

## Housing Woes Continue to Weigh on Markets

Tuesday brought more volatility as the Dow sank 280 points and all major indices declined 2% or more. The sectors which led the way up are leading the way down as financial services lost 3%, basic materials just shy of 3% and consumer services lost more than 2%. News from the housing market over the last two days was worrisome.

While home sales for July were decreased only marginally from June, inventory built up to a 16 year high with more than a 5% increase - in peak selling season. We now have an inventory that would take almost 10 months at the present rate of sales to deplete. Today's release brought more bad news as home sale prices declined on average 3.2%.

Foreclosures for July were up 93% from last year. Now, this number is not as scary as it sounds as the actual number of foreclosures is still a small percentage of the total homes. A 1% rate which goes to 2% is a 100% increase, however, the 2% is still a relatively small number. However, the rate of increase continues to jump and the trend is concerning. As adjustable rate mortgages continue to reset, many homeowners will not be able to afford their mortgage payments.

Foreclosures are now spreading to condo developments as buyers who entered agreements to purchase 2 and 3 years ago cannot get financing. If the units are not sold, the entire project is at risk.

Countrywide Credit fell precipitously the last few weeks as rumors of their demise spread. This is the largest mortgage lender in the country. They tapped out their \$11 billion credit line. Bank of America was their knight in shining armor last week as they invested \$2 billion, bailing out Countrywide. BAC got a great deal in terms of preferred interest rate and conversion ratio into equity in the future but we will have to see how long it takes to pay off.

The massive run-up in home prices over the last 10 years created a massive amount of debt which Wall Street sliced and diced and collateralized and securitized and sold across a broad array of investors. Now this is coming to haunt them as their balance sheets are taking hits. This cartoon sums up how the average investor must feel.



"I THOUGHT WE WERE JUST BUYING A HOUSE!"

Credit card balances continue to jump. The concern here is that people want to pay their mortgages so they may be loading up their credit cards paying for other household expenses. Delinquencies in this area continue to increase affecting a battered sector -the financial services companies. There is rising concern that defaults are spreading to the credit card sector.

Yields on some of the banks are over 5% and may seem tempting. However, I believe it is too soon to jump in. Investment and commercial banks chased the golden goose of M&A (merger and acquisition) fees over the last few years. As they competed for deals, they weakened the covenants on these takeovers. In many cases, they negotiated low fees, gave up their opt-out if market conditions changed and bore all the risk if the takeover do not produce or goes into default.

There is \$300 billion worth of these deals already signed but not yet funded which will be consummated over the next 6 months. The banks will have to absorb this debt as the environment has changed. Unloading the debt after the deal is done to reduce their risk as they did in the past is not viable as buyers for this debt disappear. The

banks face immediate markdowns on the debt or risk lawsuits from the takeover target if they back out. JP Morgan, Citibank, Merrill and Goldman are just a few of the names affected.

Their earnings are likely to have a double whammy as they absorb losses on already committed deals and holding this debt decreases their ability to commit to new and possibly very profitable deals. Profits from originating and trading mortgages have dried up and foreclosures and credit card delinquencies are taking their toll - this all adds up to potentially big dents in future earnings.

We believe you have to think of this market differently than you did in the 80's and 90's when not only most investors but most advisors got the bulk of their experience in the markets. In my opinion, you cannot just buy and hold unless your risk tolerance for any given quarter is fairly large. You should work some type of hedging strategy into your portfolio. There are many ways to do this from tactical strategies, core and satellite portfolio construction, non correlated asset classes, inverse positions or simply holding some cash to reduce the volatility.

The volatility has greatly increased. The beginning of the day has little to do with the way the markets trade throughout the day. The last hour of trading has become the one to watch as both gains and losses have accelerated. This is the last week of August when many traders are on vacation. September is actually historically the worst month of the year for the markets. So we are not likely to see relief in this trend soon.

No market ever goes straight up or straight down. So take a good look at how you are allocated, how your managers and advisors are performing and if you need to, use the rallies to unweight some equity exposure or add in some hedging strategies.

Feel free to call us with questions and comments.

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