August 29, 2007

Bumps in the Road

You may have noticed that the stock and bond markets have come across some rocky roads of late. It's not just that we have been heading south; it's simply that the ups and downs are proving to be a little disconcerting. On July 19th, CNBC was trumpeting the fact that we had breached the 14,000 mark on the Dow. Only three and a half weeks later, the Dow had fallen almost 1,200 points from that high, and the S&P 500 had erased its entire gain for the year. Since that low eight trading days ago, we are higher by about 500 points, but somehow it still doesn't feel real good. We all like a little order in our lives, and daily swings of two or three hundred points do nothing to contribute to our sense of tranquility.

We are remaining cautious for several reasons. As we have said before, we like to be buyers during periods when pessimism prevails, and until recently markets have been anything but. In fact, for the last three and a half years, we have seen no corrections of even ten percent. The lack of periodic declines, however, is not our main concern. The weakness of the dollar is definitely a problem, but this is a longer-term worry. Our more immediate apprehension is, once again, that nasty four-letter word – debt.

Originally, this problem started with a seemingly insignificant segment of the market known as subprime mortgages. These were loans made to people who very likely should never have been able to borrow money in the first place. During the overheated real estate market of two years ago, <u>creative financing</u> opened a floodgate of money, not just for homebuyers, but for speculators as well. Down payments were very small or nonexistent. Starting interest rates were either zero or artificially low, and the escalation in the payments would not come until a year or two later. By that time it was anticipated the property would be worth far more. There were three guilty parties to these transactions: the speculators who bought one or several properties, the homebuyers with insufficient funds, and the companies financing the purchases. All three apparently believed that any future problems would be overcome by the rapidly increasing value of the property.

True story: Two years ago a mortgage broker approached a fellow we know. The broker was trying to convince him to buy a home for around $350,000. When our friend told the broker, he was unable to come up with the down payment, the broker told him not to worry. "You can go to the closing, put nothing down, and walk away with ten thousand dollars."

Here is the way the loan procedure worked years ago: The institution makes the loan, and then collects interest and principal each month until, years later, the money is paid back in full. We all understand this process because we saw Jimmy Stewart's savings and loan do it in "It's a Wonderful Life." There is, however, a slight difference in the way the method works today. After making the loan, the institution can immediately sell it. The mortgage is then packaged with other similar loans and marketed to investors in the form of a CDO, or collateralized debt obligation. These packaged mortgages are then sold to investment companies or hedge funds, which frequently use borrowed money to buy them. It's clear to see the negative chain of events that occurs when people fail to pay their mortgages. Currently, financial institutions are not only wary of making bids on existing debt, but they are reluctant to create new mortgages. It means that even the good guys, those who pay on time, are having trouble getting loans.

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What makes the mortgage market such a problem is the fact that the housing market in the United States is so pervasive. Seventy percent of American households are homeowners, and many of those who borrowed money to buy homes in 2005 or 2006 may now owe more money than their house is worth. Reducing the availability of mortgage money impacts the economy to the extent that it affects virtually all of us. This is reason the Federal Reserve has started actively injecting funds into the economy. Economists anticipate that they will again lower the fed funds at the upcoming September FOMC meeting, and only a week ago the dropped the discount rate making cash more readily available.

Even though many real estate experts and realtors claim that the worst is over, we continue to remain skeptical. Our local newspaper periodically runs a report stating sales are picking up, but then we read that the price level has not. In his last letter, Bill Gross of Pimco Corp., stated that market forecasters currently project over two million defaults before this current cycle is complete. In short, we are not out of the woods yet.

Before you believe that we are perennially negative, let us consider a couple of possible outcomes. First, values could eventually drop to levels, which would create compelling bargains. At that point, most people will not recognize it. They would rather be shot out of a cannon than buy property, but the more venturesome and savvy investors will begin to step up to the plate. However, in the event that liquidity dries up further, there is another possibility. The Government could take forceful measures to support the loans, by offering some form of guarantee. While this would draw criticism from certain political pundits, it is exactly what the Fed has done before during periods of monetary crisis. An example is the their guarantee of commercial paper in 1987. Government aggressively supporting the mortgage market in some form would almost certainly be inflationary, but consider the alternative. Politicians will almost always opt for inflation. It's not easy to win elections during recessions.

In any event, we believe that the rising debt worries will translate themselves to lower stock prices. This will, in turn, give us some unique opportunities. It is our job to take advantage of the bargains.

Sincerely,

Mike

J. Michael Hard

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