Monthly Market Monitor

Wednesday, March 26, 2008

MMM 03-08

Sharon L. Stark, 202.906.6567

Barbara F. Buckley 202.906.6286

Office of the Senior Deputy Director

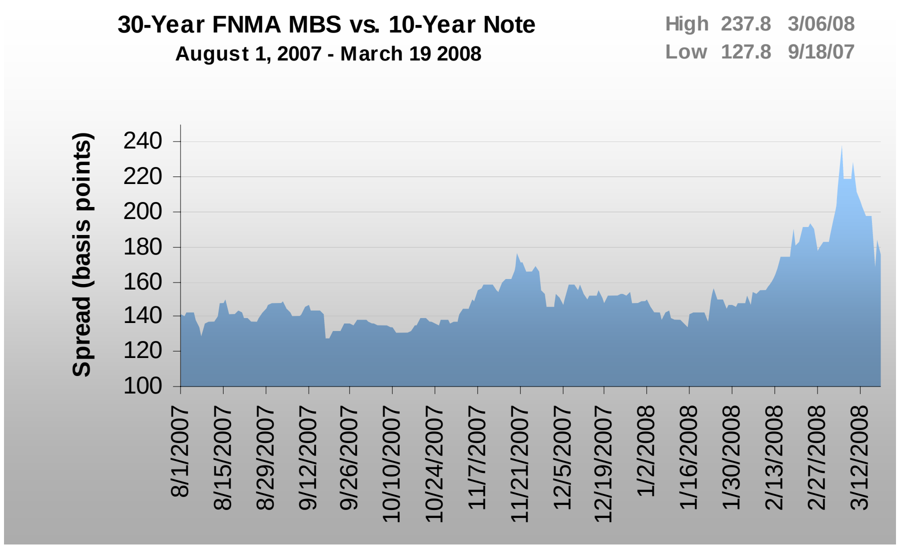
Market Commentary

Financial market conditions deteriorated markedly the past three weeks culminating with the sale on March 16, of the nation's fifth-largest broker dealer, Bear Stearns Cos., to JPMorgan Chase & Co. for $240 million, or $2.00 per common share. The sale of the company followed unprecedented action by the Federal Reserve Bank of New York to extend 28-day financing to Bear Stearns on Friday, March 14, through JP Morgan. The Federal Reserve Board has also opened its borrowing facility to the 20 primary dealers in the event they need short-term financing. This facility has historically been available to banks only.

Uncertainty with regard to future credit losses continues to punish spreads on non-government securities. FannieMae 30-year mortgage pass-through securities are currently trading at roughly 195 basis points (bps) over the 10-year Treasury yield, down from the peak of 237.92 bps recorded on March 6, but far higher than the five-year average of 116 bps.[1] The market for private label mortgage-backed securities remains challenged, with any trades executed on appointment. Issuance of subprime-backed securities was a mere $2.09 billion in January 2008, compared to $4.25 billion in November 2007 and $11.56 billion in September of last year.[2] Non-agency mortgage security issuance was $10.82 billion in January of this year, down 71 percent from the fall of 2007 and appears to be holding steady the past two months.

The mortgage market received some relief when the Federal Reserve announced that it will lend Treasury securities in exchange for all types of AAA mortgage securities as collateral for a limited period of time. This allowed spreads to fall slightly (Chart 1), but the underlying concern about the health of the housing market undermines the ability of the mortgage market to return to norms.

(Chart 1)



Source: Bloomberg L.P.

[1] Bloomberg, L.P. March 17, 2008 11:30 am EDT.

[2] Inside B&C Lending, February 15, 2008.

The Treasury yield curve flattened, as a 75 bps reduction in the target Fed funds rate drove short term yields just slightly lower, while long term yields fell. Since the beginning of March, yields on three and six-month LIBOR have fallen by 41 bps and 32 bps[3], respectively, reducing funding costs for many institutions that have access to funds. However, market expectations for a 100 bps rate cut resulted in a mere three bps decline in the two-year Treasury yield, while that of the 10-year fell by 21 bps since the beginning of the month. The result is a flattening in the slope of the Treasury yield curve to 173 bps, as measured by the difference in the yield between the two-year and 10-year notes.

(CHART 2)

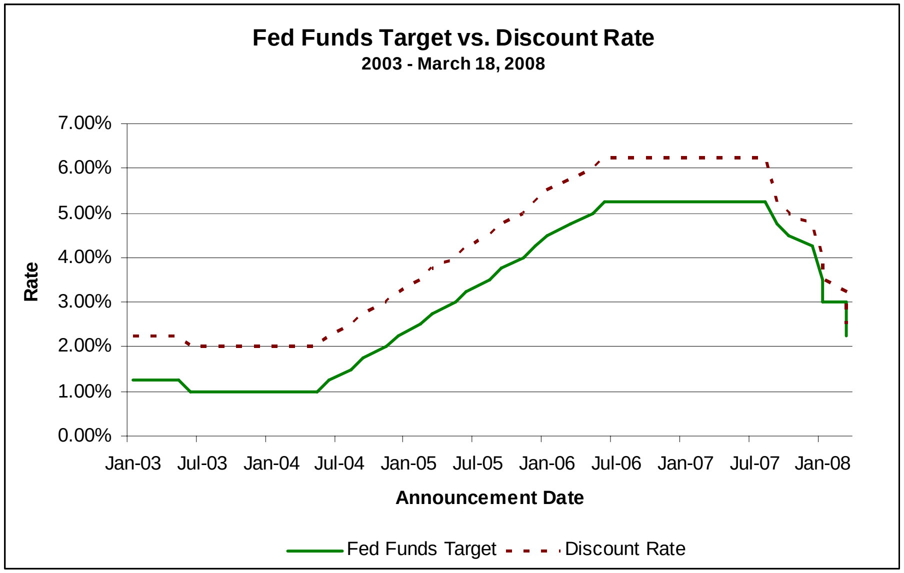
Current Interest Rates

	3/20/2008 Yield	12/31/2007 Yield	bp change
Short-term			
Federal Funds Target	2.25%	4.25%	-200
Prime Rate	5.25%	7.25%	-200
Libor (1-mo.)	2.61%	4.60%	-199
Libor (3-mo.)	2.61%	4.70%	-209
Libor (6-mo.)	2.54%	4.60%	-206
3-mo. T-bill	0.57%	3.24%	-267
6-mo. T-bill	1.18%	3.39%	-221
2yr T-note	1.60%	3.05%	-145
Longer-term			
5yr T-note	2.38%	3.44%	-106
10yr T-note	3.33%	4.02%	-69
30yr Bond	4.16%	4.45%	-29

Source: BLOOMBERG L.P. close of business pricing as of 3/20/2008

In an attempt to increase the availability of credit to the financial system, the Federal Reserve Board has cut the Fed funds rate by 300 bps since March 2007 (Chart 3). Moreover, the Fed's actions during unscheduled meetings in August 2007, and then again this month, reinforce the central bank's commitment to provide some stability to the financial markets during times of crisis. These most recent policy adjustments include reductions in the discount window lending rate, an extension of discount window lending terms to 90 days from 30 days, and a waiver to existing rules to allow non-banking institutions, the primary government securities dealers, to borrow funds from the Fed discount window. The latter is a waiver to a prohibition that has been in place since the Great Depression, and will be in place for at least six months. It is hoped that by allowing securities brokerage firms access to cash at low interest rates, these firms can stabilize their financial conditions.

(CHART 3)



SOURCE: BLOOMBERG L.P.

[3] Bloomberg L.P. March 20, 2008.

Credit problems among bond insurers continue to plague the municipal bond market. Demand for variable rate municipal securities, which are sold at "auction" on the rate reset date, remains scarce, causing the yields to rise. Approximately 521 auctions failed to attract buyers at the previous market rate, resulting in 66 percent of the auctions "failing." The rate of failures has fallen from a peak of 87 percent on February 14, and has since ranged from 61 percent to 69 percent, according to Bank of America Corp. The auction failures are another indication of the magnitude of investor caution in the credit markets. To put this data in perspective, from 1984 through 2006, only 13 auctions failed.[4]

ECONOMIC CONDITIONS

Reports of further erosion in U.S. economic performance in the fourth quarter were no surprise. Real GDP rose just 0.6 percent in the fourth quarter, resulting in a four-quarter change of 2.5 percent. The consumer pulled back spending in the last three months of 2007, with growth in personal consumption expenditures slowing to 1.9 percent from 2.8 percent in the third quarter. Business investment also decelerated from 9.3 percent to 6.9 percent, led by a sharp decline in capital spending. The contraction in the residential real estate market deepened to -25.2 percent, from -20.5 percent in the previous quarter and -11.8 during the summer of 2007. As a percentage of real GDP, residential investment has fallen to just 3.7 percent in the fourth quarter (the lowest since early 1991) from peak of 5.5 percent.

U.S. nonfarm worker productivity rose at a revised annual rate of 1.9 percent in the fourth quarter, a significant decline from a 6.3 percent gain in the previous quarter. Evidence of a slower economy was gleaned from the report, which showed that the number of hours worked fell by 1.6 percent, the largest drop since the first quarter of 2003 and the second consecutive decline.

Although personal income growth continues, real disposable income has fallen by 0.7 percent at an annual rate for the three months ending in January 2008. Rising prices are eating into disposable income and most likely causing the deceleration in consumer spending. The lack of home equity as a source of funds is also depressing consumption, a trend that will continue in the coming year as home prices fall. Retail sales, excluding autos, building materials and gasoline, have risen just 0.2 percent during the three months ending in February. Department stores, apparel purveyors and furniture show rooms have suffered declines in sales since November 2007, while building materials and auto sales fell more than 10 percent during the same period.

The U.S. lost jobs in February, according to a report from the Bureau of Labor Statistics. Nonfarm payrolls shed 63,000 jobs last month after losing 22,000 jobs in January. The back-to-back payroll contractions are a strong indication of the depth of economic weakness in the U.S. Private payrolls fell for the third consecutive month, led by the loss of 52,000 manufacturing and 39,000 construction jobs in February. Government agencies added 38,000 new jobs along with education and healthcare providers. The unemployment rate fell to 4.8 percent in February, as a result of a 450,000 decline in the number of individuals in the workforce. As jobs become more difficult to obtain, many people are less willing to look for a job and are therefore not counted as part of the available pool of labor. Employers reduced the number of average hours worked, with manufacturing cutting the most number of hours in February, the third consecutive month of cutbacks. The decline in work hours pushed unit labor costs up by 2.6 percent for the three months ending in December 2007, thus exacerbating inflation pressures.

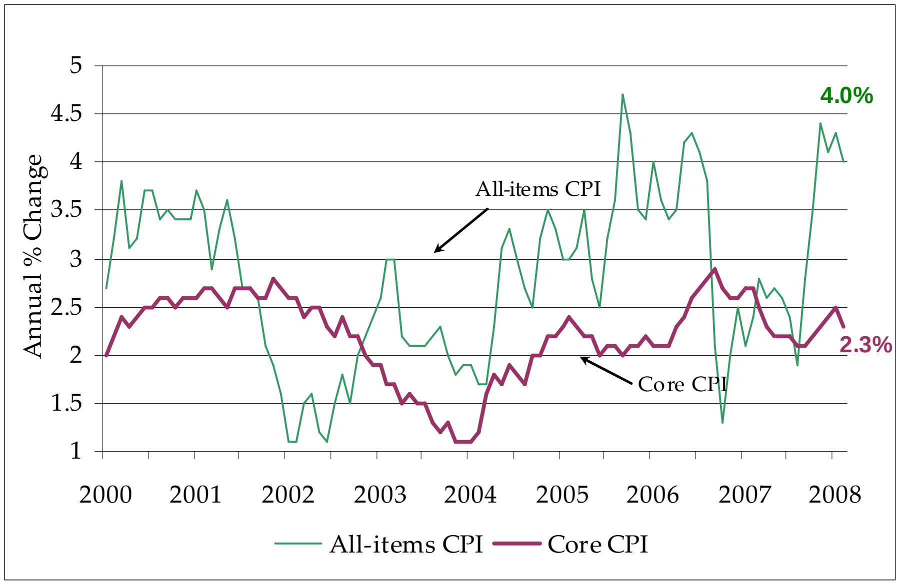
[4] McDonald, Michael. "Auction Bond Failures Near 70%; No Sign of Abating." Bloomberg News, March 5, 2008. http://www.bloomberg.com

Inflation

As noted earlier, labor costs, which comprise approximately 75 percent of the cost of goods sold, accelerated at a 2.6 percent pace at the end of the fourth quarter. Higher labor costs erode funds available for capital investment by businesses and could lead to more pullbacks in nonresidential investment in future quarters. Given the sluggishness in output and consumption, it would not be surprising to see more companies shed workers to reduce expenses, which may stem the increase in unit labor costs.

Consumer price inflation slowed in February according to the consumer price index (CPI). The CPI rose 4.0 percent last month (year-over-year), down from 4.3 percent in January. Core prices grew by 2.3 percent from a year ago, as shelter prices remained unchanged and medical care costs were up just 0.1 percent for the month (Chart 4). Nonetheless, the trend is not likely sustainable, as oil prices have accelerated once again and a falling dollar boosts the price of imports.

Consumer Price Index as of February 2008 (Chart 4)



Source: Bureau of Labor Statistics

Housing

The slump in the housing market has not only impacted residential construction, but lending and loan performance have deteriorated in concert. Non-conforming loan[5] originations fell 49 percent in the fourth quarter, as the secondary market for bonds backed by the collateral is still shuttered. According to data collected by Inside Mortgage Finance, approximately \$84.5 billion of non-conforming loans were originated in the quarter ending in December 2007, comprising just 19.9 percent of total loan production. This is the lowest volume of originations ever, and is a far cry from the peak origination period of 2005, when the total reached \$1.58 trillion, or 50.4 percent of all production.[6] By loan type, jumbo production fell 47 percent in the fourth quarter, plummeting to \$44 billion, or less than 10% of all originations. The downturn in Alt-A and subprime loan production persist, with fourth quarter volume at \$27 billion and \$13.5 billion, respectively.

In contrast to non-conforming product, FHA/VA loan production rose steadily in 2007, from a low of \$19.0 billion in the first quarter to \$31.0 billion at the end of the year. Activity in government-insured lending was twice that of subprime.

Home construction has ground to a near halt, with February single-family housing starts down 6.7 percent to 707,000, the lowest level since 1991.[7] Overall new home construction rose a scant 0.6 percent last month to 1,065,000, due to a 14.4 percent surge in multifamily home building, which tends to be volatile. From a year ago, single-family housing starts are down 40.5 percent, as builders grapple with an overflow of inventory. Permits for new construction also dropped 7.8 percent to 978,000 units in February, the largest month-over-month decline since January of 1995 (8 percent) (Chart 5). When compared to a year ago, building permits were down 36.5 percent, foretelling a continued contraction in new home construction.

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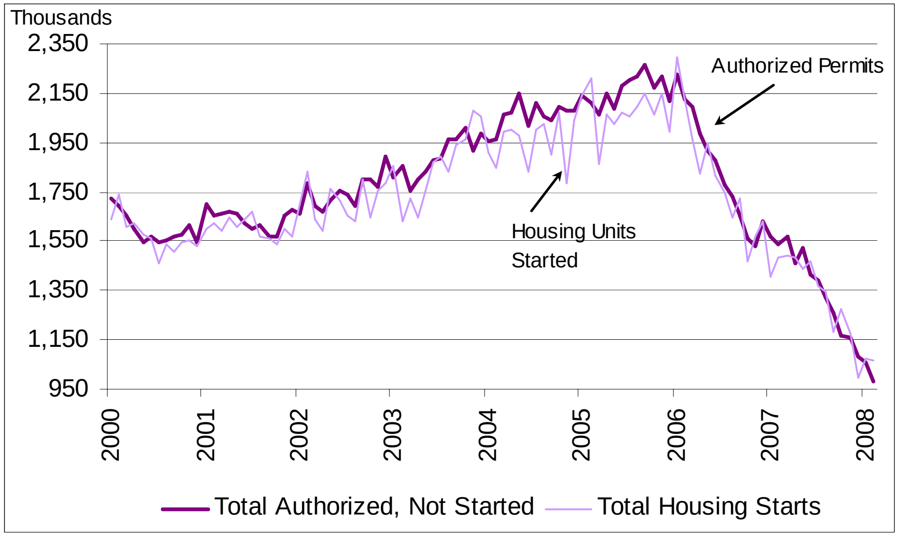
[5] Defined as jumbo, subprime and Alt-A loans.
[6] Inside Mortgage Finance, February 8, 2008.
[7] U.S. Department of Commerce, March 18, 2008.

HOUSING STARTS AND BUILDING PERMITS, AS OF FEBRUARY 2008 (CHART 5)



SOURCE: U.S. CENSUS BUREAU

Total fixed rate loan delinquencies rose to 3.58 percent of outstanding balances in January 2008, nearly a percentage point higher than a year ago. As expected, the most significant increase occurred among subprime borrowers (with both fixed rate and ARM loans) where the pace of late payments rose to 21.31 percent, or more than 7 percent greater than in January 2007. Foreclosure rates also climbed higher in all loan categories, with the greatest increases among Alt-A and subprime homeowners (Charts 6-15).

Home prices have suffered the most from weak job growth and tighter credit conditions. While house price depreciation and appreciation are influenced by location, the national home price measures point toward a decline in average prices. Moody's Economy.com[8] projects further home foreclosures, due to the lack of credit, falling home prices and mortgage loan resets. This, in turn, would increase the already bloated inventory of homes for sale and depress prices. Affordability or lack thereof, in California, Florida and Northeast markets compounds the probability of further price declines in those areas, where supply is already at record high levels. The S&P/Case-Shiller house price indices have steadily declined for roughly a year, while the Office of Federal Housing Enterprise Oversight's (OFHEO) house price index registered its first drop since its inception. The more modest drop in the OFHEO index is likely due to its composition of GSE backed, or conforming loans. It does not include homes financed with FHA/VA loans or other non-conventional mortgage products, thus does not fully capture the stress on subprime or Alt-A borrowers. Nonetheless, given that both price measures are descending and the National Association of Realtor's Pending Home Sales index is falling, the likelihood of further price depreciation in the U.S. market is heightened.

CONCLUSION

Suffice it to say that the mortgage markets remain in disarray and the downturn in the housing market has spilled over into the broader economy. Weaker job growth could further constrain the demand for housing, while falling interest rates fueled by Fed rate cuts may only offset a portion of the negative impact from labor conditions. Lenders and investors appear to remain in lock-down mode, implementing tighter credit standards and exercising great caution by investing on GSE-only mortgage backed securities. The economic environment and minimal confidence in the credit markets have resulted in a logjam in the mortgage market that will require time and patience on the part of all participants for normalcy to return. The timing of this occurrence is anyone's guess.

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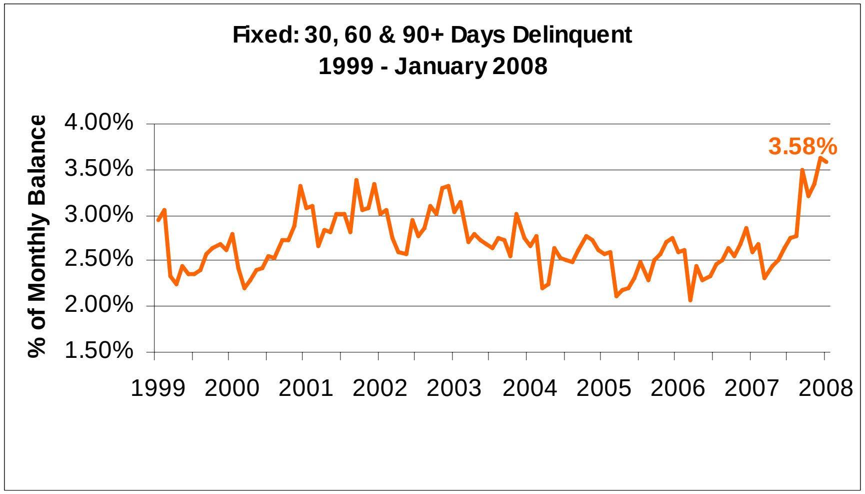
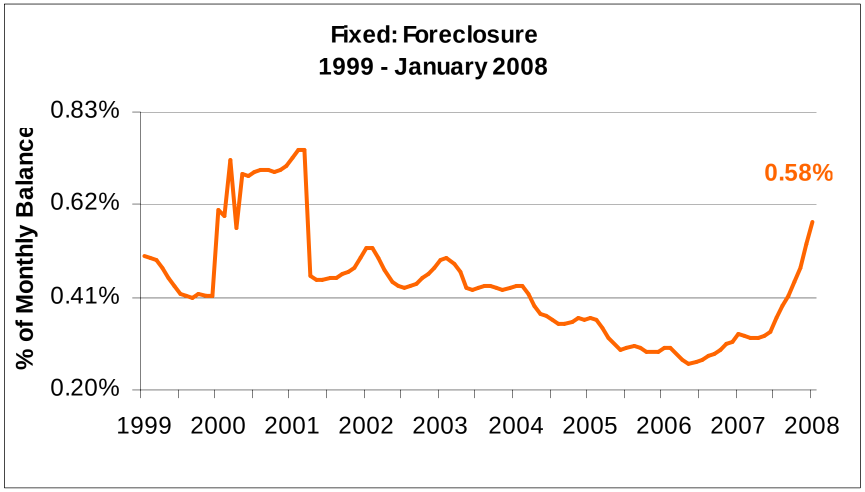
[8] "*The Single-Family Housing Market Monitor*," Moody's Economy.com, February 2008.

National Delinquency & Foreclosure Rates: Fixed & ARM Loans

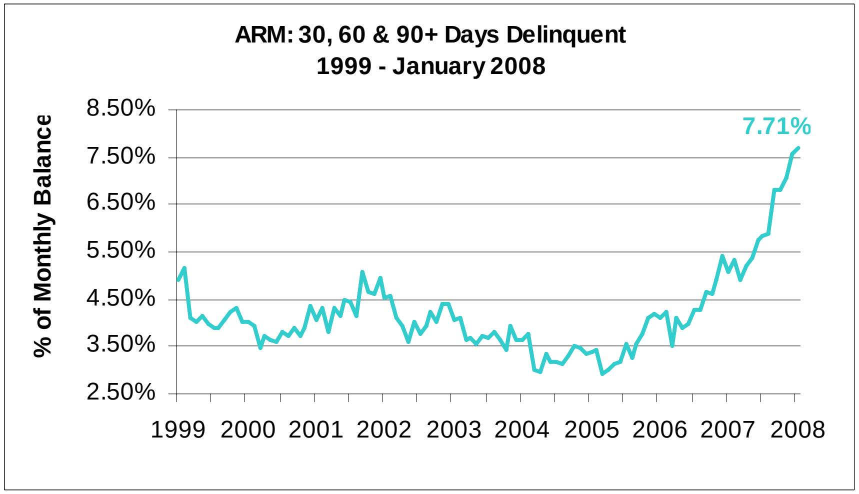
(CHART 6)



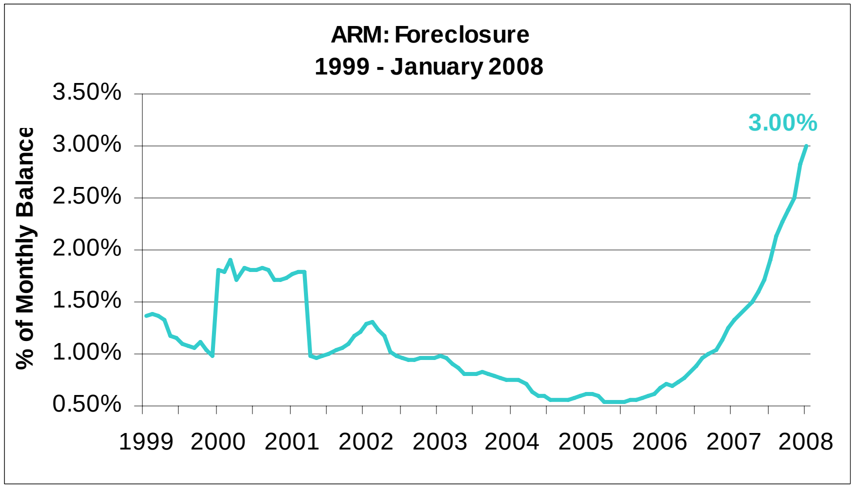
(CHART 7)



(CHART 8)



(CHART 9)



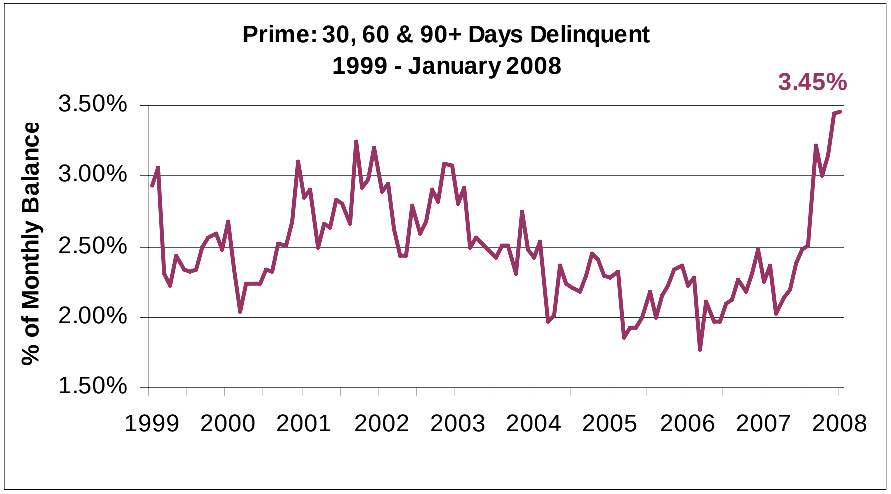
Source: Charts 6-15 LoanPerformance, a subsidiary of First American Real Estate Solutions

Note: Data uses active loan dollar balances on a monthly basis; ALT A is defined as Original Credit Score 620-659 and LTV at origination > 80%.

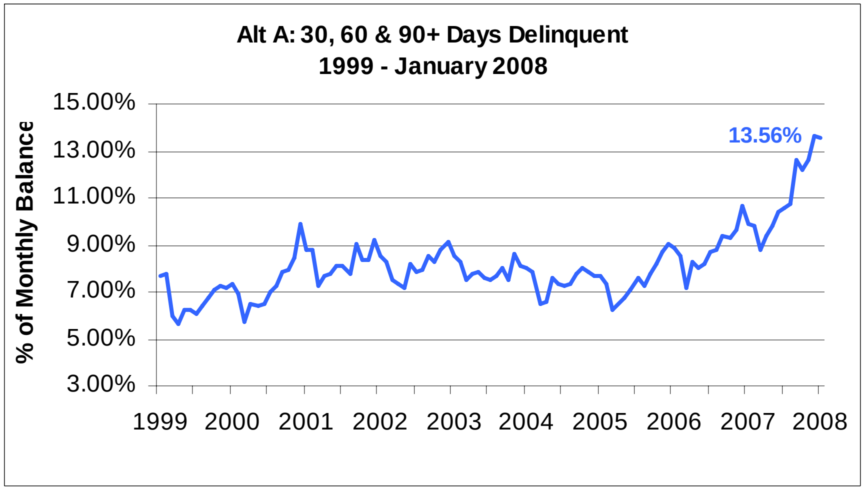
All variations of documentation are included. Data follows the MBA definition of delinquency.

NATIONAL DELINQUENCY RATES: PRIME, ALT-A & SUBPRIME LOANS

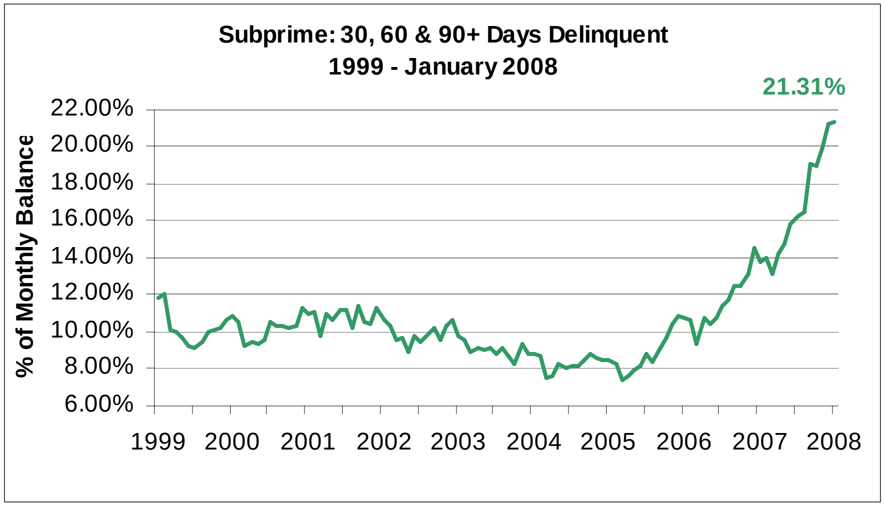
(CHART 10)



(CHART 11)



(CHART 12)



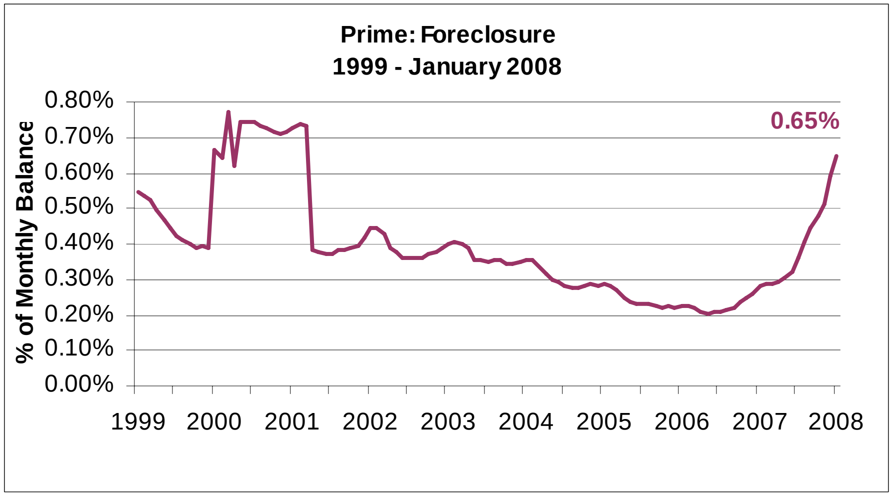
SOURCE: CHARTS 6-15 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS

NOTE: DATA USES ACTIVE LOAN DOLLAR BALANCES ON A MONTHLY BASIS; ALT A IS DEFINED AS ORIGINAL CREDIT SCORE 620-659 AND LTV AT ORIGINATION > 80%.

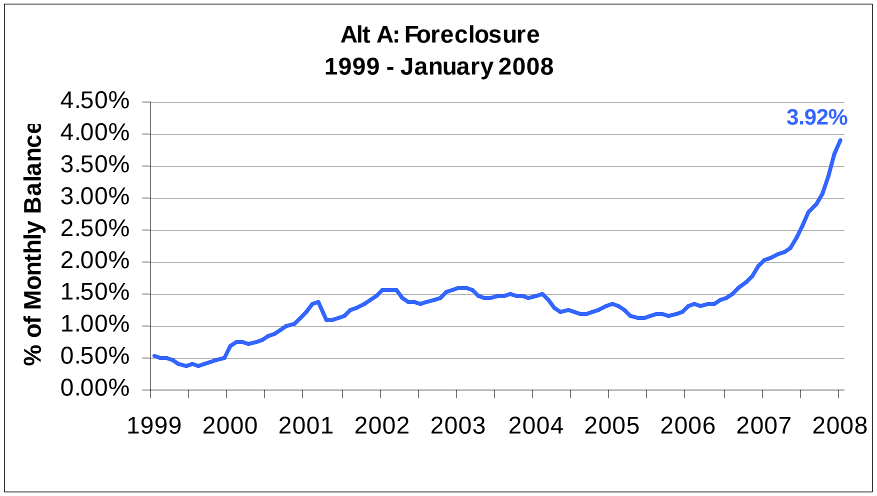
ALL VARIATIONS OF DOCUMENTATION ARE INCLUDED. DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

National Foreclosure Rates: Prime, Alt-A & Subprime Loans

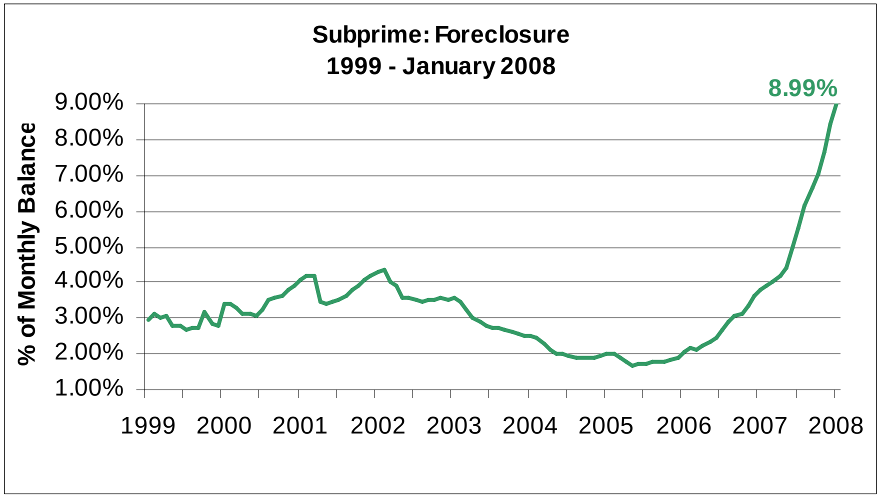
(chart 13)



(chart 14)



(chart 15)



Source: Charts 6-15 LoanPerformance, a subsidiary of First American Real Estate Solutions
Note: Data uses active loan dollar balances on a monthly basis; ALT A is defined as Original Credit Score 620-659 and LTV at origination > 80%.
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