

# Real Estate, Subprime Mortgages and Other Anxieties

## *Implications for 2008 and Beyond*

We thought you might appreciate an update regarding our observations around the current state of financial markets. As you are probably aware, after several years of smooth sailing for stock and real estate markets, things became more challenging in the second half of 2007 and in early 2008. Though we don't have a crystal ball, we can provide some perspective and understanding of these current challenges and provide you enhanced confidence in the future.

### A Real Estate Bubble?

Current market challenges are primarily rooted in an overheated *residential* real estate market that is now cool. How did this debacle happen? In 2001 the Fed lowered lending rates and speculators seized the opportunity to invest in real estate with cheap borrowed money. Also a wave of baby boomers wanting to purchase second homes in warm weather locations caused runaway prices in many markets—particularly in Las Vegas, Arizona, and certain parts of Florida and California. Until 2007, residential real estate had enjoyed several years of abnormally high growth.

As prices skyrocketed, housing was overbuilt. People bought houses with no intent of living in them. Speculators built homes assuming they could quickly “flip” them for a profit. For a while, it worked. Although many people buying properties could not afford them, lenders continued to give out mortgages, assuming home prices would keep going up.

Of course, all market bubbles eventually pop. Interest rates rose and the mortgage payments homeowners owed were no longer affordable. The result is home prices have dropped 10-15% (and more in the most overheated locales). While home prices are still 45% above 2000 levels, new housing construction is down significantly, surplus homes are not selling, and mortgage defaults are increasing.

A growing number of defaults has caused havoc in an entire class of financial securities called *subprime mortgage loans*. In specifically, financial institutions such as Citigroup lost many billions of dollars and put their balance sheets at risk. As financial institutions incurred major losses, their stock prices fell. This specific decline caused a general fear that has trickled into the broad stock market—even companies completely unrelated to housing and financial institutions. The

question remains whether more losses are still coming or if the worst is behind us.

The losses and the related “fear factor” inspired the liquidity crunch that now concerns investors. ***Please refer to the sidebar “Subprime Mortgages: What Happened?” on the bottom of page 4 to learn more about the current subprime challenge.***

### When Will the Subprime Crisis End?

When the subprime crisis will end is the million-dollar question. What is certain is that it will end. Financial crises are nothing new. Every few years, financial institutions get caught taking speculative risks, as evidenced in the Latin American debt crisis, the Savings-and-Loan crisis, and the Russian debt crisis. Of course, we had recent non-banking crises including the Crash of '87, 9-11, and Enron. The good news is that crises always end in due time.

The duration of the subprime crisis will likely be determined by how far the average American home price falls. The connection is that financially strapped homeowners tend to default when home values fall. Declining values mean there is little or no home equity value. When homeowners have little or no equity in their home, they have little reason to pay their mortgage, causing lenders to foreclose at a loss. When the foreclosures are manageable, the crisis will be over. Additionally, when the risk takers start buying again, the market will be liquid again.

Realize that equity markets, specifically mortgage-related securities, have already fallen. Even prime (higher-rated) mortgage securities now can trade at a 20% discount to fair value. The real uncertainty is whether actual losses will be worse than, or not as bad as, expected. It is possible that

mortgage-related losses will be less than markets assume—though it will likely be several months before this is sorted out.

As the mortgage-related market sorts itself out, liquidity will return and investors will be able to breathe a sigh of relief. Investors' appetite for risk will return, and markets will function more normally. In fact, there is good likelihood the worst is behind us since many financials tried to clean up their balance sheets prior to year-end. Many did so by getting cash infusions from hedge funds and sovereign wealth funds including Abu Dubai, China, Saudi Arabia, and Singapore.

## Will Subprime Cause a Recession?

This threat of a recession is the current concern. However, so far, housing and subprime problems have had little discernable effect on the economy. The Fed's injections of liquidity seem successful, and it seems likely that the Fed will intervene as necessary.

Of course, a recession is possible. A November *Wall Street Journal* poll of economists suggests a 38% chance. In fact, the likely odds are now about 50/50 after some statistics released in early January implied a slower job market than originally anticipated.

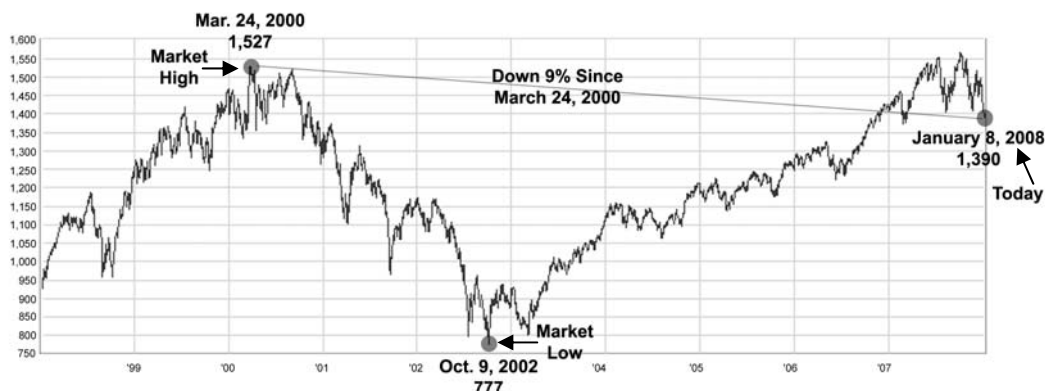
On the other hand, President Bush is considering a fiscal stimulus package to prevent a recession. Even if the economy does slow, the weakness is unlikely to last long.

The big question is whether consumer confidence will hold up. The economy is quite different today than in the past. Consumer spending is over 2/3rds of Gross Domestic Product. The good news is there has not been a broad decline in consumer spending since 1991. So, odds are that consumer confidence will remain strong—fending off a possible recession.

Though housing and construction will remain slow and overbuilt, the good news is that housing comprises a much smaller share of the economy than does business investment—which remains strong. This strength is evidenced by the manageable levels of delinquencies on business loans, commercial mortgages, and even credit card loans.

Figure 1

### S&P 500 Index – Last 10 Years Ending 1/8/2008



Source: BigCharts

## State of Markets and Economy

The real question is how subprime mortgage and housing challenges, and a possible resulting recession, will affect the stock market in 2008 and beyond. It is very important to note that while housing is down, and will likely remain troubled for a while, this does not automatically imply continuing challenges for the stock market. In fact, as you look closely at the data, you can easily make a case that significant upside potential remains for stocks in both the short- and long-term.

*First, consider that stock market prices, as measured by the S&P 500, are less expensive now than at their peak in March 2000. Stock prices are now actually fundamentally cheap relative to recent years. As of market close on January 8, 2008, the S&P 500 index fell to 1,390 compared to a high of 1,527 on March 24, 2000 (Figure 1). Amazingly, even though the stock market is almost 10% cheaper than 8 years ago, corporate profits have increased from \$869 billion to nearly \$2 trillion during the same period (Figure 2). So, the stock market is almost 10% cheaper even though the underlying stocks are approximately 130% more profitable, and the underlying companies more sound.*

Also, consider a few other statistics that suggest the market is fundamentally sound:

- The S&P 500 forward P/E Ratio is now down to approximately 15. This is the lowest it has been in nearly 20 years, so even if earnings decline in a recession, stocks will remain inexpensive.
- Globally, P/E ratios are in the range of 16 (Figure 2). Historically, this is low, suggesting reasonable overseas valuations
- Unemployment is at 5%. Economists have long thought of this as “full employment.” This is less than the 5.6% long-term average since 1950.
- Labor productivity growth is currently 2.6% per year, higher than the 2.1% average over the last 20 years.
- Core inflation remains low at only 2.2% over the trailing 12 months.
- Corporate profits and corporate investments remain strong.
- The S&P 500 dividend yield increased to 2.0%, the highest in many years.
- Personal consumption and retail sales growth remain strong.

- Interest rates are low and likely to decline further. The 10-year Treasuries now offer less than 4% yield. At such low yields, investors tend to favor stocks.
- Real GDP grew at a healthy 4.9% annual rate in the third quarter of 2007.
- The silver lining of the housing slump is that flat and lower home prices/rents mean more affordable housing for many Americans.

Of course, it's always dangerous to predict the short-term market direction. What we already know does not move markets. In efficient markets, what we already know is currently priced in. Rather, markets decline when either bad news erupts or problems surface that investors did not expect. Said differently, housing challenges, the subprime debacle, \$100 per barrel oil prices and the weak dollar are well known issues. Thus, knowledge of these ongoing problems does not give anyone a short-term advantage to predict the market—up or down!

### A False Worry: Oil Prices

But what about oil prices? \$100 per barrel oil is now causing some anxiety. Less mentioned is the reason prices are so high. Global demand for oil is increasing. Countries like China and India now use large amounts of oil to fuel their rapid growth. While this demand makes gas at the pumps more expensive, we benefit from these countries' contribution to our global economy. While you may pay more for gas, you can afford to do so since you pay less for "Made in China" goods at *Wal-Mart*, *Costco*, and *Target*.

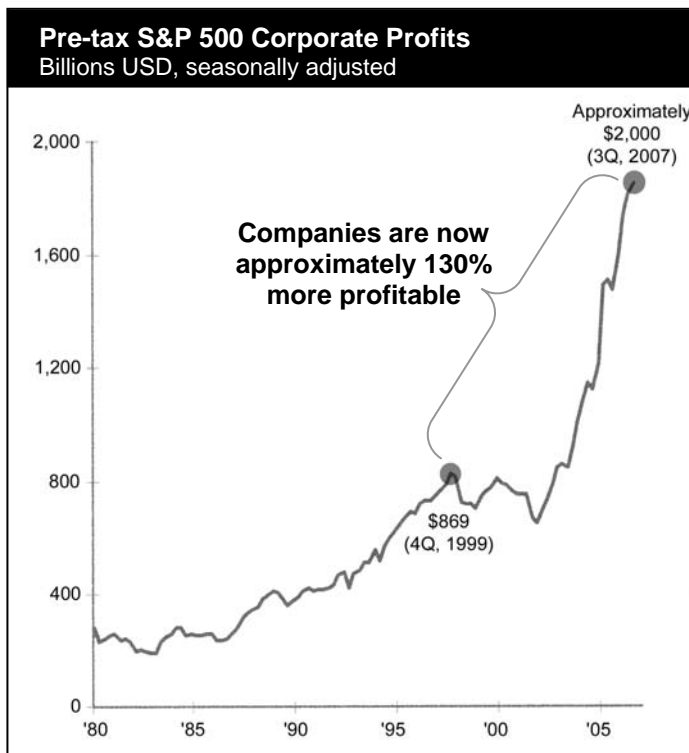
Also, don't forget that energy stocks and commodities (you own both) have been direct beneficiaries of rising oil prices. As a side note, higher energy prices now encourage many companies to look to new alternative energy sources—probably a long overdue initiative. The long-term benefits of this research could be significant.

So, the jury is out whether expensive oil is an impediment to economic growth. Energy today is also a smaller part of the average American's budget than 20 years ago.

You might have also noticed who has recently bought interests in our financial institutions. The sovereign wealth funds owned by oil-rich countries came to the rescue with recent capital infusions. High oil prices provided excess profits to oil-rich countries who funneled them right back to our own country. Had it not been for high oil prices and the resulting excess cash these countries have to invest, our financial institutions and stock market might be on far shakier ground!

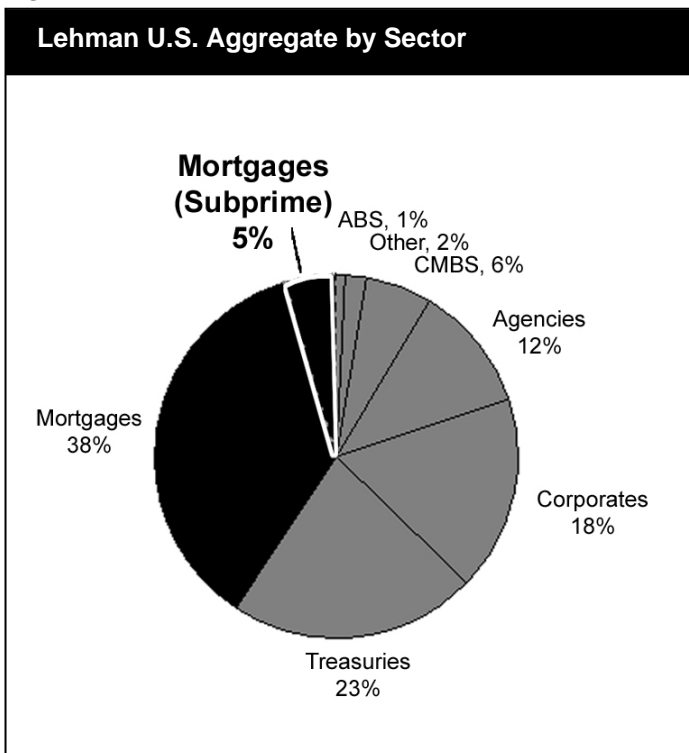
Although our view may be a bit surprising, we think it is good that foreign countries are aggressively investing in our markets. This investment makes China and oil-rich Middle Eastern countries all the more motivated to remain friendly with us to protect their increasing investments in our economy. It is truly becoming an interwoven global economy!

Figure 2



Source: BEA, FRB, BLS, FactSet, JPMorgan Asset Management. Data as of 9/30/07.

Figure 3



Source: Lehman Brothers, JPMorgan Asset Management. All weights are as of 8/31/07.

## Implications for Investors

If you are like most people, you feel anxious right now. Anxiety is not surprising, given the increased market volatility and recent declines. Still, stock prices are now fundamentally inexpensive relative to recent years. Remember the positive statistics. The glass might just be half-full! We believe it very possible that we're poised for significant gains over the next few years.

Of course, in the short-term, valuations mean little. Stocks can drop when valuations are already low. Furthermore, stocks can rally strong even when they are overvalued. Why? In the short-term, markets are 80% emotional. And emotional

markets essentially ignore fundamental valuations. In contrast, in the long-term, markets are 98% logical. Said differently, in the long-term, valuations really do matter.

What should investors do now? Since it is impossible to predict the future, just stay the course. Stay with your long-term strategy, ignore the market commentators, and read a book or watch a show completely unrelated to investing. Letting the market work, as it does 24/7, is the best and most reliable approach.

Of course, we will remain vigilant in our oversight of your portfolio and are always available to talk if you need a confidence boost! *We wish you the best in 2008!*



# Subprime Mortgages: *What Happened?*

**I**nterestingly, and despite all the fuss, subprime is a pretty small part of the overall financial markets. While mortgages now consist of approximately 38% of the bond market, subprime mortgages account for only 5% of the bond market (Figure 3 on the previous page).

While subprime mortgage news dominates the newspapers and airways, until lately, few people had even heard of subprime mortgages. Still, they are the main culprit in the current market travails. For your understanding, let us explain subprime mortgages. Loans were made to borrowers who couldn't ordinarily qualify for a mortgage. They couldn't get a mortgage because they had weak credit history based on their credit scores and weak documentation of their assets and capacity to repay. Sometimes these mortgages were "low documentation loans," or, in some cases, "no documentation loans." Many of them, in the end, became "liar loans," because there was no verification of the borrowers' repayment capacity. Additionally, the subprime borrowers had made no down payment so, of course, they had little or no equity in their house.

Why were these loans made? Borrowers and lenders both expected housing prices to increase, making it possible to refinance the loans under normal terms, in a relatively short time. As a result, banks and other lenders became dangerously lax regarding underwriting guidelines.

Making risky loans, though, was only half of the story. Unlike in the past, banks and mortgage originators rarely held loans they made. Mortgage originators and banks sold the loans to financial institutions that securitized them to remove the risky loans from their balance sheets.

Securitization is the process of aggregating similar instruments, such as loans or mortgages, into tradable securities. Financial institutions accomplished this securitization by purchasing mortgages and combining them into pools. Then the mortgage pools were separated into maturity dates and riskiness, resulting in "tranches."

The tranches were designed to meet the risk and return preferences of investors. Some of the tranches were of high quality. In each tranche, there were many different kinds of securities issued.

For example, some of the securities were very low risk and carried AAA ratings. These high-quality securities are safe because people will pay their loans back. So, these tranches were safe even as defaults rose. However, the institutions also created tranches with a much higher degree of risk. When homeowners with mortgages in the subprime pools began to default, those low-quality tranches lost money.

Many financial institutions (e.g., Merrill, Lynch and Company) got into trouble because they often kept the riskiest tranches for themselves and leveraged the investments. Furthermore, many of the high-risk tranches were later resold and repooled with other debt. Thus, the highest risk tranches were nested in multiple mortgage pools. These were called collateralized debt obligations (CDOs). So, it quickly became very difficult to know who even owned the riskiest securities and how big the real losses have actually been.

If that is not confusing enough, many of the CDOs were then placed in yet other pools called Structured Investment Vehicles (SIVs). Financial institutions like Citigroup sponsored SIVs. Pools of SIVs then issued short-term debt called commercial paper. The financial institutions profited by borrowing at low rates from the public and investing in the risky mortgages that paid higher rates—at least until the mortgages went into default. When SIVs started losing money the summer of 2007, the SIVs quickly called on credit lines guaranteed by their sponsor banks. Accordingly, financial institutions like Citigroup incurred huge losses as they were *forced* to extend loans to SIVs even though the SIVs were insolvent.

Remember, subprime is a pretty small part of the overall financial markets.