



MarketWeek 8/21/07: Ride The Storm

By Julian Hebron

Another stormy market week ended Friday with the Fed cutting the Discount Rate by .5%. This week begins with Capital One's Greenpoint Mortgage closing their doors and laying off 430 workers in Marin. My full respect and support goes out to those professionals as we all ride this storm.

Once again, I am extending MarketWeek beyond the 2 paragraph briefing to give emphasize points that may be getting lost in the barrage of Credit Crunch press coverage. Also please note: I am using this report for clients to pick up at open houses right now – in this environment, every client profile should be quoted individually (especially for Jumbo loans).

FED CUT IS NOT A BAIL-OUT

The Discount Rate cut enables banks, hedge funds and Wall Street trading desks to borrow short-term Fed funds at 5.75%. Normally Fed Discount Rate loans are only used in a pinch because there's cheaper financing elsewhere. But most global warehouse banks won't or can't offer cheaper loans to other banks right now, so the Fed stepped in. This means banks/funds/traders can use short-term Fed money to keep funding new debt such as mortgages.

This does not mean the Fed is bailing anyone out or rewarding bad decisions. The Discount Rate cut contains panic and helps reignite credit markets, but tighter lending guidelines still flush out companies and people who take too much risk. A homebuyer with 600 credit and no cash won't get loan right now, and neither will a hedge fund seeking short-term Fed money to fund high-risk investments.

WHEN WILL MARKETS IMPROVE?

The Fed's Discount Rate cut plus their infusion of about \$80 billion into the banking system has prevented an all-out market meltdown, but results are muted so far because there's still a lot of bad mortgage and investment debt in the financial system. It will take weeks or months for this to unwind – with more volatility and more company closures.

Meanwhile, new mortgage originations based on tighter approval standards will create a new wave of good quality Jumbo loans above \$417k that investors will buy, securitize and trade. Rebuilding a robust mortgage securities market could take as long as 24 months because tighter guidelines will cut down the pool of eligible borrowers.

WHEN WILL RATES IMPROVE?

This is why consumer rates eventually have to come down, to help offset tighter loan guidelines. The consumer accounts for two-thirds of the economy, and if they go down,



they take the ship with them. The Fed can help matters using the Fed Funds Rate, which has a more direct impact on consumer rates than the Discount Rate. Markets are currently pricing in .375% in Fed Funds rate cuts by the Fed's September 18 meeting, and .75% in cuts by the end of this year.

This would bolster the consumer but remember: the Fed can help, but they can't bail out consumers and institutions. That's why they started with the Discount Rate cut and the cash infusions. If that doesn't work, then the Fed Funds rate cuts will come. It won't fix everything, but it could just be enough for Jumbo loan markets to re-price back to market levels (right now they're being priced based on risk, not on market levels).

HIGHER RATES = LOWER PRICES

Home buyers, like any investors, often get nervous when markets are stormy. But this is the time to really pay attention. Higher mortgage rates mean lower property prices, and as I illustrated explicitly in my most recent client newsletter, the financial benefit of a lower purchase prices far outweighs the higher rate.

The math on this theory overwhelmingly proves the case in short- and long-term scenarios. It will become more important to use this formula for evaluating decisions in the coming months. If you need a copy of this article or need to have me run an example for you, please let me know.

Conforming (\$200,000 – \$417,000) – NO POINTS
30 Year – 6.5%
5/1 ARM – 6.75%

Jumbo (\$417,001 – \$650,000) – NO POINTS
30 Year – 7.25%
5/1 ARM – 7.125%

Better rates available for select profiles. ARMs shown have interest-only options. Full doc pricing for an average prime borrower with at least 10% equity.



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