First Quarter 2007 Commentary
The Mortgage Market Bubble Bursts

The quarter started quietly with investors still enjoying the gains produced from the latter part of 2006. And then February 27th popped up on our calendars and we were quickly reminded that the financial markets can be quite volatile.

On this one day the domestic markets sold off more than 4%--plenty to catch your attention. All of the sudden the financial news started focusing on a supposedly retired Alan Greenspan, domestic debt loads and the sub-prime mortgage markets. And to add a little salt in the wound the Chinese stock markets decided this would be a good time to sell off more than 9%.

This was certainly a wake up call to any investors who had temporarily forgotten that financial markets can, and always will be, volatile. And while volatility can be a bit scary at times it is best to embrace it as these volatile times often produce the best long term opportunities.

Although there have been a wide variety of topics and reasons thrown around for this newfound volatility, the one that seems to be getting the most attention is that of the mortgage market. Why?

If you will remember, ***we first started loudly sounding the alarm bell over lax practices in the mortgage market in May of 2005***. While we were a bit early, we were able to steer our clients safely out of harms way in what is quickly becoming a mortgage market meltdown.

We have been particularly worried about what has been brewing in the subprime mortgage market, given the loosening in underwriting standards and the extension of credit to those with little equity and the inability to pay the loans back unless housing prices continued to rise. The slow-motion train wreck, and the fact that it went on for another year or two since we first urged caution only makes it worse because the credit markets accepted more and more risk and got thinner and thinner margins while the party was still going on. The events of the past couple of weeks tell you that the mortgage train wreck is still accelerating.

The problems in subprime are not self-contained. It is a pinprick to a larger problem, and it needs to be looked at that way. Subprime home-equity lending is 12% of total mortgage loans outstanding. While that does not seem like a lot, it certainly has the ability to affect the rest of the mortgage and housing market. To further elaborate, ***subprime lending was over 20% of the total mortgage volume in 2006***. That tells us it was growing rapidly as a percentage of the mortgage business when it hit the wall.

It also tells us that the subprime borrower was increasingly the marginal buyer of housing and tilted the supply and demand of housing that resulted in such big increases in home prices until late last year.

From this, ***problems will spread--mostly through housing***. This year is going to be much worse than 2006 for mortgage and housing credit and 2006 already set the mortgage industry low.

Nearly $700 billion of mortgages reset this year and ***nearly half of that is subprime***. Remember that in 2004 the federal-funds rate was only 1% and had nowhere to go but up. Additionally, prime refinancing volume peaked in 2004, and the most popular loan product at that time was a 3/1 adjustable-rate mortgage (three years fixed and adjustable every year after that).

Those are resetting this year after 17 quarter-point increases in the fed-funds rate. The subprime home-equity market peaked in 2005 and the most popular product from that year was a two-year-fixed, 28-year-floating mortgage. ***It resets this year, and now credit spreads are widening***. Additionally, Freddie Mac is going to stop buying as much subprime paper, as are the capital markets in general, and a lot of capacity is exiting through the bankruptcy courts.

The remaining lenders left standing are raising credit standards and cutting loan products and raising coupons on the products they continue to make. Furthermore, housing hasn't bottomed. It is just getting going to the downside.

The credit crunch is spilling into the secondary market in the sense that credit spreads in the secondary market have widened. We're seeing a reversal in the appetite for risk that we've seen for the past several years. ***Credit will get more expensive across asset classes***, and that's another way in which the subprime problem will spread.

This situation presents some very difficult problems for Bernanke and the Federal Reserve.

Bernanke will attempt to hold the status quo as long as possible. With the ***economy flattening and slowing***, it takes away the desire to increase and, at the same time, with the money supply increasing and rates staying low, there is no reason to decrease.

While inflation concerns us it is important to remember that inflation goes on all the time. The question is: At what rate? ***The value of the dollar continues to erode, but it is on a consistent basis***. The only positive right now is that it appears the European countries aren't very different from us, so the dollar isn't eroding versus the European currencies. It will erode against the Canadian, New Zealand and Australian currencies, where you have natural resources and a more positive set of conditions, but it shouldn’t be a big issue.

If Bernanke and our government were to have any one concern, it would be about the loss of value in homes and the problems that have been created by adjustable-rate mortgages, subprime mortgage loans and the very high prices in residential real estate. If we were to see unexpectedly lower rates, it would be because of this area. It does ***affect some areas of retail and personal consumption and financial institutions***, and there are a series of financial institutions that have already begun to show the negative signs of this.

As a result of this collective situation we are quite cautious towards the home-building stocks and in turn less interested in retailers and makers of products that are sold to low-income people.

Reading through this commentary may give a rather gloomy outlook for real estate in general. However, make no mistake--***an affordable home is still a great place to call home***. We all need a place to sleep at night. However, ***speculating upon real estate is no different than going to Las Vegas*** and rolling the dice. And borrowing too much (whether on real estate or credit cards) is certainly asking for trouble.

A modest amount of common sense, and an ability to live below your means, will continue to serve our clients well. And if the downturn in real estate becomes too dramatic it will most likely present some very good opportunities for our clients who are long term in their focus.

Please call or stop by with questions.

Sincerely yours,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™
