

A photograph of a pool of water with a red inflatable ring floating on the left. To the right of the ring is a dark, circular shadow on the water's surface. The water is clear and blue-green with ripples.

Let's see now,
who was swimming naked...

Linda T. Patterson
Patterson & Associates



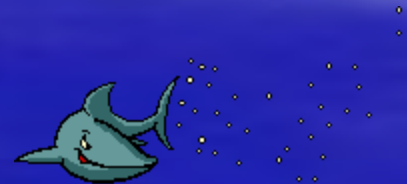
Trust in those old adages

- When the tide leaves we will find out who was swimming naked....
- Don't fight the Fed
- The trend is your friend
- Risk not your whole wad
- There will always be bulls – bears - pigs



Fundamentals

- You only get paid for RISK
 - Credit
 - Liquidity
 - Market
 - Volatility
 - Extension
 - Reinvestment

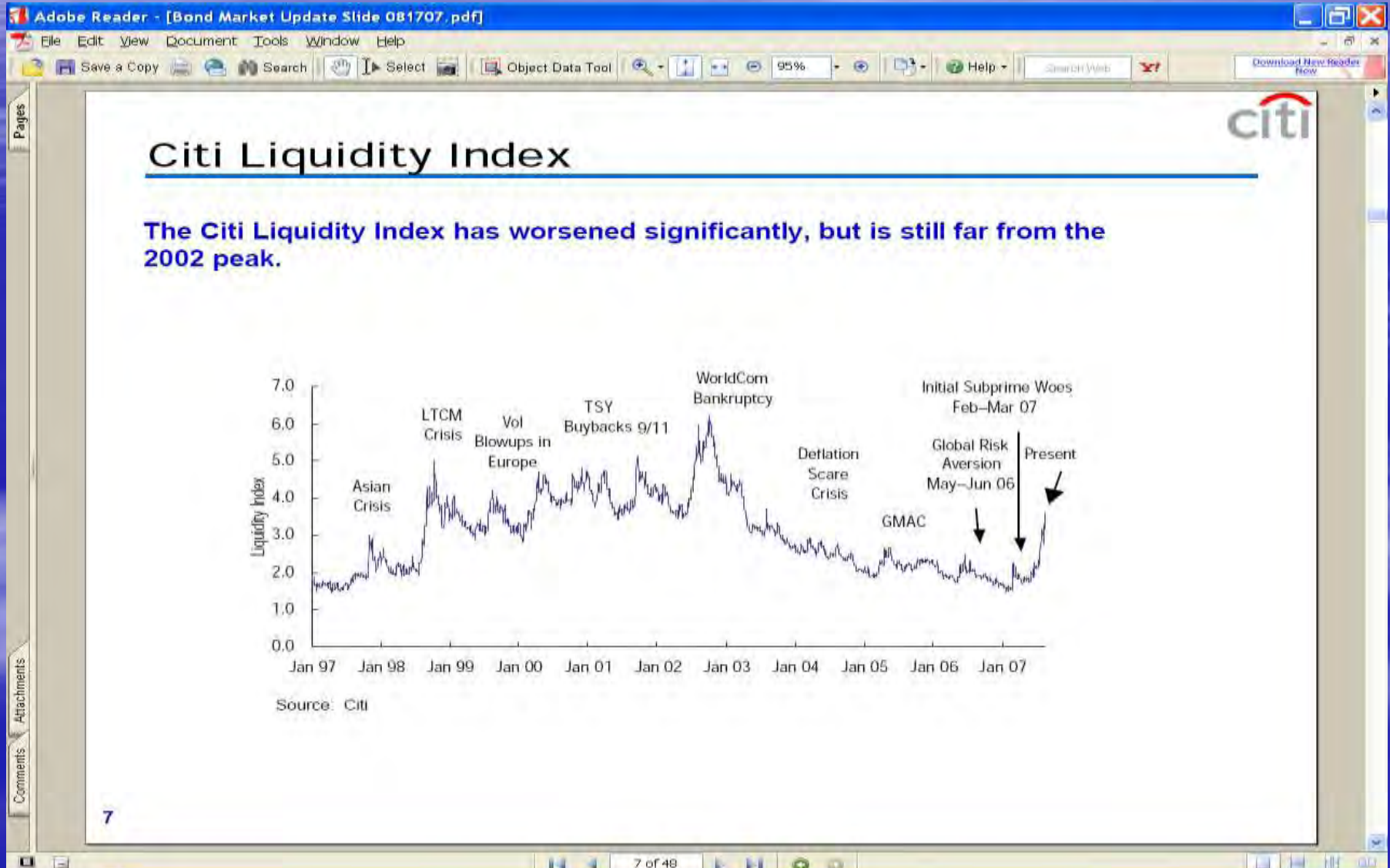


How did we get here?

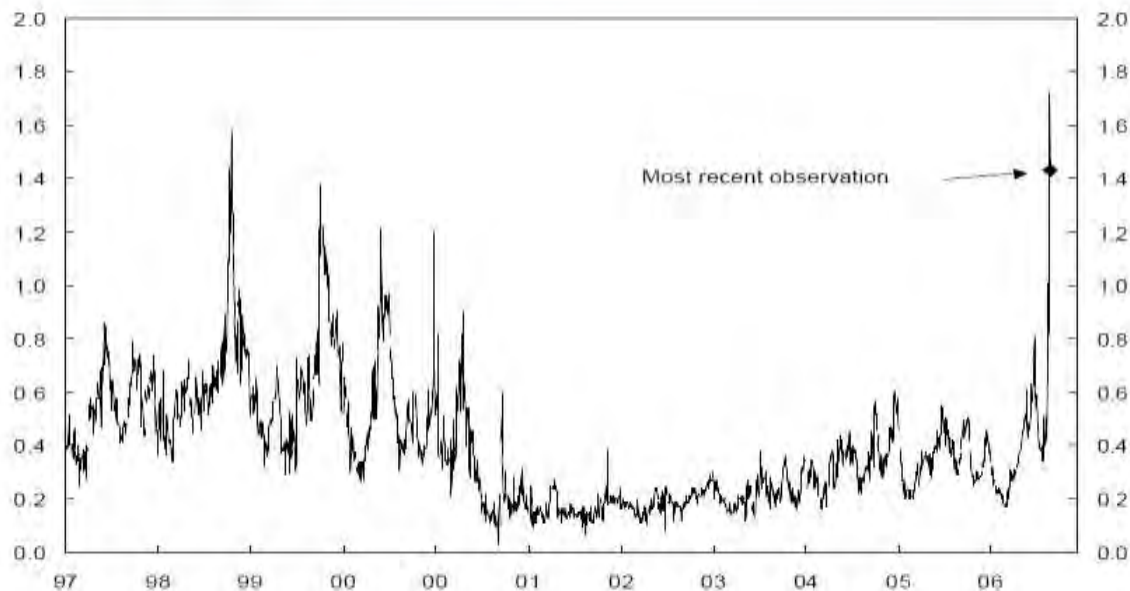
- 2001 – 2003 central banks inject liquidity
 - Rates drop to historical lows of 1%
 - Responding to global stock crisis
 - Responding to tech bubble
 - Responding to 9/11 panic
 - Spreads compressed across all assets in search for yield
 - Increased leverage to re-create yields lost
 - Housing booms on lower rates



It's all about liquidity



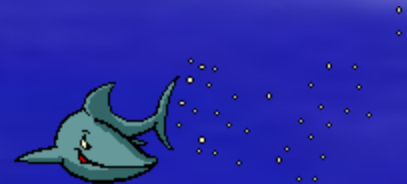
3-Month LIBOR and 3-Month T-Bill Spread, 1997-17 Aug 07



Sources: Financial Times and Federal Reserve Board.

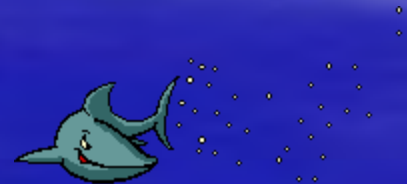
Who did what?

- Some blame “Greenspan puts”
 - Cut rates to stop the pain
 - Blamed for inflation and housing bubble
- Foreign buyers of >\$1 tt in US debt annually
- Home buyers
 - Speculators or home buyers? What ratio?
- Investors seeking yield ignored risks
- All refused to recognize the risk in their sector
 - “new economy”



And then..

- 2003 – 2006 central banks withdrew liquidity
 - Hedge funds filled the place of banks
 - But increased spread sensitivity
 - Okay with strong economy and low volatility
 - Greenspan (2005) ‘a vast increase in market valuation results from investors accepting lower compensation for risk – viewed as a permanent change’ – ‘this could be a new economy but the onset of caution elevates risk premiums and lowers asset values’ – history has not dealt kindly with protracted periods of low risk premiums’



Meanwhile back at the ranch..

- Mortgage rates were historically low
- Baby boomers bought 2nd house
- Speculators started to flip houses

- FNMA capped by accounting scandal
- Mortgage lenders (financial intermediaries)
 - New breed of mortgage lender
 - Relaxed credit checks (mirror test??)
 - Too aggressive with sub-prime starting in 2004
 - Eliminated documentation
 - Eliminated screening of borrowers



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THE MORTGAGE LENDER Implode-O-Meter

Tracking the housing finance breakdown: a saga of corruption, stupidity, and government complicity.

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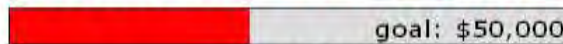
Since late 2006

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Latest imploded:

Last addition: August 22,
2007.

- Amstar Mortgage Corp
- Quality Home Loans
- BNC Mortgage (Lehman)
- Accredited Home Lenders
- First National Bank of Arizona (FNBA) Wholesale, Correspondent

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Top Mortgage Banking Bust News and Commentary:

2007-08-23: **Desperate Measures for USFed** - "The US financial system is experiencing a combination of a heart attack (fibrillation from absent trade recycled surpluses), a ...

2007-08-23: **Bank of America's Countrywide Purchase Boosts Stocks** -

"Countrywide is no longer on the endangered company list." No BOFA is.

2007-08-22: **Late loans soar on troubled mortgages: FDIC** - "delinquent loans at U.S. banks jumped 36 percent to \$66.9 billion in the second quarter, the biggest quarterly increase since 1.

2007-08-22: **U.S. Mortgage Mkt Needs \$250 Bln of Capital-FBR** - Is this a good estimate? Pop quiz: are the current problems bigger or smaller than the S&I bailout? In

Ah, the rating agencies...

- Rating agencies collected *large* fees for rating structured product
 - Irresponsible rating practices
- Banks are conspicuously absent in the fray



Hedge Funds

- Grew to over 9,800 before the downward spiral
 - Funds bought the structured products (CDO)
 - Funds leveraged them
 - Funds used models to price them because of illiquidity
- As default rates increased the market for CDOs crashed (2006-early 2007)
 - Illiquidity allowed funds to ignore the losses initially
 - By June 2007 ignorance and bliss parted ways
 - Rating agencies now acted



The Blogger Attack

The Hedge Fund Implode-O-Meter - tracking the hedge fund implosion - leverage, speculation, arb - Microsoft Internet Explorer

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Since mid-2007

13

major outfits have had "imploded" funds (around 23 of them)

Latest imploded*:
Last addition: August 18, 2007. (ML)
Sentinel Mangement Group
Sachsen LB: Ormond Quay conduit fund
Parvest Dynamic ABS, BNP Paribas ABS Euribor and BNP Paribas ABS Eonia (BNP Paribas)
Union Investment Asset Management Holding AG
Oddo: Cash Titrisation; Cash Arbitrages; and Court Terme Dynamique

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Bernanke Pankyl
IAmFacingForeclosure.com
MortgageMinister
Mortgage Misfit

Top Hedge Fund Blow-up News and Commentary:

- U.S. Mortgage Mkt Needs \$250 Bln of Capital-FBR** [2007-08-22] - *Is this a good estimate? Pop quiz: are the current problems bigger or smaller than the S&L bailout? In today's dollars, a rerun.*
- Solent Capital to wind down fund** [2007-08-22] - *The fund, called Mainsail II, was invested in commercial mortgage-backed, residential mortgage-backed securities, and collateral.*

Done Internet



A Comparison to Previous Liquidity Crises

1) '98 LTCM Unwind

Fed Measured, -75bp in 2 months, stock bubble re-inflates

#2) '01 Terrorist Attacks (exogenous event)

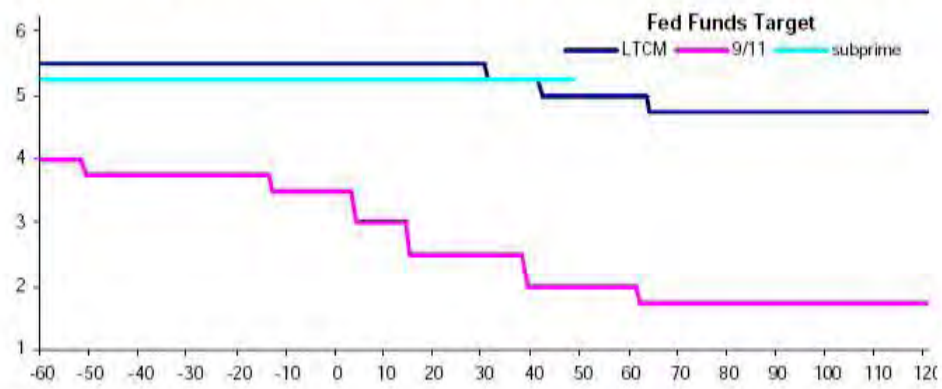
Fed Dramatic, -150bp in 2 months

#3) '07 Subprime Credit

Fed Measured (so far)

Slower developing than LTCM (more spread out)

Fundamental problems remain (high mortgage delinquencies)



Source: Bloomberg Financial.

INDU ↑13090.86 -30.49

Index **GP**

At 15:30 Op 13120.05 Hi 13178.33 Lo 13052.17

INDU INDEX

Hide

GP - Line Chart

Page 1/4

Range 02/21/07 - 08/21/07 Upper Line Chart Mov. Avgs Currency USD

Period Daily Lower None Mov. Avg 15

Last Price	13090.86
High on 07/19/07	14000.41
Average	13101.54
Low on 03/05/07	12050.41



Australia 61 2 9777 8600	Brazil 5511 3048 4500	Europe 44 20 7330 7500	Germany 49 69 920410
Hong Kong 852 2977 6000	Japan 81 3 3201 8900	Singapore 65 6212 1000	U.S. 1 212 318 2000

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The Dow since February 2007



INDU ↑ **13090.86** -30.49

Index **GP**

At 15:30 Op 13120.05 Hi 13178.33 Lo 13052.17

INDU INDEX Hide GP - Line Chart Page 1/2

Range 07/02/07 - 08/21/07 Upper Line Chart Mov. Avgs Currency USD
Period Daily Lower None Mov. Avg 15



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Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2007 Bloomberg L.P.
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The Dow in August



Summer Spiral 2007

- Bear Stearns admits to two large losses
- Australian hedge fund collapses
- Sowold sold distressed to Citadel and closed
- French and German banks admit losses
- Countrywide can not sell CP and uses entire bank line to support its portfolio

- The extent is difficult to judge perhaps until 4Q
 - Bernanke says maybe \$5-10bb or 1% of GDP
 - Compared to 2.5% from S&L debacle of early 90's

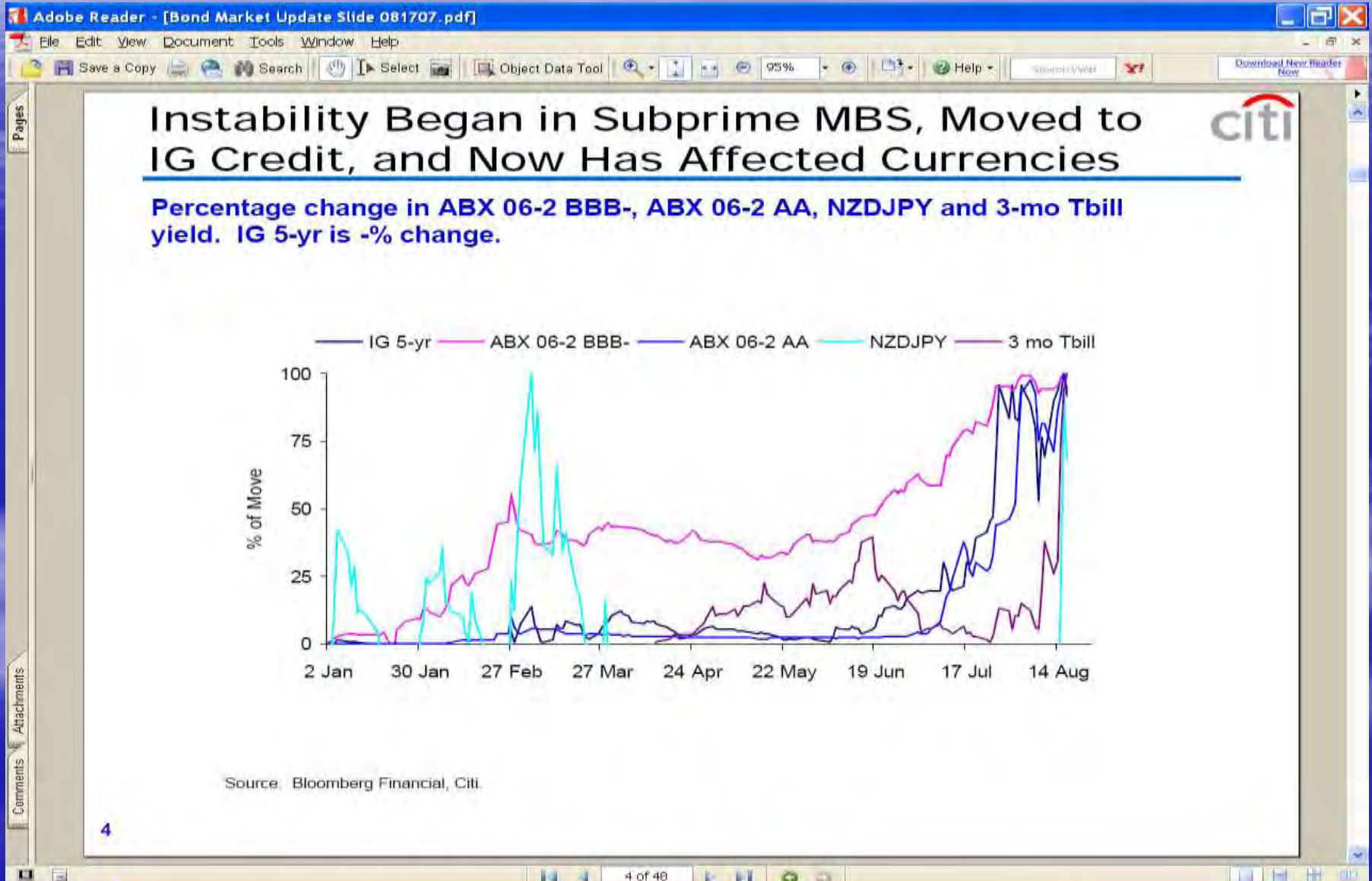


Contagion Spreads

- Sub-prime was the initiating shock to CDOs
- A reassessment of risk – normalcy?
- Flight to quality
 - Rush in to treasuries
 - ABCP next hit on quality concerns
 - Buyers of loans and funders suffer (ABCP/repo)



The ripple effect



Reappraisal Riot

- Looks like a run on the bank
 - Money pulled from hedge funds
 - Yen-carry trades unwound
 - Jump out of any speculative positions
 - Ultimately out of MMMF (especially with CP)
- Not enough money to stem the flood
 - Canadian CP dried up
 - Foreign hedge funds were closed
 - Asian and European stock markets slumped 3-5%
 - Dow runs for cover – down 300+



Fed Throws a Lifeline

- 8/17 Fed cuts the discount rate by 50 bps
 - Requested by San Fran and NY Fed
 - Lowered rate charged banks for short term borrowing
 - Usually a few days but extended borrowing time to 30 days
 - To remain until “Fed determines market liquidity has improved materially”
- FOMC acts and agrees to monitor
 - “economy continues at a moderate pace”
 - Watching for domestic growth risk increase
- Not a “secret cut” as rumored



2 Govt GIP

N208 Govt **GIP**

1-DAY CHART **BGN** B 09/13/07

17:00-16:20

16:59

Hi 3.05 Lo 1.74 Op 2.07 #Ticks 225 16:15 ↓ 2.94 +.87

High on 08/21 12:20	3.050
Average	2.357
Low on 08/21 09:24	1.740
Prev Close -----	2.07



2007 Aug 21

Australia 61 2 9777 8600	Brazil 5511 3048 4500	Europe 44 20 7330 7500	Germany 49 69 920410
Hong Kong 852 2977 6000	Japan 81 3 3201 8900	Singapore 65 6212 1000	U.S. 1 212 318 2000

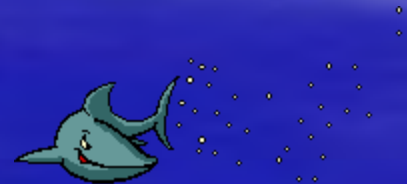
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Slight volatility in the one month Bill !



The Lifeline

- Not made to appease the markets
- Made to provide liquidity and offset downside risk to economic growth
- Ben wants no “Bernanke put”
- If Fed always responds to markets those markets do not appreciate risk



Confusion

- Markets hate uncertainty
- Serious disruption in equities and long-term
- A dichotomy between short and long term
 - Discount rate used to value corporates did not fall
- Short term contagion this week
 - 3-mo TBill down 67bps Mon & up 52 bps Tues
 - Oil stays solid and slips below \$70
- Dodd says BB will use all tools
- Lacker says volatility will not create a cut



<HELP> for explanation.

Govt C15

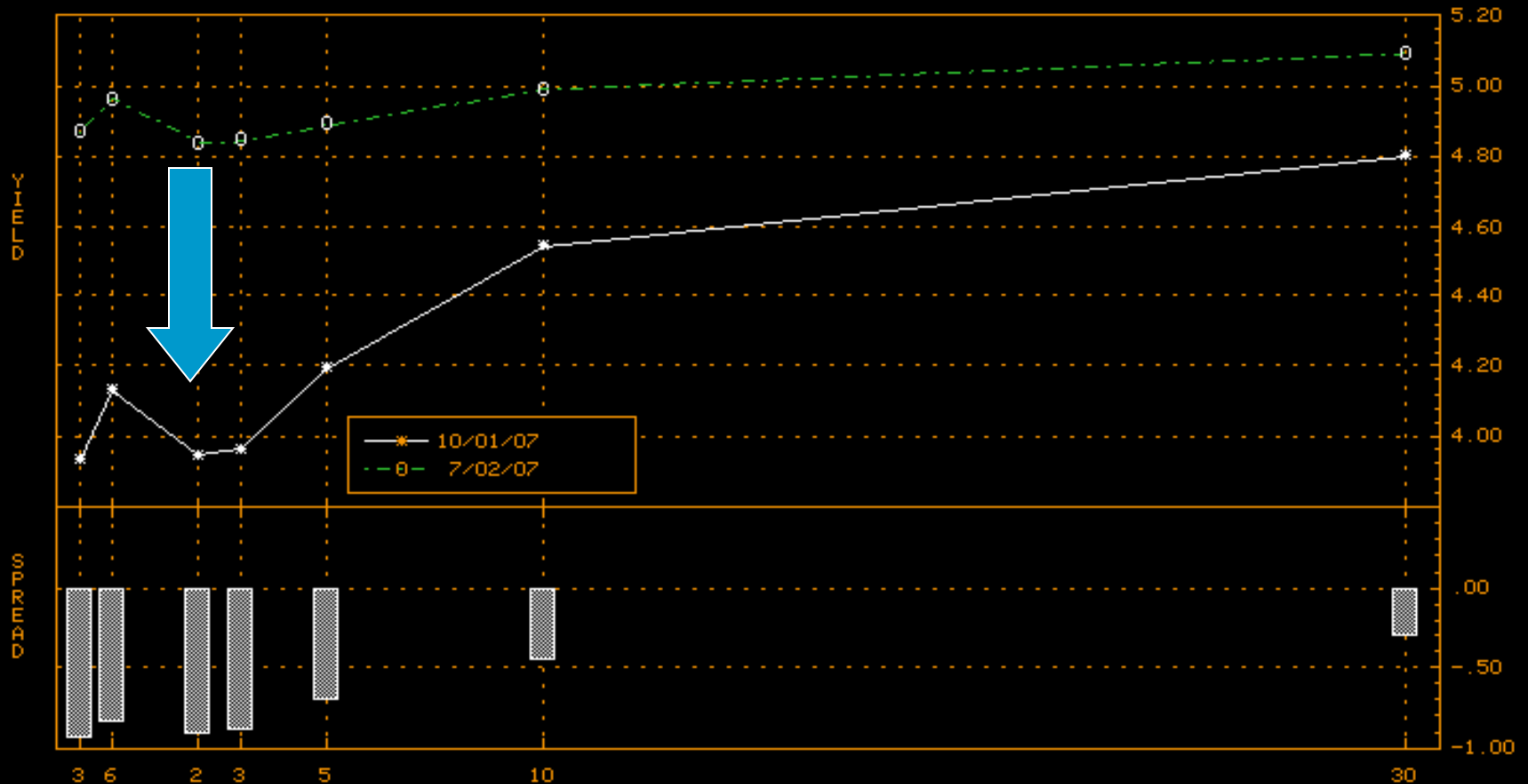
NEXT HISTORY DATE USED AS START DATE

HISTORICAL YIELD CURVE

PAGE 1 OF 2

DATE RANGE 7/ 2/07 10/ 1/07

MTY RANGE 3M 30Y



Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000

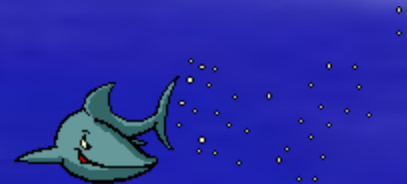
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 6469-197-0 01-Oct-07 10:00:31

Curve moves from 7/01/07 to 10/01/07



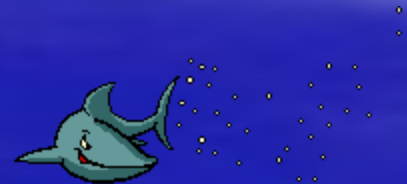
Where's the exit?

- Major restructuring
 - Leveraged IPOs slow to crawl
 - Lending rates on sub-prime up 300bps to 11%
 - Sub-prime jumbos up 100bps to 7.75%
 - Lowered values for stocks
 - Stocks are for once hoping for higher rates!
- Weaker home sales create a bigger problem
 - A sick sector with major ripples
 - Residential property prices fall 3-4% in 12 months
 - House prices could fall 10-12%
 - Confidence, wealth effect, then personal consumption
- Foreign banks may raise their rates and pull funds
- FNMA and FHLMC may be called on to expand



The Fed's Tools

- Discount Rate
 - Adds temporary liquidity
- Fed Funds Rate
 - Temporary fix with system repos
 - More permanent with coupon passes
- Reserve Requirement



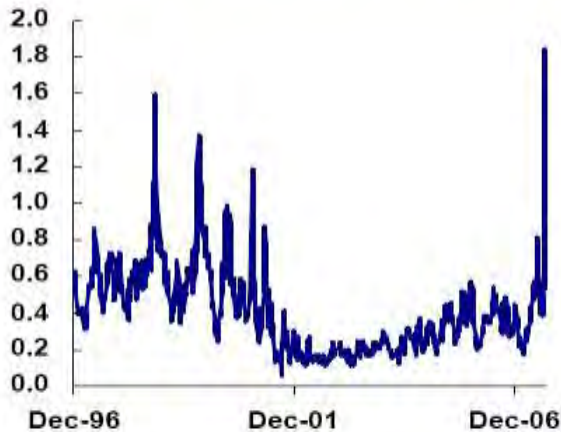
It may take two cuts



Measuring the Fed's impact

US 3m Libor Minus 3m T-bills

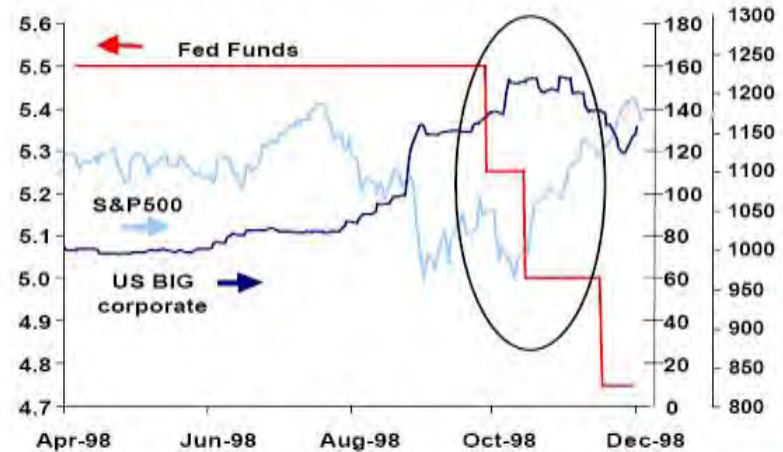
percent



Source: Bloomberg

Fed Funds, Equities and Credit in 1998

percent, index and bp



Source: Citi, Bloomberg

Not much yet – but in 1998 it took until the second cut

So who was swimming naked?



The pigs of course....

Too bad there is a pig in each of us!

Who
me?

