Tea Leaf

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Your guide to understanding today's economy and financial markets

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# Handwriting on the Wall

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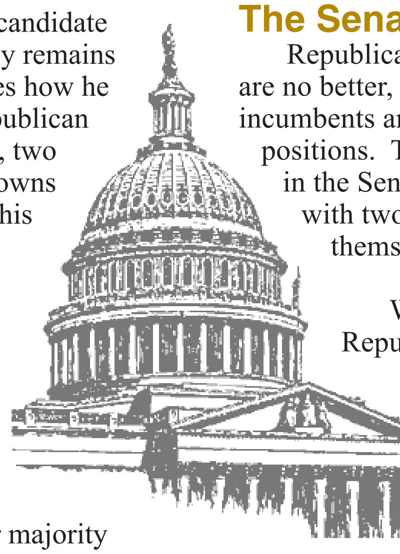
While the Democratic candidate for the American Presidency remains somewhat uncertain, as does how he or she will fare against Republican John McCain in November, two other typical election unknowns seem somewhat certain at this juncture…



…the Democrats are almost certain to strengthen their control in the U.S. House of Representatives

…the Democrats are highly likely to add to their majority in the U.S. Senate

## Incumbency

It has been no secret in recent decades that the vast majority of incumbent office holders in the Congress are routinely re-elected to their positions. The power, prestige, and purse strings of incumbency are enormous, particularly as an office holder extends their time in the Congress.

Because of this reality, voluntary retirements by current office holders represent major challenges for either party to maintain control of a particular House or Senate seat. It is an even greater challenge when the preponderance of retirements is on one side of the aisle…

…welcome to the 2008 Congressional elections, now only 202 days away

## The House

As of this writing, 32 Republican members of the House of Representatives have 1) announced their retirement from political life; 2) have announced they will seek another office such as Senator or Governor; 3) have retired early; or 4) have passed away. The old record for Republicans was 27 end-of-session retirements in 1952 *(The New York Times)*.

Eleven Democrats fit the same criteria. The current U.S. House of Representatives has 232 Democrats, 199 Republicans, and four vacancies to be filled by special elections.

## The Senate

Republican prospects in the Senate are no better, as five veteran Republican incumbents are planning to leave their positions. The Democratic majority in the Senate is currently 51 to 49, with two independents who align themselves with the Democrats.

Why are numerous Republican office holders vacating the premises? Being a member of the minority party on Capitol Hill is extremely frustrating when one's party was in control during the prior decade.

Life was already tough enough for Republicans who have suffered morale issues tied to a President with a low popularity rating, the war in Iraq, an economy likely in recession, a housing crisis, and numerous scandals and missteps. Republican officeholders have also seen the Democrats sharply outpace the Republican Party in regard to national fundraising for the current (and seemingly never-ending) election cycle.

## Shared Frustration

The Republicans can (and do) take some comfort in the fact that the American people's low regard for the Bush Presidency is exceeded by even greater distaste and frustration with the Democratic Congressional leadership (with the term leadership used loosely).

Millions of voters see Senate majority leader Harry Reid and Speaker of the House Nancy Pelosi as too fixated on obstructing the Administration and less interested in policy initiatives that can help the American people.

Republicans also face the challenge that their plight is widely understood. As a result, Republican strategists around the nation have found it difficult to attract top quality candidates to run for office in 2008. Many potential Republican candidates will look for better opportunities to run in 2010 or 2012…or further on down the road.

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# An Accident Waiting…

No shortage of ink has been used during the past year to dissect the root cause of the housing crisis that grips too many American communities…

…some focus on the idea that home prices simply went too far too fast in too many markets during 2002 to 2006, thus requiring the inevitable and painful downward move in home values

…others focus on the fact that numerous Wall Street firms got too involved in slicing and dicing mortgage-backed securities into tranches (pieces) to be bought by aggressive investors around the nation and around the world

**Many of these mortgage lenders were not really concerned about loan quality because the loans were made to be sold. It was all about quantity, and little about quality**

…others take Wall Street firms to task for creating a myriad of securities based on complex mathematical relationships to help investors (in theory) offset risk in volatile financial markets. Such exotic securities ultimately worked very poorly (in many cases) as financial markets went through emotional gyrations unimagined by math geeks and their computer models

…others criticize credit rating agencies such as Moody's, Standard & Poor, and Fitch for their eagerness to put Aaa/AAA ratings on subprime mortgage securities that were logically dubious in quality…. but generated attractive fee income for the rating agencies

…others take the Federal Reserve and other regulators to task for their being asleep at the switch as various "accidents waiting to happen" in the lending sector were in their formative stages

…still others take the Congress to task for their pressuring financial institutions to be more creative and more aggressive in helping people in less-advantaged communities, and/or with lesser abilities to qualify for mortgage loans, to be able to have the American dream…owning their own home

## The Lender's Incentive

One other factor is clearly at play which doesn't tend to get much attention

…it involves the element of lender incentives

The traditional relationship of a mortgage lender and a customer was quite straightforward. A customer needed to demonstrate stable income and the ability to repay a loan.

The lending person was traditionally compensated via the *Quality* of loans. A lender was "responsible" for (and compensated for) the performance of loans in his or her portfolio.

In recent years, a boatload of new lenders appeared on the scene, many of which specialized in subprime lending, or providing loans to people with less than glistening credit. These lending people were compensated on the *Quantity* of loans made…the more the merrier.

Some of these mortgage lenders encouraged their customers to borrow more money than perhaps needed, to over estimate their incomes and ability to repay in many cases, to actually avoid income documentation in many cases, to seek the loftiest appraisals on properties, and at times to make false statements in complex loan documents.

Many of these mortgage lenders were not really concerned about loan quality because the loans were made to be sold. It was all about quantity, and little about quality.

My favorite definition of economics is "people respond to incentives." In this case, lender incentives were simply creating another accident waiting to happen.

Jeff

## "TEA"ser

How can a slim chance and a fat chance be the same, while a wise man and a wise guy are opposites?

—Source: *Speaker* magazine

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