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Mortgage Meltdown Mania

In the past few years, the prospects of a real estate and mortgage bubble have loomed before us. Free thinking intellects have been concerned about the risks created by these social forces for years. Yet, as is normal, the collective mind of investors has ignored these issues until for some reason the information recently floated to the front.

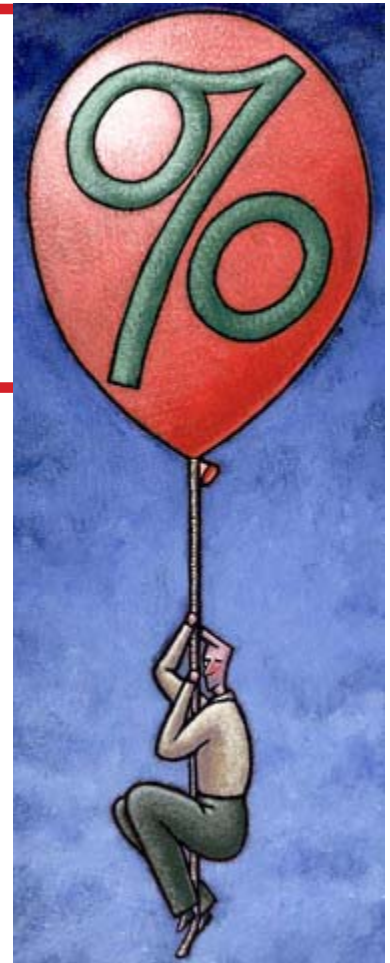
Let's step back and take a look at what has happened in the mortgage arena in recent years. As the real estate markets went up and up since 2000, more and more individuals wanted to own their own homes. At the same time, our U.S. trade deficit created a cheap supply of money from foreign creditors seeking places to invest. A recovering economy fed the supply of cheap money at hand from domestic investors. The confluence of these events created an unprecedented demand for mortgage money, and an unprecedented supply of money to loan.

As is so often the case in a booming real estate market, lenders began to assume that the market would go up forever. Competition caused financial institutions to relax standards in order to get as much market share of the refinancing boom as possible. Mortgages which are being paid by low credit quality investors are thus at an all-time high. More than 80% of outstanding loans have originated since 2002.

The Fed's recent actions to raise short term rates to control overall inflation have had novel and unexpected consequences. In the past few years, some of the households with the lowest credit have financed their homes with new styles of mortgages. About 25% of outstanding mortgages are interest only or incorporate negative amortization. These homeowners would not have been considered solid enough financially to obtain a traditional mortgage, and are thus labeled high risk "sub-prime" borrowers. Approximately another 25% of outstanding mortgages are adjustable rate mortgages. To an unknown degree, these tend to attract the less solvent homeowner who is seeking to keep payments low. All these different mortgage creations are relatively new gimmicks. Most of them base their floating payment requirements on short term interest rates, and short term interest rates have been going up. About \$270 billion of mortgages are involved.

This means that for some mortgage holders in the US, monthly payments have been uncontrollably and unpredictably soaring. The results are that the families who are least able to make the payments own the most risky mortgages, are unable to pay the monthly payments, and are defaulting in record numbers. Right here in Monterey County, the number of foreclosures has increased 150% from last year. This epidemic prevails all over the nation.

Whenever a previously lurking issue comes to public awareness, there always seems to be a Voice of Doom, some individual who makes a radical prediction and inflames the public. Sometimes the prognosticator is simply doing his or her job. Sometimes the Voice du Jour has a more self-interested motive. Recently, Jim Rogers, a famous billionaire commodities speculator, opined that he thinks real estate will crash up to 50% in bubble areas of the country. He is selling his New York mansion and moving to Asia. He is also selling out of every stock market except China.



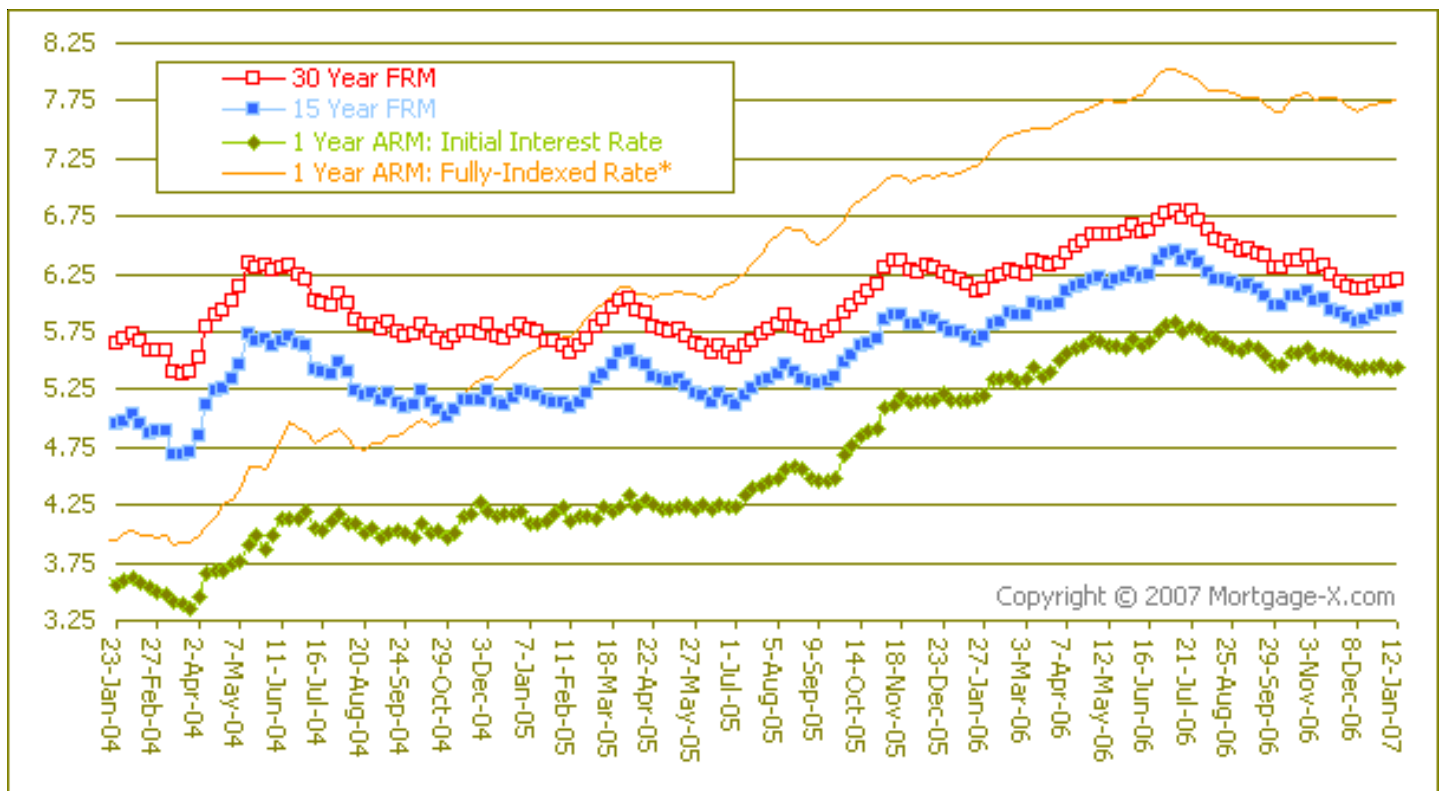
Well...he might be correct. On the other hand, given his history of self-directed investing, he might be helping to move his speculative commitments in the direction he feels they should go.

One indication that this might be so is that the Wall Street rumor mill is ablaze. It says that the sophisticated hedge fund set is taking a world-class loss in the sub-prime mortgage arena. As happened in the tech bubble of 2000, we unsophisticated mutual fund investors appear to be doing much better.

There is no question in my mind that what we are facing is potentially big, really big. On the other hand, as a percentage of all mortgages, the number of foreclosures is actually still rather low. The best WAG (wild average guess) of the experts at present is that if home prices do not drop any further, about 10% of all sub-prime mortgages, or 1% of the total mortgages outstanding, will end in foreclosure. We simply have not seen this develop into something which spills over into the larger economy. Also there is some evidence that the larger economy can withstand these foreclosures.

The National Association of Mortgage Bankers says that housing will increase only at a low single digit rate over the next couple of years. That will dampen consumer spending. It also tells us that rushing out to bargain-hunt may not be appropriate just yet. On the other hand we can be sure that our deep value funds are combing through the wreckage of sub-prime lenders' stocks to find bargains as I write this.

Very few credible economists see a bleak economic future out there. Of course anything can happen, but the numbers which indicate a coming recession just are not there. One number which IS there is average expected increase in earnings, which is down to its lowest level in five years. So I am not looking for a booming stock market with solid legs right now. However, valuations do not appear excessive, so there is not a lot of reason to expect a true meltdown either. At present, we are a little extra cautious. We are holding cash in our accounts waiting for something to clarify. Meanwhile we are remaining diversified and conservative, and focusing on long-term trends. This mortgage meltdown has been one of my concerns for years. But it hasn't truly scared me...yet.



Notes: The red and blue lines indicate "FRM's", fixed rate mortgages. Because they are tied to long term rates they have hardly budged. The green line is the "teaser" rate which mortgage makers use to lure mortgage hunters. But the smooth brown line is key: that is what an adjustable rate mortgage holder pays after the first year. That interest rate is tied to short term rates: and it has gone up a lot! That's why sub-prime borrowers are in crisis now.