NEEDLE TILTING TOWARD AN EASE

by Steve Brown

It has been awhile since we provided an update on the economy as it relates to banking. In short, GDP is low, housing is soft and many are worried the consumer (67% of our economic engine) may soon reign in their spending habits. If that occurs, many feel the FOMC would be forced to cut rates to reinvigorate the economy. Some firms, such as Merrill Lynch expect Fed Funds to dip as low as 3.75% by the 1Q of 2008. Even the forward curve is pessimistic. When adjusted to approximate Federal Funds, the Eurodollar curve shows overnight rates are expected to drop to 5.00% in the 3Q of 2007, 4.75% by the 1Q of 2008 and bottom out at 4.50% by the 2Q of 2008. For further evidence the needle remains pointing to a rate cut, consider the results of a recent Bloomberg survey of 66 Wall Street dealers. In it, the number of firms looking for FF to dip below 5.00% outnumbered those who expected it to reach 5.50% or higher by a margin of more than 7 to 1. Those who manage money for the world clearly expect rates to fall in coming quarters. Let's look at some of the catalysts to that view. Housing: Any conversation on economic weakness these days has to begin with housing. The subprime debacle has resulted in more than $1B in fraud according to a recent OTS study and defaults are skyrocketing. In fact, subprime borrowers have gotten in so far over their heads, that studies indicate they are more than 10x more likely to default than prime borrowers. Things are so ugly in the sector that more than 63 companies have gone out of business or been sold. Currently, experts predict as many as 2.4mm homes are in danger of foreclosure. Given that there are about 6mm subprime mortgages in the country, that equates to roughly 1 in every 12 homes. Taxes: Beyond subprime, another issue pundits are closely watching in the sector has been the ramp up of property taxes. While housing prices have tanked, millions of home still exceed their assessed value. In addition, a dip in economic activity has pushed local governments to increase tax rates. Last year alone, tax rates climbed 7% on average. Oil: While the newswires have largely stopped talking about the price of oil, pressure remains. Consider that at a current price of $65 per barrel, oil prices are just $1 shy of being twice as high as their 10Y average. Consumer: Even if they won't admit it, the consumer has been getting shaky for awhile. Consider a recent study that found 33% of people did not set aside any money last year and those who did only saved less than 10% of their income. Bottom Line: Moderation of the housing market, combined with lower consumer spending, is producing a mild economic slowdown. At this point, the needle is pointing toward "ease," as the slowdown deepens in coming months, driven by even softer housing and a slowdown in consumer spending. For banks, the current prediction is slightly higher non-accruing loan balances, a slightly steeper yield curve, a 15bp increase in commercial loan pricing and lower funding costs. Only time will tell if an ease is truly in the offing, but we'll keep an eye things and report back from time to time in order to keep everyone informed.

BANK NEWS

M&A

Bank of America will buy the reverse mortgage division of Seattle Mortgage Company for an undisclosed sum. Seattle Mortgage is the 3rd largest provider of home equity loans to retirees (#1 lender in this space is currently IndyMac).

Let's all sue

TJX, the company that runs Marshalls and TJ Maxx is being sued by 300 banks for a security breach that allowed information from 45.7mm credit cards to be stolen. The banks will seek damages in the "tens of millions of dollars" said a spokesman.

WAMU

The Bank introduces a home line of credit that allows the borrower to lock, and then unlock, a rate on a portion of the outstanding balance. Switching to a floating rate is always free, while fixing the rate costs an estimated $250. In addition, the line comes with multiple payment options including interest only and has limited fees. The product is intended to lengthen the average life of a loan (making the loan more valuable on a ROE basis) by allowing the borrower a multitude of options.