CLO as in CLO-aca

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Awhile back mortgages created by bank or loan institutions were packaged as a kind of 're-using of the tea bags' secondary money making operation. Instead of receiving monthly payments over many years banks sold them to investment banks and the like for some part of their total value which would include interest. The banks then packaged them in a mix ranging from very good to not so good, which supposedly made them safe investments, and sold these Mortgage Backed Securities to a wide range of buyers. But many of these highly rated bonds were really junk because the rating companies made their living from the companies selling stuff that they rate. For some reason there was great surprise when this Potemkin investment scheme collapsed in 2008.

Our government institutions professed outrage and promised to end the 'rating for cash' scheme. Of course they didn't do anything partly because MBS's were out of fashion among the many who were once-burned. For those investors that preferred to purchase something closer to MBS safe junk rather than high yield bonds the Collateralized Loan Obligation became a popular alternative. These are packaged below investment grade highly leveraged loans which are priced according to their incoming cash flow and rarely have more going out than coming in, except this October when they lost about 5%. Might this be a presage of things to come?

The recent Repo crisis caused by official bond dealers and banks withholding highly liquid bonds which are essential as collateral for overnight repo loans, forced the Fed to assume that responsibility. Apparently those that possess the good stuff don't care to share it with the needy. Might they be worried about where the economy is going and are looking out for number one first?

The key thing is liquidity. Probably most of the MBSs in 2008 were really sound, consisting of credit worthy mortgages, but the trading of these things, including CLOs, means obtaining cash from repo dealers who demand highly liquid securities as collateral. Liquidity means solidity because their prices have been freely established in the market. Any sudden fluctuation means an alteration of cash flow which may result in financial disaster.

Trying to predict where the economy is going by pointing to financial singularities is never more than guesswork even when chance comes our right occasionally. The recent worries about bond inversions have come and gone; the 10 year note now has a yield above all the bonds beneath them. But actual withholding of cash and security resulting in losses are closer to something real and in the present. Thus the CLO is like the MBS, their broad failure can sink the real economy.

<u>Economic Data</u>

– The Dow broke over the 28,000 mark on Friday for the first time. Was there some good news that signaled the rush up. Not at all, in fact, the all important industrial production and capital utilization rate for October, estimated at – 0.5 came in at – 0.8. It's all just the result of a baseless bubble market. An interesting factoid is that the rise from 27,000 included 434 points contributed by Apple, a not so important company not doing particularly well.

– The German Institute for Economic Research conducted a survey of 1200 professionals on current economic conditions. The report indicated a weaker economy in the 4th quarter then the previous low point in the same quarter of 2011 when some European and other economies went into recession.

– Industrial production growth in China fell to 4.7% in October down from 5.8% the previous month. Retail sales, fixed asset investment and exports also continued to fall.

– Hong Kong is probably the first major economy to enter technical recession with a – 3.2% decline last quarter.

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