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Economic Research:

U.S. Economic Forecast: Another Panic Of '07?

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The financial markets marked the centennial of the great panic of 1907 by holding another panic. Indeed, this one seems likely to affect the economy less than its predecessor did because the central banks have learned to handle liquidity squeezes better than in the past. The 1907 panic was one of the major reasons for the founding of the Federal Reserve System, as Congress decided that it could not rely on the good will and ability of bankers like J.P. Morgan to coerce cooperation. Will Chairman Ben Bernanke do a better job than Mr. Morgan?

Is it an accident that these crises often seem to occur in years ending in "7"? Financial turmoil struck in 1957, 1967, 1987, 1997, and 2007. It is hard to tell about 1977 because the whole decade was one long crisis (so maybe just having a "7" is the problem). Going back further, 1937 was a bad year, as were 1897, 1907, and, of course, 1917, with America's entrance into World War I.

Although the current turmoil began in the subprime mortgage market, it has extended far beyond that to a general crisis of confidence. What's happening now is a classic run on the bank, except that the banks have been disintermediated by the short-term money markets, which have become a virtual bank. A central bank's role in fighting bank runs has been well established: provide adequate liquidity so that the panic does not bring down the solvent banks. This principle needs to be extended to the money markets that now support the banking system.

Part of what is happening is a reassessment of risk. For at least the last two years, Standard & Poor's Ratings Services has noted that credit spreads were too narrow to justify the risks inherent in the instruments investors were buying. Recent credit problems have usually run their course within about three months, and we expect this one to do the same. However, that does not mean that spreads will return to the extremely narrow range of three months ago; rather, they'll likely stabilize.

We had thought that except for the housing market, the problems would have little effect on the economy. However, the drop in employment in August and the downward revisions to the previous two months of job data—together with the earlier downward revision to recent GDP—suggest less momentum than we had thought. Consequently, the danger of recession is more severe than we had thought. On the positive side, this makes a Federal Reserve rate cut nearly certain at the Sept. 18 meeting of the Federal Open Market Committee (FOMC).

Housing And Mortgages

The mortgage market was the trigger for investors to reassess risk. Delinquency and foreclosure rates have risen for adjustable-rate subprime mortgages. Although actual losses so far remain small, the high delinquencies and coming resets of interest payments make it likely that losses will rise more sharply.

The problem is mostly confined to the mortgages written at the top of the housing cycle, in late 2005 and in 2006. We expect an 11% drop in home prices by mid-2008, but that is only half the rise in home prices in 2005 alone. A homeowner who bought before 2005 will be giving back only six months' appreciation. The resets are just coming up on these mortgages because the most common subprime mortgage is at a fixed rate for two years and then adjusts, usually to the London Interbank Offering rate (LIBOR) or the one-year Treasury bill. The resets will be significant, but it should be noted that these mortgages were taken out after the Fed had already been tightening for

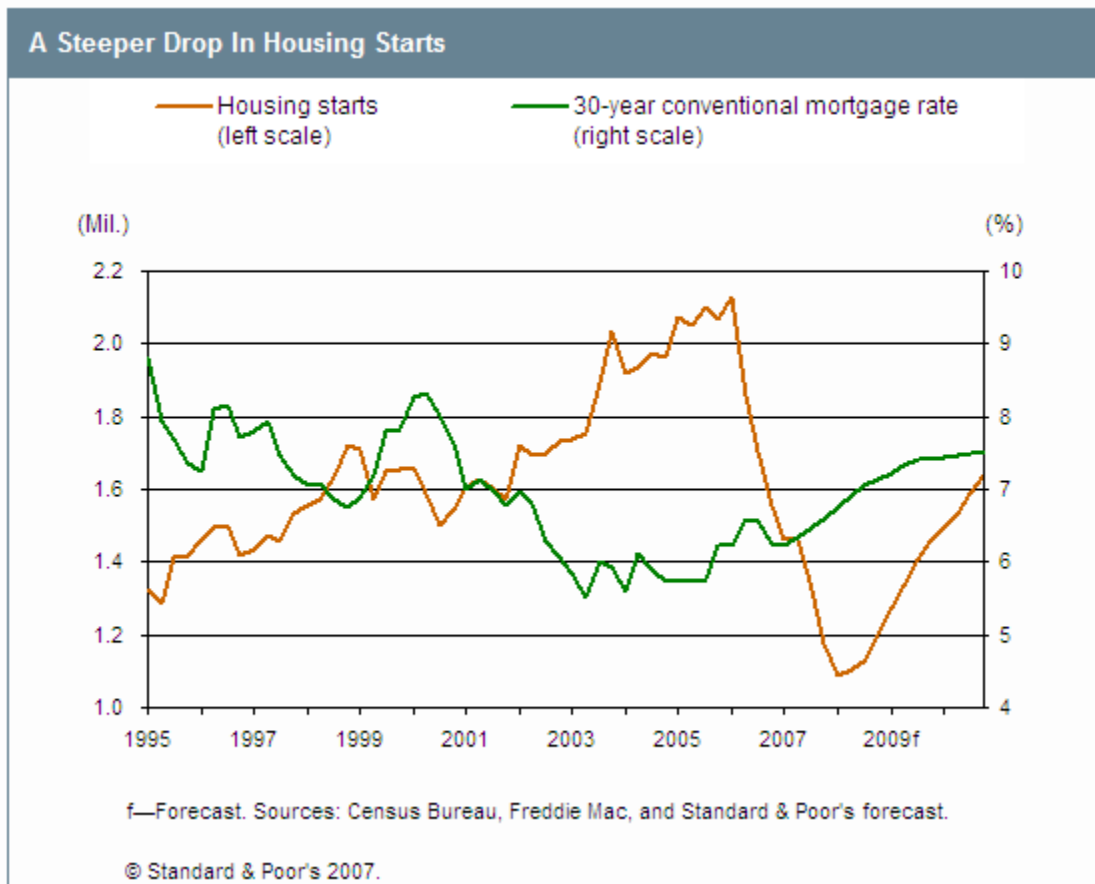
more than a year, so the resets aren't from the very bottom of the interest-rate cycle.

Normally, subprime mortgages end quickly. In recent years, borrowers have refinanced 70% of them within six months of their first reset. After two year of payments, the borrowers' credit ratings had improved, and the rise in home prices has added enough equity so that they were able to take out a prime loan—or at least a better subprime.

That will be difficult now, however, because declining home prices mean many of the houses bought during the period are now worth less than their purchase price. In addition, the freeze-up of the subprime market means mortgages are harder to qualify for. As a result, more homeowners will be forced to pay the higher monthly payments, and because many were stretched to the limit already, they might not be able to do so.

Standard & Poor's has been forecasting record defaults and losses for the mortgages taken out in this period since early last year. Most of the securities issued during this period were rated initially based on an assumed loss rate of 5.75%-7.75%, which we raised to 7.5%-8.5% in mid-2006, which is well in excess of the 5.5% losses recorded for subprime mortgage securities rated in 2000, the worst-performing previous vintage. In June, we raised the assumed loss rate range to 11%-14%. We re-rated securities issued during this period to the new range, which required downgrading \$5.6 billion of securities (1.2% of those issued during the period). More than 85% of the securities downgraded were initially rated 'BBB' or lower.

Chart 1



So-called subprime borrowers have always purchased homes. The rise in subprime mortgage securities largely balanced the drop in issuance through the Federal Housing Authority (FHA) and Veterans' Administration (VA), which withdrew from the market over the last decade. Those early borrowers' credit quality was very similar to that of today's subprime borrower, but one major difference is that FHA and VA loans had fixed rates, while about 80% of the recent subprime lending has been at variable rates. President Bush's move to allow the FHA to insure refinancing for some subprime borrowers restores the situation to its previous state, at least to some extent.

The problems in the subprime mortgage arena triggered a general reassessment of risk, with investors recoiling from it, partly because they were reminded that it is still there. The housing market itself hasn't had a recession since 1991-1992 because the sharp interest rate drop during the 2001 U.S. economic slump largely insulated the housing market from the downturn. Housing starts tumbled to 798,000 in January 1991 from their peak of 1.551 million in January 1990; home prices fell 6.5% (Case-Shiller index) over that same period.

Because the housing market has been stable for so long, many investors assumed these bonds were safer than similarly rated corporates. They are now realizing that is not the case, and for the next few years, losses will be sharply higher. In many respects, what 's happening is the housing part of the 2001 recession, which was delayed by the Fed rate moves.

Can Chairman Bernanke Channel J.P. Morgan?

Investors' reassessment of risk could cause bigger problems for the economy. Short-term capital markets have stopped functioning smoothly, as lenders fear that losses could be concealed in vulnerable places. Although Chairman Bernanke's estimate of \$50 billion-\$100 billion in losses is very small relative to the mortgage market, no one is sure who is holding the bag on these securities. There is a worry that highly leveraged hedge funds hold these securities and that the lenders to these funds could suffer losses. In other words, is there another Long-Term Capital Management out there (or an equivalent grouping) that has piled up losses and could suffer liquidity problems?

The 1907 financial crisis was recently recounted in "The Panic of 1907" by Robert Bruner and Sean Carr. The financial system has changed since 1907, but the basic reliance on confidence remains. It always seems that any long period of stability results in an underestimate of risk, which is followed by a sudden convulsion as risk perceptions return to more normal levels. When the market corrects, it usually overcorrects, at least temporarily.

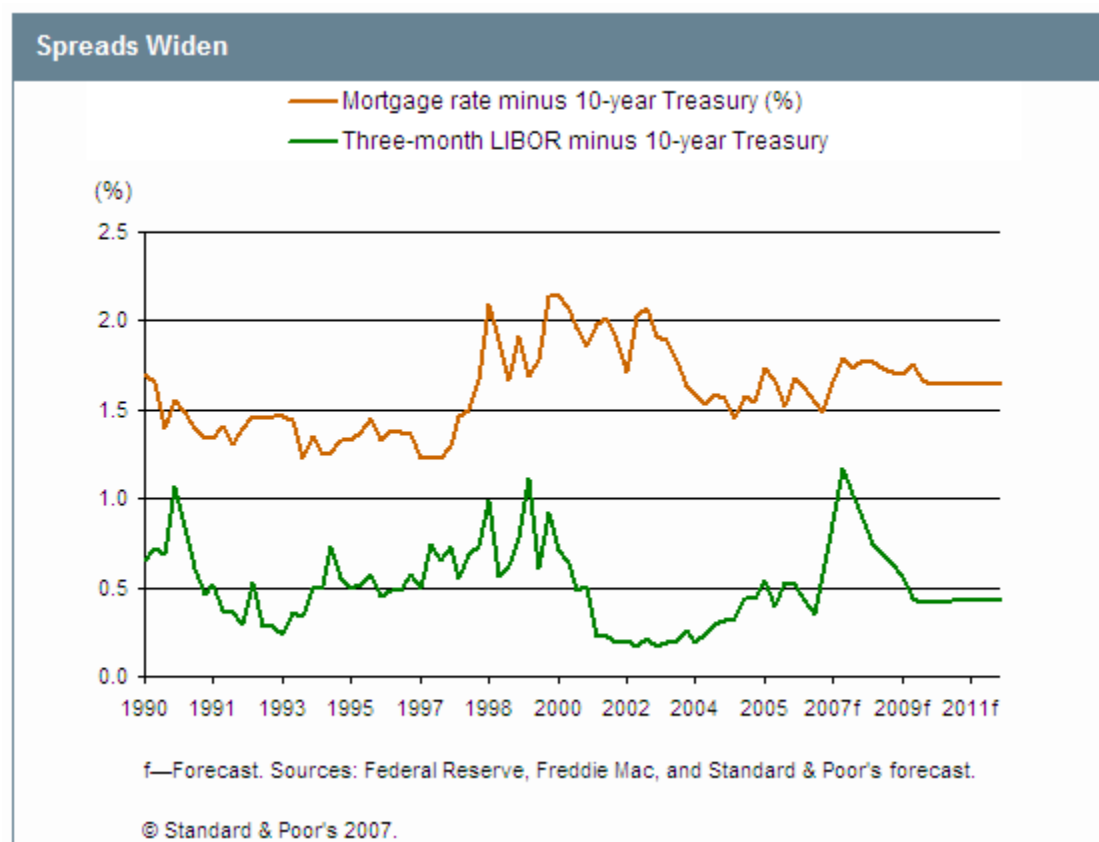
A central bank normally reacts to these crises by adding enough liquidity so that the run doesn't prevent the bank from making payments if it is solvent. The problem today is liquidity; the losses are very small relative to the size of the mortgage market or the overall securitized market. But fear has made it difficult for investors to choose assets, causing a run to the safety of securities such as Treasuries. The most usual measure of risk in short-term markets is the "TED spread"—the difference between the three-month LIBOR rate and the three-month Treasury bill, which measures the risk perceived in interbank lending. Three months ago, the TED spread was 56 basis points (bps), but today it has widened to 156 bps. It should be noted that in the last recession, the spread hit 111 bps, and it has averaged 85 bps since 1990. However, half of the recent widening has come from the 51-bp drop in the Treasury bill rate, while the LIBOR is up only 49 bps.

The upshot: It's time for the Fed to cut rates. The widening of credit spreads has effectively tightened credit conditions, so a rate cut gets the markets back only to where they were in June. The real economy is sputtering, and even though it's still likely to avoid recession, the margin will be considerably less than it appeared to be two months

ago. Three consecutive months of weak employment gains, culminating in the first payroll drop in four years, show a sharp shift in labor markets. A rate cut is thus desirable for economic reasons.

It is also desirable for the smooth functioning of capital markets, which is the Fed's first role, according to the original Federal Reserve Act. The Fed was established in large part to tame the sequence of financial panics that included the one in 1907. Keeping markets functioning is critical because the financial market is the link between Fed monetary policy and the economy. If markets seize up, the Fed's string is severed.

Chart 2



A rate cut would also help the mortgage market. The critical resets begin in the fourth quarter of this year, which is the two-year anniversary of the issuance of the peak mortgages. Lower interest rates would lead to smaller increases in monthly payments.

The Fed has tightened requirements for mortgages (an overdue move) and has expanded regulation of nonbank mortgage issuers. The Fed's "Truth in Lending" rules should also be improved to make the consequences of different mortgage types clear. Lenders created most of the exotic mortgage instruments for a class of borrowers for whom the terms made sense, but in many cases, these loans were missold to borrowers for whom they didn't make sense. The Fed is the only agency with the authority to regulate the mortgage market, but the extent of that authority has not yet been tested in court. The Fed can clearly require better documentation, but it is not clear that the central bank can ban forms of lending type that are not issued by banks or bank holding companies.

The illiquidity in the short-term financial markets needs to be addressed more clearly. These markets effectively

function as part of the banking system. The Fed's initial move to cut the discount rate and, more importantly, tell banks it is OK to use the discount window has helped because commercial paper generally has a back-up line of credit it can draw on banks for. Banks need to be able to provide these lines without damaging the rest of their lending ability. Increasing the amount that can be borrowed against these securities would be desirable. The extension of terms to 30 days is probably adequate. Further lowering the penalty would help, but cutting the federal funds rate will solve some of the problem.

Slowdown Or Recession?

We still expect the economy to avoid recession, but the slowdown now seems likely to be more prolonged than originally thought. The drop in home prices hasn't hurt consumers so far, in part because the strong stock market offset the decline. But wealth is now falling, and consumer spending is likely to suffer. Unless the decline in home values is greater than we expect or the stock market plunges more than the anticipated 10% correction, consumer spending should only slow, not stop.

Capital spending is a bigger worry. So far, corporate loans still seem to be available. The spread of speculative-grade corporate bond yields over Treasury borrowing costs has risen to 464 bps from a record low 265 bps in late May; the new spreads are more normal than the old, with the spread averaging 419 bp since 2003. Commercial mortgages are having greater problems, presumably because they include the "m" word. We expect this market to avoid the problems in the RMBS market, however, because demand is strong and rents are rising.

The external sector remains a positive for the economy. Although Europe is showing signs of slowing, in part because of the stronger euro, Asia remains strong. We expect the dollar to continue to decline, which should continue the improvement in the real trade deficit. Over the past four quarters, the improvement in the trade deficit has added 0.5 percentage points to real GDP growth, offsetting half of the negative 1.0% contribution of housing.

The impact of housing on real GDP is lessening, if only because housing is a smaller share of the economy than it was two years ago. We expect housing starts to bottom out late this year, though the weather heavily affects housing in the winter months, so an accurate forecast is impossible. But the recovery next year will be slow, because of the large inventory of unsold new and existing homes on the market. This will keep home prices declining into next summer and delay any significant recovery in starts until the end of 2008.

The risk of recession is real. The dependence of the U.S. on the continued inflow of foreign capital (\$1.05 trillion last year) means that any panic by foreign investors about either credit quality or the dollar could have a disproportionate impact on markets. So far, there has been little sign of this, as the dollar has risen only modestly against the euro. The yen has risen, however, in response to the unwinding of Japanese investments in the dollar. Foreign investment also seems to be shifting toward Treasuries.

A longer slowdown also increases the vulnerability of the U.S. economy to external shocks, such as terror attacks or a sharp rise in oil prices. There is less momentum behind the expansion than we had thought, and the Fed has less room for error.

Standard & Poor's Economic Outlook—September 2007

	—2007—											
	Q1	Q2	Q3	Q4	2005	2006	2007	2008	2009	2010	2011	
% change												
Real GDP	0.6	4.0	2.3	1.8	3.1	2.9	2.0	2.0	2.9	2.8	2.8	
Consumer spending	3.7	1.4	2.6	2.3	3.2	3.1	2.9	2.3	2.6	2.8	2.9	
Equipment investment	0.3	4.3	3.8	4.9	9.6	5.9	1.0	3.9	6.0	4.3	4.9	
Nonresidential construction	6.4	27.7	1.1	0.2	0.5	8.4	10.4	2.1	0.0	(1.6)	(0.6)	
Residential construction	(16.6)	(11.6)	(17.1)	(24.6)	6.6	(4.7)	(16.6)	(18.5)	2.4	10.0	8.8	
Federal government	(6.3)	5.9	2.3	4.2	1.5	2.2	1.3	3.1	0.5	(0.4)	(0.9)	
State and local government	3.0	3.1	1.8	2.0	0.3	1.6	2.2	1.5	1.1	1.0	1.1	
Exports	1.1	7.6	8.7	9.1	6.9	8.4	7.0	8.9	8.7	7.7	6.9	
Imports	3.9	(3.2)	3.4	3.5	5.9	5.9	2.0	3.5	4.9	5.8	5.6	
CPI	3.8	6.0	1.6	0.5	3.4	3.2	2.6	1.9	1.9	2.0	1.9	
Core CPI	2.3	1.9	2.4	1.8	2.2	2.5	2.3	1.9	1.8	2.0	2.1	
Nonfarm unit labor costs	3.0	2.1	3.2	2.2	2.0	2.9	3.8	2.0	1.3	1.9	1.9	
Nonfarm productivity	0.7	1.8	1.4	1.7	1.9	1.0	1.0	1.6	2.1	1.9	2.0	
Levels												
Unemployment rate (%)	4.5	4.5	4.7	4.8	5.1	4.6	4.6	5.0	4.9	4.8	4.7	
Payroll employment (Mil.)	137.4	137.9	138.2	138.5	133.7	136.2	138.0	139.1	140.7	142.4	144.0	
Federal funds rate (%)	5.3	5.3	5.2	4.8	3.2	5.0	5.1	4.5	4.5	4.5	4.5	
10-year Treasury note yield (%)	4.7	4.8	4.8	4.8	4.3	4.8	4.8	5.2	5.6	5.8	5.9	
'AAA' corporate bond yield (%)	5.4	5.6	5.7	5.9	5.2	5.6	5.7	6.3	6.7	6.9	6.9	
Mortgage rate (30-year conventional) (%)	6.2	6.3	6.5	6.6	5.9	6.4	6.4	7.0	7.3	7.5	7.5	
Three-month Treasury bill rate (%)	5.0	4.7	4.6	4.2	3.1	4.7	4.6	4.2	4.3	4.4	4.4	
S&P 500 index	1,425	1,496	1,476	1,510	1,207	1,311	1,477	1,569	1,666	1,751	1,844	
Standard & Poor's operating earnings (\$/share)	22.39	23.74	23.48	23.02	76.45	87.72	92.64	95.83	104.77	108.42	113.19	
Current account (Bil. \$)	(770)	(747)	(762)	(753)	(755)	(811)	(758)	(718)	(705)	(719)	(739)	
Exchange rate (major trade partner)	81.0	78.0	76.0	75.0	82.0	81.0	77.0	73.0	71.0	72.0	71.0	
Crude oil (\$/barrel, WTI)	58.09	64.96	72.68	71.67	56.56	66.12	66.85	72.21	74.35	74.13	73.62	
Saving rate (%)	1.0	0.5	0.9	1.2	0.5	0.4	0.9	1.5	2.1	2.3	2.4	
Housing starts (Mil.)	1.46	1.47	1.32	1.17	2.07	1.81	1.36	1.13	1.37	1.57	1.69	
Unit sales of light vehicles (Mil.)	16.4	16.0	15.8	16.2	16.9	16.5	16.1	16.1	16.3	16.6	17.3	
Federal surplus (fiscal year unified, Bil. \$)	(178)	\$137	(45)	(84)	(321)	(248)	(166)	(261)	(319)	(307)	(264)	

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