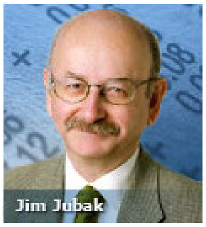

Jubak's Journal 8/3/2007 12:01 AM ET

How far will the credit crunch spread?

There's no doubt that financial markets have felt the pain of the credit mess, but it hasn't yet hit the consumer economy. Here is what I see ahead.

By Jim Jubak

The financial markets are right to be worried about the potential for a credit crunch.

In a credit crunch, lenders stop lending and credit becomes tough to obtain. A credit crunch can bring down everything from weak, deeply indebted companies to overextended lenders to over-leveraged borrowers to an economy as a whole.

So the question is: Are we in the midst of a credit crunch?

In the market for mortgage-backed bonds, leveraged-buyout loans and high-yield, or junk, bonds, yes, the crunch is upon us. The absolute paucity of buyers for those classes of assets -- what I described as a buyers strike in my July 31 column, "Stocks feel the pain of a buyers strike" -- has led lenders to cut way back on putting their capital at risk in leveraged loans or junk bonds. In these markets, not only have prices collapsed, but deals are being scrapped because of a lack of new credit.

But in the general economy where consumers live and spend, the credit crunch hasn't yet materialized. Banks are still lending, credit card issuers are still issuing, and mortgage lenders are still refinancing. Until a credit crunch hits the consumer, the damage will remain confined to the most leveraged sectors of the financial markets, and there the damage could be severe. But the economy as a whole will keep perking along at a growth rate of 2.5% to 3% -- and perhaps better -- for the rest of 2007.

A crisis that feeds on fear and uncertainty

We've certainly got some of the raw ingredients for a credit crunch right now. To create a credit crunch you need fear. Because they're taking a beating on existing loans, lenders fear that they will book big losses on future loans -- which makes them reluctant to lend.

But fear isn't enough. To create a credit crunch you also need uncertainty. A lender can compensate for fear by raising interest rates, tightening credit standards or writing more protective covenants into the terms of a loan. But if the size of the losses is uncertain enough, lenders can't compensate for the additional risk because lenders don't know how large that risk might be. Lenders become afraid to make any loan because they fear that any additional return that they ask for will turn out to be inadequate to cover the actual risk, whatever it may turn out to be.

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The market for buyout loans fits this recipe to a T right now. Banks have been willing to lend to buyout funds to finance these deals because they've been able to resell those loans to other buyers. That limited the banks' risk in any deal.

No ready buyers for the loans

But the market for buyout loans has shrunk rapidly in recent weeks. Investors with portfolios of existing loans have discovered that they couldn't sell their loans at any price during a market drop like that of the week of July 23 through July 27. They were stuck owning loans that were losing big hunks of value by the hour. And they couldn't find an exit.

With buyers for these loans in short supply, in recent deals banks have had to keep more of these buyout loans in their own portfolios than they would like. For example, in the $22 billion buyout of **Alliance Boots** (ABOYY, news, msgs), a Kohlberg Kravis Roberts deal, banks offered an extra 0.5 percentage point in yield to buyers to clear $4 billion in loans off their books. But the banks have struggled to place an additional $10 billion in loans from the deal.

Video on MSN Money

Jubak's Journal: Hello, credit crunch

The cash spigot is being turned off for hedge funds, buyout deals and junk-bond financings. Things could go from bad to worse, MSN Money's Jim Jubak says, because banks are hoping to sell $300 billion in new junk bonds and loans by the end of the year.

Or how about the delay in selling a $12 billion syndicated loan to finance the purchase of the Chrysler division of **DaimlerChrysler** (DCX, news, msgs) by buyout fund Cerberus Capital Management? The deal had to be postponed during the market turmoil of the week that ended on July 27 because banks feared that they couldn't resell enough of the loan unless they offered sweetened yields and took huge losses on the deal. They had good reason to worry: $6 billion in separate loans were sold on July 25 only after increasing yields by 1 percentage point. The parties to the Chrysler deal say it's still on track to close in the third quarter of 2007, but the underwriters -- **JPMorgan Chase** (JPM, news, msgs), **Bear Stearns** (BSC, news, msgs), **Goldman Sachs** (GS, news, msgs) and **Morgan Stanley** (MS, news, msgs) -- and DaimlerChrysler will hold the $12 billion loan on their own books in the meantime.

Implications for financial markets

Keeping these loans on a bank's books in a market where prices can plunge in hours and where buyers can vanish is a recipe for a credit crunch: There's no way to price risk in a market without reliable prices and without a potential exit from positions.

A credit crunch in the market for buyout loans wouldn't exactly be good news for the financial markets. The pipeline is stuffed with about $275 billion in leveraged loans, up from $60 billion at the same point in 2006. Unwinding a substantial portion of those deals would send tremors through the stock and bond markets.

Continued: Junk bonds hit hard

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