

Credit Issues Roiling Markets

What's behind the enormous volatility in the markets?

Fear. Fear that the subprime mortgage lending issues are spreading to our broader economy and now impacting foreign banks and investment firms. These fears are being stoked by news headlines such as "unprecedented poor conditions" in the mortgage markets and "Stocks Plunge on Rising Credit Anxiety." Given that we've already seen six days this year in which the Dow Jones Industrial Average has risen or fallen more than 2% in a single day, it is no wonder that many investors are uneasy.

How did this situation develop?

The Federal Reserve used monetary policy via low interest rates to help the economy recover from the 2000-2002 downturn. After several years of strong growth and favorable conditions, investors (both retail and institutional) grew complacent and took on too much risk. A prime example of this can be seen in the residential housing market. Homeowners who saw rapid gains in their home values extrapolated that recent experience into the belief that it would continue. Some homeowners tapped their home's equity to buy cars, boats, second homes or speculative real estate. Many used the low interest rate environment to "trade up" or buy more house than they could truly afford, oftentimes financed via adjustable-rate or interest-only mortgages.

Now that many of the adjustable-rate mortgage periods are ending and the housing market has cooled considerably (oversupply of both existing and newly constructed homes), delinquencies and defaults are rising. At first this was just occurring in the subprime sector but now it appears to be spreading to more homeowners.

Risk

A larger potential problem that we see is that institutional investors (hedge funds, mutual funds, investment banks) also took on a lot of risk in their investment portfolios. They purchased securitized packages of these subprime loans that came with higher yields (for commensurately higher risk assumed). Some institutions speculated as well, borrowing money at low rates to gain even more leverage. They were more than happy to purchase exotic securities that were not well understood.

With defaults now rising in these subprime loan packages, prices are falling as investors reassess the level of risk in their portfolios. Hedge funds and other large investors that had employed maximum leverage began receiving margin calls. In order to meet the margin calls they needed to raise cash by liquidating securities. Thus the selling began. At first it was contained to subprime debt and other riskier securities and asset classes such as low credit quality bonds, but now the selling has spread to other fixed income securities and stocks. Hedge fund unwinding of their leveraged positions is exerting enormous downward pressure on security prices. Some hedge funds have already failed due to the significant amount of risk and leverage they assumed. With billions or trillions of dollars of these securities in the marketplace, we will find out in coming weeks and months just how many other investment firms took on too much risk.

Liquidity

A few months ago the number one catch phrase in financial circles was "contagion." Then we heard about a looming "credit crunch." Now the headline of the week is "liquidity." What has happened is that investors in several asset-backed securities markets have become paralyzed, not being able to

accurately value (price) them, resulting in the short-term commercial paper market tightening up considerably. Some mortgage lenders have ceased operations or gone bankrupt. This is impacting other players in these markets, making them less willing to extend credit (make loans, issue paper), oftentimes even to more creditworthy borrowers.

The European Central Bank has injected cash into its financial system each of the past two days in order to maintain liquidity and ensure that its financial system continues to function. U.S. investors are looking for the Federal Reserve to step in as well. In fact, the Fed has been carefully monitoring the situation and today announced that it will provide “reserves as necessary” and do all it can to “facilitate the orderly functioning of financial markets.”

It is not the Fed's responsibility to bail out hedge funds and investors that took on too much risk, preferring to let the markets sort this out. However, if the financial/banking system becomes at risk, the Fed will take action. Accordingly, the Fed yesterday added an extra \$24 billion in temporary reserves to the U.S. banking system as a sign to reassure investors that the credit crunch domestically does not worsen. This action, without cutting its target federal funds rate, is what the Fed did to calm the markets following the September 11, 2001 attacks. Providing stimulus in the form of lower interest rates would go against the Fed's stated goal of keeping inflation in check, but the Fed also doesn't want the economy to slip into recession or worse.

Thrivent's view

For the past several quarters we have been seeing increasing risks to the economy and excessive risk-taking by many investors. As such, after several years of strong markets, Thrivent has been taking some risk off the table by upgrading the quality of its portfolios. We have encouraged our members to do the same and have implemented these strategies in our asset allocation products. Thrivent has positioned many of its portfolios more conservatively to help cushion against expected and unforeseen risks that could take place. This doesn't mean that we are completely avoiding risk – our portfolios are at their long-term target allocations for stocks, bonds and cash. While our investments are impacted by broad market action, our fixed income portfolios have not been directly impacted by the fallout in the subprime mortgage sector.

What action should investors take, if any?

Stick with your investment strategy – don't sell into panic. If you determine that you have less tolerance for risk than you previously believed, it may make sense to make some adjustments. But don't go overboard and jeopardize your entire long-term investment strategy in response to what appears to be a technical and fear-driven market move rather than a true change in fundamentals and economic outlook. This market volatility will likely be with us for some time, so be prepared.

We also need to remember that investor expectations, which often fluctuate between optimism and skepticism, drive market action in the short term. Investors should continue to work with their financial representatives to ensure that their portfolios are well-diversified and properly positioned to align with their short- and long-term investing goals.

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