THE DANA VIEWPOINT

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Just in time for Christmas, the Fed gave us a quarter point interest rate cut, even though everyone was hoping for a bit more in their Christmas stocking. The turmoil in the mortgage market has apparently refocused the Fed from inflation fears to recession fears. Everyone knows that our economy cannot continue to grow at the 4.9% annual rate it exhibited in the third quarter of this year. The consensus points to about 1.8% in the fourth quarter and possibly slower into 2008. As we have stated in past letters, it is not high interest rates or a lack of money that is creating a "credit crunch." It's more a lack of lenders willing to lend and of borrowers willing to borrow because of the uncertainties in the economy brought on primarily by the massive write downs of delinquent mortgages by financial institutions.

The Fed hopes to send a message to investors that it stands ready to do what they can to get us through this financial crisis. Financial panics are nothing new. We have been through them ever since money was invented, and we will get through this one too (and, no, Al Gore did not invent money).

The Fed Funds rate is a target rate set by the Federal Reserve. Banks are naturally required to hold a certain amount of dollar reserves against the amount they lend out. If a bank falls below its reserve requirement, they can borrow from another bank that has a surplus. The interest rate one pays is negotiated, and the weighted average of the rate across all banks is the effective Fed Funds rate. By reducing the target rate the Fed can stimulate more lending to promote the economy. Another means the Fed can use to stimulate the economy is through the discount rate. That is a rate the Fed will charge banks for taking a direct loan from the Fed at the "discount window." The current Fed Funds rate is 4.50% and the discount rate is 5.0%. The Fed may decide to cut both rates on December 11 and also extend the available maturities on these loans. A third way to stimulate the economy would be for the Fed to cut reserve requirements for banks. Bottom line is that the Fed has some weapons to use to forestall a recession and is letting investors know they stand ready to use them.

So, just how dire is the mortgage market? First of all, the value of US home mortgages as of 3-31-07 was $10 trillion. This is an extremely important part of the economy, and the country in general. The dream for most people is to own a home and it is usually the most valuable asset they will own and the last asset they want to relinquish. So rest assured that the Fed and the government (both federal and state) will do everything possible to insure the stability of this market. In a recent interview, Daniel Mudd, President and CEO of Fannie Mae, said that there are $600 billion to $800 billion of sub-prime mortgages in the US, and that $185 billion of those mortgages will have some kind of interest rate reset next year (mostly higher). Many homeowners will not be able to meet a higher mortgage payment and will default. Who is at fault? Virtually everyone. Unscrupulous lenders put people

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in no-down payment, no interest or teaser loans they knew would default. People that desperately wanted a house probably knew they would have trouble making payments down the road. The Fed promoted this with extremely low interest rates, and then you had people flipping houses for a quick profit. All added up to a recipe for disaster. So what is the solution? There are several ideas being discussed such as:

The consumer takes the hit, loses home and starts over.

State or federal government adds money to the market.

Lending institutions re-work mortgage payments.

Try to help only those who can pay and forget those with no chance to pay and those flipping house.

The solution will probably be a combination of these factors.

Finally, what about investments in agency pools of adjustable rate mortgages?

First of all, GNMA is a government agency and Fannie Mae and Freddie Mac are government sponsored entities (GSEs). Second, they are well capitalized and use primarily private financing for their cash needs (preferred stocks, common stocks and bonds). According to Mr. Mudd, Fannie Mae has never taken a penny in aid from the Federal government. Third, the agencies exposure to sub-prime loans is minimal. Again according to Mr. Mudd, Fannie has less than 2% exposure to this market, and they have put a heavy emphasis on restructuring those loans.

One last note on solutions. We need to keep the Bush administrations tax cuts in place. Raising taxes, both corporate and personal, would only cause more defaults in both areas.

Here we are approaching the end of another calendar year. Maybe it's just age, but every year seems to bring more changes and crises. But what a great country we live in. The human spirit in this country is phenomenal and is the main force available to resolve these crises and move forward. May this human spirit touch all of you in some way as we enter the New Year.

Random thought for December : A global warming thought for the holidays - In orbiting the sun, the earth departs from a straight line by one-ninth of an inch every 18 miles – a very straight line in human terms. If the orbit changed by one tenth of an inch every 18 miles, our orbit would be vastly larger and we would all freeze to death. One-eighth of an inch? We would all be incinerated!

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