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15 Things You Need to Know About the Panic of 2008

By Fred W. Frailey, Kiplinger.com

1. It all began with cheap money. To prop up ailing economies early in this decade, central banks in the U.S. and Japan kept interest rates unusually low, which encouraged speculation. In the U.S., the Federal Reserve lowered the federal funds rate -- the rate that banks charge each other for overnight loans and a barometer for the cost of borrowing money on a short-term basis -- from 6.5% in 2000 to 1% by mid 2003. Cheap money quickly ignited a sharp rise in home values in virtually every corner of the country.

2. Financial magicians made subprime loans golden. Banks and mortgage companies fed speculation in home prices by offering cheap credit to all comers, including those who would not normally qualify. What to do with these subprime loans? Package them with thousands of high-grade loans to sell to investors. To make the subprime loans attractive, underwriters bought insurance policies guaranteeing that the loans would be repaid. With insurance on the loans, credit-rating agencies stamped such paper as triple-A-rated debt.

3. The global economy became infected with poisoned debt. The loans came to investors as collateralized-debt obligations, or CDOs. A CDO is a huge package of loans sold in assorted segments -- known as tranches -- with varying interest rates and levels of risk. Buried inside the least-risky tranches were those subprime mortgages masquerading as triple-A-rated debt because of their insurance policies. Companies that wrote the insurance policies on these mortgages assumed that default levels would be minuscule.

4. So much for those assumptions. Home prices tipped downward, setting off a chain reaction. All bubbles eventually burst. The Fed began raising short-term interest rates in 2003, eventually boosting the federal funds rate to 5.25% by the summer of 2006. As a result, adjustable-rate mortgages (particularly the subprime variety) began to reset at far higher interest rates, and in July 2006 the rise in home prices abruptly stopped. In fact, home values began a descent that continues to this day, in many communities averaging a loss of 15% to 30%. As borrowers realized their homes were worth less than the amount they owed on their mortgages, the default rate shot up.

5. Rating agencies lowered their assessment of those supposedly triple-A subprime loans to junk levels. The investment and commercial banks, pension funds, and other institutions that had bought the supposedly safe, triple-A-rated CDO tranches woke up to find their investments tainted by those poisonous subprime loans, which began to default at alarming rates. Holders of these CDOs found it all but impossible to know what they were really worth. And when they tried to sell them, there were few buyers -- the beginning of a seize-up of U.S. debt markets.

6. A wave of write-downs on the value of those loan packages commenced. Financial accounting standards require banks and investment companies to "mark to market" the value of their assets each day. If it's impossible to value a security because there is no market for it, too bad -- make a smart guess. Starting in 2007, one financial institution after another announced a series of quarterly write-downs of hard-to-value and unsalable CDOs that turned into a financial tidal wave.

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Market Watch

	9/30/2008	YTD
DJIA	10,850	-18.20%
S&P 500	1,164	-20.73%
NASDAQ	2,082	-21.50%

This Week's News

In response to the failed attempt to pass a $700 billion rescue package, the DJIA tumbled 777 points (6.98%). Frustration, and then panic, weaved its way through the market. Seven and a half frantic hours later, $1.2 trillion had vanished from the U.S. stock market. September 29, 2008, will go on record as the 17th biggest (percentage) decline for the DJIA; the most severe was -22.6% on October 19, 1987. Expectations of a revised plan fueled the DJIA to a **485** point gain today (9/30/08).

The Troubled Asset Relief Program was voted down yesterday by a small margin (228 to 205). Like many others, we expected the plan to pass despite its imperfections. We expect Congress to reconvene later this week and come to an agreement that will pass and provide much needed relief for the credit markets. In addition to investor capitulation, this further supports signs of a market bottom and a near-term rally.