Monthly Market Monitor

October 2, 2008

MMM 09-08

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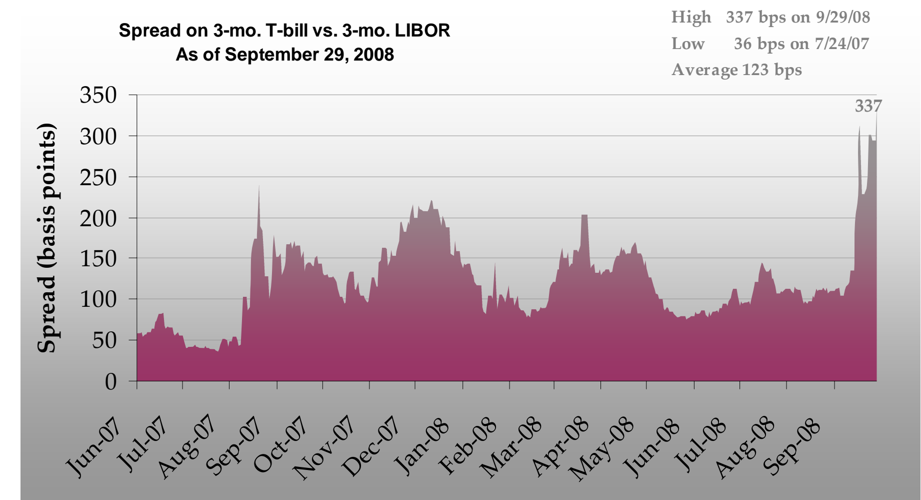
Market Commentary

Global financial markets were in turmoil in the past weeks as the House of Representatives failed to pass the Emergency Economic Stabilization Act of 2008, which would have allowed for roughly $700 billion in government assistance to U.S. financial institutions. The Dow Jones Industrial average suffered its largest one-day decline since October 1987 on September 29th and credit spreads on bank debt reached the widest levels since previous recessions in 2001 and 1990. The uncertainty in the credit markets caused short-term borrowing costs to surge, with the overnight LIBOR rate rising 431 basis points (bps) to an all-time high of 6.88 percent the morning of September 30, 2008. The spread between 3-month LIBOR and Treasury bills, or the TED spread, also spiked (chart 1) to 337 bps, an indication of the scarcity of cash.[1] The 3-month LIBOR jumped to an eight-month high of 3.90% in Asian trading on September 30th. Institutions appeared to be hoarding cash to meet unexpected funding needs due to the breakdown of the money markets, where trading has come to a halt. For many institutions the 3-month rate is indicative of potential funding conditions for the year-end quarter. Some financial institutions may try to lock in funds for the last three months of the year to avoid the volatility in short-term rates that is typical at the end of a year. The lack of confidence in the financial markets coupled with persistent concerns of further weakness among world financial institutions is likely to lead to continued gyrations in U.S. stock and bond markets and in turn, high funding costs.

(Chart 1)



Source: BLOOMBERG, .LP.

As investor confidence deteriorated, the demand for safe havens skyrocketed. The decline in the value of a large money market fund to below $1.00, or "breaking the buck," ignited ferocious demand for Treasury securities and caused yields on Treasury bills to plunge. As a result, yields on 3-month treasury bills declined by approximately 117 bps from a month ago.[2]

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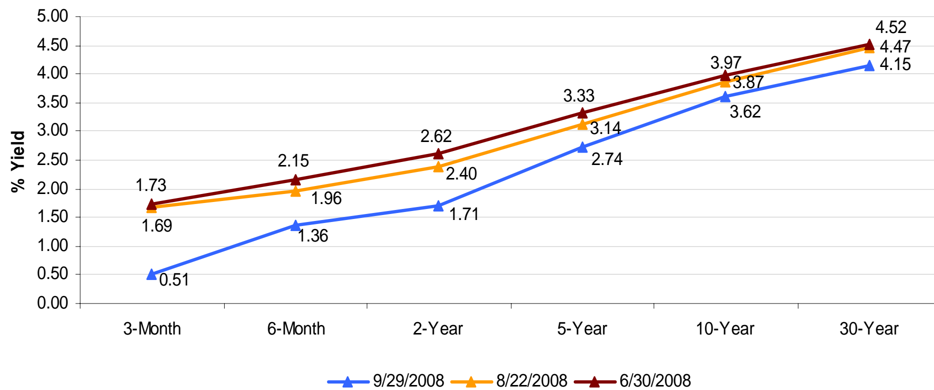
[1] Bloomberg L.P., September 29, 2008.

[2] Bloomberg, L. P., September 29, 2008

The remainder of the Treasury curve followed suit (albeit to a lesser degree), as investors fled to the safety of Treasuries, causing yields to fall further. Demand for bank certificates of deposit (CDs) also increased substantially. Many corporate treasury managers shifted short-term funds from money market funds to bank deposits.

HISTORICAL YIELD CURVE, AS OF SEPTEMBER 29, 2008 (CHART 2)



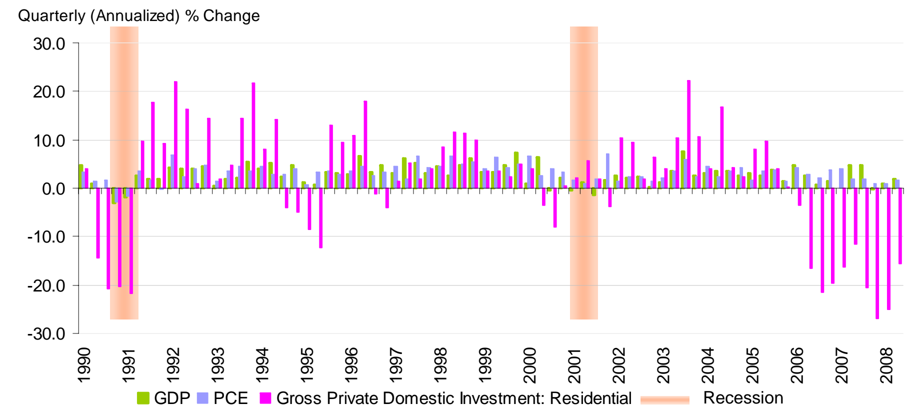
SOURCE: BLOOMBERG, .LP.

The status of the private-label mortgage securities market did not change from the previous month, with little liquidity and minimal new issuance. The prospect of some form of assistance from the Treasury and Federal Reserve to remove troubled assets from bank and thrift balance sheets shed brief sunlight on an other-wise dark market. Agency mortgage pass-through spreads received a reprieve when the Treasury announced that FannieMae and FreddieMac could purchase more mortgage-backed securities for their portfolio. The result was a 20+ bps tightening in spreads relative to swaps and roughly 10 bps relative to Treasury securities. Nonetheless, at issue is the continued rise in delinquency rates on the underlying collateral. Even Prime jumbo loan late payments are climbing and there seems to be an endless stream of credit rating downgrades on outstanding bonds. Until credit losses stabilize, yield spreads are likely to remain wider than the norm and volatile.

ECONOMIC COMMENTARY

Sometimes second round effects can be as potent as the initial event. That is the current fear and impetus for projecting a deep recession, as the marked decline in homeowners' equity has damped the consumer's propensity to shop. The challenges facing consumers are formidable and include rising unemployment, eroding disposable income and increasing debt levels. Personal consumption expenditures (PCE) are headed for a contraction for the first time since the 1991 recession. The importance of consumer spending cannot be overstated. It currently comprises roughly 70 percent of U.S. GDP and 18 percent of global GDP. As illustrated in the chart below, consumer spending has also historically been an indicator of the direction of economic growth. In 1991, a protracted drop in housing investment eventually resulted in a deceleration and contraction in consumer spending, followed by a recession. The recovery period for the consumer recession was much greater than that of the downturn in 2001, which was largely a business recession as PCE remained barely positive during this period. In the current environment, a similar pattern has emerged with residential investment contracting for more than seven consecutive quarters and PCE trending lower.

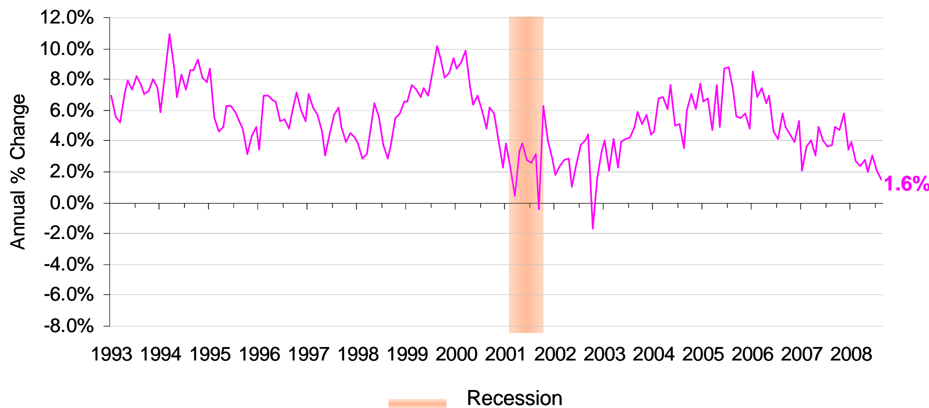
CONTRIBUTIONS TO GDP, AS OF 2Q 2008 (CHART 3)



SOURCE: BUREAU OF ECONOMIC ANALYSIS

So far, the consumer has remained resilient in the face of a spike in gasoline prices, higher food prices and falling home equity. However, the specter of job loss, mounting household debt and declining disposable income add another layer of restriction to spending. The U.S. unemployment rate currently stands at 6.1 percent with jobless claims climbing and payrolls contracting. The likelihood of a jump toward 7.0 percent is not out of the question. The number of individuals filing for first time unemployment benefits rose to 493,000 the week ended September 20th, which was the highest number of claims since September 2001. This number could move higher as nonfarm payrolls have fallen for eight consecutive months and corporations trimmed staff in anticipation of slower demand. Consumers have faced a weak job market before, but the lack of an alternative source of funds may put an end to the spending spree. Indeed the downward trend in purchases of goods and services (chart 4) is just one indication of the weaker demand. The growth in retail sales has slowed to 1.6% as of August 2008 and is approaching the levels posted during the 2001 recession.

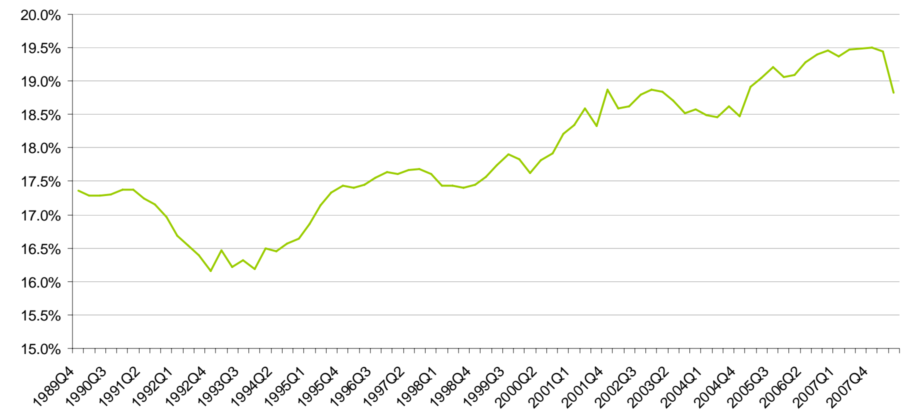
ALL RETAIL SALES, AS OF AUGUST 2008 (CHART 4)



SOURCE: U.S. CENSUS BUREAU

The level of household debt as measured by the financial obligations ratio currently stands at 18.83 percent. This ratio of debt payments to disposable personal income includes required payments on outstanding mortgage and consumer debt, lease payments, property taxes and homeowners insurance. Households appear to be paring back debt obligations. The ratio is down from its peak rate of 19.50 percent in the fourth quarter of 2007.

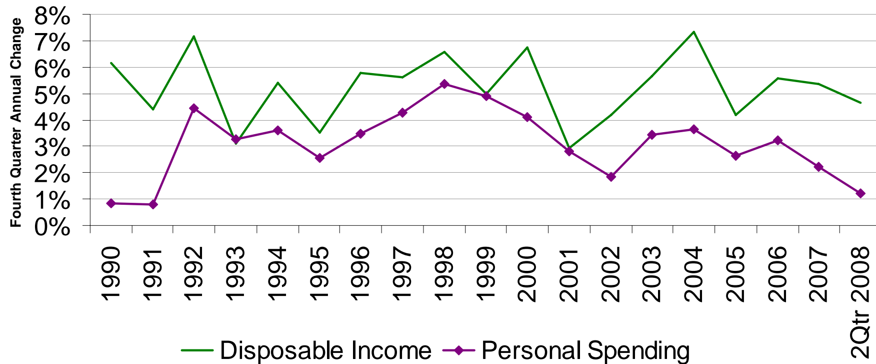
HOUSEHOLD DEBT OBLIGATIONS AS A PERCENT OF DISPOSABLE INCOME, AS OF 2Q 2008 (CHART 5)



SOURCE: FEDERAL RESERVE BOARD

However, as chart five illustrates, disposable income is steadily declining, which may cause the ratio to reverse its trend. The lack of wage growth and job creation causes income to stagnate and damps the consumer's ability to service its debt. Consumers often reduce expenditures in response to mounting debt levels and lower disposable income as portrayed in chart six. A drop in income in 2001 was followed by a corresponding decline in spending the following year and a steady deceleration in income growth in 2006 and 2007 was followed by similar behavior in consumer spending over the same period. Weakening labor conditions add another challenge for households and when coupled with fewer funding resources portend a pull back in demand.

DECLINING DISPOSABLE INCOME, AS OF 2Q 2008 (CHART 6)



SOURCE: BUREAU OF ECONOMIC ANALYSIS

New home sales fell to a 17-year low in August, with just 460,000 annualized units sold during the month. Weak sales caused the inventory of homes to rise to 10.9 months worth at the current sales rate, indicating that price declines are likely to continue. The median length of time that a home stayed on the market rose once again to 9 months, compared to a normalized period of 4 months, and higher than the 5.7 month average in 2007. Despite the paltry demand for new homes, the number of single family housing starts outpaced sales due in part to the outstanding obligations builders are required to meet. This resulted in approximately 630,000 annualized units of new construction even though sales numbered just 460,000 in August. In previous downturns, the industry has been able to recover when demand for homes improved and the economy improved. Unfortunately, the current economic trend is an impediment to reducing housing stock as rising unemployment, stagnant wage growth, tight credit conditions and a 68 percent homeownership rate provide minimal incentive to purchase a new home. As a result, prices continue their descent as indicated by the S&P/Case-Shiller® Home Price Index.

(CHART 7)

	June 2008	Year/Year %Change	Month/Month %Change
West			
Denver	131.64	-4.67	1.48
Las Vegas	158.51	-28.55	-1.57
Los Angeles	195.74	-25.32	-1.44
Phoenix - AZ	153.19	-27.92	-2.63
Portland - OR	175.03	-5.78	-0.28
San Diego	175.37	-24.20	-1.49
San Francisco	159.83	-23.70	-1.76
Seattle - WA	178.28	-7.11	-0.22
Midwest			
Dallas - TX	122.38	-3.24	0.66
Minneapolis - MN	141.50	-13.87	0.98
Central			
Chicago	150.25	-9.46	0.20
Cleveland - OH	109.67	-7.32	0.73
Detroit - MI	92.68	-16.29	-0.09
Northeast			
Boston	162.32	-5.24	1.23
New York	194.22	-7.29	0.16
Southeast			
Atlanta - GA	125.08	-8.10	0.60
Charlotte - NC	133.64	-1.04	0.36
Miami	189.87	-28.32	-1.72
Tampa - FL	175.11	-20.14	-1.15
Washington, DC	197.39	-15.65	-0.93
Composite	180.38	-17.02	-0.61
Composite-20	167.69	-15.92	-0.50

SOURCE: STANDARD & POORS/CASE-SHILLER®

Signs of strain among U.S. households are most evident in the delinquency data for prime borrowers. The percentage of late payments among subprime borrowers, while still growing, is decelerating, while late payments from stronger rated borrowers are growing. There are approximately $1.34 trillion prime jumbo loans outstanding[3] of which roughly 40 percent are securitized. Recent data on the securitized loans showed a surprising increase in delinquencies with some states, including Florida and Arizona, exhibiting worse performance than others. Deterioration in prime loan performance is yet another sign of the economic weakness in the U.S. OTS data shows the largest percentage, 4.04 percent, of 90+ day delinquent prime loans since 1999. Late payment rates for fixed and adjustable rate loans are also at a 9-year high.

CONCLUSION

The housing downturn is spilling over to impact the consumer. They must not only confront higher gasoline and food prices and diminishing home equity, but also job losses, lower income and tight credit. A subsequent drop in personal consumption could cause GDP to fall further. Financial institutions will feel the impact of lower demand through a decline in overall lending and weak economic conditions suggest little relief from rising delinquency and foreclosure rates. Liquidity, or lack thereof, is an immediate challenge for global financial institutions. As we approach the end of the calendar year, banks and thrifts appear to be conserving cash causing the overnight and 3-month LIBOR rates to reach year-to-date highs almost on a daily basis. The uncertainty regarding the disposition of illiquid mortgage assets also adds to the stress in the funding markets as investors are demanding higher quality assets. We are operating in unprecedented times and as a result, caution and patience are obvious guideposts for managers. Expect depositories to trim expenses, initially in the form of staff reductions, and eventually exiting businesses that do not provide the requisite returns.

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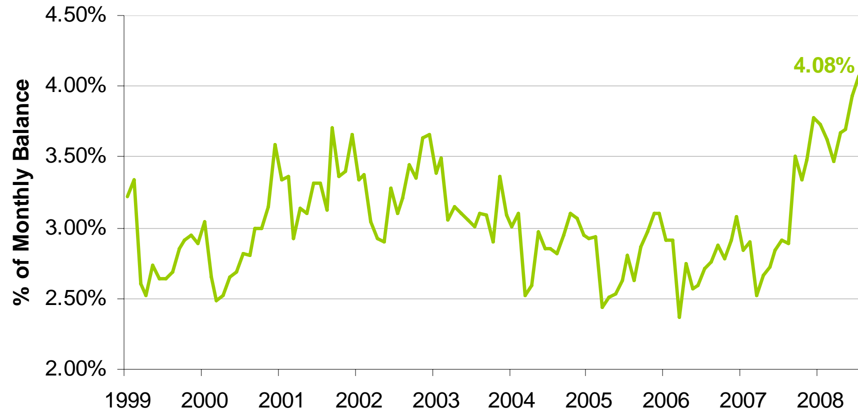
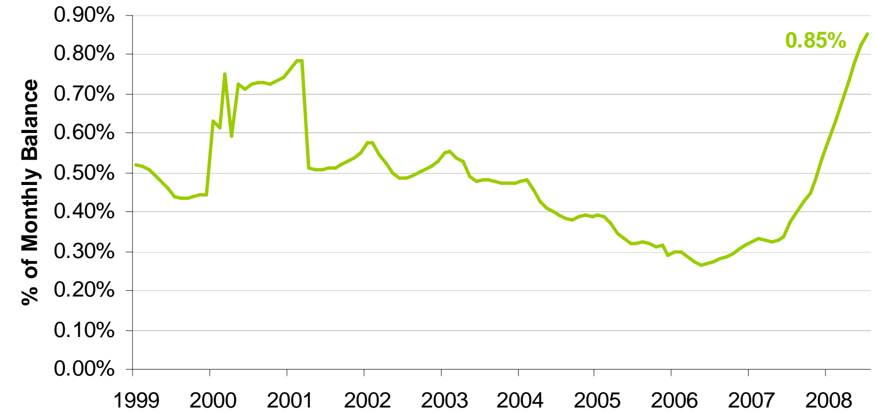
[3] UBS "Mortgage Strategist," September 16, 2008.

NATIONAL DELINQUENCY & FORECLOSURE RATES: FIXED & ARM LOANS

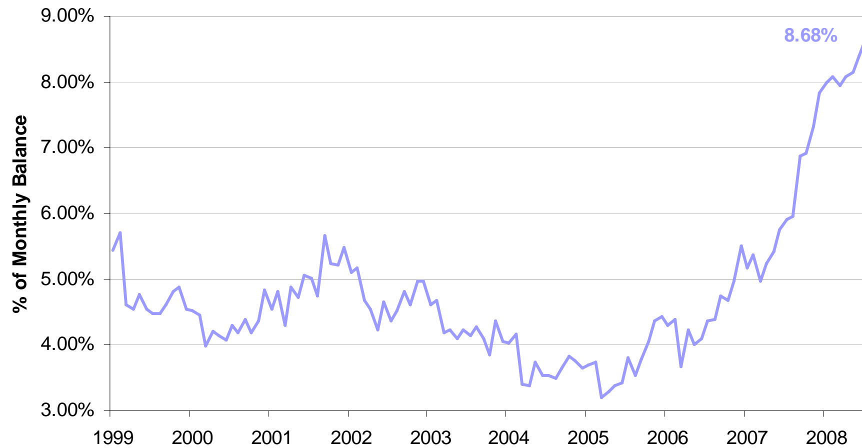
(CHART 8)



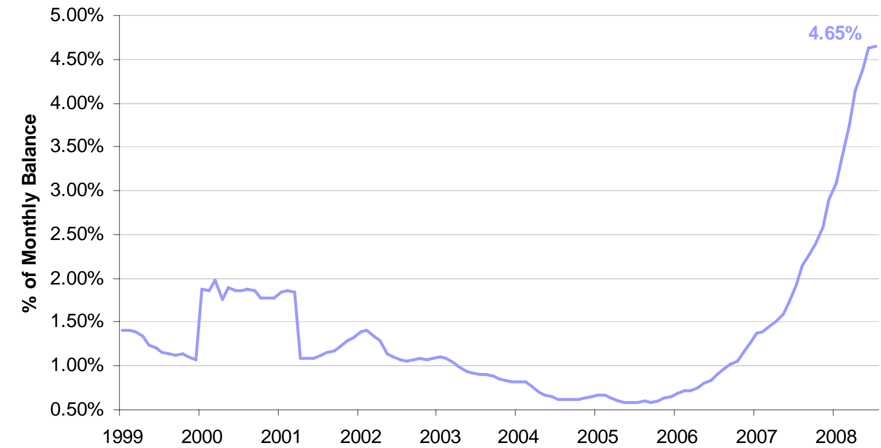
(CHART 9)



(CHART 10)

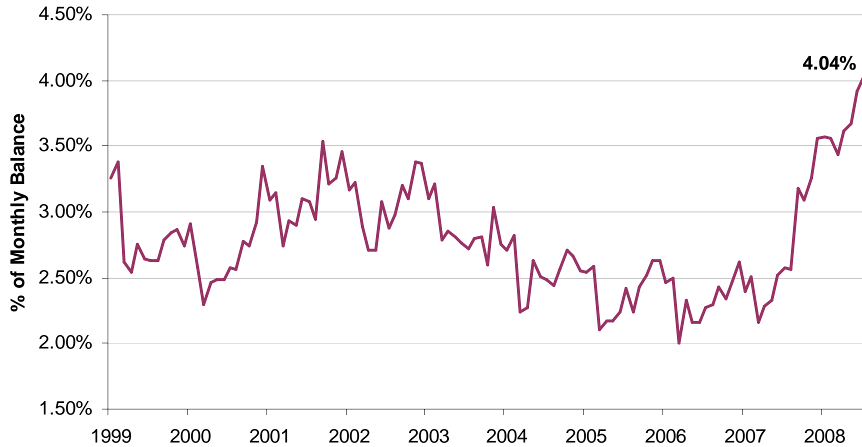


(CHART 11)

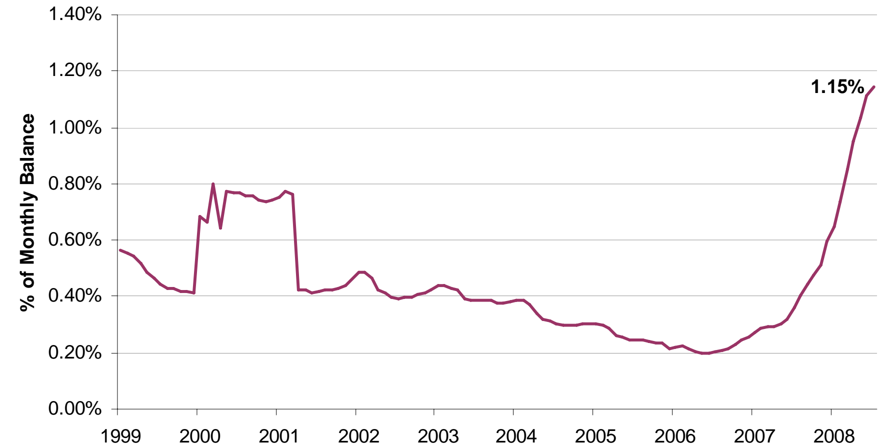


National Delinquency & Foreclosure Rates: Prime & Subprime Loans

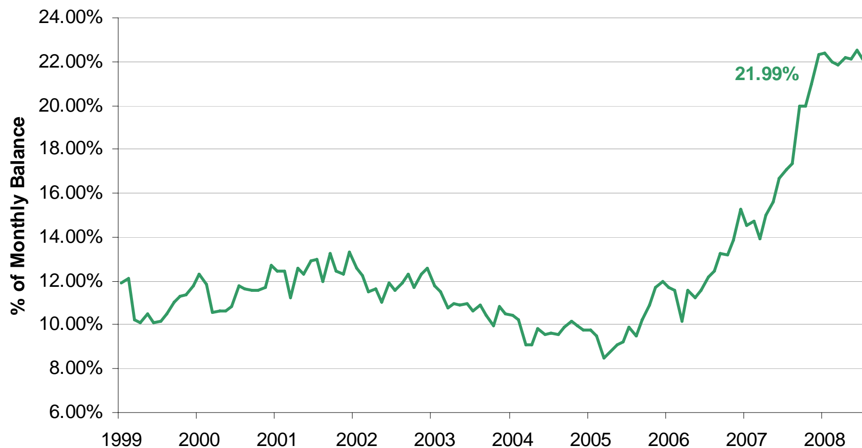
(CHART 12)



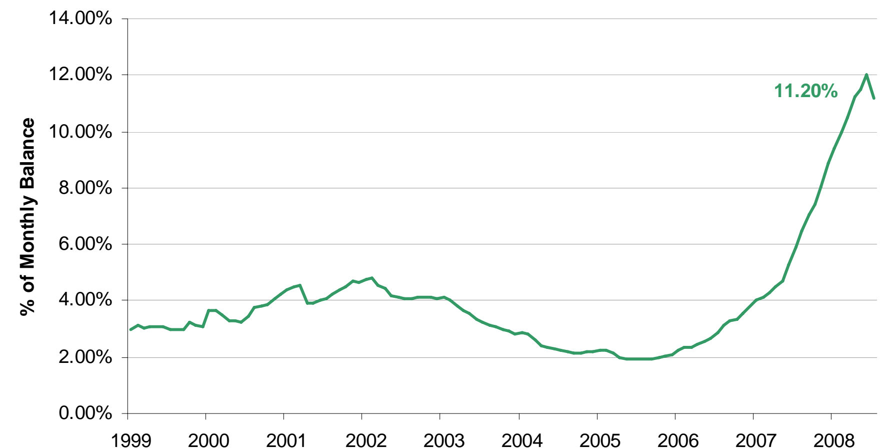
(CHART 13)



(CHART 14)



(CHART 15)



SOURCE: CHARTS 8-15 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS
NOTE: DATA USES ACTIVE LOAN DOLLAR BALANCES ON A MONTHLY BASIS; DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

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