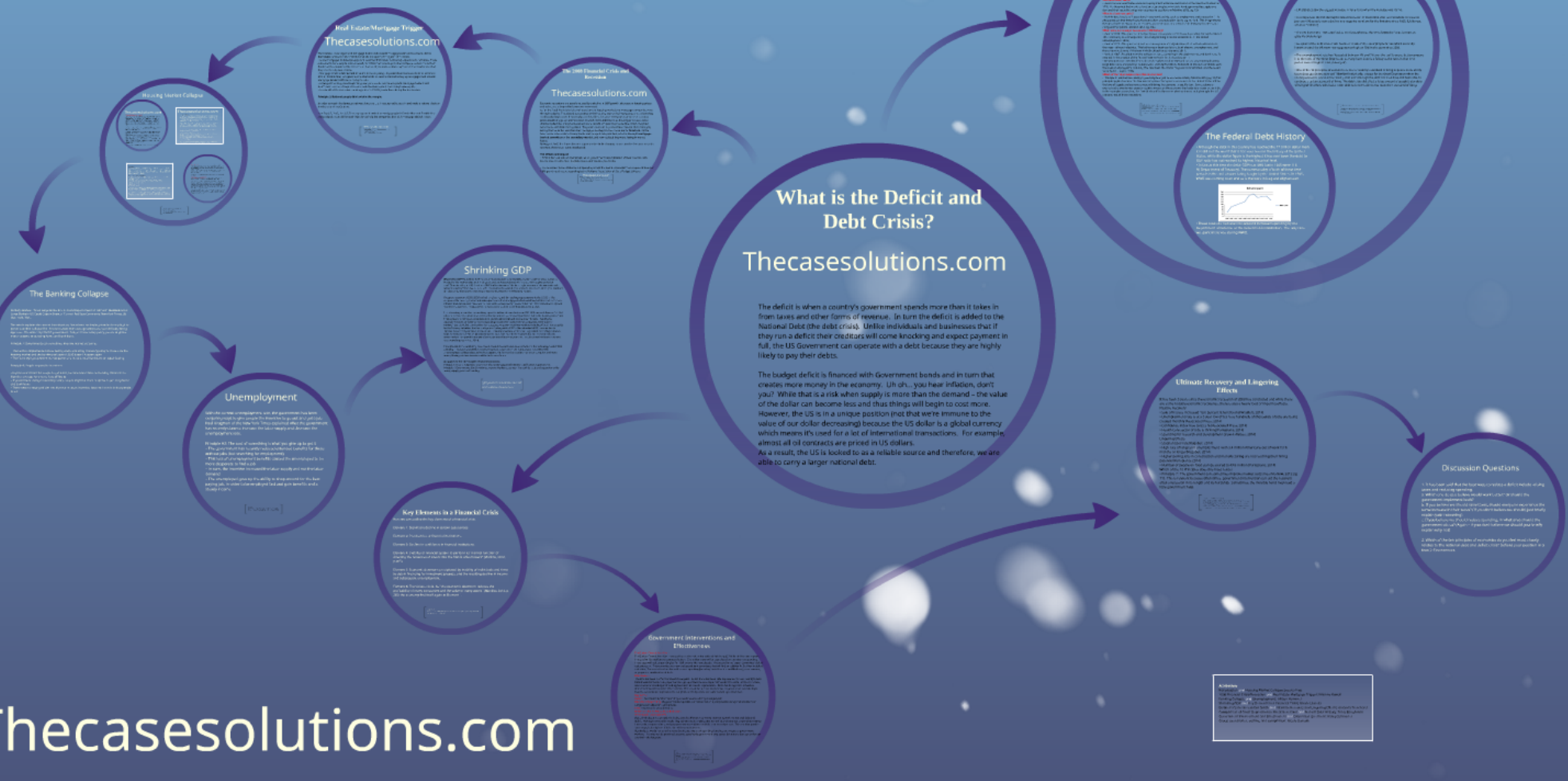
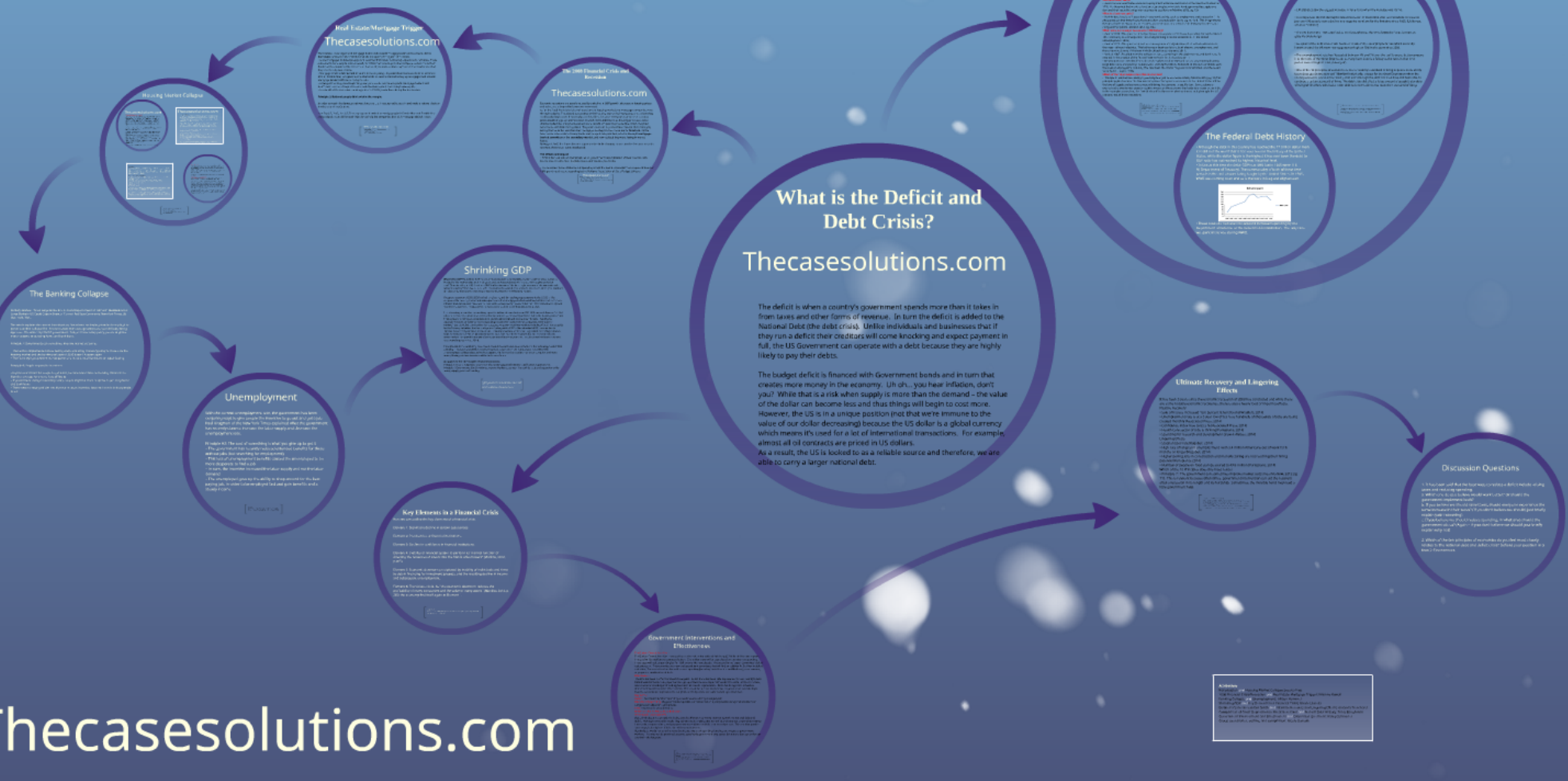


Taking Advantage of Market Opportunities in the Credit Crisis: Cengage Learning



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What is the Deficit and Debt Crisis?

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The deficit is when a country's government spends more than it takes in from taxes and other forms of revenue. In turn the deficit is added to the National Debt (the debt crisis). Unlike individuals and businesses that if they run a deficit their creditors will come knocking and expect payment in full, the US Government can operate with a debt because they are highly likely to pay their debts.

The budget deficit is financed with Government bonds and in turn that creates more money in the economy. Uh oh... you hear inflation, don't you? While that is a risk when supply is more than the demand – the value of the dollar can become less and thus things will begin to cost more. However, the US is in a unique position (not that we're immune to the value of our dollar decreasing) because the US dollar is a global currency which means it's used for a lot of international transactions. For example, almost all oil contracts are priced in US dollars. As a result, the US is looked to as a reliable source and therefore, we are able to carry a larger national debt.

The 2008 Financial Crisis and Recession

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Economic recessions are usually caused by a decline in GDP growth, decrease in housing prices and sales, and a drop-off in business investment.

As for the 2008 financial crisis and recession the housing market and mortgage companies were the main culprits. The absurd exuberance in the housing market led many people to believe they could easily buy houses they simply couldn't afford, because everyone assumed the housing prices could only go up and not down. In 2006, the bubble burst as housing prices started to drastically **decline**. Many homeowners were caught off guard by the decline, which they had taken loans with little money down. They soon realized they would lose most of their money by selling the house for less than their mortgage, so they had no choice but to **foreclose**. As the foreclosure rate escalated many banks and hedge funds panicked, who had bought **mortgage-backed securities** on the **secondary market** and now realized they were facing immense losses.

By August 2007, the banks became apprehensive to lend money to one another because they did not want these toxic loans as collateral.

The effects and impact

- \$700 billion bailout, and bankruptcies or government nationalization of Bear Stearns, AIG, Fannie Mae, Freddie Mac, IndyMac Bank, and Washington Mutual
- The recession forced states to cut spending across the board, a reversal from a general trend of 1.6% growth each year, according to the National Association of State Budget Officers.

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Real Estate/Mortgage Trigger

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The financial crisis began with mortgage dealers who issued mortgages with terms unfavorable to **borrowers**, who were often families that did not qualify for regular home loans.

- Some mortgages included prepayment penalties that made it extremely expensive to refinance. These agreements were easy to miss especially for first-time home buyers, the mortgage dealers made them think that the amount of their income or their ability to make a down payment did not matter and that they could easily own a home.
- Mortgage lenders did not hold on to the loans very long, they sold these loans to a bank or to Fannie Mae or Freddie Mac, two government-chartered institutions created to buy up mortgages and provide mortgage lenders with more money to lend.
- As long as housing prices kept rising, everyone would continue to profit. Mortgage holders with insufficient sources of regular income could borrow against their rising home equity.
- As a result of the recession, housing prices fell 31.8%, more than during the depression.

Principle 3: Rational people think within the margin.

In order to repair the damage that was done, the U.S. Treasury had to step in and make a rational decision for the sake of the Country.

- On Sept. 8, 2008, the U.S. Treasury captured control of mortgage giants Fannie Mae and Freddie Mac and pledged a \$200 billion cash injection to help the companies deal with mortgage default losses.

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What's what in the real estate market?

The real estate market has long been considered a way to invest ones money. It's been regarded an income source for many and a viable option to grow your money (although, at times, the return may take longer than at other times). That was until the bust in 2007 from which we are still recovering. It's been reported the worst of it was from 2007-2009 where foreclosures (and short sales) were happening are record rates. However; before we dive into what precipitated the bust, let's first consider the real estate market and the various parts that make it work.

The fundamental aspects of the real estate market are as follows: Market Economy Growth (Demand), Unemployment, Consumer Confidence, Interest Rates, Mortgage Availability and Supply.

- When unemployment rises less people will be able to afford a house or want to buy a house. Even the mere suggestion of unemployment can sway someone's decision to buy.
- Consumer confidence is the belief or expectation towards the housing market - if people fear house prices could fall, people will defer buying.
- Interest rates serve as a great incentive or deterrent in the market - they directly impact the monthly payment.
- Mortgage availability is essential and limited mortgage options means buyers will be faced with more buying challenges.

(Pettinger, 2013)

All of these parts move together and when one falters the other parts suffer.

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The Real Estate Bust:

The real estate market was booming. Houses would sell in a matter of hours and there would be bidding wars. By all accounts you had to have your guns a blazing and the funds ready to pay significantly more than the asking price of a house. There was a plethora of financing options available too, making it all too easy for those who wouldn't qualify for a conventional loan to achieve the dream of buying a house (and, likely, one far beyond their financial capabilities). As the saying goes, what goes up must come down. That couldn't have been truer for the real estate market.

Welcome to the (bust) year 2008 when unemployment was on the rise and housing prices began dropping (dramatically). As home owners found themselves upside down in their homes (meaning they owed more than what the house was valued), mortgage payments ceased, teams of families nationwide abandoned their homes (often destroying the interiors) and banks found themselves losing money at a dangerous rate.

As teams of economists, attorneys and investigators began researching the cause of the crash it was gathered that it was triggered by a series of events:

- providing easier access to loans for (lending) borrowers,
- overvaluation of bundled subprime mortgages based on the theory that housing prices would continue to escalate
- questionable trading practices on behalf of both buyers and sellers
- compensation structures that prioritize short-term deal flow over long-term value creation
- lack of adequate capital holdings from banks and insurance companies to back the financial commitments they were making.

(Financial crisis 2007-08, June)

It was a recipe of disaster, homes being overvalued, and risky combinations of financing options. After looking back, there was no way it could have continued – it was bound to implode.