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*Marshall & Sullivan, Inc. / Registered Investment Advisor*

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# THE VIEWPOINT

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Fall 2007

During the third quarter, financial companies that were even remotely involved in subprime lending saw their stock prices fall. This was not exclusive to the U.S. but was felt globally. Corporate bond prices tumbled pushing interest rates higher. Mortgage rates increased and new loans seemed to grind to a halt. The ripple effect of rising interest rates sent shock waves through the stock market. From its high, the S&P500 fell almost 10% wiping out all of this year's gain, and then some. This moved the market returns into negative territory for the year.

This is when our phones started ringing with clients asking the important question; "What is a subprime loan and how is this going to affect the economy?"

Our local newspaper defined a subprime loan as follows: "A 'subprime' is a riskier loan, generally given to those who don't qualify for a bank's best rates. It is designed for consumers with subpar credit and carries a higher interest rate." This means subprime loans can include car loans, credit card loans, variable rate mortgages, jumbo mortgages.... In other words the loans that make the world go round.

Once the drop in the price of stocks extended past the financial industries to the average company, the Federal Reserve stepped in and took action. First they added liquidity to the market by repurchasing bonds. Next they lowered the discount rate. This is the rate banks can borrow money from the Federal Reserve. The lower the rate the more banks can profit on a loan. The stock market stabilized and gave financial institutions and investors a chance to research which subprime loans were not performing.

The main culprits were loans to homeowners who became over extended. They likely had purchased their homes in the last 5 years using an adjustable rate mortgage and had their loan reset at a higher rate. In addition they were in areas where residential real-estate was declining in value (see our Summer 2006 newsletter for an explanation of why). Now that their home is worth less than what they owe, they stop paying their mortgage, move to an apartment and leave the lenders with a glut of loans about to go into foreclosure.

These loans were included in many packaged products (collateralized debt obligations or CDO's) that banks, investors and hedge funds were purchasing without realizing the risk. Once hedge funds saw some loans going into default, they sold their CDO's because they were worried the entire package might default. Because not enough was known about the underlying loans, the only way that banks, investors and hedge funds could attract buyers was to sell the CDO's at values far below their purchase price. This panic is what caused the subprime crisis.

Now that we have identified the issue, we can focus on how this will affect the equity markets. Namely will the economy fall into recession? If it does, the average companies' earnings would decline and drag the stock market with them.

Subprime issues have already been responsible for slowing down the economy. The Federal Reserve will do what is necessary to keep the economy growing and the U.S out of a recession. This was demonstrated by how fast and decisively the Federal Reserve reacted to the subprime crisis. They added liquidity to the bond market and lowered the discount and federal funds rates.

To show they were serious about keeping the economy growing, they lowered the federal funds rate by a larger than expected amount. It was originally expected that the Federal Reserve would lower the federal funds rate by ¼%. To send a strong message to the markets they lowered by twice that much. This signaled that if the economy continues to slow the Federal Reserve will continue to cut rates in order to keep the economy growing.

Because the Federal Reserve reacted quickly the stock market has stabilized and recovered the ground it had lost. Surprisingly the S&P500 finished the quarter a little higher than it started. Going forward we feel the market will see a decrease in day to day volatility compared to the past quarter and that in a year; will be higher than it is today.

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