

# WEEKLY MARKET MONITOR

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### **VOLATILITY AND ITS DISCONTENTS**

The financial crisis that was triggered by the meltdown in the subprime mortgage market began in the second half of 2007 and continues into the second quarter of 2008. Many global financial market observers and participants who are asserting that the credit crisis is primarily a crisis in the subprime mortgage market assume that when the painful correction in the subprime market is complete the credit crisis will come to an end. Unfortunately, this is not a plausible interpretation of the credit crisis. This week we will present more realistic interpretations for the volatile global financial markets.

- Is the credit crisis contained in the U.S.?
- Why is there a contagion in global financial markets?
- Identifying symptoms of the disease when analyzing the credit crunch.

As of April 10, 2008, the broad U.S. stock market had fallen 7.08 percent. The decline paralleled other developed world equity markets, with the U.K. market falling more than 8 percent, the German market more than 10 percent, the French market about 6 percent and the Japanese market nearly 7 percent. Emerging markets, which had recorded tremendous gains in the past several years, were not immune to the losses. In China the market fell nearly 19 percent, in India 26 percent and the Russian market almost 8 percent. The only region that experienced equity market gains was Latin America, where the Brazilian market was up about 2.5 percent, the Mexican market about 7.5 percent and the Chilean market nearly 12 percent. Indeed the pattern of losses was so widespread that in the developed world every single equity market, save one, recorded a loss year to date. The sole exception was the market in Finland which managed a very slight gain of a 0.25 percent.



The global pattern of market losses indicates how extensive the credit crisis that began in the U.S. has spread. The global pattern of market losses also indicates that the credit crisis is more than just a phenomenon of losses attributed to mispriced subprime mortgages and mortgage-backed securities. We will present our analysis for this phenomenon.

It is reasonable to ask why a problem originating in the U.S. became such a widespread global phenomenon. A major part of the answer lies in the increased globalization and connectivity of world capital markets and world finance. For example, thousands of residential mortgages in the U.S. — subprime and prime — are bundled together into residential mortgage-backed securities (RMBS) and sold to investors all over the world. Hence, a mortgage on a house in Denver is bundled, with thousands of other mortgages on houses from Boston to Bakersfield, and sold to investors as an RMBS security. Within the RMBS structure, there are different levels or tranches of risk/reward ratios that represent different cash flows on the underlying mortgages. The different tranches of risk/reward ratios allows investors to better construct portfolios with the desired characteristics of expected risks and returns. It is important to note that the investor(s) in question are not necessarily U.S. institutions, but include global institutional investors such as, European banks and insurance companies. Therefore, when the housing market soured and losses began to pile up in the RMBS markets global investors suffered along with their U.S. counterparts.

The globalization of finance explains the distribution of losses but not the scale. While losses on RMBS were felt by institutions around the world, the meltdown in subprime mortgages alone does not come close to explaining the magnitude of losses incurred. Furthermore, the meltdown in subprime mortgages cannot come close to explaining the hundreds of billions of dollars of losses expected for the duration of the credit crisis.

In fact, the subprime meltdown is merely a symptom of the credit crisis, not the actual disease. The disease is the systematic mispricing of risk that occurred in the years leading up to the credit crisis. The credit crisis is a consequence of this systematic mispricing, which involved the price of virtually every class of risky asset in global capital markets. This systematic repricing of risk by global capital market participants reached across asset classes

to include fixed-income securities of the highest rated government bonds and agency securities, to much lower rated, below investment-grade (BIG) securities and leveraged loans created to finance leveraged buyouts by private equity firms. This re-pricing is reflected in the dramatically higher spreads of all classes of fixed-income securities vis-à-vis government bonds. At the same time, the prices of government bonds have risen across the entire yield curve in many markets as investors have become more risk averse and purchased government bonds in a flight to quality. Similarly, investors have been repricing other risky assets such as equities in capital markets from around the world.

In addition to re-pricing risk, many investors have begun to reduce their total risk exposure, particularly in the more exotic parts of the fixed-income and structured securities markets. The result is that some sellers cannot find buyers of certain assets at any price.

The credit crisis will continue unless global financial market participants arrive at a new demand and supply equilibrium for risky assets. This process is far from complete. An unfortunate but necessary part of the price discovery process, vital for arriving at the new global equilibrium price for risky assets is that the prices of many types of risky assets, will be marked down significantly. This will in turn result in losses for the institutions holding these assets. Therefore, it is inevitable that institutions around the world will announce further losses in this quarter and upcoming quarters. The final total of losses resulting from the credit crisis is not known but will be in the hundreds of billions of dollars.

A fever may be the sign of an infection. Similarly, the volatility experienced in global capital markets since the onset of the credit crisis is the sign of this crisis. We expect market volatility to continue as long as the crisis infecting the markets persists. The closer global capital markets come to an equilibrium for prices for risky assets, the closer we will probably be to the end of this period of volatility.

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