COMMENTARY | Will strategy prevent a downturn?

FED'S LIQUIDITY INJECTION MUST GO WHERE NEEDED

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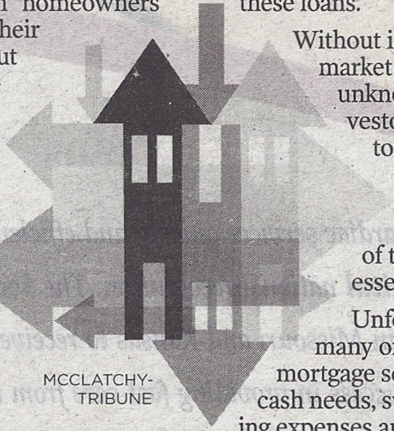
The recent market downturns have been triggered by a credit crunch. The subprime mortgage debt written in the past few years, especially adjustable-rate mortgages, were riskier than the markets had priced into the cost of these products when underwritten, securitized and resold.

As the "teaser" rates rose to market rates, mortgage defaults have increased dramatically. This has finally forced the securities markets to recognize the enormous credit risks contained in these loans. Home prices have declined as foreclosures increase the number of homes on the market. In addition, stricter credit criteria have reduced the number of qualified buyers. This prevents "upside-down" homeowners from selling their homes without incurring significant losses.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This means the collateral underlying these outstanding loans has less market value and the debtors are less able to pay off many of the newer subprime ARMs. How much value has been lost in these loans is unknown. Therefore, the markets are unable to reliably price hundreds of billions of dollars of these loans.

Without identifiable market prices and with unknown risks, investors are unwilling to buy these instruments, in whatever form. That part of the market is essentially "frozen."

Unfortunately, many of the holders of mortgage securities have cash needs, such as for ongoing expenses and redemptions.

Robert Rhea wrote in his classic book, *The Dow Theory*, that "in

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FROM D6

bear markets good stocks will suffer with the bad ones, because people sell at some price for which there is an assured market in order to protect what they cannot sell at any price."

In other words, when you can't sell what you want, you sell what you can at whatever price you can get to meet your obligations. This almost always brings on a generalized price decline for all investments as securities are dumped wholesale onto the markets to generate cash.

So much for the subprime crisis being "well-contained."

The **Federal Reserve** has recently made a "surgical strike" at alleviating the crunch by cutting the discount window interest rate 50 basis points and encouraging more discount window borrowing. The Fed will also accept some subprime mortgage securities as collateral in the discount window.

This is both a unique and inspired move by the Fed. Lowering the target Fed funds rate would inject liquidity into the markets but would not address the crunch in the subprime loan area. Recently, the Fed did create additional liquidity, but the effect was to create additional demand for the safest securities and it did not provide liquidity where needed. This new method would provide* enough liquidity to the proper markets without endangering the U.S. dollar exchange value or encourage further "bubble" behavior. This strategy also allows future discount interest rate cuts, if necessary.

The best the Fed can hope for is that this targeted liquidity injection will ameliorate short-term wholesale dumping of other securities on the markets, incurring massive investor losses and perhaps even triggering a recession. A lot depends upon whether the needed liquidity will find its way into the needed parts of the markets.

The losses in the real estate-related markets have been incurred. Now they need to be measured and realized, so these securities can be priced and traded. The Fed is counting on liquidity injections to buy enough time for this process to happen.

Will the Fed's strategy prevent a generalized market downturn? Maybe, if the Fed is right and the remainder of the economy is healthy enough to withstand the lost capital from the real estate bubble. If not, it could be a rough ride in the near future.

* The KC Star edited this sentence, significantly changing its meaning. It should read: "will hopefully provide" rather than "would provide." As of now, no one knows whether this move will provide enough liquidity into the frozen markets. Other editing made some sentences less clear, but did not completely change their meanings as this change did.