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A quick synopsis of the unraveling of the credit markets

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The Federal Reserve has begun the loosening process, in response primarily to the sudden lack of liquidity in the credit markets and collapse of some financial institutions.

The crisis began in the real estate market, as poorly qualified buyers with little net worth and assets had access to cheap loans. These mortgages were typically aggregated and then divided into sleeves, dividing the risks of the pool. Called Collateralized Debt Obligations (CDOs), they contain tranches that vary depending on the quality of the underlying loans.

On one side, there were tranches with the highest-quality borrowers, which had little chance of default. On the other are tranches that received the first losses of value, made up of more risky loans and borrowers.

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The rating agencies typically earned huge fees in rating these pools and were eager to work in this large, new market. After all, this offered subprime or high-risk borrowers access to real estate mortgages for the first time, and mortgage originators were heavily incentivized to meet this demand by lending other people's money.

Last spring, as the housing market began to decline, rating agencies finally downgraded a number of CDOs. Many institutional investors who either relied on the rating agencies or made mistakes in their own due diligence were forced to sell their previously investment-grade holdings (many investors have investment policies that prohibit below investment-grade holdings). The massive selling weakened the CDO market, and subprime CDO issuance virtually stopped. The era of cheap home-mortgage credit came to an end.

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The collapse of the CDO market has had a domino effect on the credit markets. Investors (mostly hedge funds) that had leveraged their CDO positions faced margin calls, but struggled to sell positions as the market collapsed from the weight of the intense pressure of deleveraging process.

Consequently, these investors were forced to sell more liquid investments. Other fixed-income securities that would be vulnerable in a weakening economy were hit hard as well. Equities, high-yield corporate bonds and Collateralized Loan Obligations (CLOs) used to finance leveraged buyouts and other bank loan products were hit particularly hard.

Investors sought refuge in default-free instruments such as U.S. Treasury bills, forcing yields to fall below 4 percent. Banks became reluctant to lend to one another, sending the spread between three-month LIBOR (London Interbank Offered Rate) — the rate at which international banks lend to one another — and three-month Treasury bills to more than two percentage points.

The spread since has narrowed but is still well above the normal spread, which is 0.25 percent or less.

To address the credit crunch, the Fed reduced the fed funds rate from 5.25 percent to 4.75 percent in September to give banks more breathing room if other banks refuse to lend.

The sudden need to reduce risk or de-leverage has been difficult for financial institutions. Those with hard-to-value investments — such as CDOs, CLOs, bank loans and low-grade corporate bonds — have continued to struggle for funding.

Compared to past credit crunches, the investment-grade bond market is reasonably liquid, and investors have more confidence in the health of companies.

Instruments relating to the housing market are another story. Investors in the lower-grade CDOs face difficult head winds.

Home prices are declining, homeowners have little or no equity, credit requirements have become stringent, and new funding has evaporated. All of these factors apply even more to the starter home market.

All of this makes it easy for the homeowner to walk away.

While the global economy is relatively strong and corporations are in good condition, the effects of the lousy housing market affect not only the economy but also the way securities are priced.

As always, diversification generally has preserved investment portfolios. But risk-seeking investors have been crushed by concentrating on risky areas and investments they don't understand. Plus, they're overleveraged in these investments.

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