

MARKET NEWS

Keeping our Clients Informed

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Putting the Risk Back in Risky Investments

If you had been on vacation for the last three months and not read the news, you might have returned to think not much had gone on in the financial markets during the quarter. After all, the Federal Reserve had met and left rates unchanged. The equity markets finished the quarter unchanged to modestly higher. And finally the only damage to your beach house would have been caused by spring-breakers and not a hurricane.

All in all, it would have seemed pretty tame. Looking through your collection of unread Wall Street Journals, you'd find a different story. The equity markets actually had a pretty wild ride the first three months of the year. The upward trend that began back in August continued on into this year with a steady progression to new highs week after week through January and February. That all came to a dramatic end in mid-March. Within a two week period of time stocks gave back four months worth of gains.

The S&P500 index, after reaching 1460, retreated to an intraday low of 1381. The Dow Industrials gave back 856 points during this time, off of its high of 12795. Both of these moves represented a significant pullback for the market but were compounded by the fact that there had not been a meaningful decline since March of last year. The news was full of talk about how investors had forgotten about "risk".

We take exception to those comments because risk is in fact simply a description of volatility. Volatility goes both ways – up and down. We've actually seen a fair amount of volatility in the past twelve months. It's just that it's all been on the upside. No one seems to mind that kind of "risk".

Nevertheless, the pull back was enough to catch everyone's attention. What was interesting and gave everyone an added sense of discomfort was that the usual reasons for a market contraction that we've grown accustomed to had nothing to do with it this time. The worry of any further Fed tightening had all but disappeared. Energy prices (both oil and natural gas) had receded to more tolerable levels. Gas prices at the

pump had actually dipped below \$2 per gallon in most parts of the country.

This time the market driving news was about the real estate market and the bursting of the real estate bubble. Naturally, this brought back memories of another recent investment bubble burst – technology.

Most of the carnage was felt in the financial sector. The real blowup in the real estate market was in fact with the *lenders* to the real estate market. Of course when the liquidity for real estate dries up, the market for the real estate assets themselves can't help but to take a hit.

Beginning in early March, several high profile lenders to the sub-prime real estate market announced that they were starting to experience high delinquency rates on the loans that they originated over the last few years. These were loans that did not conform to conventional lending standards that most of us are familiar with – some examples: ARMs with big step ups, interest only, balloons, no verification of income, etc.

These lenders had made huge profits underwriting loans with cheap money to anyone on anything. They then turned around and sold these loans to mortgage investors. The problem was that these investors had recourse to the original underwriters if the default rates went above certain limits. That is exactly what has begun to happen. Now many of those lenders are being forced into bankruptcy because they don't have the liquidity to pay back the mortgage holders demanding refunds – so to speak.

While this may seem like a niche market, the implications are far reaching. Almost all mortgage lenders have some exposure to the sub-prime market. A significant dollar amount of the recent real estate transactions in the last couple of years have been financed through sub-prime borrowing. Then there is the fact that some portion of the recent refinancing activity has driven consumer spending.

These factors, along with others, caused a serious shock in the financial services industry, as well as other real estate related industries. Bank stock prices declined markedly. Home builders were also hit hard. Any retailer that catered to the housing market saw their

share prices get hit (Home Depot, Lowes, etc). Even mortgage-backed bonds declined some in value, regardless of the quality of loans in their portfolio. No one wanted to touch anything that had anything to do with the mortgage or housing market. It certainly didn't help when the head of the nation's largest home builder stood in front of a conference and announced, "2007 is really going to suck."

Within days the fear had spread to any economically sensitive security. The peak decline occurred when the Dow Industrials closed down 243 points on March 13th and then fell another 136 points during the day of the 14th. Interestingly, the Dow Industrials managed to actually close 58 points higher on the 14th. That represented an almost 200 point positive swing.

Since then, stocks have gotten back on track and have continued their trek to new highs. The whole affair lasted less than a month. Now that's volatility – no one is complaining anymore.

Why Sub-Prime Matters to the Prime

Long ago and far away, there used to be an old "20% down" reality that morphed somehow into a sub-prime/Alt A cyberspace free-for-all (literally "free for all").

U.S. homeownership has expanded from 65% to 69% of households since the turn of the century, in part because it became so easy to finance a home. People knowingly or unknowingly have accomplished this by taking advantage of "low doc" or "no doc" applications, or might have taken out a "liar loan" in the face of "full disclosure" documentation required of their mortgage lenders, or simply might just have jumped on board the 1% Fed Funds financing train of 2003.

No matter. They bought a house, began living the American dream by making money with someone else's money, and expected to live happily ever after. Well not so fast, at least for some of them it seems. Home prices, as measured by the National Association of Realtors, have gone down by 2% nationally over the past 15 months and there's fear in the air that it could get worse.

It most assuredly will get worse because the full effect of the liquidity crisis hasn't yet been felt by everyone. The easy money may have only recently run out, but it won't be back for a very long time. Think of all those people getting pinched every month as their rates continue to adjust up. Who will they sell to now that the well has run dry for so many of their potential buyers?

The problem with housing is not the frequently heralded increase in sub-prime delinquencies or defaults.

Of course write-offs, CDO price drops, and even corporate bankruptcies of sub-prime originators and servicers will not help an already faltering U.S. economy. But foreclosure losses as a percentage of existing loans will be small and the majority of homeowners have substantial amounts of equity in their homes.

Because this is the reality of our U.S. housing market, analysts and pundits now claim we're out of the woods: the sub-prime crisis is or has been isolated and identified for what it is – a small part of the U.S. economy.

It will not be loan losses that threaten future economic growth, however, but the tightening of credit conditions that are in part a result of those losses. To a certain extent this reluctance to extend credit is a typical response to end-of-cycle exuberance run amok. And if one had to measure this cycle's exuberance on a scale of 1-10, double-digits would be the overwhelming vote.

Anyone could get a loan because shabby credits were ultimately being camouflaged within the Collateralized Debt Obligations (CDO) that in turn were being sold to unsophisticated foreign lenders in need of yield as opposed to ¼% bank deposits (read Japan/Yen carry trade).

But there is something else in play now that resembles in part the Carter Administration's Depository Institutions and Monetary Control Act of 1980. Lender fears of potential new regulations can do nothing but begin to restrict additional lending at the margin, as will headlines heralding alleged predatory lending practices in recent years.

After doubling over 18 months between 2005 and the first half of 2006, non-traditional loan growth has recently turned negative, and lenders' (the ones that are left) attitudes are turning decidedly conservative.

Recently, at a conference of mortgage executives, the executive vice-president of a major seller of sub-prime loans admitted that his company knew better than to make these loans, but they couldn't stop themselves. He said, "We need to spend some time being introspective."

That's code speak for the party's over. The easy money is gone and for the foreseeable future consumer spending is going to have to come from current income and not the equity in your house.

In the end, the fear is that the overall economy will feel the absence of those dollars and that will be felt by everyone. That's what the market was reacting to. The good news is that these things always leave the economy stronger after the bad stuff is flushed out.

