

Viewpoint

One of a series of opinion columns by bankruptcy professionals

Beware Zombie Credit Markets

By Anders J. Maxwell

The movie "28 Days Later" is a chilling portrayal of a future where an uncontrolled virus turns society into a wilderness populated by zombies. Now, nearly 28 months since the onset of 2008's "great recession," this science fiction thriller seems an apt metaphor for U.S. capital markets.

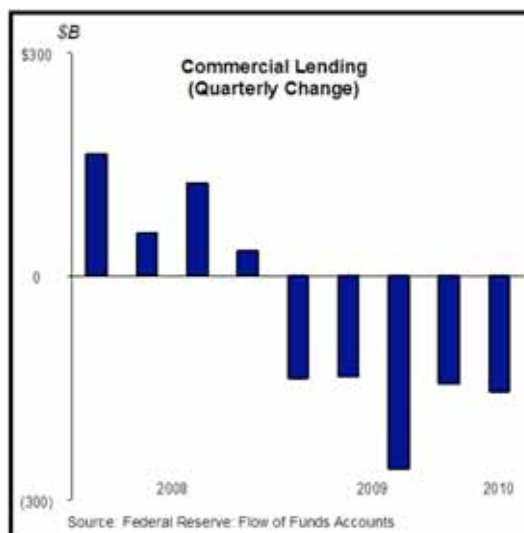
Equity market gyrations have dramatically increased during the current recession. Key indices have swung wildly with both the Dow Industrial and S&P 500 indices' variance mirrored in an unstable Volatility index. U.S. equities are struggling to find direction, confronted with extraordinary, and often contradictory, economic indicators. The once popular presumption that equity markets are always efficient in their valuations or accurate barometers of economic activity has been discredited. Increasing attention and emphasis is due credit markets.



Following the height of the market's crisis marked by Lehman Brothers' bankruptcy, U.S. credit markets afford a stark indication of the economy's direction and attendant risk. Three marked changes are evident: (1) a steady decline in private lending and borrowing; (2) the shuttering of the Asset Backed Securities (ABS) markets; and (3) the federal takeover of the mortgage market. Taken together, these developments reinforce the pervasive impact of systemic deleveraging and reregulation of markets and raise the specter of huge deferred mortgage losses, further depressing the economy.

Contracting Private Credit

Generally anticipated, a substantial decline in private credit is apparent in recent Federal Reserve data, with both financial intermediaries reducing assets and nonfinancial corporations and households cutting borrowing. Corporate downsizing and lower growth has become the "new normal" (as characterized by Bill Gross). Of greater impact as a proportion of GNP, household deleveraging and faltering consumption driven by declining home prices is the subject of a recent commentary in Daily Bankruptcy Review, "Housing and the Economics of Sand Castles." Both trends portend a weak economy the balance of 2010.



ABS Lockdown

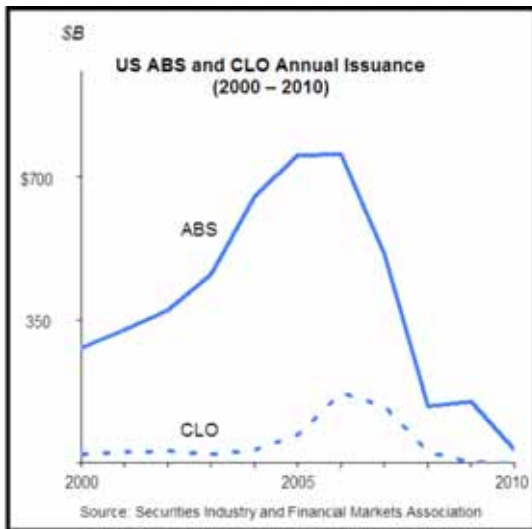
The securitization market is adding another damper. While a relatively small segment of a \$35 trillion credit market, ABS (excluding mortgages) are tremendously significant in setting market pricing on a broad range of asset classes. Characterized rather philosophically by the Financial Times as confronting an "existential crisis," the ABS market has actually hit a wall. New issuance effectively ceased by 2008. A casualty of fundamental flaws ranging from fallacious bond ratings, controversial structures, opaque pricing and outright fraud, the integrity of this pivotal segment of the credit market is held in doubt. It remains to be seen how this once key market fares in the future. The deep freeze prevailing reflects a ground swell of political support for re-regulating markets. Clearly overdue, reregulation inevitably raises the cost of corporate lending, bond financing and consumer credit.

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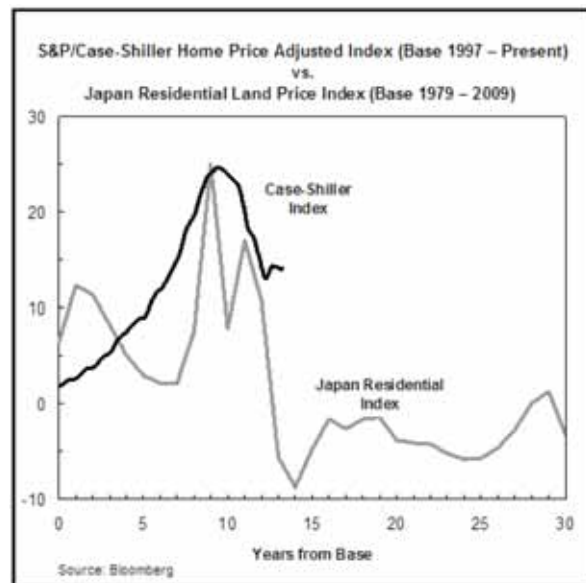


Socialized Mortgage Markets

The most consequential structural change in credit is the federal takeover of the mortgage market. The Federal Reserve, in concert with the half-dozen emergency liquidity facilities comprising the Treasury's TARP program since the third quarter of 2008, has acquired \$1,250 billion in mortgage-backed securities. When added to the mortgage assets of Fannie Mae and Freddie Mac - the GSE's effectively wards of the state - the federal government now has a controlling interest of 45% in the \$14 trillion residential mortgage market. Given the ongoing decline in housing values nationally, the potential losses realized by the U.S. taxpayer on these securities could add significantly to current estimates of the federal deficit. More to the point, this speculative portfolio of mortgages represents a major overhang depressing real-estate prices, new construction and, in turn, the general level of economic activity. The very real prospects for loss on these securities is highlighted by this week's estimate by the Center for Responsible Lending that 9 million homeowners - representing one in four residential mortgages - are likely to be foreclosed on by 2012!

Deleveraging and reregulation of credit markets are generally acknowledged risks some 28 months since the recession's commencement. It is far from clear, however, that the risks of a zombie mortgage market of overvalued inventory are appreciated. Similar in key respects to the dilemma confronting the Bank of Japan following the bursting housing price bubble in the late 1980s, the Fed

now holds mortgage securities with imbedded and unrealized losses. As these losses are forced through foreclosures and liquidations, expect further and prolonged housing price declines. As referenced previously, a further drop in this key household asset's value lowers aggregate consumption with overwhelmingly negative effects on the economy. The potential magnitude and duration of decline is suggested by Japan's land price index (land is used as a measure of residential value as Japan is prone to earthquakes making land more significant than house value) over that country's "lost decade." A similar pattern of escalating property value and subsequent collapse is evident to date in the U.S. A comparison with the Case-Shiller Price index at the corresponding point in the housing cycle presents the possibility for significant declines in prices beyond the 30% pullback to date, bringing with it the prospect for a period of economic weakness extending well beyond 2010.



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