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# Intelligent Money

*Current thinking from Haven Financial Advisors*

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***Special Notes of Interest:***

With the 2nd quarter earnings season nearly complete, companies in the S&P 500 have increased earnings another 6.3% relative to 2nd quarter 2006

Anticipated earnings growth for the S&P 500 in calendar 2007 currently stands at 7.0%

A record $2.1 trillion in tax revenue has been recorded by the treasury during the first ten months of the fiscal year. That's up 7% from one year ago.

## Subprime Mortgage Lending

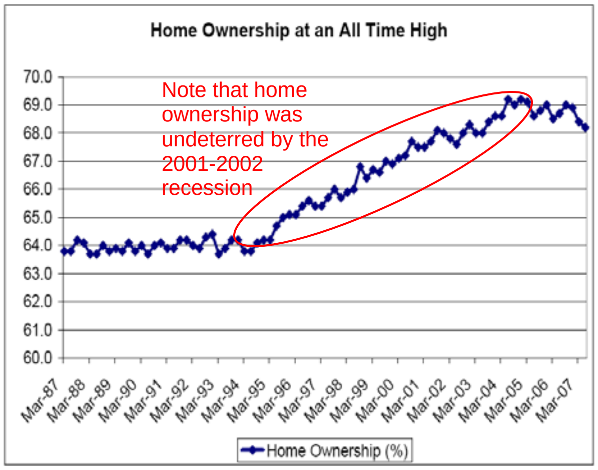
Recent reversals in financial markets have been largely attributed to problems with subprime mortgages. The past few weeks witnessed reduced liquidity in many fixed income markets as credit problems with underlying mortgage collateral. Both the US Federal Reserve Bank and the European Central Bank (ECB) injected over $250 billion into the banking system within 48 hours last week to insure orderly function of the financial markets. There is a growing consensus now that our Federal Reserve bank will begin cutting the federal funds rate to stimulate lending. Stocks all over the world have fallen in the last two weeks despite very healthy corporate earnings reports.

Let's take a broad look at mortgage finance in this country and try to figure out where we are. "Subprime" mortgages are made to borrowers with lower credit. There are several features that distinguish the subprime loan from the prime loan. The former consists usually of an interest rate that resets every year after an initial "teaser" period of 2 to 3 years. Subprime loans are made to borrowers with lower FICO credit scores of 580 to 650 while prime loans typically go to recipients with scores above 700. Loan to value ratios are also higher with subprime loans.

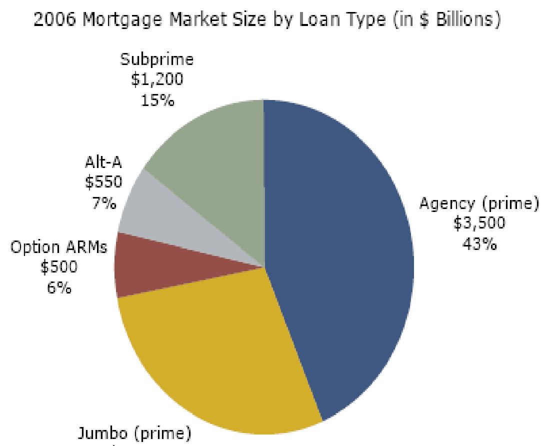
Other mortgage segments lying outside the prime market are coming under scrutiny as well. *Alt-A mortgages* are offered to borrowers with good credit scores but without income verification. *Option Arms* allow the borrower to pay less than the interest due. The unpaid interest gets added to the outstanding balance. Clearly, these mortgage features are tailored to attract marginal borrowers and will likely engender poor repayment performance.

In recent years, "nonprime" mortgages have comprised a larger fraction of origination as the chart to the right indicates. Increasing home values helped to keep defaults low as homeowners who fell behind were able to refinance their mortgages. Bankers were able to lay off much of their risk by selling securities collateralized with these mortgages to 3rd parties – freeing up capital for more loans. These asset-backed securities or ABS were thought to distribute risk more efficiently.

Easy access to credit buoyed home ownership in the United States. From 1965 through 1995, home ownership hovered remarkably close to 64%. Since then, it has climbed to 69% Many of these marginal homeowners were served by the subprime market and are poor or elderly.




Unfortunately, home prices have peaked in most places and interest rates have been trending upward for a few years. While increases in overall home foreclosure have been small, delinquencies and foreclosures among subprime ARM borrowers have ratcheted upward. In fact, the 2006 cohort of subprime loans has one of the highest delinquency rates on record.




Source: Lehman Brothers

The key for equity investors is whether problems in subprime lending spill over to corporate America. One avenue of transmission is  the financial sector. Subprime lending in the past decade has been facilitated by securitization. Many financial companies have exposure to subprime mortgages either as guarantors or investors. New issuance of ABS has fallen by more than 50% and trading in the secondary markets is way down. Bear Stearns is a high profile casualty of subprime woes through its hedge fund investments. More bad news may follow.

A more subtle transmission mechanism is consumer spending. As personal savings rates have plummeted, the one healthy store of value has been the family residence – until this year. If home prices stagnate or fall as is currently predicted, domestic consumer demand is likely to suffer (See *Intelligent Money* Volume 5, Issue 1). The good news here is that a loss in domestic consumer demand could be offset by growing demand overseas.

So far, corporate earnings look healthy although companies in the financial sector have collectively revised their own earnings projections downward. Currently, S&P 500 companies are forecast to grow earnings 7.0% in 2007 while the financials are expected to grow only 2.5%.

The Federal Reserve is in a tight spot. Last week, Chairman Bernanke reiterated that inflation fighting remained the Board’s top priority. Such a posture would argue against rate cuts. Yet the Fed continues to flood the banking system with money. About $400 billion in subprime ARMs will be resetting in the next 16 months. The homeowners with these ARMs face major increases in their mortgage payments. Wall Street firms, known to be generous political contributors, would also benefit from easier credit.

Historically, the Federal Reserve has intervened to smooth markets in times of crisis. Recent examples include the 1998 Russian default, and the 2001 terrorist attacks. While these interventions were successful, there is concern that a Fed-inspired bailout will only encourage more profligate lending in the future.

“Since 2000, the price of shipping dry goods has increased five-fold.”

## Shipping Costs are Spiking

We last discussed the shipping sector in the aftermath of Hurricane Katrina.  At the time, the Price of dry goods transfer had fallen drastically from 2004 through 2005. Katrina’s damage to the Port of New Orleans had comparatively little effect on pricing. In fact, the port of New Orleans has made a nice recovery since the hurricane. According to figures released recently, which cover January through December 2006, cargo volumes within the Port of New Orleans exceeded the Port’s five-year average by 4 percent. Gains are mainly due to a 37 percent increase in bulk cargo imports, such as steel, natural rubber and coffee.

Despite the physical recovery of the port of New Orleans, the price of worldwide shipping has soared. The primary driver here is burgeoning demand for coal, iron ore and cereals. Since 2000, the price of shipping dry goods has increased five-fold.  China is now importing 80 million tons of iron ore from Brazil. Until recently, China had been a net exporter of coal to nearby Japan and South Korea. These countries now get their coal from South Africa.  More generally, the length of well-traveled shipping lanes has increased – thereby taking up more time for each of the 311 dry bulk carriers worldwide.  The price of most commodities has been increasing for years as the chart to the left indicates. Strong demand for commodities has created a complimentary demand for the means to ship them.

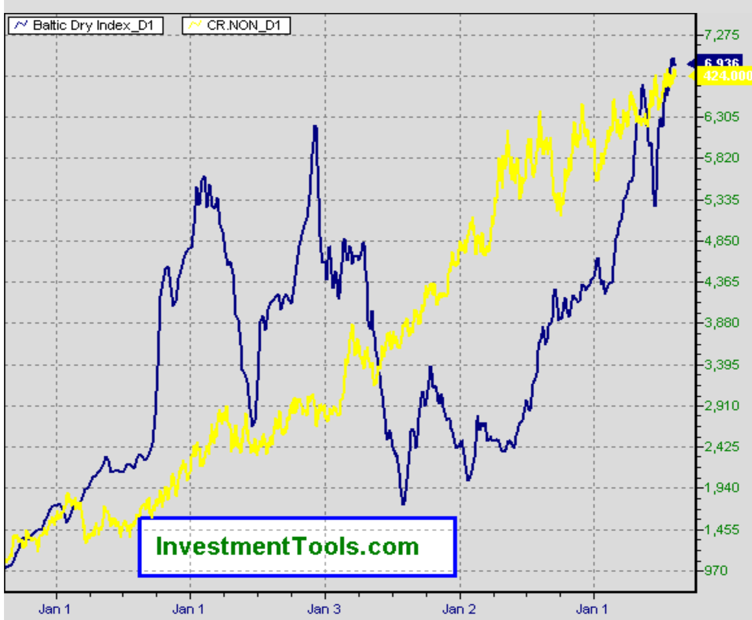


Chart created with NeoTicker EOD © TickQuest, Inc. 1998-2004

“Currently, S&P 500 companies are forecast to grow earnings 7.0% in 2007 while the financial sector is expected to grow only 2.5%.”

Shipyards have contributed to the squeeze in dry goods by focusing on more profitable ships that transport liquefied natural gas and crude oil tankers. Dry bulk carriers are comparatively cheap.  So far, shipping costs have not reacted to the turmoil in global fixed income markets. Perhaps foreign demand will mitigate the mortgage fallout.