

**Is Ben Bernanke Alan Greenspan  
With a Beard?  
The Latest Cut in Interest Rates**

Since the Federal Reserve's decision to cut interest rates a half point on September 18, the stock market has risen, the bond market has fallen and the dollar has crashed against foreign currencies.

All of this was predictable. The question is whether the effects of the move are lasting or transitory, and whether the potential for inflation accelerating is worth the efforts to avoid economic contraction.

The housing crisis facing the Federal Reserve Governors (which is the basis of the justification for the rate cut) is one that does not lend itself to resolution by dropping interest rates. While lower rates may make adjustable rate mortgages more bearable for homeowners in certain cases, the steepening of the yield curve is offsetting much of the effects of lower Federal Reserve interest rates.

What the interest rate cut does not do is address the cases of fraud and omission in the granting of the mortgages in the first place. In a recent study quoted in *Forbes* magazine, jumbo mortgages (ones granted to buy mansions by the supposedly affluent) that were not properly documented as to income and net worth are defaulting at a percentage rate higher than sub-prime mortgages that were properly documented. Thus the variable is not interest rates alone but the honesty and diligence of the parties involved in the origination of the mortgages.

Such mortgages were usually written up by mortgage brokers. These people are essentially free-lance loan originators. They forward the loan applications to organizations that funded the mortgages in exchange for pooling the obligation with other mortgages and selling securities based on the mortgages in the pool. The securities were then ranked by who would receive the principal portion of the pool. Those who were to receive repayment first were considered the least risky investors in the pool. Those who received payment last were the most risky investors. Presumably the yield on the securities was adjusted to reflect the risk, with the average yield being about half a percentage point less than the average yield of the associated mortgages. This difference was pocketed by the company servicing the mortgage pool that collected the monthly

payments. The rating agencies (Moody's, Standard & Poor's and Fitch) assigned investment grade ratings to the securities based on their limited historic record of low defaults.

These collateralized mortgage obligations (called CMOs in the trade) were patterned after mortgage pools originated by the two government entities set up to do so: GNMA and FNMA, known by their monikers Ginnie Mae and Freddie Mac. The crucial differences are that loans by these two entities require at least 20 percent down payment or mortgage insurance for as much. The terms have to be fixed with even monthly payments of some combination of interest and principal. The mortgages are also capped at \$470,000. Payback of principal is pro rata for all securities in a pool. Finally, the loans were guaranteed against default by the Federal Government.

No such restrictions or guarantees exist on mortgages that were bundled into CMOs. With far higher commissions paid out on CMO-destined mortgages, many mortgage brokers pointed new homeowners in this direction in a clear case of conflict of interest. As mortgage brokers have little regulatory oversight compared to banks and savings and loans that were the original sources of most mortgages, their ability to optimize their income often worked at cross-purpose to getting the best mortgage for the client. Possessing inferior information, homebuyers relied on the mortgage brokers to come up with the best mortgage solution. Add usurious prepayment penalties effectively cutting off the homeowners' ability to re-finance such mortgages with fixed obligations, and the mortgage owner was trapped in a scenario of escalating payments.

These differences in loan terms essentially explain why the meltdown in the mortgage market is not one that will be resolved by lower interest rates. While rates are a factor, especially for loans that came with low initial rates, the structure of the loans prevents easy resolution. What is needed is a demand for the CMO issuers to modify their onerous terms, making them compatible with Fannie Mae's or Freddie Mac's. If this is done these two agencies can buy back the mortgages. By doing this they can put liquidity into the mortgage markets. Loans that are too shaky to be modified to meet government underwriting standards will have to be worked out between the issuer and the borrower.

Presumably all this is known to the Federal Reserve. How a half-point interest rate cut is justified in this circumstance is questionable. While the economy is slowing, foreign demand for US goods is increasing. The dollar, in slow descent for the past three years, has now adjusted sharply downwards. This factor will make imported goods more expensive than previously the case, contributing to inflation. The bond market, sensing the lack of resolve of the Fed at fighting inflation, is going to demand a higher premium over the inflation rate. This will prevent long-term rates from declining in tandem.

The one party that is helped by the rate cut is the hedge funds. This is because margin debt is tied directly to short-term rates. Hedge funds thus far have rewarded the rate decision by bidding up stock prices. Whether this is sustainable is anyone's guess. As Alan Greenspan was once accused of trying to bail out the stock market in 2001, so is Ben Bernanke performing the same feat in 2007. One should recall that after Greenspan first cut interest rates in 2001 the market jumped 5 percent, only to decline 43 percent in the subsequent 21 months as gauged by the Standard & Poor's 500 stock index. The Nasdaq did even worse, declining some 57 percent. The jury is still out on the wisdom of this Fed decision.

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### **The Economy**

Economic activity is showing signs of slowing, but thus far there is no contraction. Job growth has slowed sharply in recent months, although layoffs are slowing as well. These two trends are symptomatic of a shrinking labor market, where fewer workers enter the work force. The demographic trend of retirements exceeding new entrants is intact. The difference is that immigration is no longer filling the gap.

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### **Inflation**

The most positive inflation trend is a contraction in the cost of housing. This helps those shopping for a place to live but hurts those who own homes. Other categories such as health care and food are showing increases in the range of 4-6 percent.

The falling dollar has not yet made itself felt in the government data. Nor have the demands for more product testing for goods imported from China. Such testing could add 5-20 percent to the cost of Chinese imports in excess of whatever effect comes from the dollar devaluation.

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### **Interest Rates**

Typically when the Federal Reserve cuts interest rates the decline is felt by all. This may not be one of those times.

Because the interest rate cut has led to a loss of appetite of foreigners to hold US Government bonds, the yields on such bonds have increased since the rate cut instead of declined, with special emphasis on longer-dated bonds. Thus the efforts to decrease interest rates tied to Treasury yields have been mitigated by the demand shift in the associated debt. This may imply that the Federal Reserve is running out of bullets to keep a possible recession at bay.

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### **The Stock Market**

The V-shape pattern of the latest market decline and rally has put the indexes about where they were in July before the problems with mortgage securities began to surface. Year to date some 40 percent of stocks are down in spite of the Standard & Poor's 500 index being up 7 percent.

This disparity shows both the focus on larger issues as well as the decline in the fortunes of smaller companies with less foreign exposure as a group than large firms. Finance companies of all sizes have been hit by the higher cost of funds and questions as to the value of collateral backing various loans and advances.

Smaller firms also were more often take-over targets of private equity groups. Now that the easy financing has dried up such appeal has become problematic. Going forward one should bear in mind the fact that international growth is higher than that of the US, and that the decline in the dollar means that commodities will be priced higher in dollar terms even if their value is unchanged elsewhere.

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