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The Housing and Credit Markets: Some Relief?

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Day after day, the media pounds us with news about the troubled housing and credit markets and their negative effects on the economy. Blaring doomsday headlines have drained investor confidence. The "run" on Bear Stearns is but one of the most spectacular examples of the havoc created by plunging confidence and the abrupt refusal of many of its trading partners to do business with the firm.

Historically high housing inventory levels, declining home prices, rising loan delinquencies and foreclosures keep weighing on the housing and credit markets. Is there any silver lining at all? To help keep your balance and perspective, below we discuss some developments that leave room for optimism.

Housing Prices. The National Association of Realtors reported that the decline in the national median sales price for existing single-family homes from the prior month decelerated to -1.75% in February from -3.8% in January. The latest S&P/Case-Shiller Home Price Indices, which track the average change in single-family home prices in 20 major metropolitan areas, also show that monthly price declines in certain areas like San Diego and San Francisco have been stabilizing or decelerating towards the end of 2007.

The latest quarterly numbers from U.S. Department of Commerce indicate that while the median sale price for new single-family houses sold across the nation was down 4% in 4th Quarter of 2007, the same measurement for the Northeast and West regions was up 14.3% and 2.6%, respectively. Certainly, further price declines are likely in the coming months, especially in the "hottest" areas during the boom years, like California, Nevada and Florida. As painful as these declines are, they eventually will help attract enough buyers to put the housing market on a path to recovery.

Housing Inventory. While the supply of existing as well as new single-family houses for sale is still at historically high levels, we have seen ***some*** improvement over the last few months. The supply of *existing* single-family homes dropped from the peak of 10.2 months in October 2007 to 9.2 months in February 2008. As for *new* single-family homes, supply remained unchanged in February at 9.8 months. Permits for new home construction, however, recently fell to the lowest level in 17 years, suggesting far fewer new houses are being added to existing inventory.

For the housing market to stabilize, we need help from both the demand and supply side. On the demand side, some anecdotal evidence exists that prices have dropped enough to spur selective buying. For instance, falling housing prices helped lift sales of existing single-family homes up by 2.8% in February from January, the second monthly increase in a row over the past 12 months. The 1.8% drop in new home sales was smaller than the market expected. While declining prices are painful, it is a first and necessary step to spurring demand and bringing down housing inventory. Still, it has become much more difficult to qualify for mortgage financing in the aftermath of the housing bubble bursting.

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On the supply side, the evidence is mixed. On the one hand, the March numbers on plummeting housing starts are encouraging. However, offset against this positive development is the massive amount of foreclosed inventory being added. Nevertheless, we are beginning to see opportunistic buyers stepping up to buy foreclosed properties at auctions. Ryan Knott, CEO of National Home Auctions, estimates that his company as well as several competitors will likely auction off 60,000 homes this year, and confirms his business is booming. The online home auction leader RealtyBid.com has seen its total sales in 2007 up by 157% over 2006. Industry research results from National Auctioneers Association show that total home sales sold at live auction in 2007 grew 5.3% from 2006, despite the slump in sales of new and existing homes via traditional channels during the year.

Interest Rate Resets. The 6-month LIBOR rate, which is used for many subprime adjustable rate mortgages ("ARMs"), has fallen over 250 basis points (100 basis points = one percent) from a year ago to the current level of 2.63% after the Fed slashed the fed funds rate 6 times since last September. Lower rates probably won't offer much help to borrowers who bought houses that they simply could not afford or purely for speculation. Walking away from their homes becomes a practical decision when housing values keep falling, destroying their incentive to keep making payments. Nonetheless, the big drop in the 6-month LIBOR means that future monthly payments subject to reset would not jump as much as they would have otherwise, offering the possibility that fewer foreclosures would result than previously expected. So while a large amount of ARM resets will occur in the coming months, relatively speaking their negative impact won't be as severe.

Fannie and Freddie to the Rescue. Federal regulators recently allowed Fannie Mae and Freddie Mac to take on a bigger role in combating the housing and credit crisis. First, the portfolio growth caps for Fannie and Freddie which limited the total value of mortgages and mortgage-backed securities ("MBS") that these two government-sponsored entities ("GSEs") can buy and hold for investment have been lifted beginning on March 1, 2008. Second, the ceiling on conforming loans that Fannie and Freddie can buy or guarantee has been substantially raised from $417,000 to $729,750 for single family homes in certain high-cost areas like California and the East Coast. Conforming loans on two, three and four-unit homes have higher limits as well. These developments should give buyers greater access to less expensive loans, especially in the high-cost areas.

Also, the capital reserves requirement for both Fannie and Freddie has recently been lowered from 30% to 20%. By some estimates, this change will allow the two GSEs to immediately pump $200 billion into the mortgage and MBS markets. Combined with Fannie and Freddie's existing capabilities, government officials expect these initiatives to permit the two GSEs to buy or guarantee about $2 trillion in mortgages this year. Success in motivating Fannie and Freddie to buy more mortgages and MBS from banks and other lending institutions would stimulate more mortgage lending and help establish more transparent and reliable prices for mortgage related securities.

Liquidity and Clearer Pricing in the MBS market. The illiquidity in the MBS market has been a huge obstacle to the recovery of the mortgage and credit markets. Demand for MBS and mortgage derivatives has dropped off sharply. Consequently, bankers and lending institutions have become unwilling to lend as the resulting mortgages have to be kept on their balance sheets rather than securitized and sold to third parties. This is one of the reasons why mortgage rates have not fallen much in response to the Fed's repeated cuts in interest rates.

In addition to lowering the fed funds rate, the Fed has taken other aggressive actions to pump liquidity into the credit market. First, the Fed announced a $200 billion term-auction facility (TAF) which offered short-term funding, but to only banks. The Fed followed up with the Term Securities Lending Facility (TSLF), which allows primary dealers (a group of 20 banks and securities firms that trade Treasuries directly with the Federal Bank of New York) to borrow up to $200 billion of Treasury securities for as long as 28 days, instead of on an overnight basis. It also increased the size of loan auctions to commercial banks to $100 billion, while planning for another $100 billion in one-month repurchase operations.

Perhaps more importantly, in exchange for highly liquid Treasury securities that borrowers can easily convert into cash, the Fed expanded the universe of acceptable collateral from borrowers to include agency debt, agency MBS, non-agency AAA-rated private-label residential MBS, agency collateralized-mortgage obligations (CMOs) and AAA-rated commercial mortgage-backed securities (CMBS). These moves have the salutary effect of liquefying some of the more illiquid assets on the balance sheets of the primary dealers. These latest actions taken by the Fed have calmed the financial markets sufficiently to lower the rates on fixed-rate mortgages by more than a quarter of a point.

By agreeing to hold (and ascribe collateral value to) a large volume of securities that banks and dealers are struggling to sell, the Fed is doing more than just injecting the much needed liquidity into the credit markets. The Fed's action helps relieve some of the pressure on financial institutions to dump the hard-to-sell securities at fire-sale prices, which in turn contains the spread of falling prices to other related securities. The private sector is coming to the rescue as well. Fortress Investment Group has announced plans to raise $15 to $20 billion in new capital this year to buy up cheap mortgage-related securities made available by the credit crisis. No doubt more private buyers are on their way.

The Fed has also gotten involved in other ways to improve market liquidity via facilitating more certain pricing of mortgage related securities. For example, in JP Morgan's amended deal to purchase Bear Stearns, the Fed has asserted a high degree of control over the portfolio of mortgage-related assets that is acting as collateral for the Fed's $29 billion non-recourse financing to JP Morgan. Such control, which de facto makes the Fed more like an owner than a lender, includes hiring Blackrock Financial Management to manage the Bear Stearns assets, with any profit from the asset liquidation (after full payment of the loans from the Fed and JP Morgan) inuring to the Fed's benefit. The Fed has essentially bought time for the troubled assets to be sold free from duress, helping stabilize prices. Most significantly, this arrangement is only a short step away from the Fed buying troubled mortgage-related securities outright, which would go a long way to addressing the current crisis. After the JP Morgan/Bear Stearns deal was announced, Wells Fargo came out and said they would not be adverse to doing a similar Fed-assisted transaction, thereby offering the prospect of more stabilization.

Another noteworthy development is the recent flood of customer deposits into commercial banks, which took in $47.2 billion of deposits during the week ended March 12, following another $43.3 billion of inflows the prior week. Customer deposits are one of the cheapest and most preferred ways for commercial banks to restore their capital and liquidity. Because of volatile markets and the "perceived" safety of banks, people have been shoving their money into these financial institutions. How's that for irony, since many of these very same firms are to blame for the current credit and mortgage debacle?

Purchases and Refinances. Mortgage Bankers Association reported that the recent drop in the 30-year fixed mortgage rate led to a sharp increase in mortgage refinancing applications. Applications for home purchases also increased. For the week ended March 21, 2008, the Refinance Index was up 82.2%, the Purchase Index was up 10.6% and the Market Composite Index that measures mortgage loan application volume was up 46.1%. It is true that application volumes are still below where they were last year. However, assuming a fair number of these applications are actually approved, this is another data point that bodes well for housing demand and inventory reduction.

It would be a stretch to expect that the downturn in the housing and credit markets to end abruptly. Just as it took several years for the market to get itself into this current mess, it will take time to heal. However, it would be just as unwise to ignore some of the positive developments out there. While late to the party, the Fed has recently shown some creativity in managing the crisis. It is too early to tell whether the positive developments discussed in this article are sustainable, but there are some encouraging signs.

Some Useful Research Resources

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So you are ready to make a stock investment. What are some of the factors you need to focus on when deciding to invest in a company's stock and where do you find this information? To make good investment decisions, you need to do your homework. There are many reports you should read and understand before (and after) you make the purchase.

Whether a company will be a good investment depends on many factors, some tangible and others intangible. While by no means an exhaustive list, the ubiquity of the Internet has made many of the relevant company filings available on the web, including Forms 10K, 10Q, 4, 13F and DEF 14A.

What follows is a brief description of what information you can get from each of the filings.

Form 10K, also called the annual report, is a report that all publicly traded companies have to provide their shareholders at the end of each fiscal year. It offers the most comprehensive information on how the company's business performed during the period covered by the report.

You should pay special attention to the following information: financial condition shown on the balance sheet; gross and operating margin trends; year-over-year trends in sales or revenues and profitability; unusual or non-recurring expenses or benefits; footnotes; how cash flow is being deployed; growth rate of various balance sheet accounts (such as inventory and receivables) versus sales or revenue growth; the nature and existence of material litigation or contingent liabilities. This is by no means an exhaustive list.

Form 10Q, also known as the quarterly report, is filed three times a year by the company in between annual reports. It is a shorter and simpler version of the 10K, with a summary of the company's operations on a quarterly basis.

You should focus on the same types of information that you would pay attention to in the Form 10K.

Form 4 is the statement of change of beneficial ownership. The form is filed when there is a change in the holdings of an individual owning 10% or more of the outstanding stock of a company or in the holdings of a company officer.

These forms are useful to monitor because ownership increases via stock purchases might indicate better times ahead for the company, as such purchases might evidence increasing confidence in the company from those who are important insiders. In contrast, decreases in ownership might indicate pessimism about the company's future prospects, though insiders often sell for many reasons that do not reflect negative assessment of the company's prospects.

Form 13F is a report filed by institutional investment managers. All institutional investment managers who exercise investment discretion over $100 million or more in what is known as "Section 13(f) securities" are required to report their holdings with the Securities and Exchange Commission. Section 13(f) securities generally include equity securities that trade on an exchange or are quoted on the Nasdaq National Market, some equity options and warrants, shares of closed-end investment companies, and some convertible debt securities.

Form 13F's disclose the buy/sell activities of major institutional investment managers who manage and control large amounts of money. Their decisions collectively have a disproportionately large effect on the markets. Dissecting the Form 13F's filed by good investment managers may reveal potential investments worth investigating for purchase.

Form DEF 14A is the proxy statement. This annual statement, on its face, seems an unlikely source of useful research information. The proxy contains an announcement of the annual shareholders' meeting, with voting and election options to be presented at the meeting. The proxy also provides the qualifications of management and board members, sets forth information about executive compensation, and lists the company's largest shareholders.

Relevant proxy information that might materially impact your purchase decision include the following: whether top management was over-compensated; stock option repricing in favor of executives; existence of self-dealing transactions; and performance of the stock price versus that of its peer group over the past 5 years.

Doing your homework before you buy a stock, and then continuing to follow relevant developments during the period of your ownership will increase your chance of investment success. The more you know about the company and its industry, the better your decisions will be when buying, selling or holding.