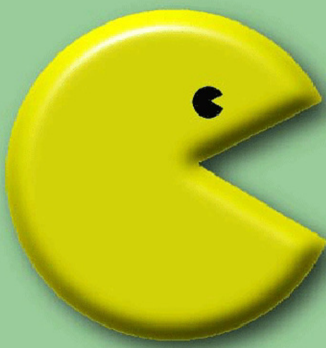

Newsletter - Vol. 5 Issue 1

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mortgagestraightTalk.com

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30 Yr. Fixed Conform. & Jumbo	5.7 & 6.875%
5/1 ARM Conform. & Jumbo	5.5 & 6.25%
Prime Rate	7.25%
MTA Index	4.788%
COFI Index	4.383%
Home Ownership Accelerator Index	5.225%

Morty's Bench Marks - 12/28/07

Above rates assume 30 day locks priced at par, that is, at wholesale with no rebate. Rates change daily.

CURRENT EVENTS

Though the holiday season is supposed to infuse one with "tidings of comfort and joy", there was precious little of it during the month of December. As more and more dire economic news piled up after Thanksgiving it became increasingly evident that the Federal Open Market Committee's (FOMC) earlier stance of no more rate cuts this year would have to be abandoned. Thus, by the date of its December 11th meeting, the expectation of a cut was a foregone conclusion. The only real question that remained was whether the cut in the Fed Funds rate would ¼ or ½ percent. [The **Fed Funds rate is a key short-term lending rate** that influences consumer loans like the **Prime Rate].** The Fed erred on the side of caution, cutting the Fed Funds rate to 4.25%, instead of the stock market's hoped for half percent—and the market loathed it. On hearing the news, the Dow sank like stone, dropping nearly 300 points within an hour and closed down 294 points by day's end. **The Prime Rate now stands at 7.25%** (borrowers with home equity loans and credit cards that are tied to the Prime Rate can expect to see modest reductions in their payments while those with loans linked to the LIBOR index will see no change).

The next day, a coalition of central banks, Canada's, the European Central Bank (ECB) and our Federal Reserve announced a $100 billion infusion of capital into the banking system scheduled for this month and next. The purpose of the move was to stave off the increased risk that a credit crunch could tip the respective economies into recession. The cash infusion is for a limited duration; it's to cover short-term loans for 35 days. Thus, the move will do nothing to assuage the problems facing borrowers in the sickly American mortgage market.

To shore up the ailing mortgage market and aid beleaguered homeowners, Treasury Secretary Henry Paulson's proposed a plan with a five-year freeze on interest rates for borrowers facing unaffordable interest rate resets. But the freeze is limited to borrowers who are current on their mortgage payments. It excludes anyone more than 30 days late at the time the mortgage would be modified or anyone who has been more than 60 days late at any time within the previous 12 months. It also only covers borrowers with ARMs resetting beginning in 2008 and leaves out any who are judged capable of continuing to make payments at the higher reset rates. The proposed plan would offer relief to only about 12% of borrowers so affected.

The Fed's prescience in limiting the rate cut to a quarter percent was confirmed on the 14th when reports showed that the Producers Price Index (wholesale prices) jumped 3.2 percent in November. The spike was the biggest increase in 34 years and the Dow registered its apprehension with a 178-point drop. The inflationary hike was attributed to a record rise in wholesale gasoline prices and does not bode well for the chance of another quarter-percentage point interest rate cut in January. Monday's close nearly equaled Friday's as stocks dropped 172 points reflecting the market's uneasiness with future rate cuts by the Fed.

The likelihood of a drop, as predicted by the Fed Funds futures, retreated from 100% before the Producers and Consumer Price Indices came out to 84% after. Yet, investors in the Futures market are pricing in a nearly 100 percent chance that the federal funds rate will be 3.5 percent by July.

On the 18th, the European Central Bank's (ECB) announced that it upped the ante by $140 billion and pumped $180 billion of loans with two-week maturities into its financial system to help the European Union (EU) economies withstand the deteriorating U.S. housing market in hopes of averting a global year-end lending crunch. The year-end boost was estimated to be more than twice the amount actually needed and will help short-term interest rates for borrowers, domestically, with loans tied to the LIBOR index.

The Stock market gave itself a present of sorts on the two trading days prior to Xmas with a combined increase of nearly 300 points, but floundered the day after Xmas, as retailers reported weak holiday sales and the housing market took another blow when the S&P/Case-Shiller 10-City Home-Price Index was released. It registered a record drop, the largest in more than 16 years and marked the 10th consecutive month of price depreciation and 23 months of decelerating returns.

With the assassination of former Pakistani Prime Minister Benazir Bhutto on Dec. 27, the markets were awash in uncertainty and the government's larger-than-expected drop in crude oil supplies last week fueled the rise in oil prices to above $97/barrel as the Dow closed off 192 points in light trading.

Since last month, 20 more mortgage lenders have closed down their wholesale operations, bringing the last year's total to 210. The most prominent names among the current wave of imploding lenders were Wells Fargo's Home Equity (wholesale), Citigroup's First Collateral Services Inc., Option One, the mortgage unit of H & R Block, SBMC, Washington Mutual sub-prime (wholesale). and National City Mortgage (Whole Sale).

A LONG OVERDUE CORRECTION

This past year the media have incorrectly ascribed much of the liquidity crisis to sub-prime lenders. No doubt about it, they made some injudicious loans, but they were hardly alone. The meltdown in **the sub-prime market was the catalyst, not the cause of the current credit fiasco**. The other major error that the media make is when they conflate what they label the sub-prime market. **The sub-prime market** as identified by most mortgage brokers and bankers**, as those borrowers with FICO scores below 620.** But **the media incorrectly labels everything that is non-prime as sub-prime.** Such is clearly not the case.

There are borrowers with 750 FICO scores that have a 1st & a 2nd that are be deemed Alt-A borrowers because the CLTV (combined loan to value) on their property exceeds 80%, but those of us in the industry would hardly call them sub-prime borrowers. Similarly, there are borrowers with credit scores well above the 680 threshold for Stated Income borrowers that the media misidentifies as sub-prime. Also labeled as sub-prime were borrowers who opted for the lower payments that Interest Only and the Option ARMs afforded, yet most of these people had scores and payment histories of prime borrowers. The No-Ratio, NIVA (No Income, Verified Assets), NINA (No Income, No Assets) and No Doc programs favored by many retirees, corporation owners, business partnerships and those who treasure their privacy have also been lumped into the sub-prime category yet these loan types required FICO scores as much as 100 points above what would be deemed sub-prime. In some instances I've even seen articles that suggest anyone having an ARM (adjustable rate mortgage) constituted a sub-prime borrower. Again, while many sub-prime borrowers may have had ARM loans, not all ARM mortgages were sub-prime.

I've been meaning to address this for some time because a reader emailed me that he thought I underestimated the impact of the sub-prime crisis when I wrote about it in May of '07. [I had assessed the sub-prime situation as not as dire as had been portrayed because they (sub-primes) only comprised about 18% of the mortgage market and those expected to go bad were in the neighborhood of 12-13% which amounted to 2% or .36% of U.S. Gross Domestic Product]. Given the media's misidentification, it's easy to see why my reader came to this conclusion because he (like they) equated non-prime loans as being synonymous with sub-prime.

Had he attended a little more carefully to what I wrote I believe he would have noticed that the Option ARMs and Pick-a-Pays with the abnormally low 1-2% teaser rates were the ones I named as most likely to wreak havoc. Because not only did these loans constitute a much larger portion of the market, but a good many of the borrowers were likely to rely on the low minimum payments these loans afforded them with little concern for their loans nearing the 115% amortization caps which would trigger a loan recast and cause their mortgage payments to nearly double.

THIS ISSUE'S TOPIC: THE ANNUAL FORECAST OR ANOTHER LONG OVERDUE CORRECTION

To comprehend where the mortgage markets are headed, it's crucial to understand what went wrong and where we are. Today, when a lender makes a home loan, it doesn't hold on to it. Instead, it quickly sells the mortgage off to Wall Street, who chops it up, repackages and resells home loans pretty much the way supermarkets chop up, repackage and resell meat. It's a business model that depends on trust. As a consumer, you don't know anything about the cows that contributed body parts to your package of ground beef, so you have to trust the supermarket when it assures you that the beef is U.S.D.A. prime. Similarly, investors don't know anything about the mortgage loans that were sliced, diced and ground to produce that mortgage-backed security or CDO (Collateralized Debt Obligation). So, investors have to trust the seller—and the rating agency—when they assure them that it's an AAA investment.

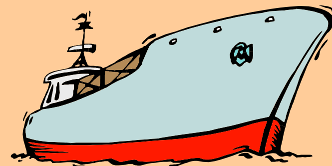
But, as we saw last year, investors' trust was betrayed which led to the credit crunch. Supposedly safe investments suddenly turned into junk bonds when the housing bubble burst. When investors find they've been duped there is a crisis of confidence. The coming year will be based on the restoration of that lost confidence in the credit markets.

To aid in that restoration, Lender guidelines have tightened considerably: higher FICO scores are required, higher PITI reserves, CLTVs have dropped 5-15%, No Doc, NIVAs, NINAs and No Docs are gone from many lenders loan repertoires as are many lenders. The rating agencies like Moody's, Standard & Poors, and Fitch's are now scrutinizing mortgage-backed securities more carefully. Wall Street investment banks have collectively written down 100+ billion dollars worth of losses. To insure that the credit markets don't seize up, the Federal Reserve has already injected approximately about $70 billion into the banking system with another $20 billion promised this month. Some things have changed, but I fear not enough to make a difference.

THE YEAR AHEAD—2008

As you may recall, this time last year, I observed that the economy was more or less at a turning point, that is, one where an economic expansion is about to turn into a recession (or vice versa). I also added that "the bond market which has a pretty good record of forecasting recessions is pointing toward a serious economic slowdown" and that the inverted yield curves we'd witnessed in the bond market reinforced my suspicion that a slowdown, if not a recession, was in store. In some ways it's like the Savings & Loan crisis of the 90's all over again: when banks borrow short to lend long it usually presages catastrophe. As a final caveat, I predicted that we should expect to see considerable stock market volatility and 2007 stock market was a roller coaster ride if ever there was one!

In the normal course of events when banks sustain big losses there is a contraction of credit, a slowdown in consumption and investment, a rise in unemployment, and a recession. If recessions served no useful purpose they might be considered bad things. But they do. On Wall Street, they speak of "corrections". What "corrections" correct are errors in judgment or overvaluations. In a downturn, previously overpriced assets like buildings, businesses, houses and stocks are made affordable again. Understandably, people hate these painful correctives. No one likes the attendant insecurity, foreclosure, bankruptcy, and joblessness that ensue. But if the Fed makes additional interest rate cuts it will push inflation even higher. So should the Fed risk a recession to protect against inflation or move to avoid recession and risk inflation? This will likely be one of the hotter economic topics of 2008. It's most likely that the Fed will err in favor of a recession and try to mitigate the damage to the economy as opposed to the inflationary alternative which would impact the wealth of all Americans.



EXPORTS > IMPORTS

Even economists agree that the crisis is far from over—there are still two million borrowers facing interest rate resets. While those of us in the housing sector have been painfully aware of our industry's plight for some time, now the rest of the economy is apt to feel the brunt. If "every cloud has a silver lining," in the current situation, ours would be the falling dollar. A devalued dollar makes our exports cheaper and slows the importation of more newly expensive foreign goods, thus helping to bolster the U.S. economy.

But, our economy is overwhelmingly consumer-based, comprising 70 percent of

Gross Domestic Product. American consumers spent close to $9.5 trillion last year. Chinese consumers spent around $1 trillion and Indians $650 billion. Even with American consumers retrenching, exports to South America and European Union nations aren't likely to offset the approximate $8 trillion differential. And borrowers can't tap their home equity the way they did between 2001 and 2005 when they took $5 trillion out of real estate through refis and home equity loans because prices have dropped, guidelines have tightened and CLTVs have dropped. Rising energy prices aren't likely to enhance the situation, either. So, contrary to what economists are claiming I don't see exports bailing the economy out of the coming correction.

SUPPLY > DEMAND

The excess supply of homes on the market reached near-record levels in October. Realtors estimated that there are now 4.5 million homes available for sale, which represents nearly an 11-month supply. This is up from the 10.4-month supply in September and is the largest glut of homes in more than 22 years. The Commerce Department said that starts of new homes fell 3.7% in November, a 16 year low, and further indication that the housing sector is still slowing. With a normal correction, as prices drop, sales rise as a natural consequence of the supply and demand curves intersecting at new equilibriums. But when Prices and Sales continue to fall in tandem, it indicates that owing to the oversupply, the demand has yet to find that locus of equilibriums to support Prices.

REAL ESTATE S & P DOWN

In October, nation-wide home prices were down 6.7% from a year earlier and it marked the eighth straight month that the pace of existing home sales had declined from the month before. Sales of new homes in the U.S. fell 9% to a 12-year low in November. New home prices were down 13%, the biggest plunge in 37 years. Sun Belt cities have suffered deep losses with **San Diego down 11.1%** in the past year, Phoenix off 10.6% and Las Vegas 10.7%. In Los Angeles, a huge market, home prices have fallen 8.8%. The numbers underscored that the slump in the housing markets was more severe than suspected. Nationally, existing home prices are projected to decline about another 6-7% and home sales 12% in 2008 according to Fannie Mae, the first such occurrence since 1933.

LEHMAN BROTHERS

Analysts at Lehman Brothers, the fourth-biggest US securities firm by market value, estimate almost 1 million mortgage loans will default in 2008, up from about 300,000 this year. The national foreclosure rate has climbed steadily throughout 2007. The rate of homeowners going into foreclosure hit a record high in the third quarter, while those late with their payments rose to the highest level since 1986. Over 5.59% of borrowers are now at least 30 days late making their mortgage payments, while 1.26% of the borrowers were 90-plus days late and at risk of going into foreclosure. The chief economist at Lehman, Ethan Harris, observed "We're only halfway through the housing shock—it's just a matter of time before the weakness spreads to the rest of the economy."

The United States conference of Mayors forecast a reduction in property tax collections in California of nearly $3 billion for 2008. Even if lenders sell off still viable homes to new owners, those homes could still bring in lower tax revenues. Many of these homes will turn over only at fire-sale prices and the new owners will want assessments redone. Existing homeowners in areas with plunging values will ask for reassessments too.

Not surprisingly, defaults are not just showing up in the mortgage markets but also for borrowers with charge cards. The value of credit card accounts at least 30 days late jumped 26% since October a year earlier to $17.3 billion. Defaults increased by 18% to almost $961 million. Some of the nation's biggest lenders reported increases of 50% in the past year in the value of accounts at least 90 days delinquent.

With energy prices on the rise, if the Fed cuts interest rates to keep the economy out of a recession or if employment drops as a result of the slowdown, we may see the return of something we haven't seen since the 80's—the combination of rising inflation and slower economic growth—stagflation.

If history serves to indicate the future of the economy it's this: **we've never had a housing correction approximating this magnitude that has not triggered a recession.** Even, if the economy doesn't go into a recession it will be so narrowly averted that it would one would be hard pressed to tell the difference between it and the real thing. Either way, the future in 2008 doesn't look to be all that great!

A NEW YEAR, A NEW DIRECTION

This year marks the beginning of the 5th year of publishing this newsletter. Since its inception I have written on some 70 different topics, all of which have gone to round out my website. I have spent the last several of months re-editing the articles that first appeared in the newsletter. We have revamped the website to make it more user- friendly. The subjects are listed alphabetically and far more easily accessed than was the case with the archived newsletters (no more having to scroll back up to the top of the page to read the next page). You will find everything (within reason) that you might ever need to know about loans and the loan process **under the Talking Points heading** at my website, **www.mortgagestraightTalk.com**

Past issues have been overly long especially in months of market turmoil that we've witnessed this past year. Thus, I've decided to take the newsletter in a slightly different direction: most of the features will remain like Current Events, Morty's Mailbag, and Mortgage Mirth. My aim is to streamline the newsletter and to give the Current Events section more coverage. Readers seem to be more interested in where the economy, credit and mortgages are headed than in loan basics, which are, as ever, available on the website. From time to time, I will still present in depth coverage of financial, credit or real estate topics of general interest to the readership and to round out the website. In the meantime, I invite your comments and appreciate your feedback.

WHAT'S IT WORTH TO YOU?

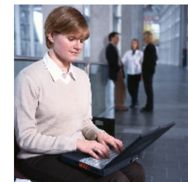
My readership seems to breakdown into 3 categories. Since its inception, I've provided the newsletter gratis to former clients as a way of keeping my name in front of them, to retain their business and as a source of referrals. No change is planned in this regard.

As a professional courtesy (and for the much the same reasons), I've provided the newsletter to realtors, as well. Ironically, while the newsletter is written for the layman, I find that (based on their comments) realtors have often been the greatest beneficiaries. Perhaps it's not surprising as many real estate brokers offer little (other than a desk and a phone) in the way of formal training. The training that most agents receive is of the on-the-job variety. Then, there are realtors who receive the newsletter, but don't read it or refer business to you.

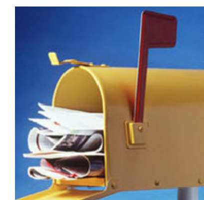
The third category is one of recipients that are not part of either camp but that I've indulged in an effort to build my business. Here, the response has been truly underwhelming and I must bear some of the blame for it. It's been said that the value of anything is what one is willing to pay for it, but if one gets something for nothing there is no incentive on the recipient's part to "up the ante", as it were.

The Law of Reciprocity is basically one wherein one gives to get back. In contradistinction to this, one of the major tenets that I learned in business school is that "Information is not a free good." In trying to resolve the disparity between these two schools of thought it has forced me to reassess how little value is attached to something that is freely given.

As most everyone knows these are lean times in the real estate and mortgage industry. Producing the newsletter requires considerable expenditures of time, energy and resources and given some of the results it has forced me to rethink my marketing largesse. Over the span of the past 4 years I've spent thousands on postage, paper, and ink. And, despite entreaties involving pre-addressed postcards to recipients I've not seen so much as a referral from the vast majorityof my readers, let alone a deal. In an effort to cut costs we have experimented with different methods of transmitting the newsletter: standard mail, email and links. Each of them has advantages and drawbacks. But, for some recipients, regardless of the means of transmission, it has become evident that the end result is the circular file or the delete key.



Consequently, lest I become reproachful about "casting one's pearls before swine", I will be contacting a number of you non-clients to see: if you find the newsletter of value, if you still wish to receive it, and if so, are you willing to pay the postage and production to continue receiving it. In lieu of cash I will gladly accept a deal or a referral.



MORTY'S MAILBAG

Q. As a frequent reader of your newsletter, you usually do a very good job of explaining things, but I still don't understand what the Fed Funds Rate is that you sometimes refer to and how it relates to the Prime Rate. Please explain.

A. In brief, the "Federal Funds Rate" is the interest rate at which banks (depository institutions) lend balances (federal funds) via the Federal Reserve to other banks (depository institutions) overnight. Example: Bank of America could lend $50 million to Wells Fargo overnight at 4.25%.

The Prime Rate, on the other hand, is the lowest commercial interest rate that banks will make on the short-term loans to their most creditworthy borrowers. It is 3% above the Fed Funds Rate. Example: Bank of America (again) could loan Chevron Oil (a commercial enterprise, not a depository institution) $50 million at 7.25% for 270 days (short-term time frame, but longer than overnight).

In longer form, here's the "mechanics" of the system. U.S. banks and thrift institutions are obliged by law to keep certain non-interest-bearing reserves with the Fed (or to keep an equal amount of vault cash, but this imposes risks and costs). The level of these reserves is determined by the outstanding assets and liabilities of each depository institution, as well as by the Fed itself, but is typically 10% of the total value of the bank's demand accounts.

Recipients of the newsletter are invited to Ask Morty any real estate or financing questions. The answer to the question will be answered in the next issue for the benefit of all. Questions may be forwarded via mail phone or fax. (See front of issue for phone and fax numbers). Morty's email address is.... **Morty@MortgageStraightTalk.com**

NEXT ISSUE'S TOPIC:
ANNUAL PERCENTAGE RATE (APR)
A MISUNDERSTOOD CALCULATION

Happy New Year

MORTGAGE MIRTH

Why don't oysters give to charity?

Because they're shellfish.

If you'd care to share one that you've heard, please email it to me at....
Rod@mortgagestraightTalk.com