

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Fourth Quarter, 2007
Investment Outlook
October 1, 2007

Subprime: All the Time, Part II

The subprime crisis is like the Energizer Bunny: it just keeps going and going. And like watching a slow motion train wreck, we can see the next stage coming as ARM (adjustable rate mortgage) resets lead to foreclosures, which lead to larger inventories of unsold homes, which lead to more downward price pressures, which lead to less consumer confidence, which leads to less consumer spending, which... well, you get the picture. Even Osama bin Laden has noticed this and in his latest video commented on “the reeling of many of you under the burden of interest-related debt, insane taxes, and real estate mortgages.” Bin Laden has a solution — convert to Islam — but our politicians are working on their own plans, so watch out below.

Subprime mortgages allowed many people to become homeowners, but not all who took out subprime mortgages should be. Someone should send a memo to the politicians and to the press to let them know that if a person offered more for a house than it was worth or that he could afford, if he borrowed more than the price paid, if he put nothing down, if he lied about his income, and if he was having trouble servicing his mortgage while it was still on its “teaser rate,” let alone when it reset, then that person is *not* a homeowner. Rather, he is a renter with an option to service a subprime mortgage. (Have you ever noticed that industries that are heavily favored with government incentives often go onto the rocks in the most spectacular fashion? Does the S&L industry ring a bell?)

Already Ben Bernanke and the Fed have ridden to the rescue by cutting the Fed funds and discount rates by 50 basis points (one-half of one percentage point) in hopes of keeping the housing problems from spreading into the broader economy. Not to be outdone, Congress and the White House are devising their own plans to help. You know the three great lies: I love you; the check is in the mail; and, we’re from Washington and we’re here to help you. God help, *us!*

Economic Outlook

The fear, or at least the current and biggest fear, is that weakness in housing will spread to the consumer thereby curtailing spending and sending the economy into recession. Certainly the recent economic news has been pretty downbeat. The August unemployment data was especially discouraging, but consumer confidence and spending as well as industrial production and order rates have also been disappointing. Forecasting is always a difficult proposition and with the U.S. economy now near \$14 trillion and increasingly global, the task hasn't become any easier. Even all of those economists at the Federal Reserve apparently missed forecasting the last two recessions and there have only been two in the past quarter of a century. Additionally, as you can see from the chart on the right, recent quarterly GDP growth has been quite variable, especially over the last seven quarters. Mercifully, the economy entered the third quarter with a pretty decent head of steam but that's scant consolation.

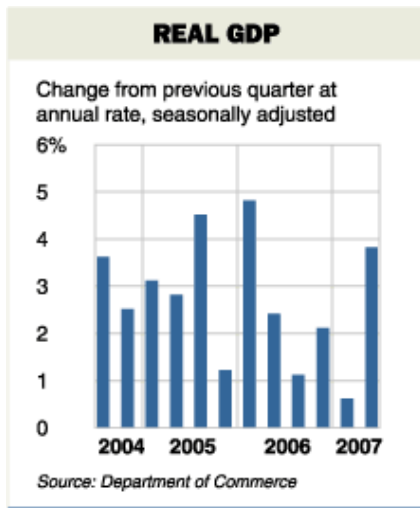


Chart 1

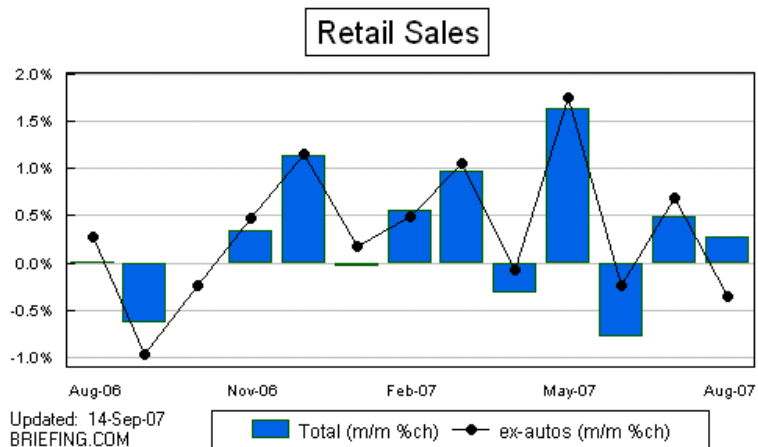


Chart 2

Without a doubt, the greatest threat to the economy is a possible decline in consumer spending which recently has been erratic (see Chart 2).

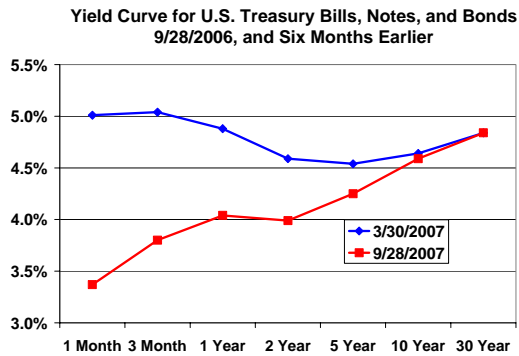
But the consumer is a hearty soul and has historically not been prone to being susceptible to crises, even of the subprime variety. But if a man's home is his castle and if the price of the castle is declining, he may feel that he has less coin of the realm to spend. According to the statistical data, August represented the peak month in the number of ARMs to be reset for the current cycle although resets will remain at high levels well into next year. While last month's foreclosures filings rose 36% from the previous month and were up by 115% from last year, foreclosures currently represent only 0.65% of all mortgages. Not an insignificant number but less than the hysterical coverage of the situation might indicate.

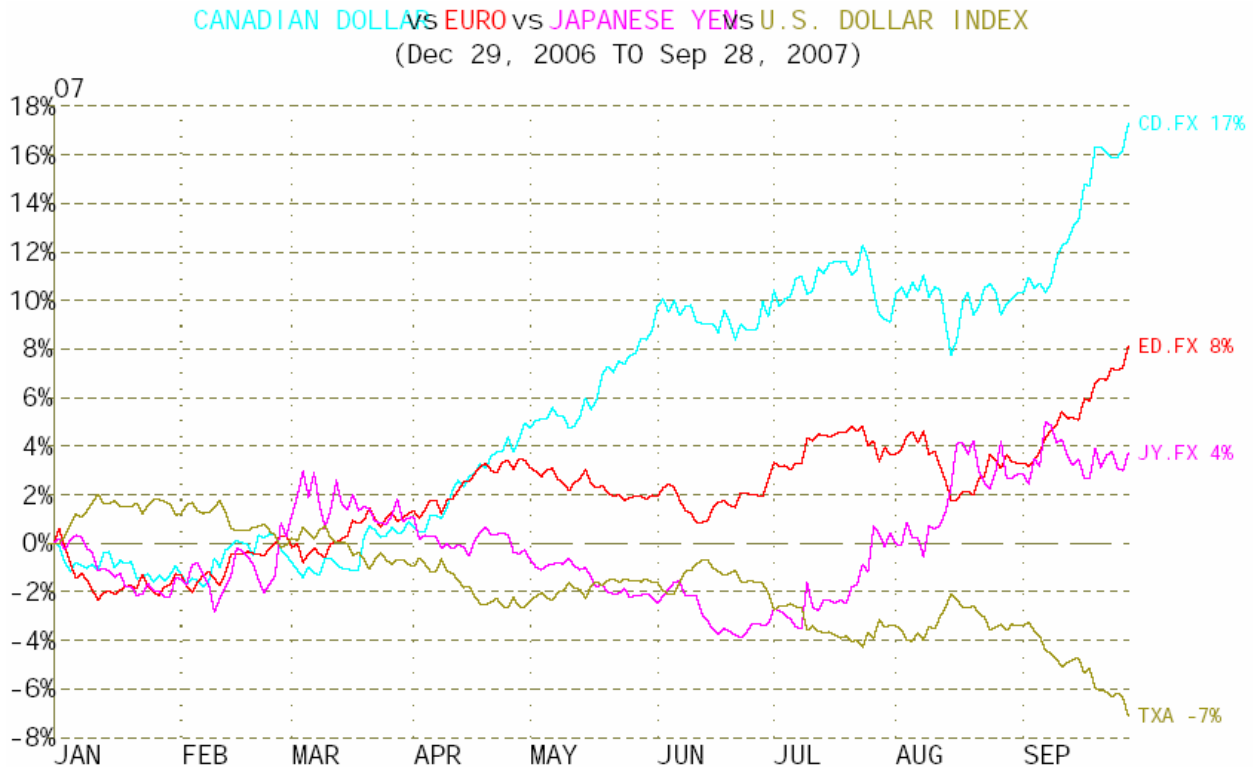
The problem is that no one knows with any certainty how many of these borrowers, mostly subprimes and ARMs, are likely to default and who actually owns those mortgages, and as we all know since we are constantly being told, “the markets hate uncertainty.”

Interest Rate Outlook

The Fed has two major responsibilities and they are not necessarily compatible. The first is to maintain the value of the dollar, a.k.a., to fight inflation. The other is to act as lender of last resort, specifically, to prevent financial panics. Whether you believe that Alan Greenspan was “the Maestro” or was more like Snidely Whiplash, there is little doubt that during his 19 years at the helm of the Fed, a lot of liquidity was added to the system. When combined with what Ben Bernanke refers to as the global savings glut, there is certainly plenty of liquidity to go around. Yogi Berra once said, “If people don’t want to come to the ballpark, how ya gonna stop ’em” — so it’s a question of getting the liquidity to where it’s needed and hopefully without creating inflationary pressures.

Unfortunately, one needs not look far to find signs of inflation. The yield curve has steepened sharply, the dollar is weak (the dollar is at a 30-year low versus the Canadian dollar, also known as the Loonie, and at an all-time low versus the Euro), and the price of gold recently hit a 27-year high. (See charts 3, 4, and 5.) If inflation heats up, you do not want to own fixed-income securities.





The Fed's recent interest rate reductions were aimed at restoring credit market trust, and trust is essential to the smooth functioning of the debt market. The "credit meltdown," or whatever you want to call it, revolved around the inability to price misunderstood and infrequently traded securities whose values suddenly became suspect. While it appears that the credit markets are returning to something close to normal, uncertainty is likely to periodically reappear as the bodies from the sinking subprime market continue to wash ashore.

Stock Market Outlook

Many years ago a *New Yorker* cartoon showed a newscaster reporting that "the stock market opened up strongly this morning with the Dow climbing to an all time high only to plunge at mid-day to near zero before a bout of late day bargain-hunting led to a rally which left the market unchanged for the day on heavy volume." And so it was during the third quarter when the Dow Jones rose 3.6% on heavy volume and increased volatility as it swung from a closing high of 14,000 on July 19th to a closing low of 12,845 on August 16th to close at 13,895 on the last trading day of September.

The aftershocks to both the economy and financial markets from subprime are likely to continue for a while, but MBI doubts it will be as bad as the bears would lead us to believe. As usual, there are a few caveats. The Fed never cuts (or raises) interest rates just once. When it does initially cut rates many often wait for rates to go even lower. Also, after the initial euphoria of the recent 50-bps cut wears off, if it hasn't already, many may start to wonder if the Fed doesn't feel that things may be worse than most currently believe. Since the Fed didn't just

reduce rates by 25 bps, it “slashed” rates by 50 bps, and since it’s likely that the Fed will cut again, many people will wait a while to see what happens. What seems likely to happen is that the economy weakens further, at least partially, as a result of the Fed’s cutting rates in an effort to spur the economy. Ironic!

For the past 20 years the Fed has run an activist monetary policy which flooded the financial markets with liquidity in times of so-called crisis and led to a feeling of “entitlement” by investors. Moral Hazard, or the “Greenspan Put” if you will, is now part and parcel of the economic and investment outlook. While Bernanke would probably prefer to dish out a little pain and retribution to the most egregious subprime sinners, neither are popular with those receiving the beating or with the politicians who curry their favor and votes. Additionally, a surgical strike on the guilty parties is beyond the capability of monetary policy.

Will Rodgers once famously said, “I am more interested in the return *of* my principal than the return *on* my principal.” A little “old time religion” would go a long way to returning greater discipline to economic and financial systems but that’s no fun so don’t count on it happening.

In spite of some justifiable fear during this most recent stock market correction, there has yet to be a 10% correction in the S&P 500 on a closing basis. There have been 31 10%+ corrections in the S&P 500 since 1970 or one every 14 months, or so, but none since March of 2003, which is the longest stretch without a 10% correction since WWII. We’re due and, sooner or later, we’ll get one. However, with everyone looking for one, it’s less likely that it will happen soon. Look for more of what we’ve recently seen.

MBI continues to believe that the market’s sentiment is becoming somewhat more risk averse which should favor large capitalization, high quality, multi-national company stocks with higher yields on well-covered dividends. Rising gold and oil prices, a lower dollar, and highly uncertain bond markets are not positives for stock prices. Therefore, investors are likely to look for safer stock market havens. Additionally, since alternative investments and hedge funds are now, at least temporarily, in the investor dog house, fewer investment dollars will flow their way. Unfortunately, large cap growth is becoming a “crowded trade.” The uncertainty caused by subprime is likely to continue for some time, but hopefully there will be no Subprime: All the Time, Part III.

October 1, 2007

JOHN E. MONTGOMERY
7475 WISCONSIN AVE, SUITE 810
BETHESDA, MD 20814
301-652-6950 PHONE
301-652-6954 FAX
888-293-6668 TOLL FREE

Some charts courtesy of Baseline and Briefing.com.