The Risk of Not Investing in a Recession

Thecasesolutions.com

Thank you!

The Risk of Not Investing in a Recession

Thecasesolutions.com

The Great Recession

The 2008 stock market crash is the worst stock market crash in U.S. history since the Great Depression. U.S. stock prices fall by 55 percent from October 2007 to March 2009 (Uygur, 2014).

Through this presentation we will argue how an unsustainable increase in the housing market pooled with an unregulated CDS system was the key factor that led to the crash of the United States economy.

The Sub-Prime Mortgage Crises

Securitization

Financial institutions then pooled these mortages into Mortgage Back Securities (MBS). MBSs are just one form of Collaterized Debt Obligation (CDO) that were packed with Credit Default Swaps. Class Notes)

Investment firms and other financial institutions would then purchase CDS's for either monthly payments or a lump-sum payment if the loan goes into default. (Class notes)

On Mainstreet

Pre-2008 America saw substantial economic growth, mostly impart due to the easily accessible *Sub-Prime Mortgages.*

Sub-Prime Mortgages are loans given to low-income individuals who otherwise wouldn't be able to afford the payments on the loans. The most lethal of the sub-prime mortgages were Adjustable Rate Mortgages (ARMS). These adjustable Rate Mortgages would be set at 1-2 percent interest rates for the first year or so, but would then adjust to regular, prime-mortgage rates over time. (Class notes)

Individuals receiving sub-prime mortages did so under the assumption a sustainable increase in housing prices would provide them with enough equity in their home for financial independence. (Class notes)

Securitization

Financial institutions then pooled these mortages into Mortgage Back Securities (MBS). MBSs are just one form of Collaterized Debt Obligation (CDO) that were packed with Credit Default Swaps. Class Notes)

Investment firms and other financial institutions would then purchase CDS's for either monthly payments or a lump-sum payment if the loan goes into default. (Class notes)

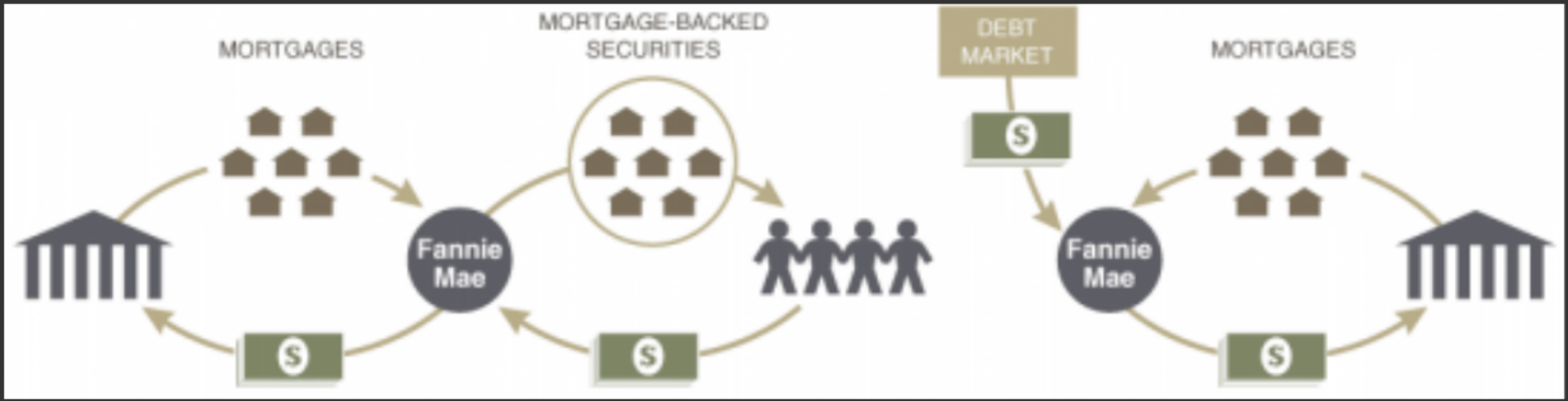
On Mainstreet

Pre-2008 America saw substantial economic growth, mostly impart due to the easily accessible *Sub-Prime Mortgages.*

Sub-Prime Mortgages are loans given to low-income individuals who otherwise wouldn't be able to afford the payments on the loans. The most lethal of the sub-prime mortgages were Adjustable Rate Mortgages (ARMS). These adjustable Rate Mortgages would be set at 1-2 percent interest rates for the first year or so, but would then adjust to regular, prime-mortgage rates over time. (Class notes)

Individuals receiving sub-prime mortages did so under the assumption a sustainable increase in housing prices would provide them with enough equity in their home for financial independence. (Class notes)

Visual Representation of Sub-Prime Crisis



(Investopedia, 2013)

Thecasesolutions.com

Securitization: the American Dream?

For a while, securitization appeared to be a win-win situation.

- ✓ Lower-income individuals could purchase homes they wouldn't regularly be able to afford
- ✓ Investors and financial insitutions (like Fannie Mae and Freddie Mac) profited off these pooled mortgages.

Unfortunately, the reality of the situation was far worse...

- ✗ Lower-income individuals couldn't afford the adjusted rates.
- ✗ The Credit Default Swap was deregulated and, consequently, highly volatile.

(In-class notes)

The Housing Bubble

Bubble Definition:

A surge in equity prices, often more than warranted by the fundamentals and usually in a particular sector, followed by a drastic drop in prices as a massive selloff occurs. (Investopedia, 2014)

As the housing bubble inflated, the US economy grew at a very fast rate (DOW up 23% in a three year period) - hitting all-time highs (Staff, N/A)

- Dow Jones: Record High 14,000
- S&P 500: Record High 1,500