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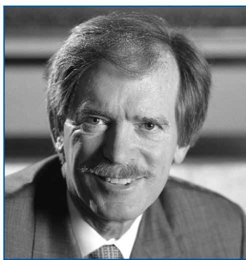
Investment Outlook

by PIMCO's Bill Gross

Looking for Contagion in All the Wrong Places



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Whew, that was a close one! Ugly for a few days I guess, but it could have been much worse! No, I refer not to Paris Hilton upon her initial release from the L.A. County pokey after serving three days of hard time, but to the Bear Stearns/subprime crisis. Shame on you, Mr. Stearns, or whoever you were, for scaring us investors like that and moving the Blackstone IPO to the second page of the *WSJ*. We should have had a week of revelry and celebration of levered risk taking. Instead you forced us to remember Long Term Capital Management and acknowledge once again (although infrequently) that genius, when combined with borrowed money, can fail. But (as the Street would have you believe), this was just a close one. Sure, Bear itself had to come up with a $3 billion bailout, but folks, most of these assets are worth 100 cents on the dollar. At least that's how they have 'em marked! Didn't wanna sell any so that someone would think otherwise…no need to yell "fire" in a crowded theater, ya know. After all, hasn't Ben Bernanke repeated in endless drones that financial derivatives are a healthy influence on the financial markets and the economy? And aren't these assets well…financial derivatives? Besides, I direct you to the **investment grade**, nay, in many cases, AAA ratings of these RMBS (Residential Mortgage-Backed Securities) and CDOs (Collateralized Debt Obligations) and defy you to tell me that these architects were not prudent men. (Sorry, ladies, they **are** still mostly men!)

Well, prudence and rating agency standards change with the times, I suppose. What was chaste and AAA years ago may no longer be the case today. Our prim remembrance of Gidget going to Hawaii and hanging out with the beach boys seems to have been replaced in this case with an image of Heidi Fleiss setting up a floating brothel in Beverly Hills. AAA? You were wooed Mr. Moody's and Mr. Poor's by the makeup, those six-inch hooker heels, and a "tramp stamp." Many of these good looking girls are **not** high-class assets worth 100 cents on the dollar. And, sorry Ben, but derivatives are a two-edged sword. Yes, they diversify risk and direct it away from the banking system into the eventual hands of unknown buyers, but they multiply leverage like the Andromeda strain. When interest rates go up, the Petri dish turns from a benign experiment in financial engineering to a destructive virus because the **cost** of that leverage ultimately reduces the price of assets. Houses, anyone?

Oh, I kid the Fed Chairman—and I should stop because this is no laughing matter, and somehow I have a suspicion that this "close one," this Paris Hilton charade of a crisis, is really so much more than just a 3- or 27-day lockup in the L.A. County jail. Those that point to a crisis averted and a return to normalcy are really looking for contagion in all the wrong places. Because the problem lies not in a Bear Stearns hedge fund that can be papered over with 100 cents on the dollar marks. The flaw resides in the Summerlin suburbs of Las Vegas, Nevada, in the extended city limits of Chicago headed

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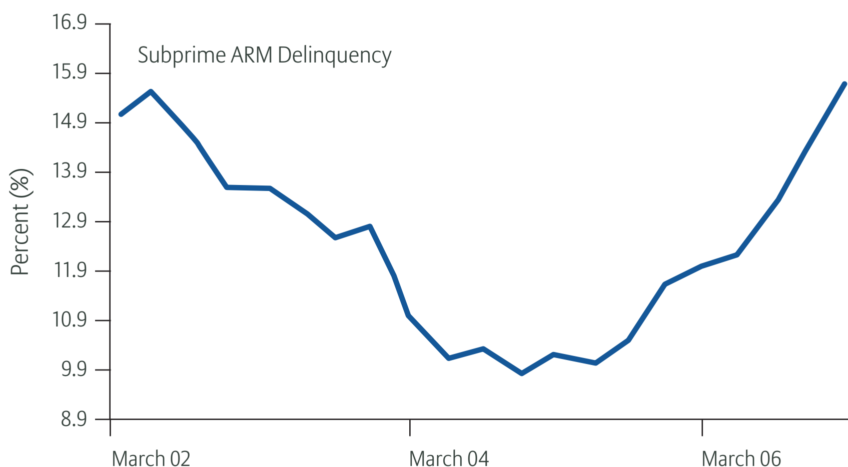
west towards Rockford, and yes, the naked (and empty) rows of multistoried condos in Miami, Florida. The flaw, dear readers, lies in the homes that were financed with cheap and in some cases gratuitous money in 2004, 2005, and 2006. Because while the Bear hedge funds are now primarily history, those millions and millions of homes are not. They're not going anywhere…except for their mortgages, that is. Mortgage payments are going up, up, and up…and so are delinquencies and defaults. A recent research piece by Bank of America estimates that approximately $500 billion of adjustable rate mortgages are scheduled to reset skyward in 2007 by an average of over 200 basis points. 2008 holds even more surprises with nearly $700 billion ARMs subject to reset, nearly ¾ of which are subprimes.

It was not supposed to be this way. 1% teasers or 3% 2/28's were supposed to be rolled with no points into something resembling…well…1% teasers and 3% 2/28's. Instead today we have nearly 7% fixed rate mortgages and not a teaser to be found. Congress, regulators, even Fed officials are stepping in and warning mortgage originators (even mortgage buyers!) that they'd better be careful and only make **good** loans. Those nasty capitalists! They must have gotten carried away a few years ago. Somehow all those BMWs in the New Century parking lot in Irvine, California didn't attract much notice in 2006. Now, well, there's nary a Prius to be found there, but lots of outraged politicians in Washington, that's for sure.

CHART 1
Skyrockets in Flight!



Source: Bloomberg, MBA, CreditSight
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

The right places to look for contagion are therefore not in the white-washed Bear Stearns hedge funds, but in the subprime resets to come and the ultimate effect they will have on the prices of homes—the collateral that's so critical in this asset-backed, and therefore interest-sensitive financed-based economy of 2007 and beyond. If delinquencies lead to defaults and then to lower home prices, then we have problems and the potential for an extended—not a 27-day Paris Hilton sentence. Take a look at Chart 1, which graphically points out the deterioration in subprime ARM delinquencies.

Escalating delinquencies of course ultimately lead to escalating defaults. Currently, 7% of subprime loans are in default. The percentage will grow and grow like a weed in your backyard tomato patch. Now I, the curmudgeon of credit, am as sure of this as I am that the sun will set in the west. The uncertain part is by how much. But look at it this way: using the current default rate of 7% (3%–4% total losses), the holders of some BBB investment grade subprime-based CDOs will lose all of their moolah because of the significant leverage. No need to worry about fictitious 100 cents on the dollar marks here. One hundred percent of nothing equals nothing. If subprime total losses hit 10% then even some single-A tranches face the grim reaper. AAAs? Folks the point is that there are hundreds of billions of dollars of this toxic waste and whether or not they're in CDOs or Bear Stearns hedge funds matters only to the extent of the **timing** of the unwind. To death and taxes you can add this to your list of inevitabilities: the subprime crisis is not an isolated event and it won't be contained by a few days of headlines in *The New York Times*. And, it will not remain confined to a neat little Petri dish in some mad financial derivative scientist's laboratory. Ultimately, through capital market arbitrage it will affect risk spreads in markets completely divorced from U.S. housing. What has the Brazilian Real to do with U.S. subprimes? Nothing except many of the same bets are held in hedge funds that by prudence or necessity will reduce their risk budgets to stay afloat.

And the U.S. economy? Of course it will be affected. Consumption will be reduced to say nothing of new home construction over the next 12–18 months. After all, attractive subprime pricing has been key to the housing market's success in recent years. Now that has disappeared. **Importantly, as well, and this point is neglected by most pundits, the willingness to extend credit in other areas—high yield, bank loans, and even certain segments of the AAA asset-backed commercial paper market should feel the cooling Arctic winds of a liquidity constriction.**

If not taken too far—and there is no hint yet of a true "crisis"—these developments may be just what the Fed has been looking for: easy credit becoming less easy; excessive liquidity returning to more rational levels. Still, PIMCO looks for the Fed to issue an insurance policy in the form of lower Fed Funds at some point over the next six months. And what happened to our glass half-full secular thesis of last month? We still believe in strong global growth, but…as we also suggested…that the U.S. housing downturn will affect growth **and** short-term yields over the next year or so. We remain consistent and resolute. Contagion? Maybe, but you won't be finding it at "99.9%" pure Bear Stearns. Look for it instead, in the subprimely financed homes of Las Vegas, Rockford, Illinois, and Miami, Florida. This problem—aided and abetted by Wall Street—ultimately resides in America's heartland, with millions and millions of overpriced homes and asset-backed collateral with a different address—Main Street.

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About the Author

Bill Gross is Co-Founder and Managing Director of PIMCO, one of the country's foremost fixed income managers with a client list that includes many of the largest U.S. corporations. Regarded by many as America's most influential authority on the bond market, Mr. Gross makes frequent appearances on TV and in the business press.

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