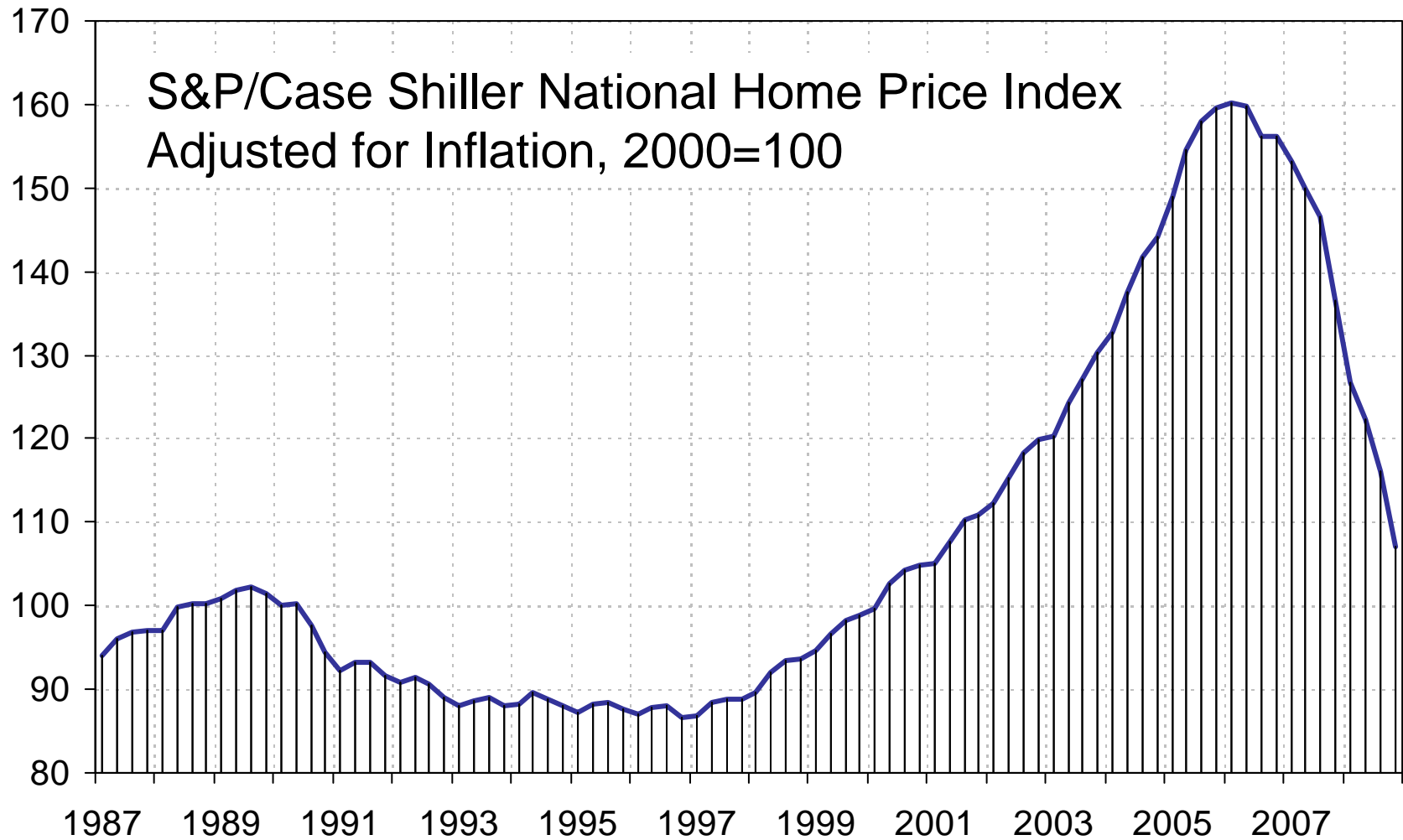
- **Why**

- Debt
- Instability
- And Feedback

- **What Next**

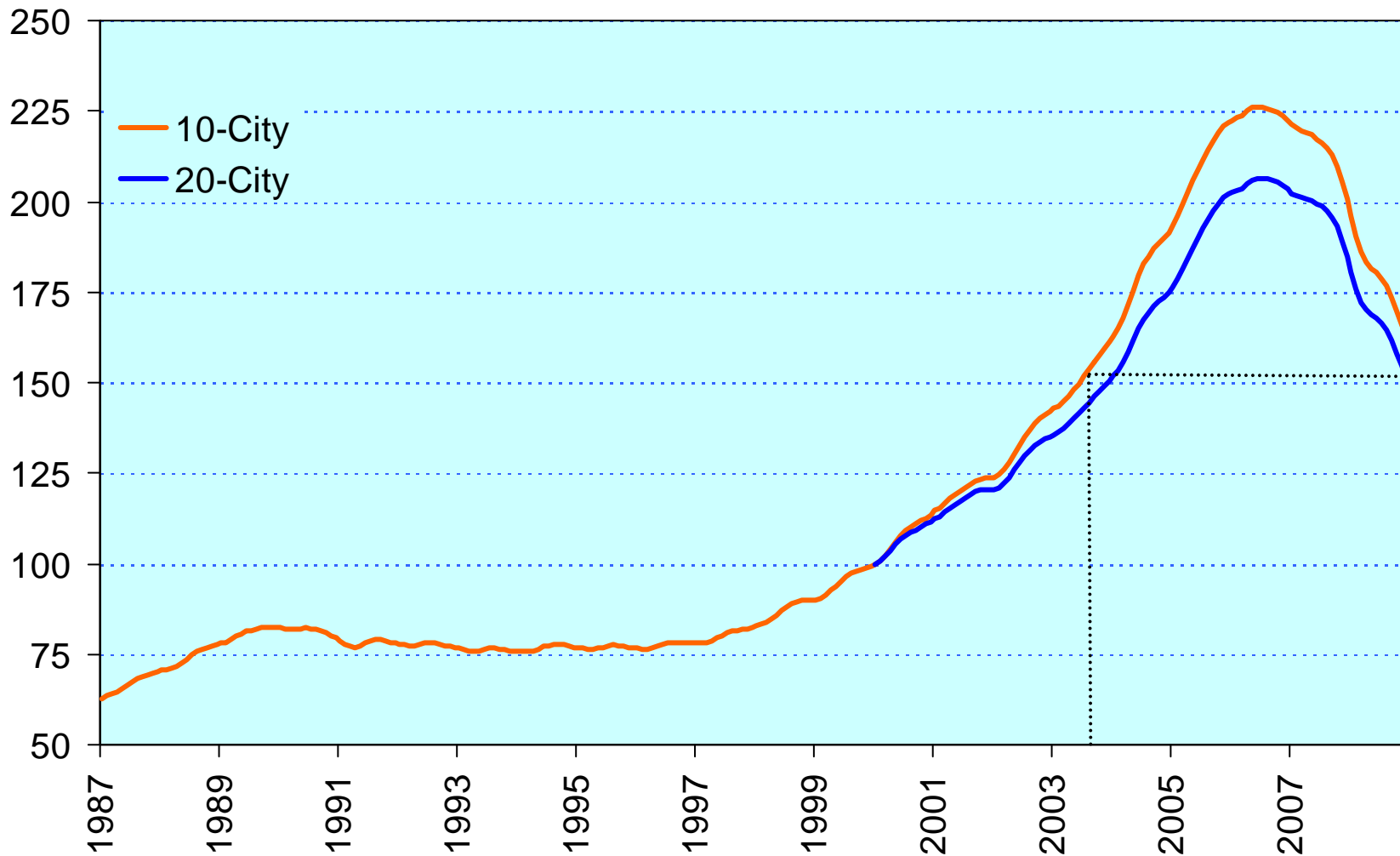
The Housing Story

Home Prices



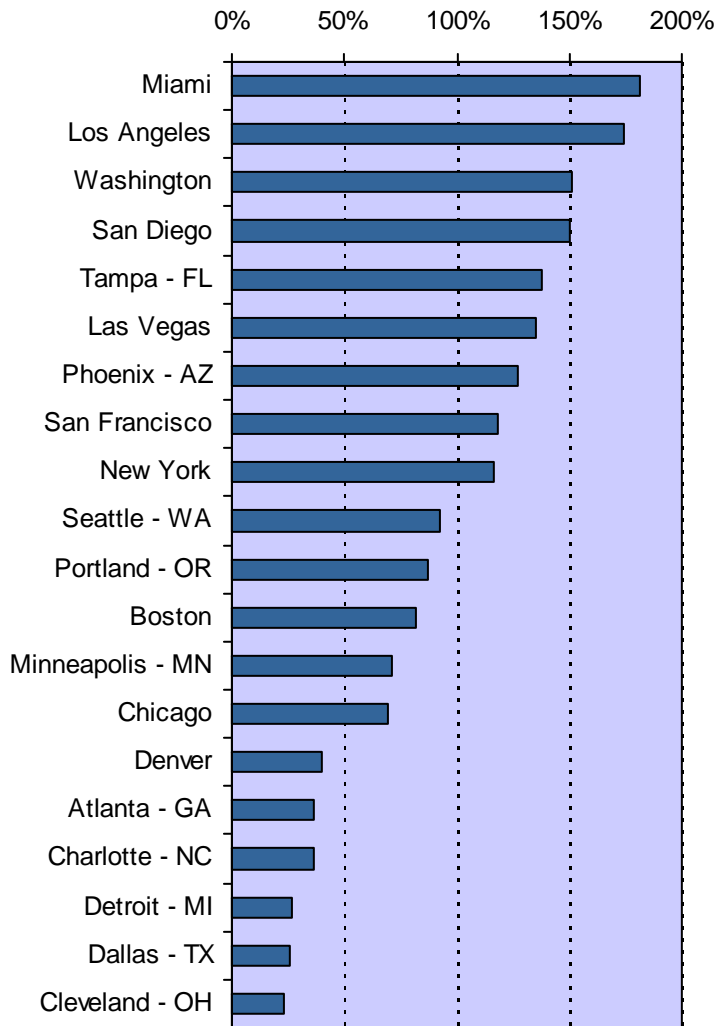
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S&P/Case Shiller Composite Indices

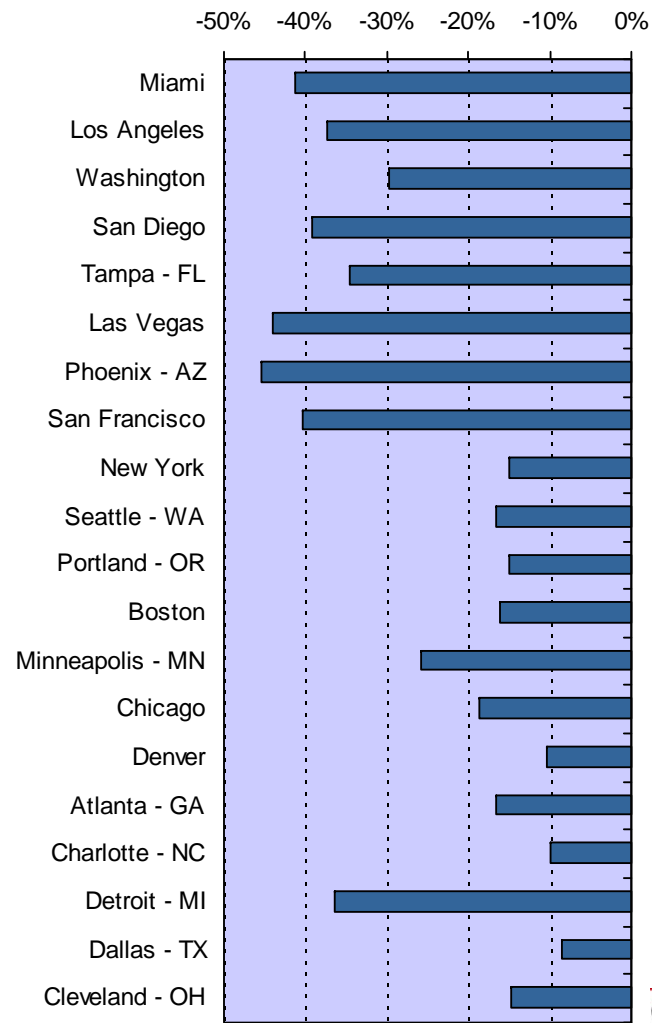


Regional Trends

Peak Gain Since 2000



Decline (%) from Peak
As of December, 2008

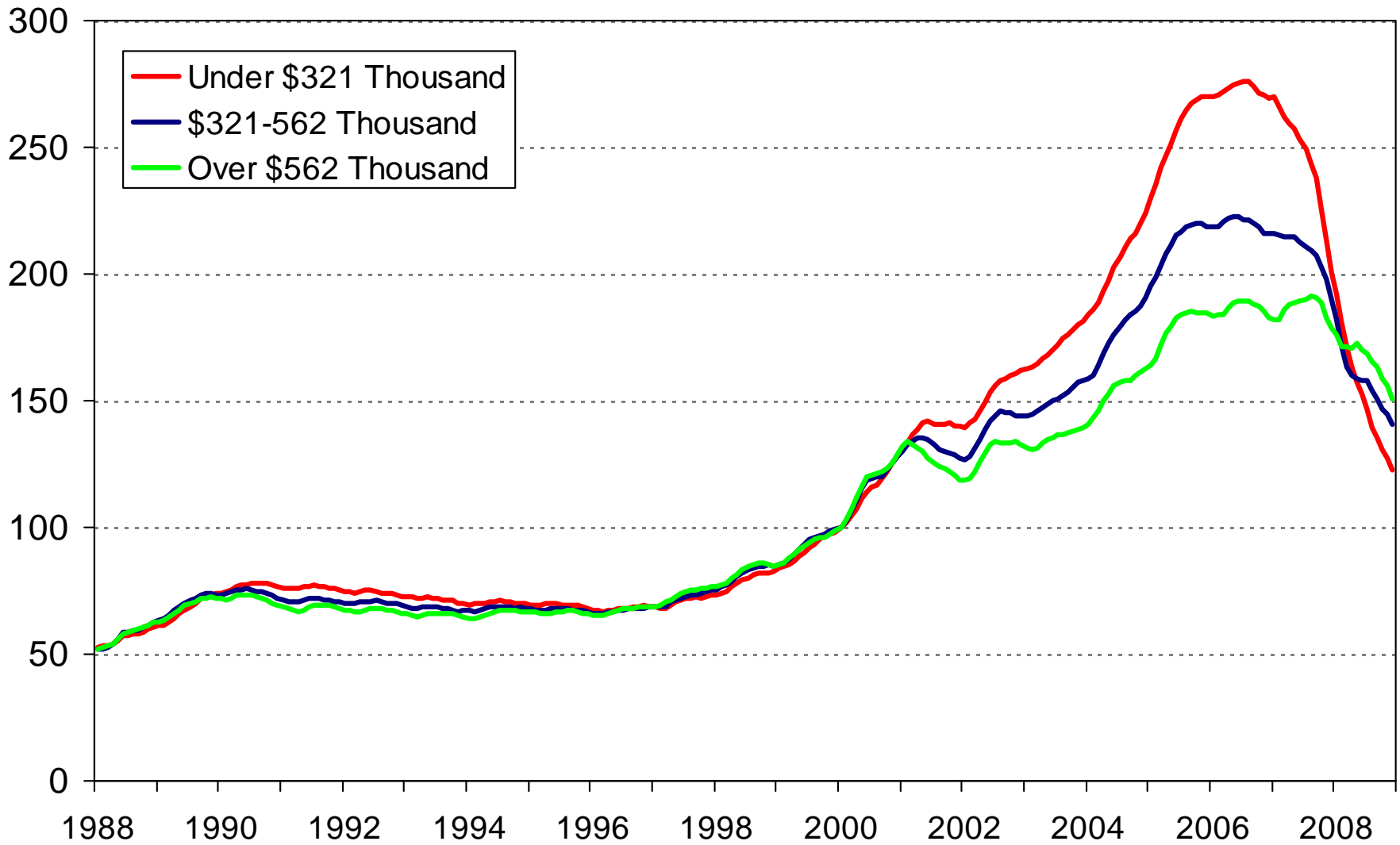


S&P/Case Shiller Home Price Indices



Source: Standard & Poor's

Tiered Home Price Indices for San Francisco

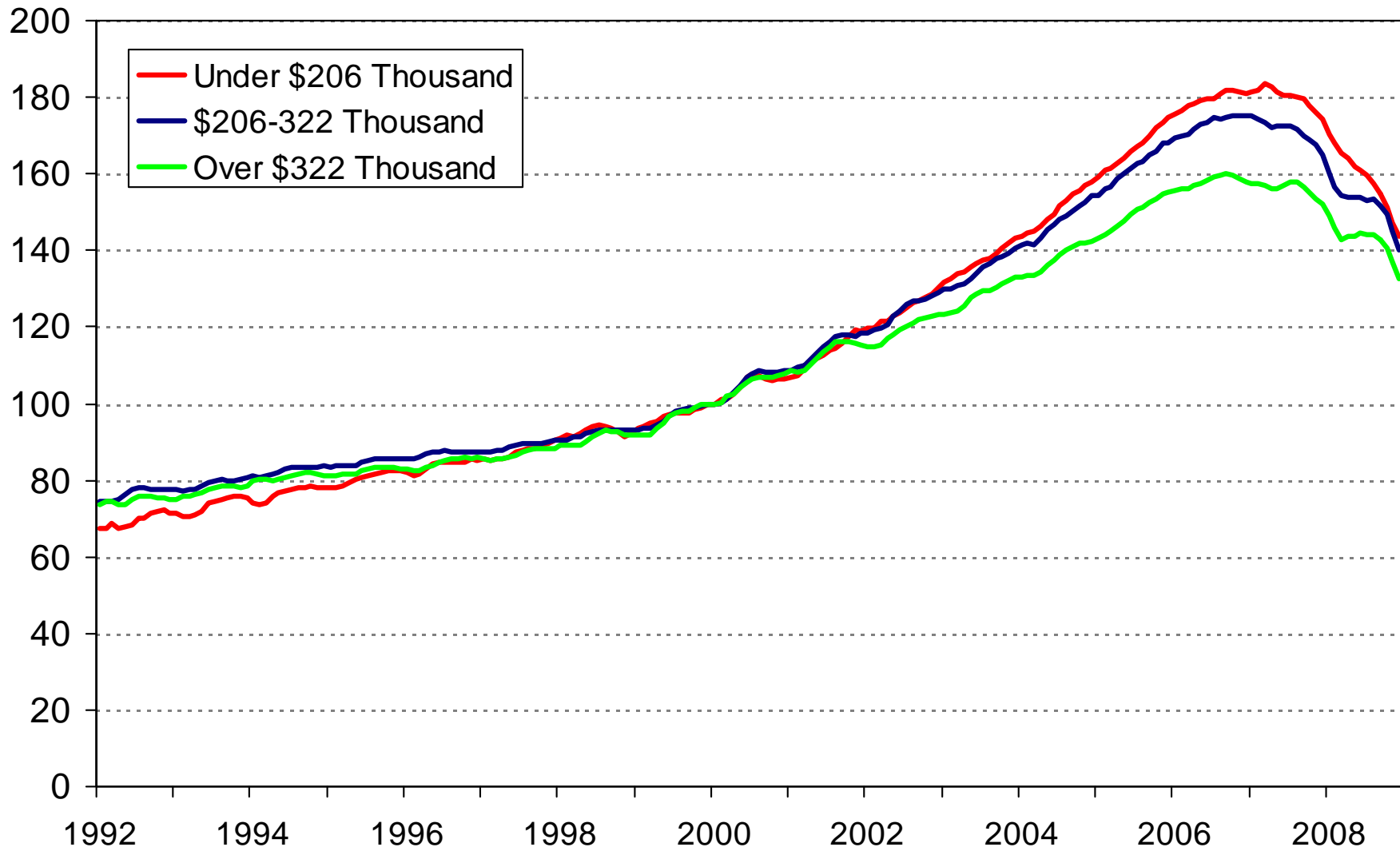


S&P/Case Shiller Home Price Indices

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Tiered Home Price Indices for Chicago

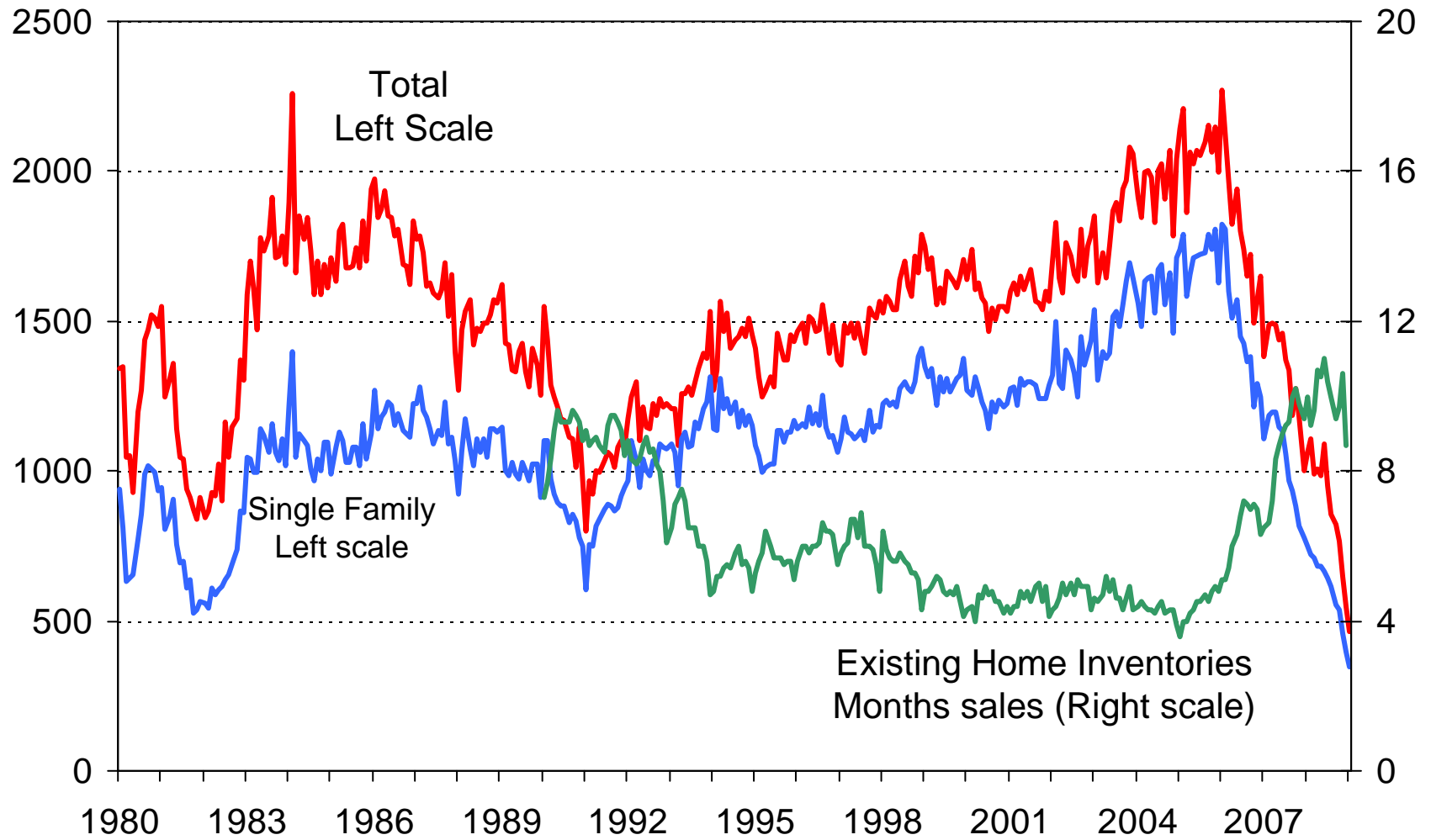


S&P/Case Shiller Home Price Indices

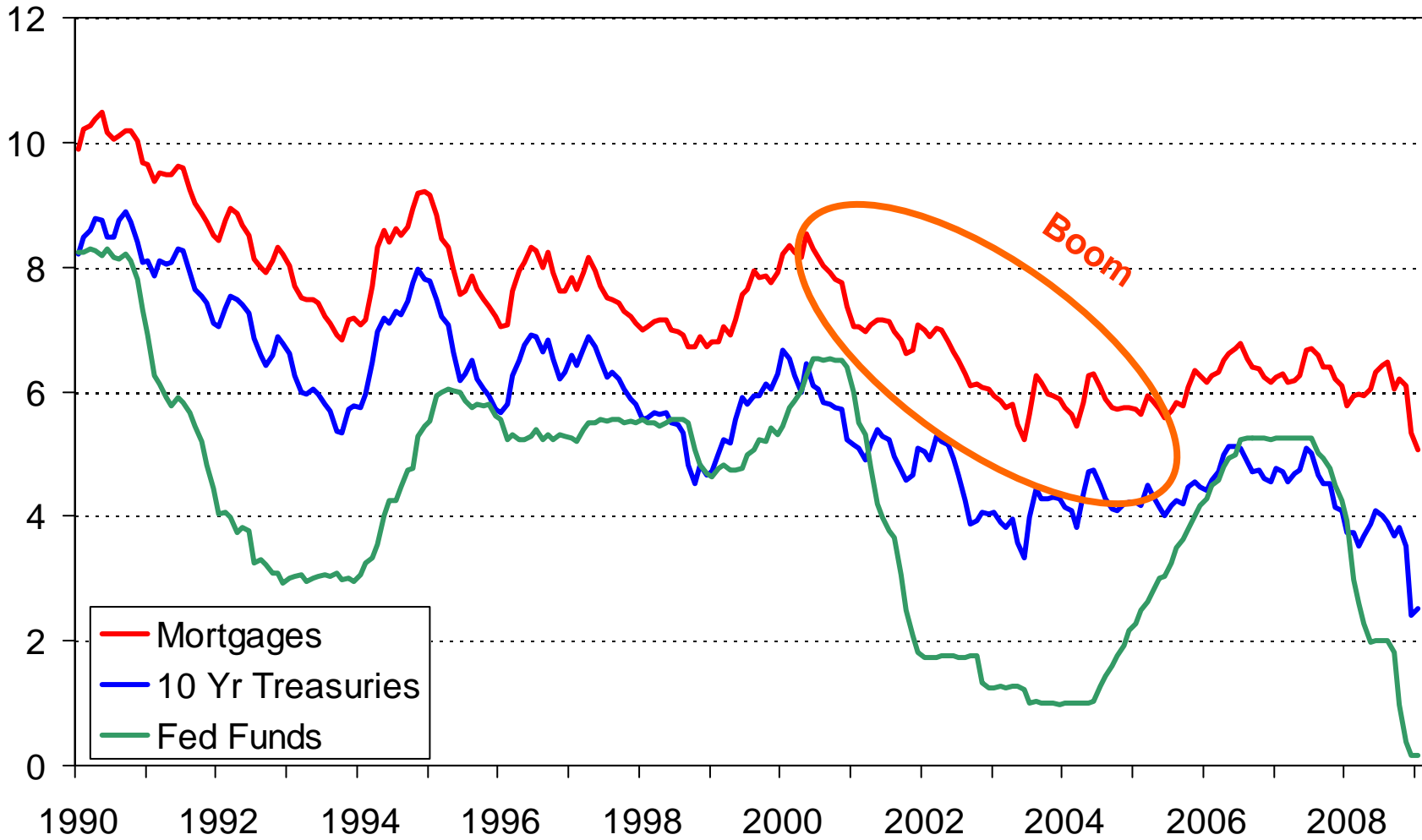
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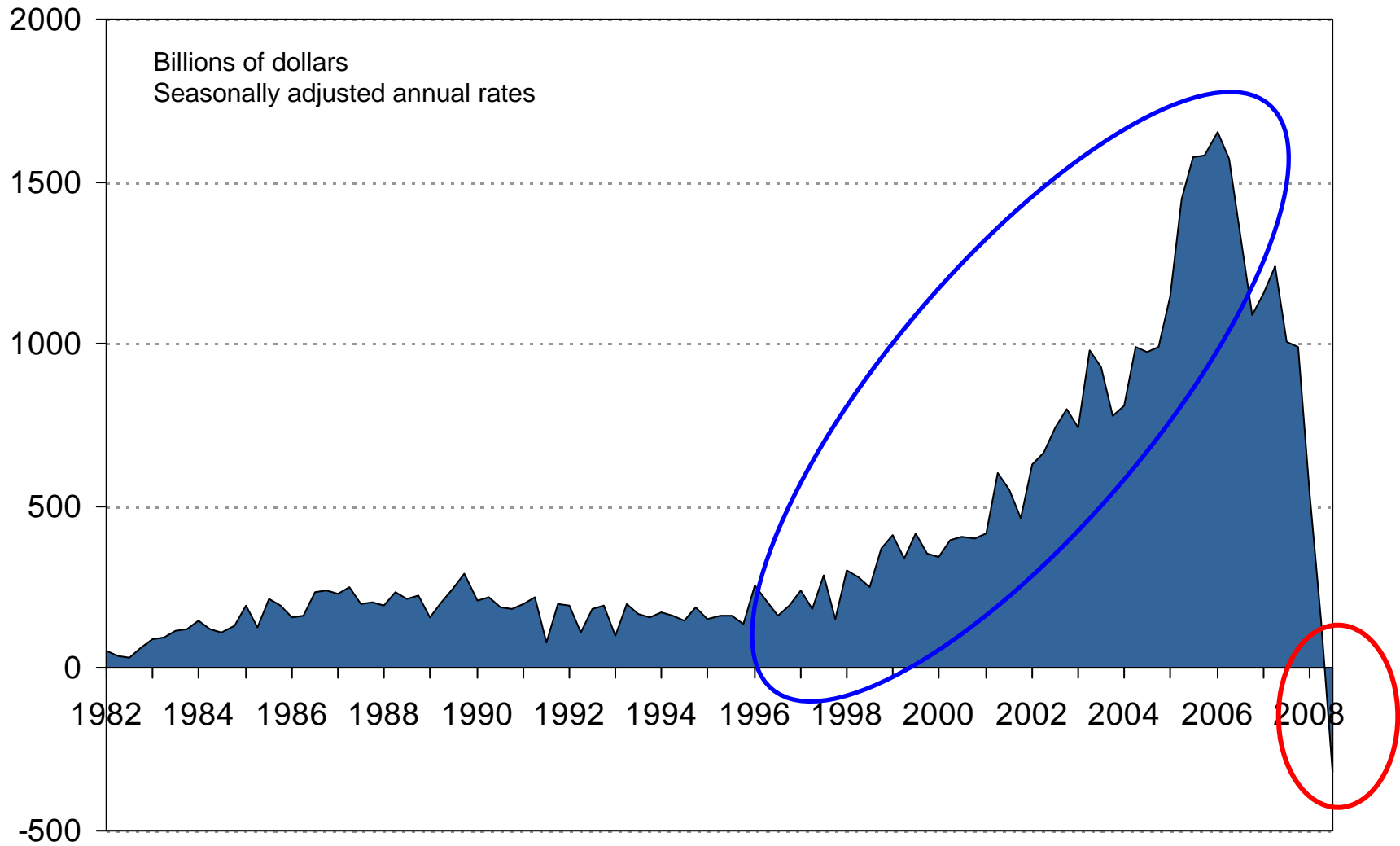
Booming Housing



Interest Rates



Net Increase in Home Mortgages



Flow of Funds table F 217, Federal Reserve

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The Boom

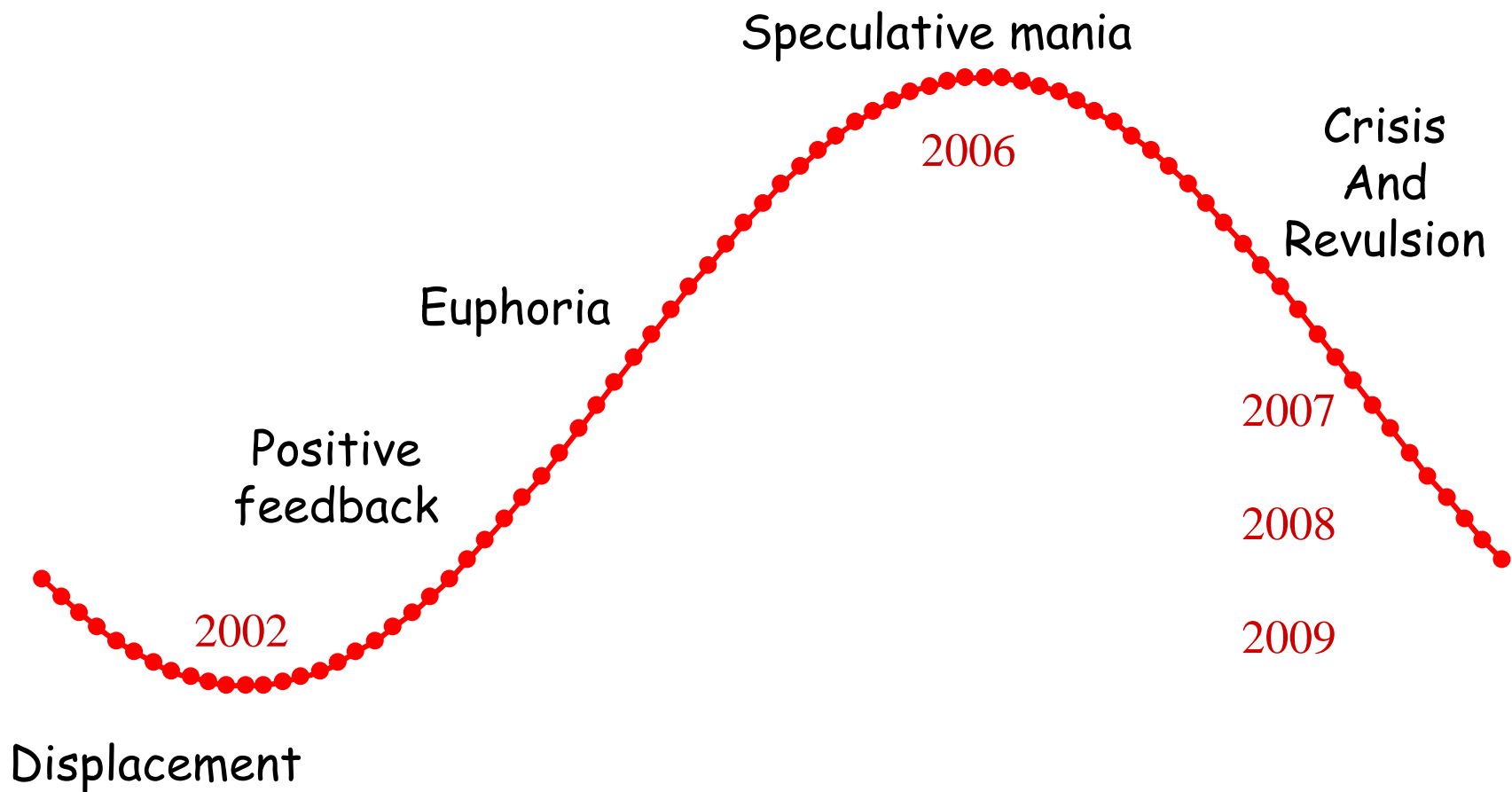
Setting the stage

- **Avoiding stocks after the bear market of 2000-2002**
- **Easy money and low interest rates**
- **Ongoing policy efforts to spur home ownership**

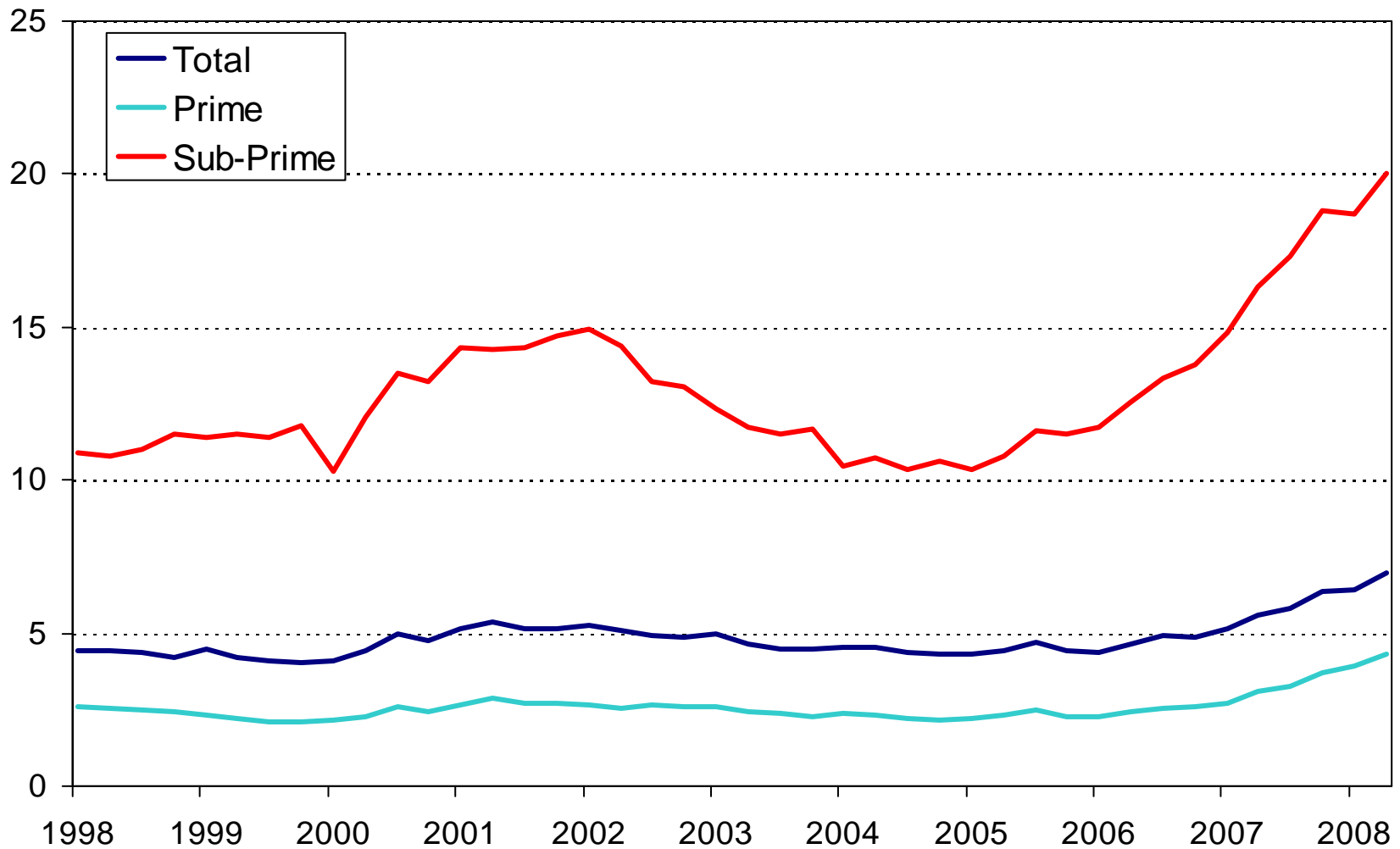
Results

- **Construction boom**
- **Rapid mortgage expansion**
- **Rising house prices**

The Cycle



Delinquent Mortgage Loans (Percentage)

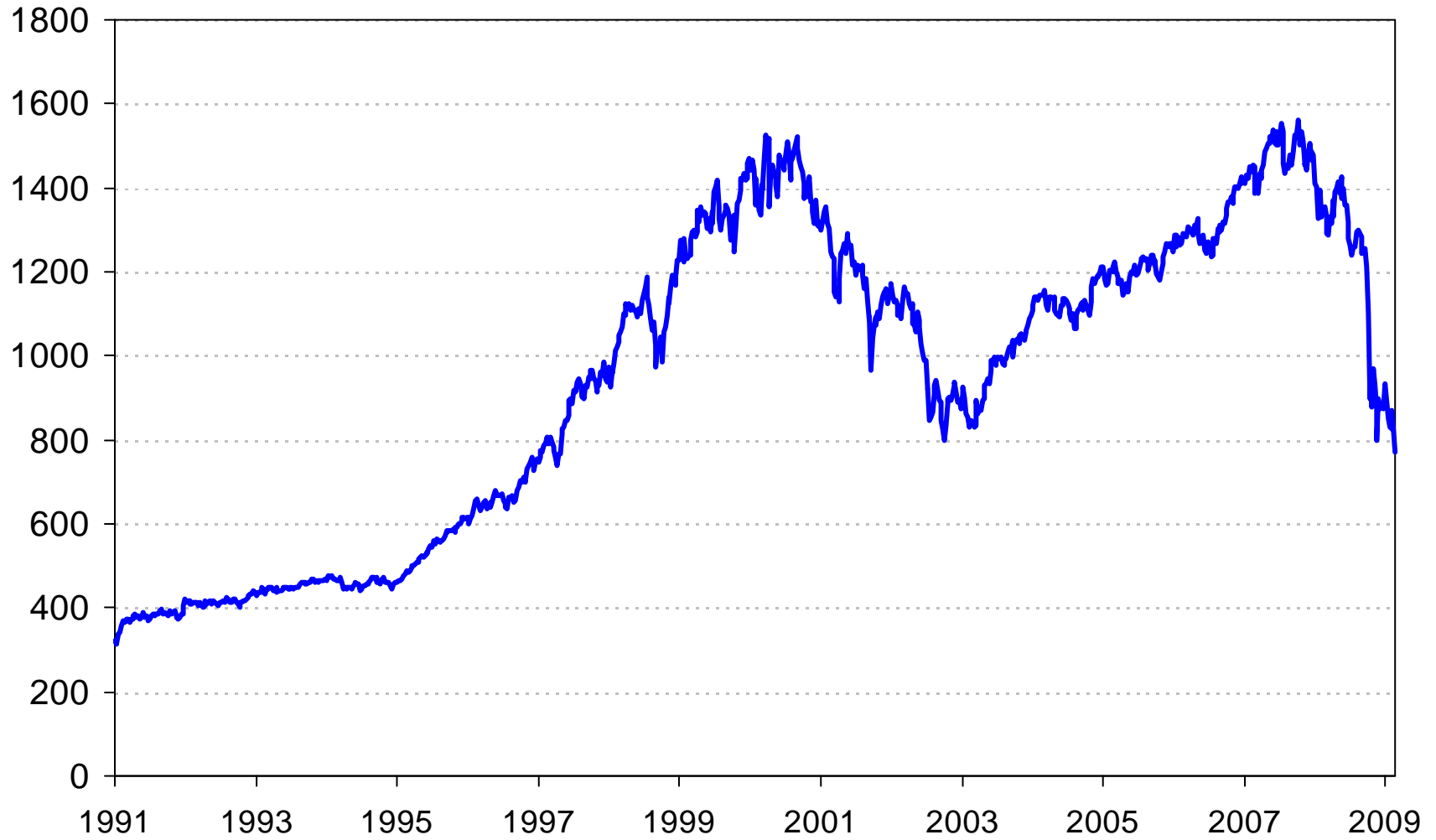


Source: Mortgage Bankers Association via Bloomberg

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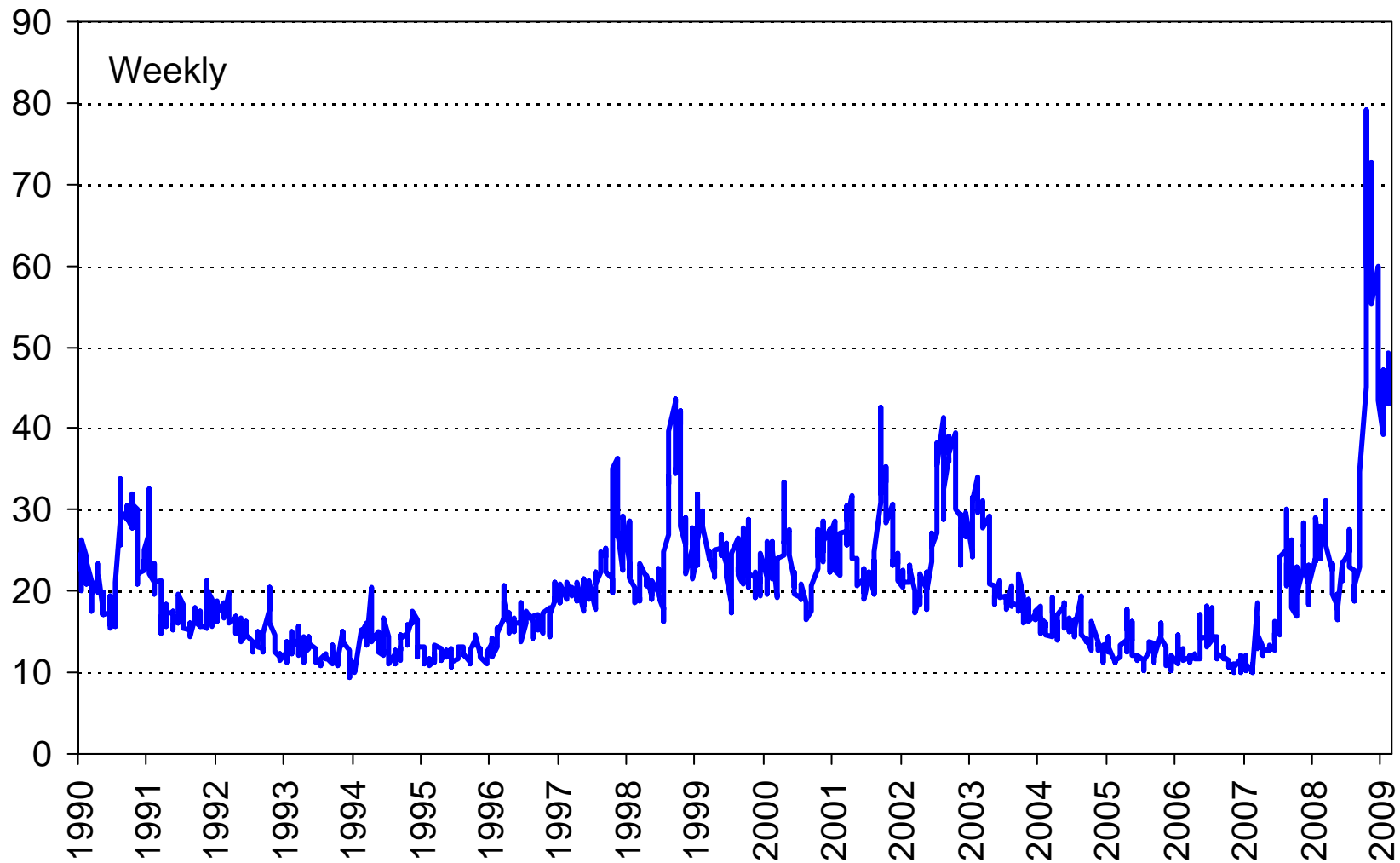
The Stock Market

S&P 500

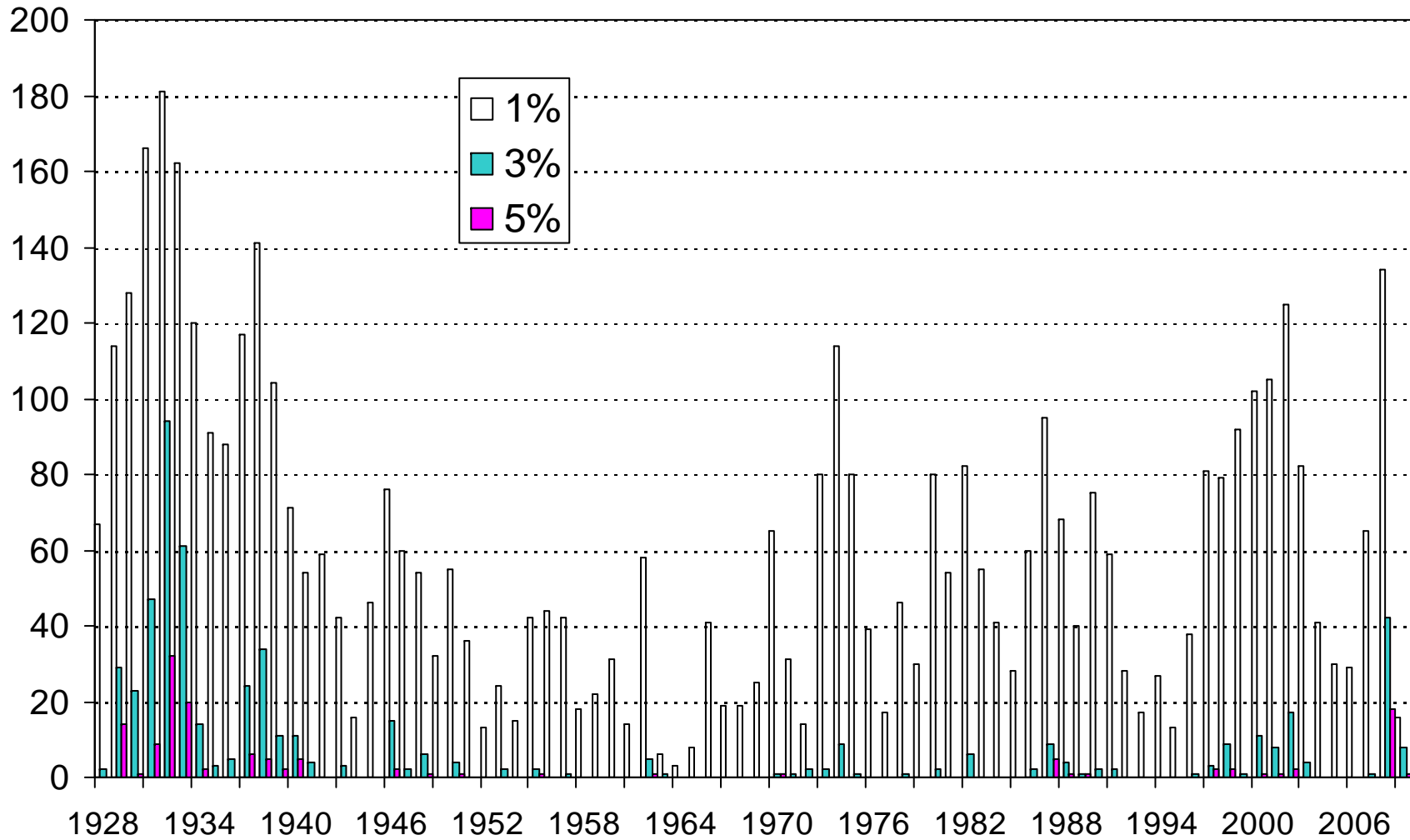


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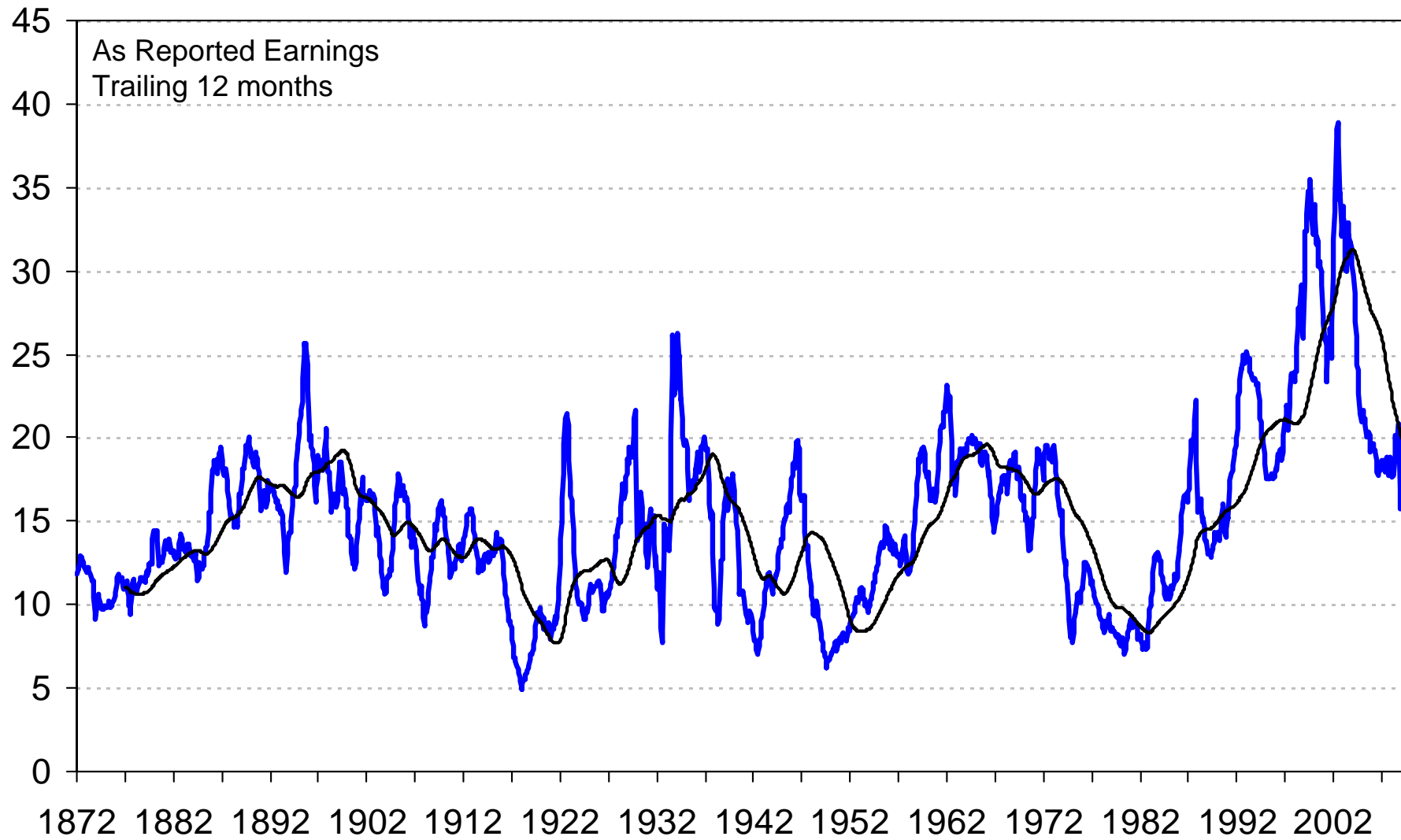
VIX



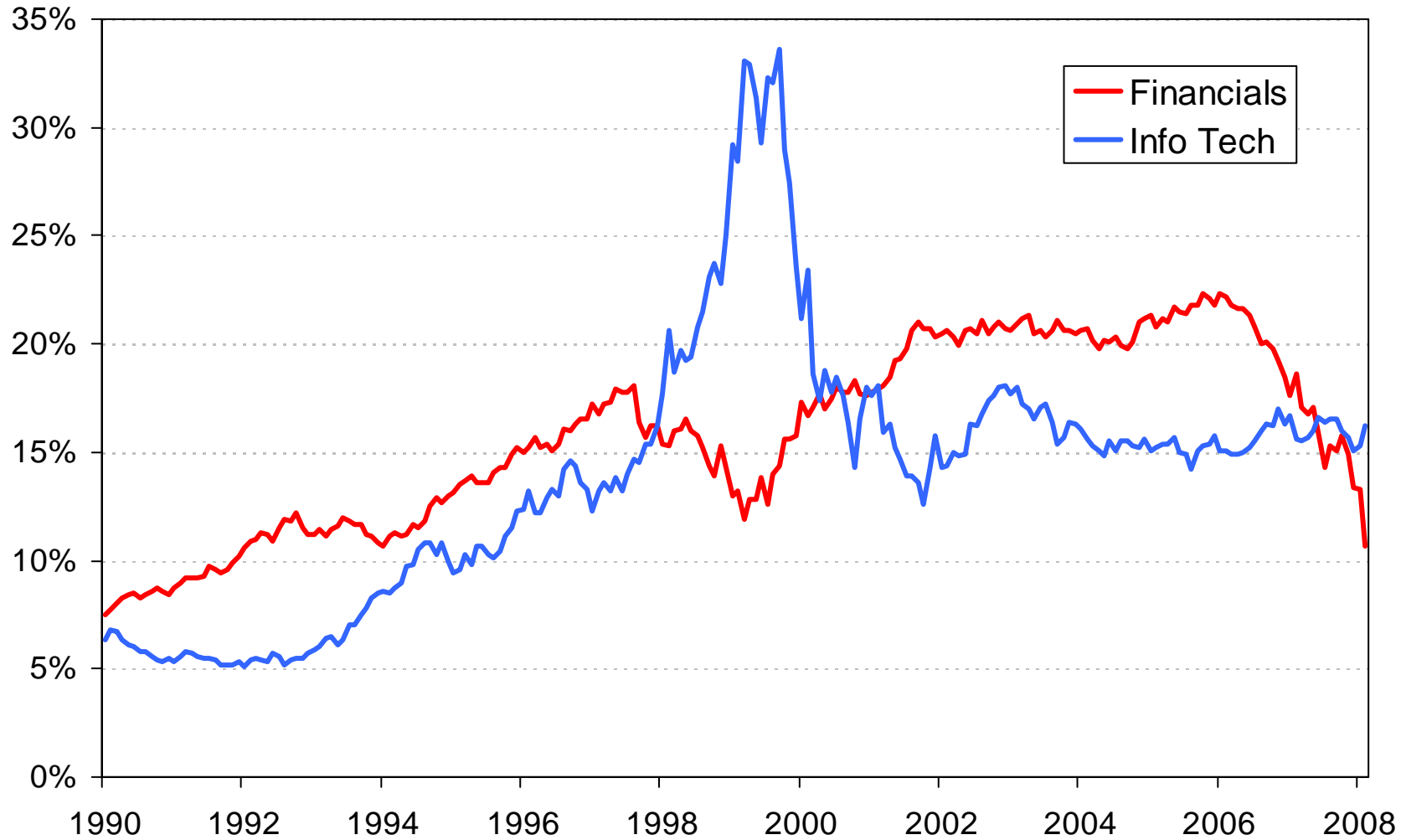
Big Daily Moves in the S&P 500



S&P 500 P/E Ratio



A Tale of Two Sectors

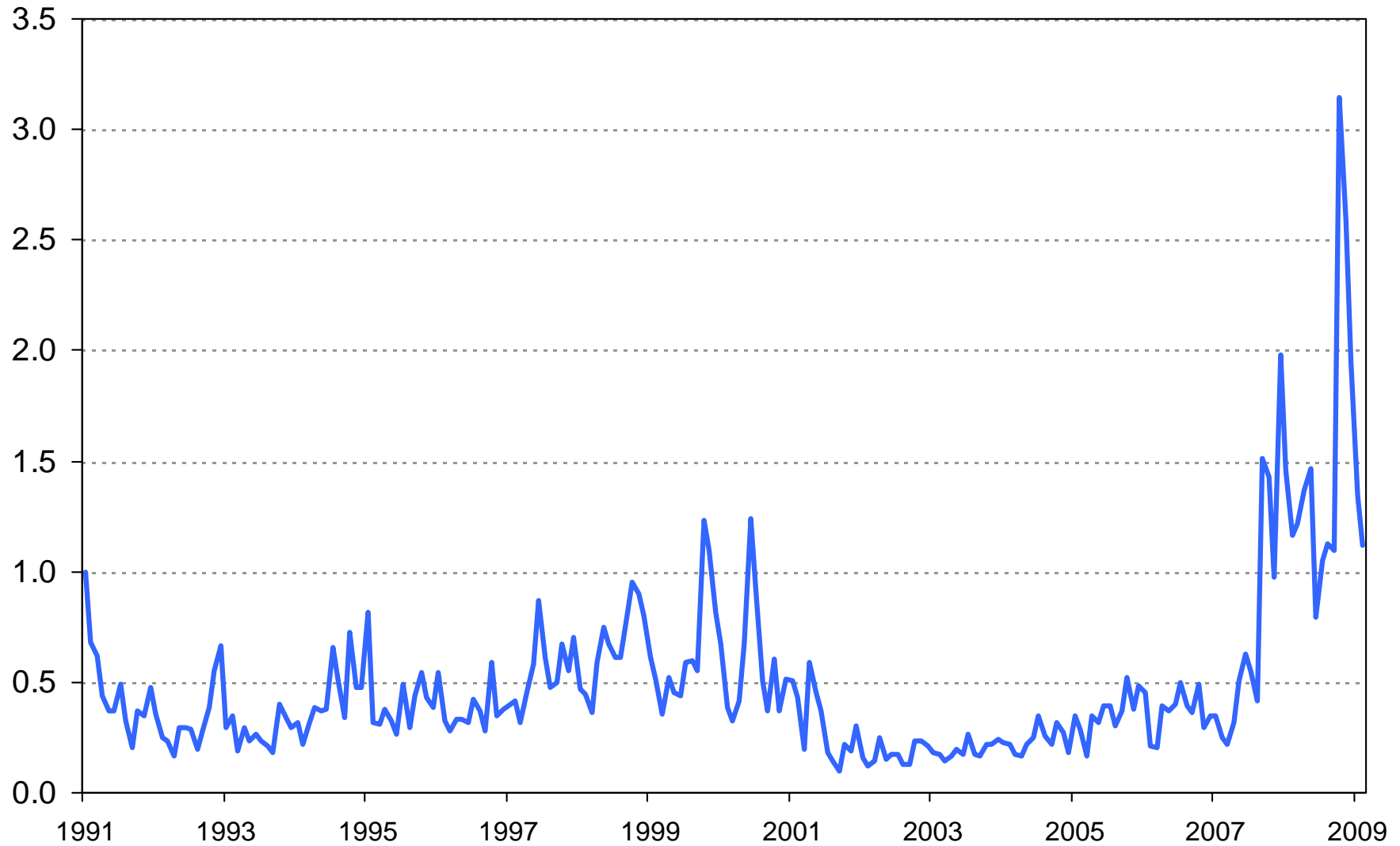


Stages

	Housing 2002-2009?	Stocks 1995-2000
Displacement	Low interest rates, sub-prime mortgages	Internet and Web
Positive Feedback Loops	Mortgages drove prices up, higher prices raised expectations, opened path for more aggressive mortgages	Rising stock prices respond to internet
Euphoria – Irrational Exuberance	Home prices don't go down	Productivity gains and low inflation convince people the internet is real
Speculative Mania – feeds on itself and departs from reality	Rising demand for MBS and securities built on MBS	AOL Time Warner merger
Crisis	FNM, FRE, LEH	March 24, 2000... S&P 500 at 1527

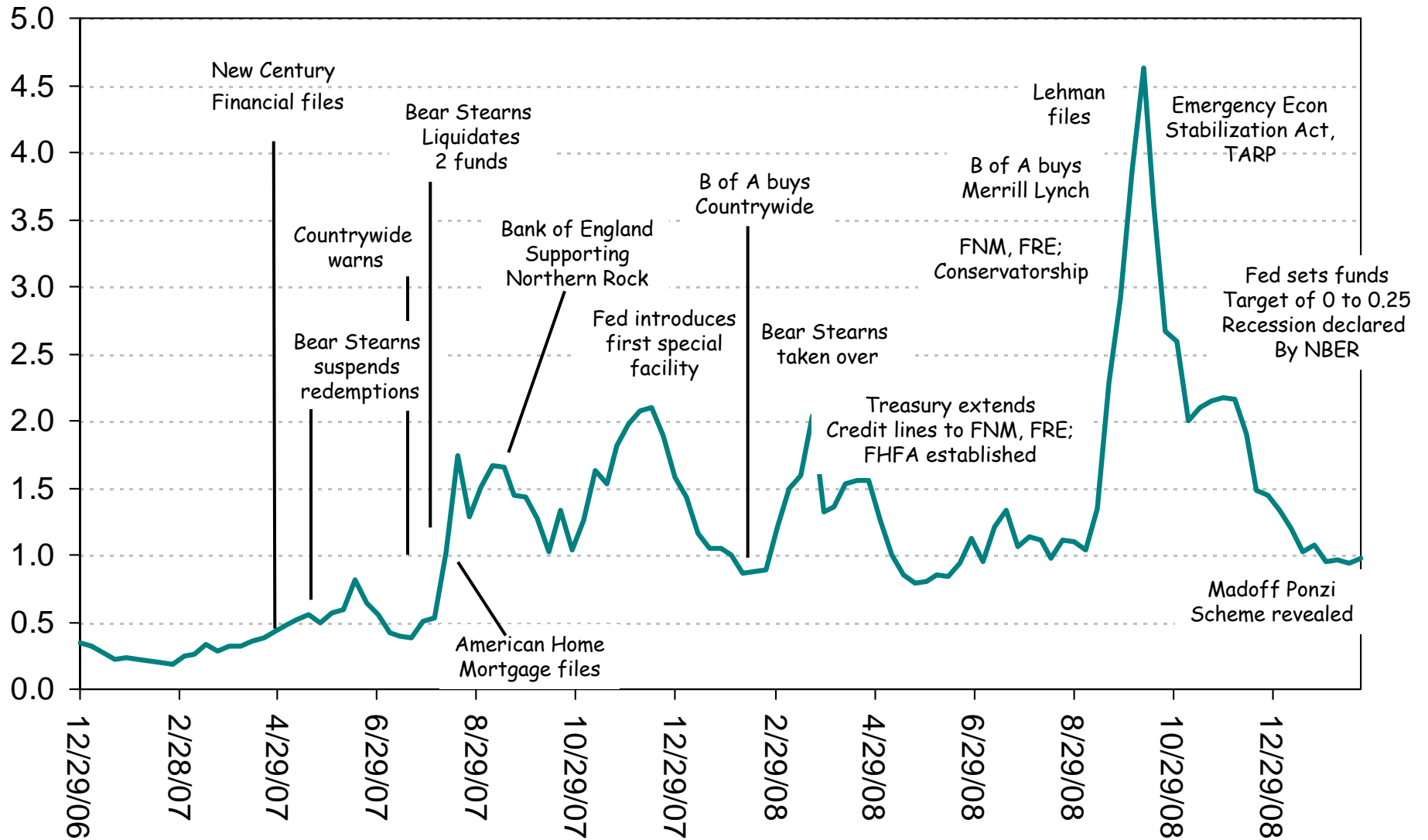
The Credit Crisis

TED Spread – T-Bills vs. LIBOR



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What happened when



The Beginning of the unwinding

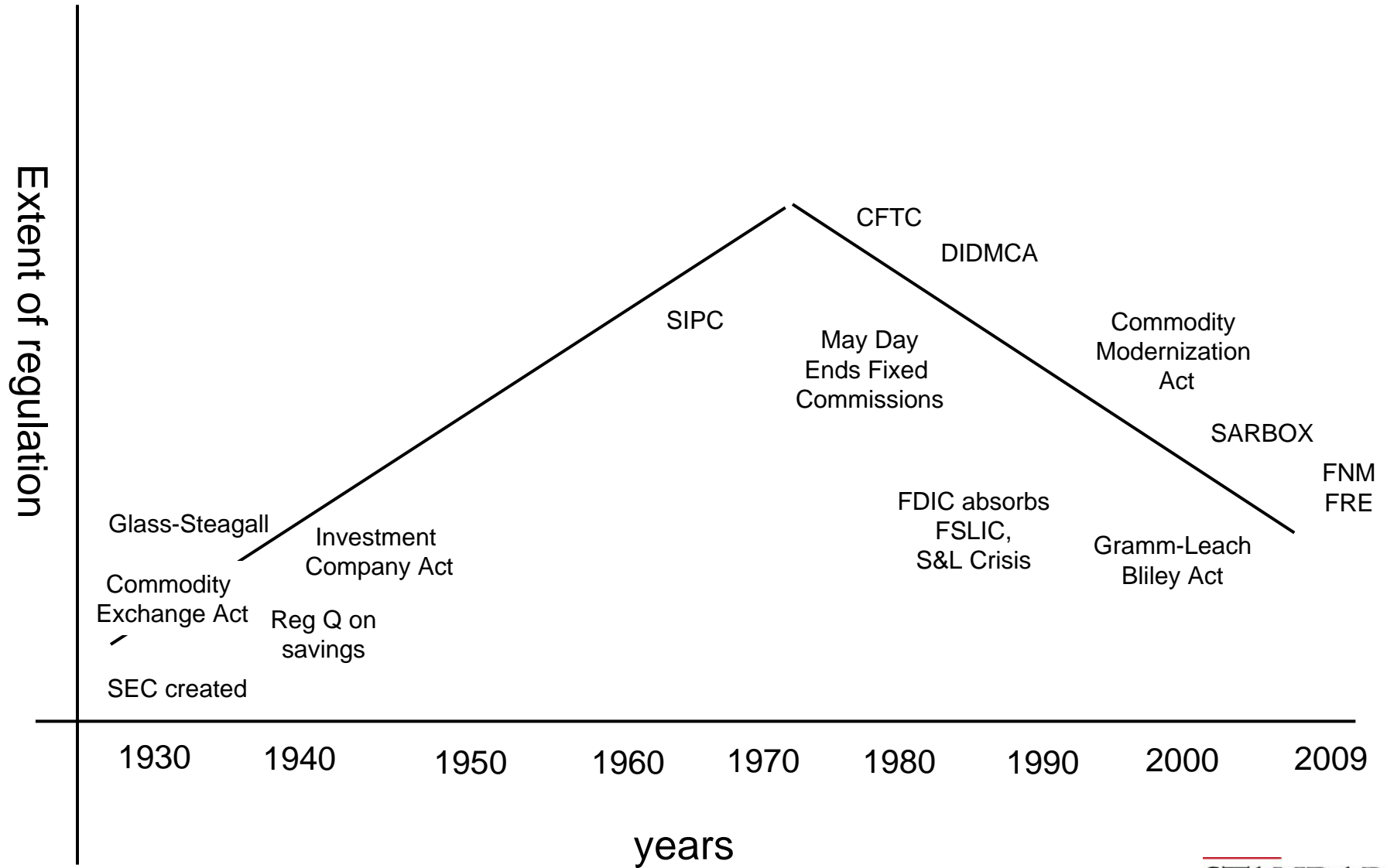
- **The housing boom was predicated on rising prices**
- **As prices peaked and slipped the resulting financial weakness spread**
- **Investors' willingness to take on risk dropped**
- **Bankruptcies generated fear and a rush to de-leverage**
- **The question remains: why is this event much deeper and more dangerous than recent recessions or crises?**

Why

Why?

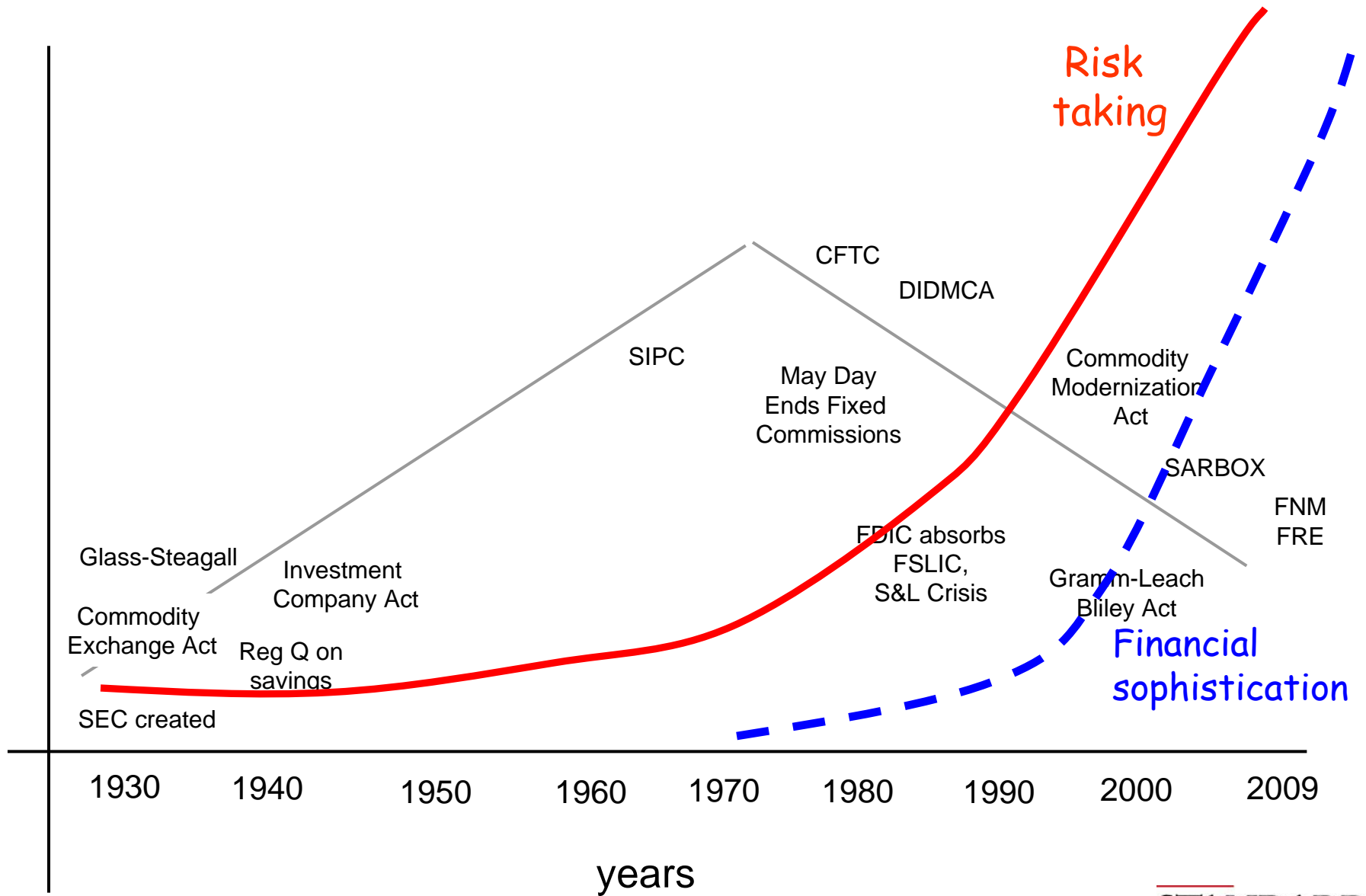
- **Since 1980 the regulations inherited from the Great Depression have been chipped away**
- **Financial markets and instruments became more complex and sophisticated**
- **Leverage rose in the U.S. and global economies**
- **Willingness to take risks grew**
- **Innovation and technology in finance left many without a clear understanding of the true level of leverage, risk or how markets work**

Markets and Regulation

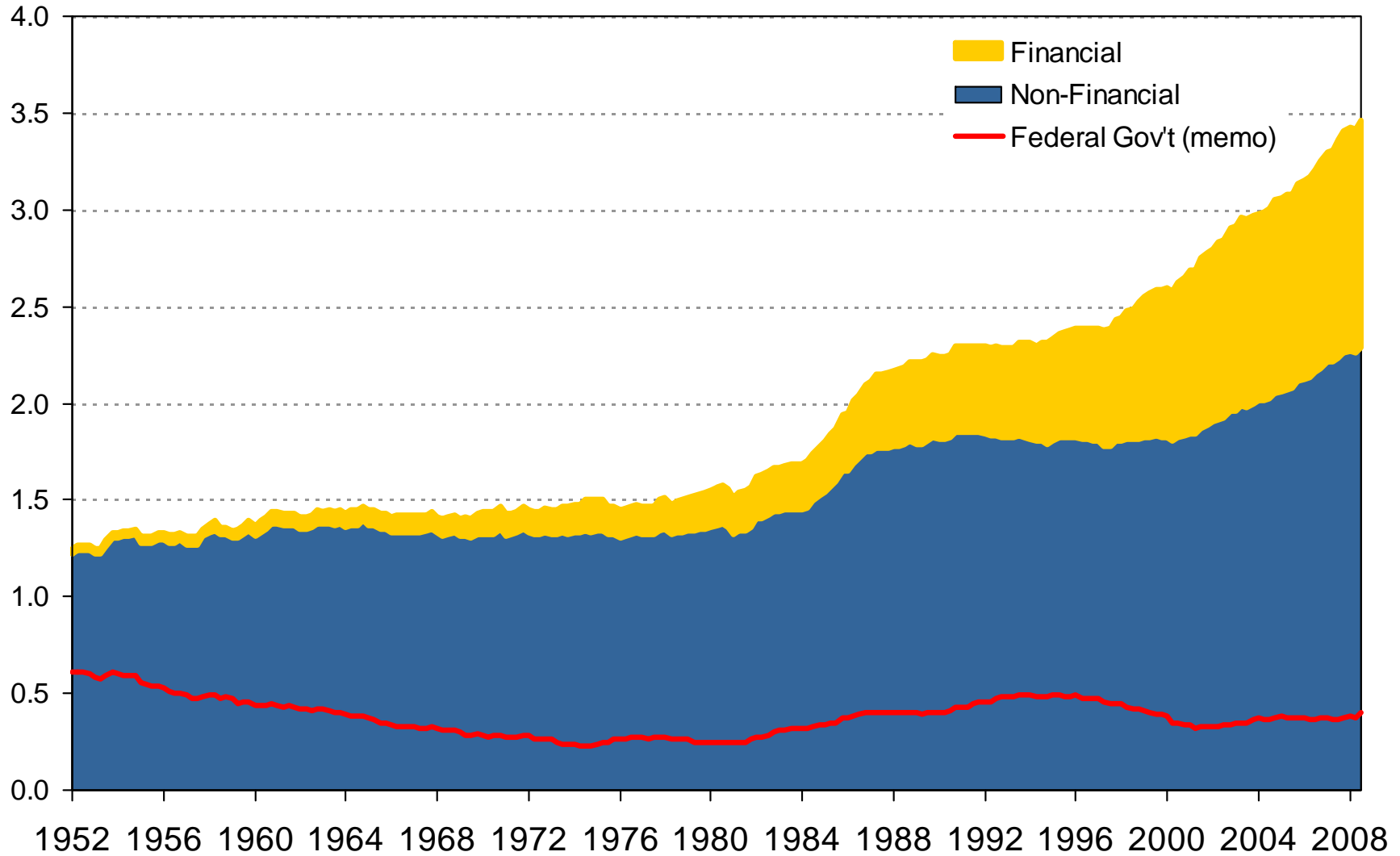


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Markets and Regulation



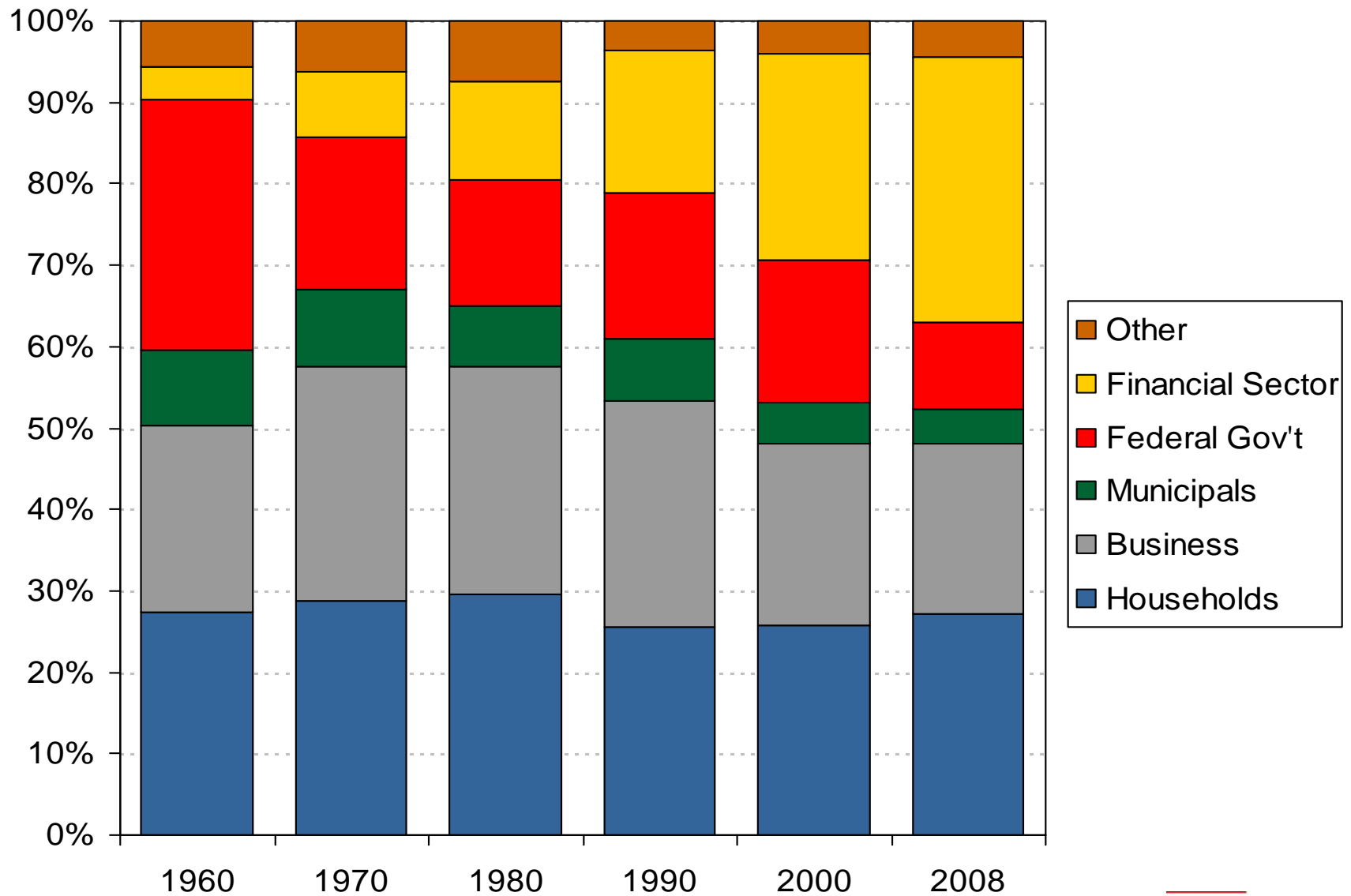
Debt:GDP Ratio



Source: Federal Reserve Flow of Funds Accounts

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Components of Our Debt



Source: Federal Reserve Flow of Funds accounts

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Where and When Debt Grew

Annualized rate of change in Debt:GDP ratio
for selected sectors over presidential terms

	Total	House- holds	Business	Federal Gov't	Municipals	Other	Financial sector
Eisenhower	1.7%	6.3%	3.0%	-3.4%	6.6%	1.7%	9.6%
Kennedy-Johnson	-0.2%	0.9%	1.8%	-4.6%	-0.3%	1.6%	4.7%
Nixon-Ford	0.6%	-0.2%	1.5%	-1.6%	-0.8%	2.1%	6.7%
Carter	1.3%	2.5%	0.2%	-1.9%	-1.6%	2.5%	7.1%
Reagan	4.2%	2.4%	4.2%	6.0%	4.7%	-5.9%	9.5%
Bush 1	1.0%	1.5%	-3.4%	4.4%	-0.2%	0.7%	3.4%
Clinton	1.9%	1.7%	2.2%	-4.1%	-4.1%	3.1%	7.3%
Bush 2	3.6%	4.2%	1.9%	2.2%	3.3%	5.9%	4.8%
2008:3 Amount (\$ Trillion)	51.8	13.9	10.8	5.8	2.2	2.2	16.9

The Recession of 2007-2009

- **The Recession began in December, 2007**
- **This will be the longest post-World War II recession**
- **Recession of 1973-75 was Fed policy and oil prices**
- **Recession of 1981-82 was high interest rates to fight inflation**
- **This time the key is the debt over hang**
- **The crucial step to recovery is the debt**

How We Got Here

- **Years of growth with low inflation and growth lead to:**
 - Less regulation
 - Belief that markets are fundamentally stable, even predictable
 - Increased willingness to take risks
 - Decreased understanding of those risks
- **Stability lead to its own demise**

How Things Got Out Of Control

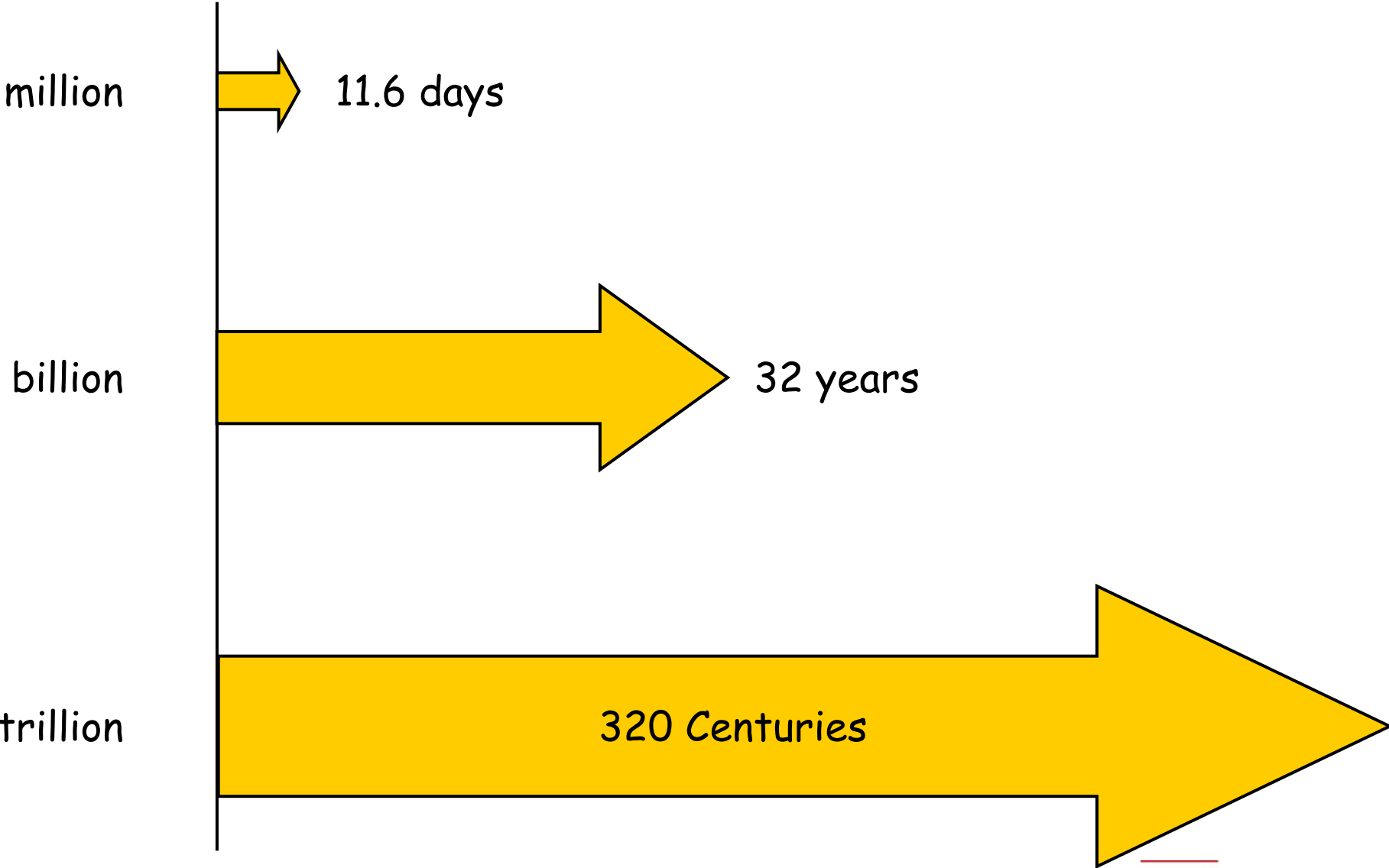
- **Stability and growth changed fundamentals**
 - As home prices rose, people were able to borrow more, driving home prices even higher.... And the process repeated
 - We act as if Past Performance is a guarantee of future results
- **Who thought a national housing bust was possible?**
- **When the 2000 Bear market started, few remembered the last time stocks lost 50% but almost everyone remembered the rapid rebound in 1987**
- **Everyone believed the Fed could, and would, save the day no matter what happened.**

What happens next

Real Money

- **Possibly the only thing about the stimulus, bailout, TARP and other plans everyone agrees on is that the dollars are **BIG****
- “A billion here, a billion there - pretty soon it adds up to real money.” Everett Dirksen
- **How big is a million? A billion? A Trillion?**
 - How long is a million seconds?
 - A billion seconds?
 - A trillion seconds?

How big?



Stimulus and all that...

- **Key issue is eliminating bad debts and re-liquefying the banking and credit system**
- **This means more spending**
- **And it requires patience from all of us....**
 - It takes time to get programs running, money spent and debts retired
 - It takes more time for the results to show up in financial markets and economic reports
- **The news will be bleak for awhile longer**

Thank You

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