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From the Desk of Karl Denninger

August 3, 2008

Kevin Daucher
National Coalition Coordinator
Arlington, VA
By Email in PDF

Dear Sir:

I was in attendance at your "McCain 2008" Reception with Tom Ridge last week, and found it informative and helpful.

I would like to ask if you can submit the attached into the campaign, with carbon copies to Governor Ridge and Governor Keating, as I do not have contact information to either of them. It bears directly on the question I raised during the roundtable session, and puts some "facts and figures" behind a position that I believe is critical for the McCain 2008 campaign to address.

In addition, you can find a short video that I was involved in bearing on this issue at http://storage.denninger.net/Financial.wmv; if you are a Mac user a Mac-friendly copy is at http://storage.denninger.net/Financial.mov

That file is identical to the DVD that was being handed out in the Capitol last week in three separate events, including the Banker's Conference at The Regis, in front of the Canon Building, and of course at the University Club. Nearly 1,000 copies were distributed, and many attendees of the Tom Ridge McCain 2008 reception – including Governor Keating – requested and received copies.

Time, unfortunately, is of the essence in this matter, as the credit market situation continues to deteriorate.

I have been attempting to get the GOP's attention in this matter since last fall. As I'm sure you're aware, the "punditry" has been decidedly of the opinion that "it's all contained" since the spring of 2007 – a claim that has been repeatedly proven false.

It is my hope that the GOP will understand that failure to deal with this issue in a forthright manner is likely to not only cost the party the Presidency, but could easily lead to a 50 seat loss in The House. Such a shift would have grave implications for our nation's political balance.

Standard electoral politics – that is, caring in the main (or even at all) only about the few "swing states" - is insufficient if losses in the Legislature make governing and enactment of McCain's agenda impossible.

Finally, I believe that before the election the capital markets may come to the realization contained in this document – that the "bad debt" issue is NOT limited to housing, but in fact is literally everywhere. If that occurs an all-out panic is essentially assured, and we could very easily see an S&P 500 trading under 1,000 before November.

For obvious reasons, this would not bode well for the Republican Party in November.

I look forward to prompt engagement on this issue; I can be reached at any time either by return email or, if you prefer, by telephone at 850-897-4854 (my home) or 850-376-9364 (cellular.)

Sincerely,

Karl Denninger

The "housing issue", in a nutshell, and why the McCain campaign should care,

or

"How to get (or lose) an 80% result in the 2008 election."

We have been told for over a year now that we have a "subprime" issue, or a "housing crunch", and now, a "credit crunch."

Every politician on both sides of the aisle, it appears, is doing everything in their power to prevent home prices from declining, and this is trumpeted as a "good thing" for America.

There are two basic problems with this approach:

1. It won't and can't work - affordability is determined by income to price ratios; holding prices high actually harms affordability. To address that imbalance you would have to generate a wage/price spiral, resulting in a 1970s-style outcome for the economy – a disaster in the making. Neither outcome is good, objectively, for Americans.

2. The losses have already occurred; we are now allocating them, not deterring them from taking place.

Let's back up and go to the most simple of examples - a DVD or CD player, or, for that matter, a cell phone.

20 years ago cell phones were very expensive - both to buy and use. Almost nobody had one. Today, they are inexpensive, costing as little as $20 to buy at WalMart, and airtime is 1/10th the cost of a few years ago. Everyone has one.

The same circumstance exists with CD and DVD players.

It is the stated public policy goal of the American Government, and has been for decades, to promote sustainable home ownership.

Yet the Government has taken, both through inaction and action, steps that in fact are designed to make homes more expensive, with the latest being the introduction of HR.6694, a bill to "restore" seller-financed down payment "assistance" via non-profits (which was struck by the housing bill HR.3221 that just passed and was signed) – and act that, if passed, will in fact make homes 3% more expensive than they would otherwise be (through the fiction of price manipulation, thereby raising comparable values.)

Simple logic dictates that this is exactly backwards.

Never in the history of mankind has a good or service become more affordable by making it more expensive!

There are many who claim that we "must" support housing prices, under the rubric that most Americans have a large portion of their net worth tied up in their homes.

But is this really a winning strategy with The American People, and is this "wealth" real?

Or is it not backwards by destructive to America on balance?

Let's consider the following mathematical facts:

1. 65%, approximately, of American families own their homes. *This means that 35% of American families do not, and in fact have seen their rents jump dramatically as the price of housing has escalated during the bubble.*

2. Of the 65% of American families who own their homes, 40% of those **have no mortgage at all.** These people got **nothing** in real benefit from the housing bubble, but they sure got screwed by the costs – a doubling of food and energy prices, among others.

3. Of the 60% who have mortgages, about half have a conventional 30 year fixed mortgage and put down 20% or thereabouts; they also did not "refinance" or "HELOC" out during the bubble years. In short, they did not treat their homes as an ATM machine. They also got nothing in real benefit from the bubble, but again, they got screwed by the costs in our economy, and continue to do so.

When you add up 1, 2, and 3, you have 35% + 25% + 19.5%, or 79.5% of Americans **who got nothing from the Housing Bubble in benefit – they were DAMAGED, not helped.**

There is a common chestnut that people who own a paid-off (or soundly-mortgaged) home "benefited" if they needed to move or otherwise sell their home due to price appreciation.

This is false; if you sell a "bubble priced" home you still need somewhere to live – you are thus forced to **buy** a "bubble" home, or rent a "bubble" property (at an inflated price) to replace it with! In many states (Florida as an example) this is a monstrous net negative as due to "trading houses" you are subject to a stepped-up basis on your property taxes – an event that can double or more your property tax burden.

Further, the "feeling" of wealth from home price appreciation is in fact a chimera. Today, it is getting increasingly difficult to tap that "wealth" to be able to spend it, and if you do, you have in fact, damaged your economic standing as you have replaced equity with debt – on an asset that is overpriced and **will** correct downward. Replacing equity with debt does not demonstrate or promote wealth; quite to the contrary, it promotes debt-slavery as you are then forced to pay interest on that which you once owned free and clear!

Therefore, all of the three groups above were harmed **–** not helped **–** by the housing bubble.

So who DID benefit? Three groups of people:

1. The 20% who serially refinanced or used "exotic" mortgage products, were "flippers" or "speculators", and got out before the housing bubble imploded.

2. The bankers, lenders, and mortgage brokers who made billions from the exotic instruments.

3. The Realtors who work on a percentage basis, and on average, saw their "take" double for the same amount of work (pricing doubling means their commission doubled as well, even though the house was the same.)

So we have on one side the 80% of Americans who got nothing but insane rates of price inflation in the economy and crushing levels of personal debt, and for whom their best interest is served by **LOWER** prices, and the 20% on the other side screaming for a bailout from either their bad investment or the ability to continue to screw the other 80% of America.

Now let's look at the Federal Reserve's "Flow of Funds" reports and tally up net mortgage lending for the last 10 years in an attempt to quantify the damage:

1998 $301.7B
1999 380.1
2000 385.7

2001 506.9
2002 708.4
2003 856.7
2004 940.7
2005 1030.8
2006 990.2
2007 668.8
2008 (projected) 320.9

1998 was the last year before the "Internet Bubble" really took off and went through its blow-off top and implosion (in 2000); the bubble simply shifted to housing. 2005 was the peak both for lending and price, as expected.

But here's the rub – 1998 was, roughly, the last time that we had SUSTAINABLE lending practices. The back half of 98 and all of 99 were fueled by insane price appreciation due to the "Internet billionaires club" and following 9/11/01 Greenspan's "willful blindness", along with that of the rest of the government, fueled "reflation" into housing.

Make no mistake; the housing bubble was not an accident. It was an intentional act committed by thousands for their own enrichment, and the policies of the Federal Government were a necessary element. The OCC, for example, overruled state agencies (particularly in New York State) that attempted to crack down on unsound lending practices in the early part of the decade, arguing federal preemption. The SEC and other regulators looked the other way while firms moved over $5 trillion dollars into "off balance sheet" vehicles – exactly like ENRON did before it imploded. And The Federal Reserve held liquidity intentionally high and thus interest rates intentionally below market levels for years; when borrowing costs are below the rate of inflation you are literally being paid to borrow money, and when risk is presumed to be zero, the logical level of leverage is "infinite."

Now we have banks that are literally redefining what it means to be "late" or "non-performing", with some recently changing their definitions from "90 days past due" to "180 days". This, of course, results in their quarterly results looking much better than they actually are. This sort of practice, whether in regional banks or in investment banks moving huge blocks of "assets" to "Level 3" where they can literally invent a value to prevent having to report the market's opinion of their worth, has done nothing but "paper over" a pre-existing loss – temporarily.

There is no way to fix the housing bubble. To "reinflate" it you must first figure out how people can make the payments at these higher home prices. It can't be done. Houses cannot sell, on average, for more than three times incomes on a sustainable basis. A sustainable, safe mortgage consists of a 30 year fixed rate loan with no more than a 36% "back end" ratio and 20% in cash as a down payment.

When you price loans such as this you find that it results in a house price that approximates three times the buyer's income. *It is only through unsafe lending that brings very high rates of foreclosure that higher prices can be maintained!*

Most of the lending beyond 2000 levels is in fact an unrecognized (to this point) loss! This amounts to somewhere in the neighborhood of $2.5 to $3 **trillion** dollars, of which only $300 billion or so has thus far been recognized and reported.

It would be nice if this loose lending was limited to housing. It was not. It is in fact **everywhere**; corporate buyout loans (LBOs), student loans, car loans, credit cards, ordinary corporate and industrial (so-called "C&I") loans. All were made under loose, unsupportable underwriting standards **and all will be re-priced over time to reflect true credit quality, as firms and individuals are unable to pay a large percentage of these loans back**.

We are going into this economic slowdown with record numbers of corporations having debt rated as "junk" (lower than investment grade.) This occurred because the "spread", or cost of high-quality credit, was insanely low compared to historical standards and so corporations saw no reason to "pay up" in the form of reducing leverage to get better ratings. We thus are now stuck with corporate borrowers having their leverage at unsustainable levels as well, heading into this economic period.

We cannot change whether the losses on these loans will be taken, **because they have already occurred.**

They occurred when the bad loans were made to people who did not and will not have the ability to pay **and nothing can change an event that has taken place in the past.**

All we are doing now is allocating who gets to **recognize** or "eat" the loss.

This is a critical point – the economic damage is not happening now, rather, it is being **recognized** now but occurred throughout the last five years.

Hiding the damage will simply make the ultimate outcome worse as confidence continues to deteriorate and an increasing number of firms are discovered to be, in fact, liars.

Fannie and Freddie were **chief architects** of this damage in the housing space. Even today they are making unsound loans, allowing DTI levels as high as 50% or more. These firms are operating with a leverage ratio of 60-200:1 (depending on how you reconcile their balance sheets) which is nearly **double** that of Bear Stearns just prior to its collapse. The GSEs have hundreds of billions of dollars worth of potentially bad paper on their balance sheets from "automated approvals" of mortgages purchased from Countrywide, IndyMac and others, many of which were "Streamline" refinances that, in many cases, verified nothing but a borrower's FICO score.

The FHA is compounding this error. The "3.5%" down payment in the housing bill (or the former 3%) is commonly thought of as "skin in the game", but that is not the truth of the matter. The real issue is leverage – with a 3% down payment you are "levered" 33:1 as a home buyer, or roughly as heavily as Bear Stearns was just before it imploded! With "down payment assistance" rendering the true amount "out of pocket" to be near (or actually) zero, your leverage is infinite. The consequences of the latter are visible in the foreclosure statistics – loans with "Down Payment Assistance" through institutions such as Nehemiah foreclosure at a rate **double** that of those in which the borrower puts down just 3%. More to the point, those who put down 3% foreclose at a rate of more than **four times** that of those who put down 20%.

The key is not "skin in the game", it is leverage and operational risk. With increased leverage comes greatly increased risk of foreclosure (failure) should you suffer a job loss, medical emergency or other serious economic hit (e.g. your car's transmission fails or the roof needs replacing.)

The **only** solution that will **actually work** in the housing space, if the goal is **sustainable home ownership**, is to force leverage ratios **down**, restoring safe underwriting and the truly-conventional, 30 year fixed, 20% down, 36% "debt to income" mortgage as the primary means of financing a home purchase.

There are two paths, essentially, which can be taken at this juncture:

1. Attempt to "paper it over" and transfer the losses around. This simply screws the 80% of Americans who didn't profit from the bubble worse than they have already been hurt. It **does** reduce the damage to the 20% that profited – in essence, allowing them to keep (some of) their ill-gotten gains. **This will not stop the economic damage from occurring nor will it lessen the impact, but it can and will shift where it falls – it will drop it directly on those who were and are innocent!** This is already happening in the form of insane price inflation in food and energy, among other impacts to the economy.

2. Force recognition of the losses by withdrawing artificial lending and price supports on housing, withdraw excess general liquidity and, at the same time, prosecute and (when and if proven guilty) jail those who committed fraud up and down the line, from investment bankers to mortgage

brokers to realtors and appraisers to borrowers. This will cause the losses to be concentrated on those who committed the bad acts and force sound lending to take place going forward.

In either case much collateral economic damage has and will occur. That cannot be avoided or significantly mitigated – it is inevitable because, as I noted, the loss has already happened, whether firms with to admit it or not.

Those who wish to argue that we “aren’t in a recession and won’t have one” are wrong. We not only are in one now, it will get much worse before it gets better, as the bad decisions and thus losses have already happened.

The longer the government allows the “book cooking”, off-balance sheet games and outright redefinition of what is a “performing” loan to continue, the worse the economic malaise will become.

Should this continue for much longer the risk of a replay of the 1930s, driven by a near-complete seizure in commercial and personal credit, becomes quite likely as there will be literally nobody left who anyone trusts to tell the truth!

Home prices, in either event, will contract to sustainable values – whether we want them to or not.

The risk in attempting path #1 above is severe. Should we attempt to shift and spread these costs so they fall on “the taxpayer” generally instead of concentrating them on those who benefitted from the fraud and intentional mispricing of credit, we run the risk of radically increasing the cost of **ALL** borrowing, as there is a very real risk that Treasury borrowing costs could increase.

To put this in perspective we spend $300 billion, roughly, on debt service today. Most Treasury funding is done through short-term notes and intermediate term bills, and is subject to rollover rate risk in competitive auctions. Should these costs rise materially it could choke off the ability to fund The War in Iraq, Social Security, Medicare, or all three.

We have already committed $1.3 trillion (that we do not have and will have to borrow) and have failed to stem price declines in housing nor have we materially impacted the economic damage. This is because, as I noted, the harm has already been done; we are engaged in a futile attempt to undo the past!

The bond market has reacted to this. While Treasuries have been quite sedate (thus far) the “high yield” market is not so sanguine, and mortgage rates are currently higher than they were last summer – when Fed Funds was at 5.25%, or more than 3% higher than it is today. Current projections in the marketplace put the total economic damage well north of the 2000 recession; I believe we could easily surpass the 1980/81 recession in terms of damage in the corporate debt space.

But, once again, this damage occurred when the bad loans were made – you can’t “stuff the toothpaste back in the tube”, and it is unjust to attempt to force the costs off on those were prudent.

Again, 80% of Americans were prudent during this period.

Both political parties are, for the moment, pandering to the 20% of Americans that made fortunes during the boom and hoping that (1) the 80% don’t wake up, and (2) the “other guy” doesn’t figure all this out – and how to exploit it.

I put forward the proposition that Mr. Obama is unlikely to remain ignorant of these facts for very long. Mr. Obama further has an advantage in this matter, and it is in fact his *lack of experience*. He can (justifiably) claim that he wasn’t in Congress when the bad decisions were made and thus should “get a pass” – something Mr. McCain cannot do.

Therefore, my proposition is that John McCain needs to get out in front of this issue here and now – and take path #2. That is, as a matter of “McCain 2008 Policy”, he must state and pledge:

1. No bailouts for any part of the lending and housing industry. It must be articulated that (1) these losses already happened, and it's not right for those who got no benefit from these practices to eat them, and (2) the economic damage should be concentrated on those who profited from and created the mess to the extent possible. The claim of "systemic risk" is a chimera; in fact, it is ALL systemic risk as bad lending was spread through the entire marketplace!

2. ALL financial institutions must conform to standardized methods of reporting what is and is not a performing loan, and all off-balance-sheet securitizations must be repatriated onto those balance sheets. *Trust is essential in our capital markets and it is being systematically destroyed while both political parties cheer "bailout" proposals. This must stop immediately.*

3. Withdrawing "support" for home prices will benefit the vast majority of Americans. Property tax bills will FALL, as assessed values decline. The cost of living will come down – for renters, their rent will likely decrease significantly, and for owners who were prudent, their other costs of living will decrease, although their "unrecognized gains" will evaporate. The key item here is that *an attempt to prevent these "unrealized gains" from disappearing will not work – but we will continue with $4 gasoline and $5.50 blocks of cheese – both more than 50% higher than the price of just two years ago - if we try!*

4. We must withdraw the "excess liquidity" that is currently fueling insane price inflation in commodities. *You cannot help a drunk (someone who has abused credit) get better by giving them another bottle of whiskey; they MUST withdraw from the addiction.* The debt-carrying capacity of society and the consumer has been reached; the credit bubble must be encouraged to deflate because only when that has occurred can the economy heal.

5. Those who committed fraud – all of them – will be investigated, indicted and prosecuted, no matter who and where they are. This includes borrowers, lenders, brokers, appraisers and ratings agencies as appropriate, without exception. In addition, the Campaign must pledge (and follow through on same once elected) that future attempts to commit fraud such as what occurred during the housing bubble will be met with immediate and severe legal consequences. *We must not let this happen again.*

6. The economic damage from this "credit bubble" cannot be avoided as the loss has already occurred. Proof of this can be found in the quarterly reporting of virtually every financial entity on Wall Street; they have repeatedly claimed to have had a "kitchen sink" quarter but only days, weeks or months later confess to yet more loss that had been previously hidden. The public debate must center on who gets the hot potato and has their hands fried. The McCain campaign's position should be that those who profited from the fraud should, to the maximum possible extent, be those who are consumed by the consequences, and the Campaign <u>MUST TELL THE TRUTH</u> about our present economic circumstances and how we got here.

We as Americans will be forced to deal with significant economic austerity in the months and years ahead as a result of these bad practices. **That is unavoidable**.

But we can, and must, to the extent of our ability, NOT allow the costs engendered by this credit bubble – an intentional act of many – to be foisted off on that portion of The American People – the 80% majority – who got nothing from it.

John McCain's campaign has a decision to make, and the time to do so is now.

It can either choose to face this head-on, explain it to The American People, and promise to act on it, or it can watch as Senator Obama picks off the 80% of the electorate who has been harmed.