MONTHLY MARKET MONITOR

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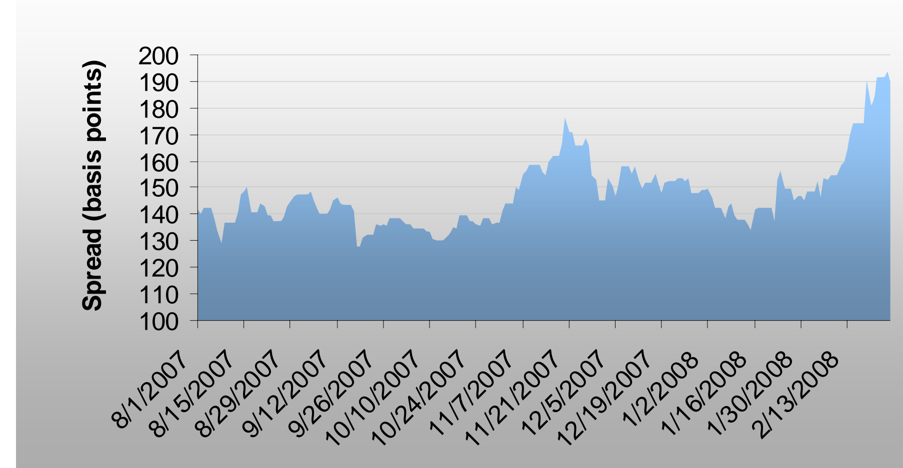
SHARON L. STARK, 202.906.6567
BARBARA F. BUCKLEY 202.906.6286
OFFICE OF THE SENIOR DEPUTY DIRECTOR

MARKET CONDITIONS

Volatility continues to plague the financial markets as credit fears abound. Subprime woes penetrated the municipal bond market in recent weeks as several bond insurers recorded losses. The insurers "diversified" credit exposure by guaranteeing payment on several collateralized debt obligations (CDOs) backed by subprime mortgages. The losses incurred as a result of loan write-offs weakened the credit ratings of the insurers and, in turn, the value of the insured municipal bonds. Approximately half of all municipal bonds outstanding carry bond insurance, and many rely on the guarantee for the AAA rating. The disruptions have been most prominent in auction-rate securities, which are long-term bonds with interest rates that reset at auctions held every seven, twenty-eight and thirty-five days. In the past week, bonds auctioned at market rates of 4 percent to 5 percent for investment-grade bonds failed to attract enough buyers, causing many issuers to offer rates above 10 percent in order to raise funds. The "failed" auctions are an indication of investors' persistent aversion to credit risk.

Demand for mortgage-backed securities largely exists in agency issued bonds, while private label securities trade on an appointment basis, if at all. Liquidity continues to command a premium, and thus, private label securities are a less attractive investment alternative at this time. Nonetheless, the Agency mortgage market is not without its own set of issues to be addressed. Yield spreads on current coupon 30-year fixed rate passthroughs skyrocketed in recent weeks, as concerns over the financial conditions of the GSEs were voiced by market participants. While these "concerns" were never specified, spreads on 30-year passthroughs jumped to more than 195 basis points (bps) over the 10-year Treasury note yield and +158 bps over swap yields (Chart 1).[1] The increase in interest rate volatility contributed to the widening spread, but these are the widest nominal spreads since 1986 and swap spreads since 1988, respectively.



(CHART 1) SOURCE: BLOOMBERG L.P.

[1] UBS Investment Research, February 25, 2008.

SHORT-TERM INVERSION

Inflation fears have caused longer-term Treasury yields to rise in the past month, while expectations for further easing of monetary policy by the Federal Open Market Committee (FOMC) has resulted in an inversion in the money market curve. As indicated in the chart below, 1-month LIBOR rates exceed those of 3- and 6-months, while higher long term rates steepened the yield curve with the difference between 2- and 10-year Treasury note yields at 184 bps versus 150 bps a month ago. Financial institutions that typically borrow at LIBOR rates may experience a near-term increase in funding costs; however, if the FOMC continues to cut the target Fed funds rate, this may be short-lived.

(CHART 2)

Current Interest Rates

	2/28/2008 Yield	12/31/2007 Yield	bp change
Short-term			
Federal Funds Target	3.00%	4.25%	-125
Prime Rate	6.00%	7.25%	-125
Libor (1-mo.)	3.12%	4.60%	-148
Libor (3-mo.)	3.07%	4.70%	-163
Libor (6-mo.)	2.96%	4.60%	-164
3-mo. T-bill	1.86%	3.24%	-138
6-mo. T-bill	1.91%	3.39%	-148
2yr T-note	1.87%	3.05%	-118
Longer-term			
5yr T-note	2.72%	3.44%	-72
10yr T-note	3.71%	4.02%	-31
30yr Bond	4.55%	4.45%	10

Source: BLOOMBERG L.P. as of 3:00 p.m. 2/25/2008

The risk perceptions of the investor community are readily apparent in the repurchase agreement (repo) rates for agency and non-agency securities. For example, in July and August, repo rates on agency securities had been approximately 1 month LIBOR-2 bps with a 4 percent haircut.[2] The current funding levels are roughly LIBOR +5 bps with a 5 percent haircut. The significant increase in the premium above LIBOR is due to investor fears of further reported losses by the GSEs. Adjustments to non-agency repo rates are far greater. **The non-agency repo rate is approximately LIBOR +20 bps (versus 10 bps in July) with a haircut of roughly 15 percent compared to previous 5 percent discounts, resulting in an approximate rate of 3.35 percent.**[3] Note that these rates are typical, but will vary depending on the nature of the loans posted as collateral. Funding rates have been elevated for the past six months and are likely to remain volatile this year as events in the housing market unfold.

IMPACT ON THE INDUSTRY

The distress in the housing market has also taken a toll on the nation's thrift industry. In the fourth quarter of 2007, thrift institutions posted a record loss of $5.24 billion as a result of loan write-downs, restructuring costs and provisions for anticipated loan losses. The $5.1 billion in loan loss provisions, or 1.35 percent of average assets, is a significant increase from the 0.92 percent in the previous quarter and an indication that bank management is anticipating further problems in the housing sector. While the decline in the value of mortgage assets has diminished thrift earnings, capital levels remain solid with 99 percent of the industry exceeding well-capitalized standards.

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[2] LIBOR is the London Interbank lending rate. The 1-month rate is 3.125 percent as of February 25, 2008. The 4 percent haircut refers to the price discount applied to the market value of the collateral to account for liquidity risk.
[3] Stifel Nicolaus & Company, Inc.; February 25, 2008.

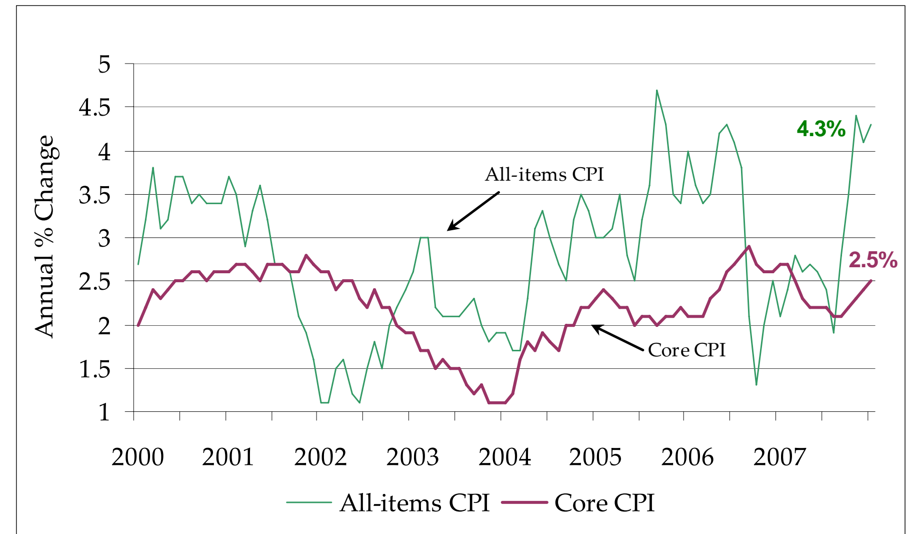
The next month brings a host of events that could determine the direction of interest rates and credit spreads for the remainder of the year. **On March 18, the FOMC meets to discuss potential adjustments to monetary policy.** The global financial markets anticipate a minimum 25 basis point reduction in the target funds rate to 2.75 percent; any deviation from this expectation could cause a considerable increase in yields (if the rate is left unchanged). A series of economic reports on employment, GDP and housing will also determine the direction of financial markets. **Finally, quarter end mark-to-markets** could result in significant markdowns in asset valuations and set the tone for the fixed income market as financial intermediaries may find capacity constrained, thereby further reducing liquidity and credit in the global financial market.

ECONOMIC CONDITIONS

Economic conditions remain weak as the decline in the housing market deepens. Strains in capital markets and subsequent pressure on financial institution balance sheets have reduced the availability of credit to both the consumer and business sectors of the economy. The impact of these events is a sharp pullback in growth in the coming months, which may anchor GDP growth at low levels.

Unfortunately, as economic output softens, inflation pressures are building as indicated by another increase in the consumer price index (CPI) to a 4.3 percent year-over-year pace in January (Chart 3). The jump in consumer prices was led by food, energy and rental fees, and supplemented by further gains in medical care and apparel. The broad inflation pressures led to a 2.5 percent gain in the core inflation rate, the fastest pace since March 2007. The higher inflation reading, if repeated, could affect any plans for aggressive Fed rate cuts in the future.

CONSUMER PRICE INDEX (CPI) AS OF JANUARY 2008 (CHART 3)



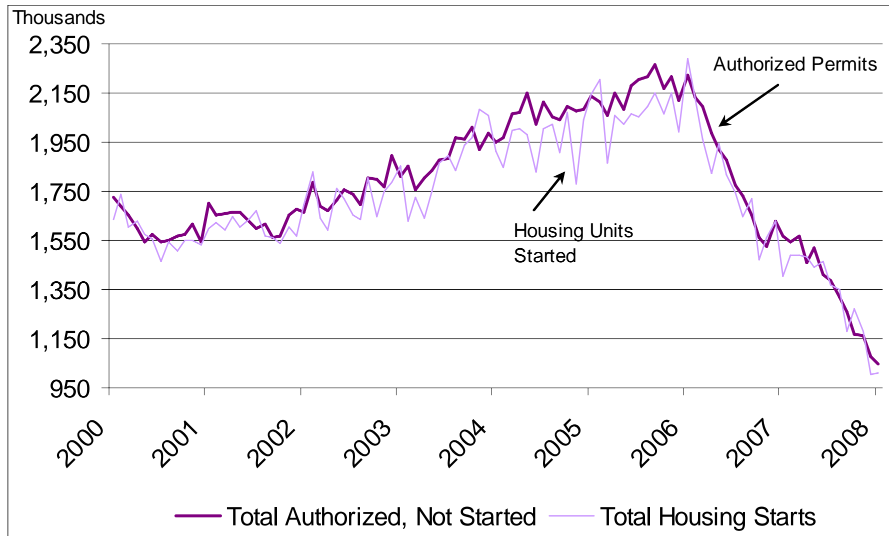
SOURCE: BUREAU OF LABOR STATISTICS

The lack of employment growth is expected to weigh on consumer spending growth over the next few quarters. Monthly payroll gains averaged a mere 40,000 in the three months ended in January compared to an average of 100,000 per month during the prior three months. The confluence of weaker employment, diminished home equity and heavy debt exposure may have led consumers to pare back spending in department stores, furniture companies, and eating and drinking establishments in January. While the Bureau of Economic Analysis reported a monthly increase in retail sales, much of the gains were attributed to gasoline and autos. Higher gasoline prices (sales are measured in dollars) resulted in the marked gain in fuel sales. A mysterious increase in auto sales is a direct contrast to the 6.3 percent decline reported from auto manufacturers. A review of consumption data from November and December suggests a slowdown in consumer spending, which could hold GDP growth below 1 percent for another quarter.

HOUSING---THE BAND PLAYS ON

The housing market is beginning to sound like a broken record. January housing starts were down 27.9 percent on a yearly basis and were 60.2 percent lower in the last three months (Chart 4), as the lack of credit availability amplify the downturn. New construction of single-family homes has fallen by 33.8 percent from a year ago, as home builders ceased production until overloaded inventories were trimmed. January marked the twelfth consecutive monthly drop in single family production, suggesting the contraction in the housing market is much deeper than initially projected.

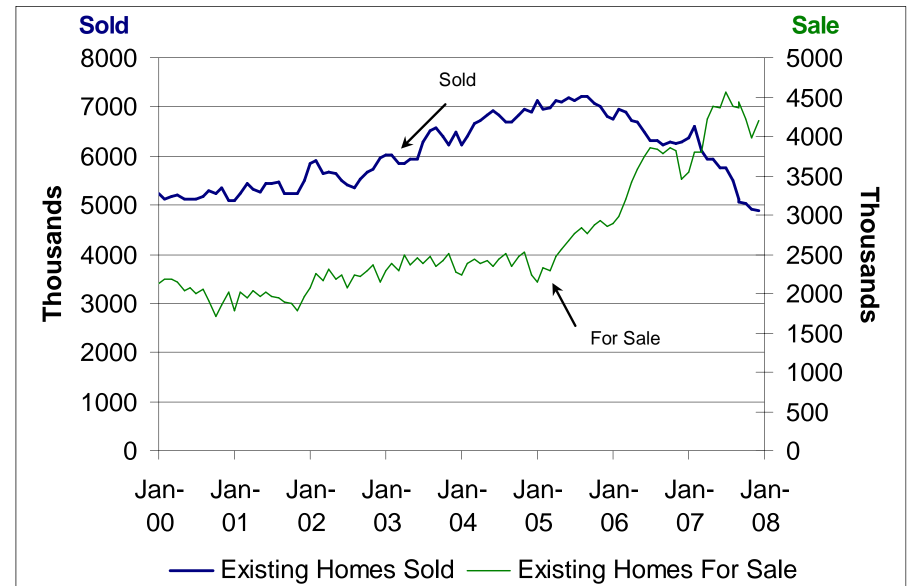
HOUSING STARTS AND BUILDING PERMITS, AS OF JANUARY 2008 (CHART 4)



SOURCE: U.S. CENSUS BUREAU

The slump in home sales persists, as the National Association of Realtors reported the sixth consecutive decline in existing home sales in January (Chart 5). The 6.5 percent drop in condo sales more than offset the 0.5 percent increase in single-family sales, the first advance in eleven months. The slight pick-up in single-family purchases resulted in a three-month annualized rate of change at -8 percent as of January, from a trough of -39 percent in October. Unfortunately, the trend was not quite as encouraging for condo sales which were down an annualized 40 percent since November 2007.

EXISTING HOME SALES & INVENTORY, AS OF JANUARY 2008 (CHART 5)



SOURCE: NATIONAL ASSOCIATION OF REALTORS®

The inventory overhang of existing homes available for sale rose more than 5.5 percent in the prior month, resulting in 10.3 months of inventory, assuming the January sales pace. More importantly, the inventory levels were very near the peak reached in October 2007. The median price of an existing single-family home fell 5.1 percent on a year-over-year basis in January. The record low for this data series, recorded in December 1968, is 7.2 percent. [4]

LOAN PRODUCTION AND PERFORMANCE

The plunge in home sales in 2007 resulted in the lowest yearly production of single-family loans since 2001. Approximately $2.43 trillion in loans were originated last year, 18.5 percent less than in 2006.[5] As expected, originations of subprime and Alt-A loans also fell significantly, especially in the second half of 2007. Subprime loan issuance was down 61 percent from the third to fourth quarter of 2007 for a total of $11.94 billion, 55 percent less than in 2006. The lack of liquidity in the Alt-A and jumbo security markets resulted in a 58 percent downturn in production in the quarter ended in December 2007, 26 percent lower than the previous year.

Not surprisingly, mortgage loan performance deteriorated in December 2007, as reported by LoanPerformance.[6] The national delinquency rate for prime loans climbed to 3.44 percent in the last month of 2007, nearly 1.00 percent higher than a year ago (Chart 6). On a monthly basis, greater borrower stress was exhibited by subprime and Alt-A loans, which experienced an increase in late payments of 1.29 percent and .96 percent increase, respectively, from November to December 2007. Foreclosures displayed similar characteristics, with larger monthly and yearly increases in the non-prime and ARM categories.

[4] National Association of Realtors®.
[5] Inside Mortgage Finance, January 2008.
[6] LOANPERFORMANCE a subsidiary of First American Real Estate Solutions

(Chart 6)

	Dec-07	Dec-06	bp change
National			
Fixed			
DQ	3.62%	2.86%	76
FC	0.53%	0.31%	22
ARM			
DQ	7.58%	5.40%	218
FC	2.82%	1.24%	158
Prime			
DQ	3.44%	2.48%	96
FC	0.59%	0.26%	33
Alt-A			
DQ	13.60%	10.63%	297
FC	3.70%	1.94%	176
SubPrime			
DQ	21.27%	14.52%	675
FC	8.47%	3.63%	484

Source: Loan Performance
Delinquencies (DQ) and Foreclosures (FC) as a percent of active loan dollar balances

The next series of rate resets will be those of option-ARMs, which accounted for 8.9 percent of all loans originated (approximately $3 trillion) in 2006 and 8.3 percent of loans originated in 2005.[7] Roughly 2 percent of these loans required no down payment and many were made to investors.[8] The UBS mortgage research group estimates that one in five option-ARMs securitized in 2007 had loan-to-value ratios of 90 percent or more and no documentation of income. While the amount of option-ARMs outstanding relative to the entire mortgage universe may be less than 10 percent, given the general characteristics of the borrowers, the risk of rising delinquencies and foreclosures among this category of ARMs is quite high.

[7] Inside Mortgage Finance; January 2008.
[8] UBS Mortgage Strategist, January 22, 2008.

HOME PRICES FALLING

Home price declines intensified in the fourth quarter, according to the Office of Federal Housing Enterprise Oversight's (OFHEO) purchase-only home price index. The index posted it first four-quarter decline in seventeen years, falling 1.3 percent in the quarter ended December 2007. On a quarterly basis, prices fell in every state of the country, with the exception of Maine.

A review of the more widely monitored all-transactions home price index[9] showed less weakness, rising 0.84 percent on average from a year ago (Chart 7). California (-6.6 percent), Nevada (-5.9 percent) and Florida (-4.7 percent) home prices led the drop in the index. Eighteen of the 20 metropolitan areas showing price declines were in California or Florida. Consistent with the price depreciation is the marked drop in home sales in the two states. Since the peak in the fourth quarter of 2005, home sales in Florida and California combined are down nearly 50 percent, compared to a nationwide average of 30 percent over the same period. Unfortunately, the industrial Midwest region of the country did not participate in the rapid price appreciation, but is plagued with sharp home price declines as a result of weak economic conditions.

The monthly S&P/Case-Shiller home price index of 20 U.S. metropolitan areas fell by a record 9.1 percent in December 2007 (Chart 8) and the national index dropped 8.9 percent for the last quarter of the year. The December monthly decline is the twelfth consecutive drop and the largest since the inception of the 20-cities index in 2001. Like the OFHEO index, the Case-Shiller price measure was led by annual price declines in Miami (-17.5 percent), San Diego (-14.96 percent) and Las Vegas (-15.3 percent). The cities of Charlotte, Portland and Seattle were the only three to show slight annual price gains of 2.34 percent or less. On a monthly basis, all 20 metropolitan areas experienced home price declines. Both the OFHEO and S&P/Case-Shiller indices show the same trend of falling home prices, exacerbated by rising home inventories and foreclosures (which contribute to the inventory of unsold homes), a decline in household wealth and tighter loan underwriting.

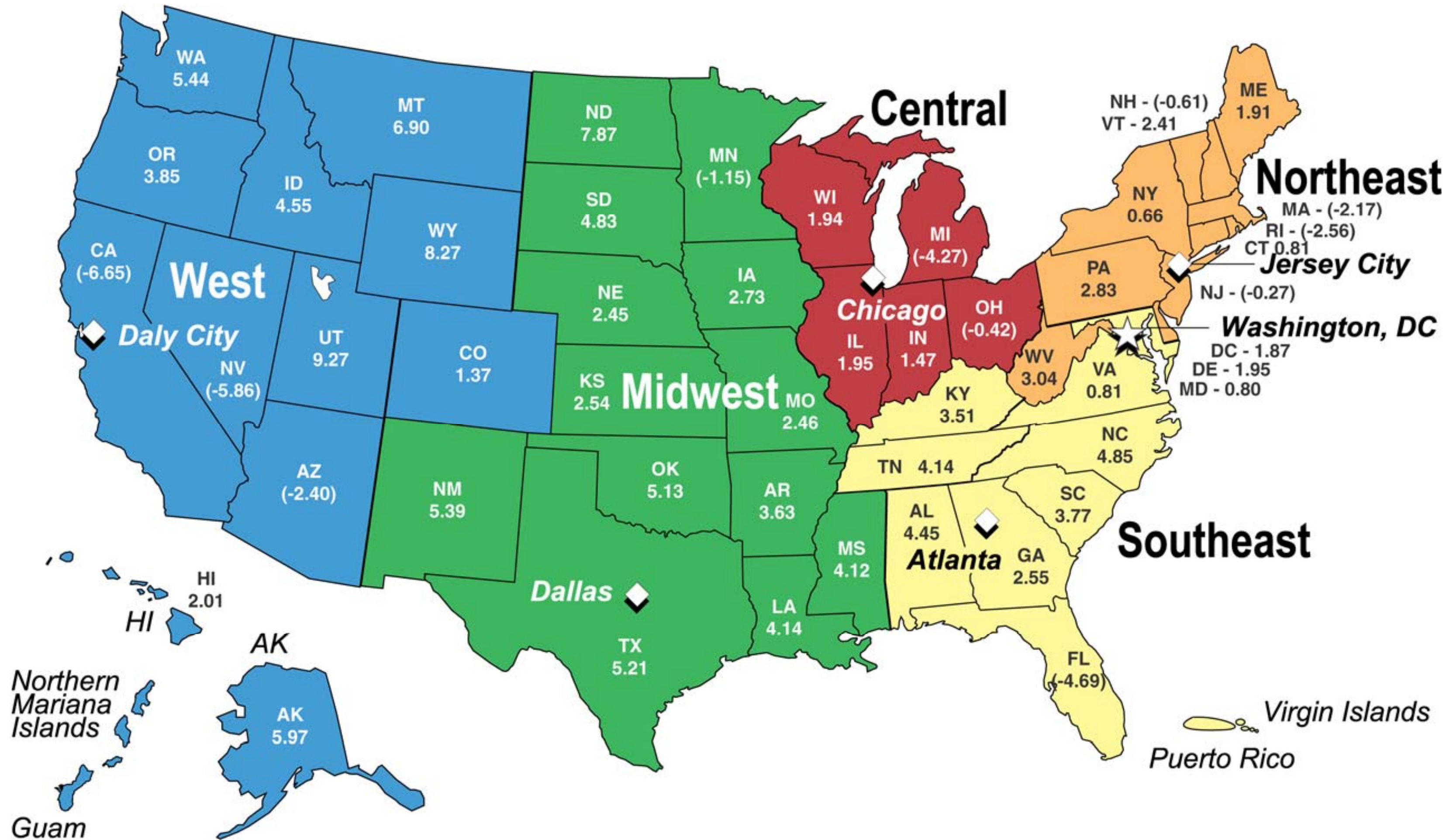
CONCLUSION

The data on economic, inflation and housing conditions portend greater stress on the consumer and financial institutions in the coming months. The prolonged slump in home sales and attendant drop in home prices is likely to result in rising foreclosures. The lack of meaningful job growth and rising costs for food and fuel could finally cause consumers to stem the shopping spree. The next wave of rate resets on option ARMs may lead to a difficult summer for borrowers as the lack of home equity prevent many from refinancing, and the falling value of the homes reduces the borrower's incentive to stay in the home. Initiatives by lenders to modify loan terms may slow the rate of delinquencies and foreclosures among this borrower class; however, there are likely to be borrowers that seek other remedies. Stresses on homeowners will transfer to the lenders and thrift earnings capacity will be significantly challenged in the coming months.

[9] The all-transactions index tracks average house price changes in repeat sales or refinancings transactions (roughly 34 million) as reported by Fannie Mae and Freddie Mac. The purchase-only index is based on more than 5 million repeat sales transactions.

PERCENT CHANGE IN HOUSE PRICES, AS OF FOURTH QUARTER 2007 (CHART 7)

NATIONAL AVERAGE: 0.84%



SOURCE: OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT (OFHEO)

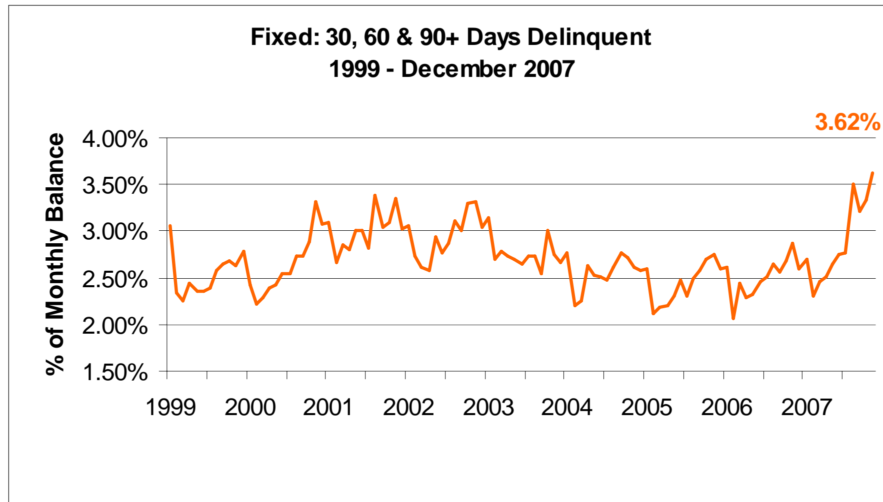
METROPOLITAN REGIONS IN THE S&P/CASE-SHILLER® HOME PRICE INDICES, AS OF DECEMBER 2007 (CHART 8)

	December 2007	December 2006	November 2007	Year/Year %Change	Month/Month %Change
West					
Denver	130.98	137.11	133.36	-4.47	-1.78
Las Vegas	196.05	231.57	201.95	-15.34	-2.92
Los Angeles	233.03	270.03	240.43	-13.70	-3.08
Phoenix - AZ	187.67	221.50	194.45	-15.27	-3.49
Portland - OR	182.47	180.27	183.65	1.22	-0.64
San Diego	202.45	238.07	209.60	-14.96	-3.41
San Francisco	189.23	212.13	195.49	-10.80	-3.20
Seattle - WA	184.88	183.97	187.14	0.49	-1.21
Midwest					
Dallas - TX	120.77	123.68	122.38	-2.35	-1.32
Minneapolis - MN	155.37	168.82	158.57	-7.97	-2.02
Central					
Chicago	160.03	167.65	161.61	-4.55	-0.98
Cleveland - OH	112.07	119.59	113.29	-6.29	-1.08
Detroit - MI	103.30	119.51	105.24	-13.56	-1.84
Northeast					
Boston	164.59	170.32	167.40	-3.36	-1.68
New York	201.80	213.80	203.88	-5.61	-1.02
Southeast					
Atlanta - GA	129.43	134.01	131.46	-3.42	-1.54
Charlotte - NC	131.90	128.88	132.68	2.34	-0.59
Miami	231.71	280.87	237.99	-17.50	-2.64
Tampa - FL	200.13	230.91	203.45	-13.33	-1.63
Washington, DC	217.78	240.45	223.45	-9.43	-2.54
Composite	200.55	222.39	205.09	-9.82	-2.21
Composite-20	184.86	203.33	188.82	-9.08	-2.10

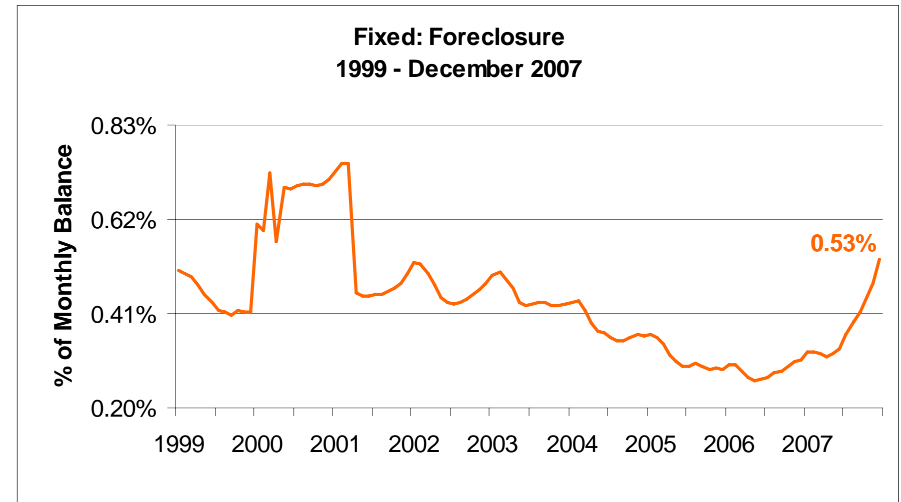
SOURCE: S&P/CASE-SHILLER®

NATIONAL DELINQUENCY & FORECLOSURE RATES: FIXED & ARM LOANS

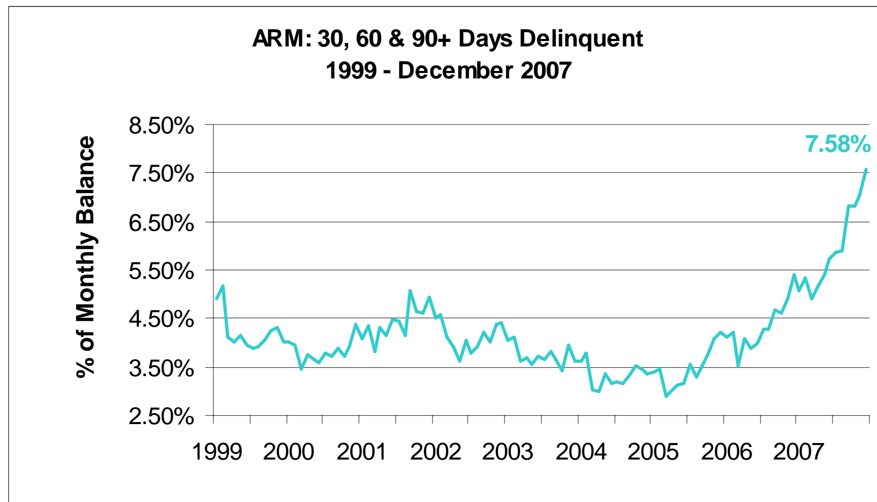
(CHART 9)



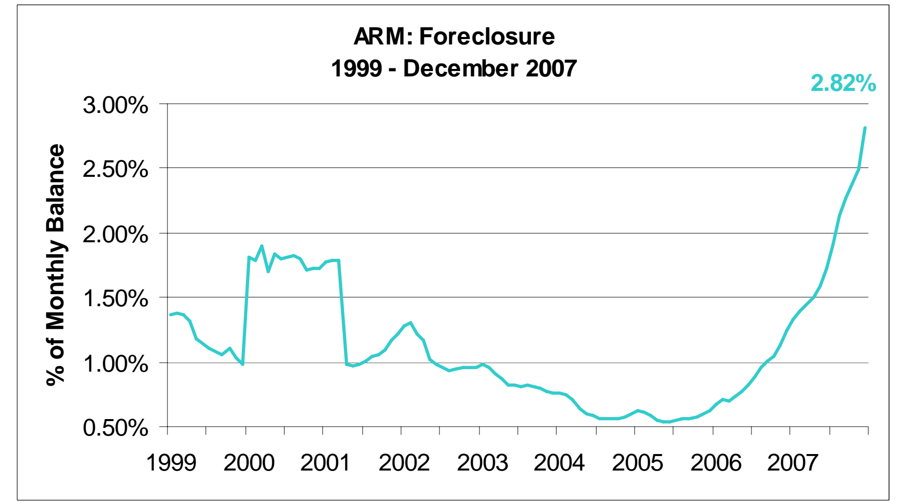
(CHART 10)



(CHART 11)



(CHART 12)



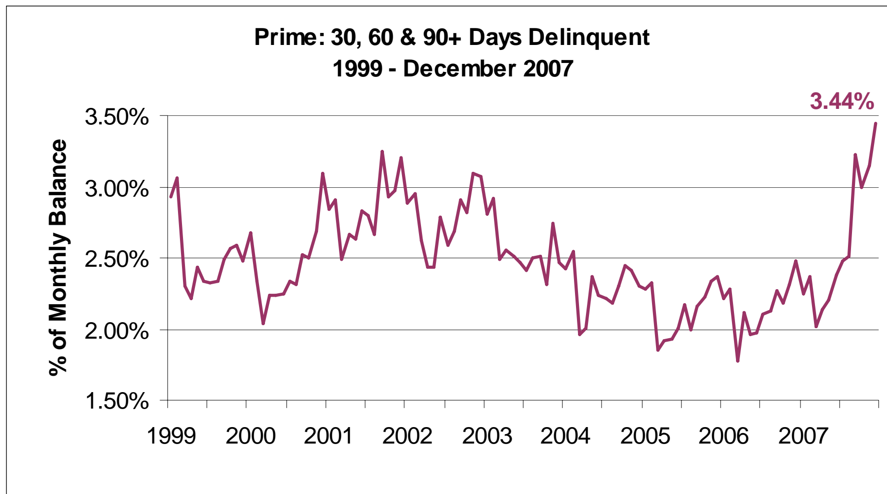
SOURCE: CHARTS 6 AND 9-18 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS (FARES)

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%.

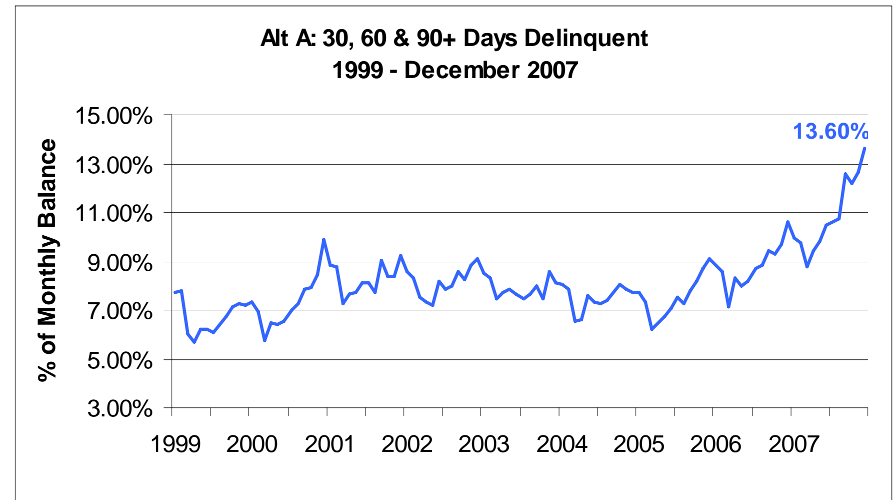
ALL VARIATIONS OF DOCUMENTATION ARE INCLUDED. DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

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

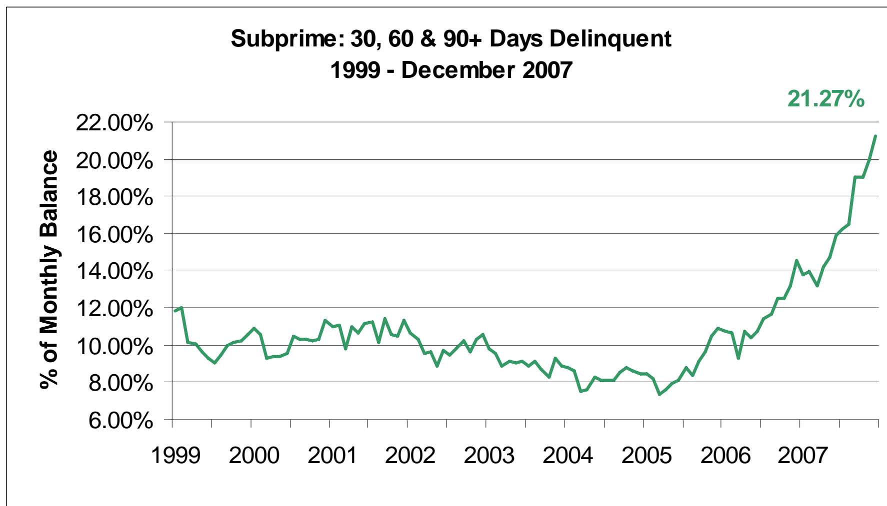
(CHART 13)



(CHART 14)



(CHART 15)



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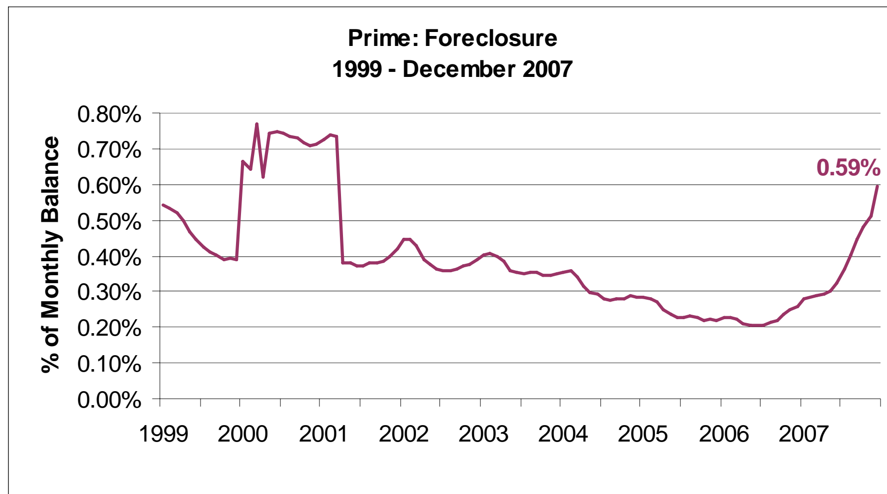
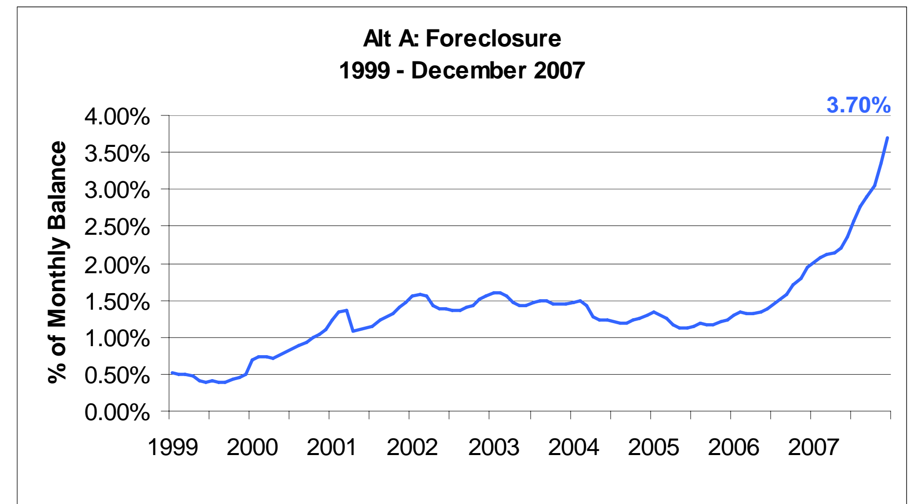
NATIONAL FORECLOSURE RATES: PRIME, ALT-A & SUBPRIME LOANS

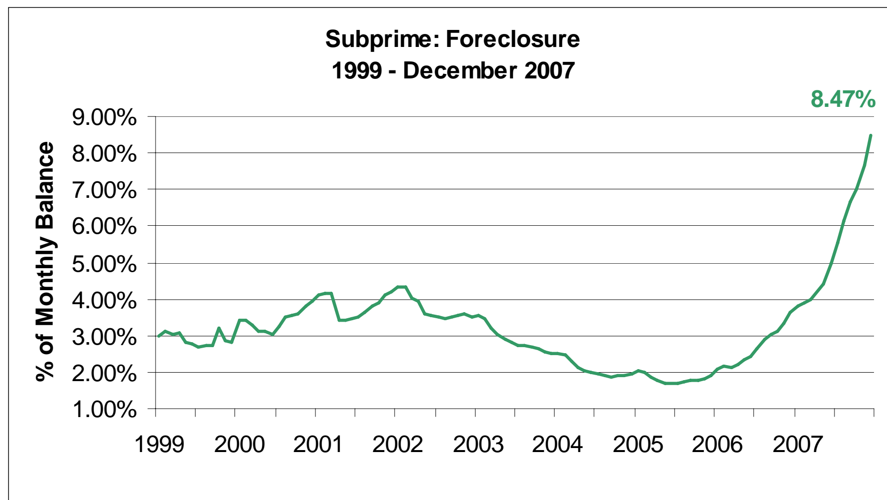
(CHART 16)



(CHART 17)



(CHART 18)



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