



ECONOMIC NOTES

Monday
January 14th, 2008

Dramatic Fed Cut Would Hike Mortgage Rates

Long-term rates are unchanged this week, about the only things in finance that are. The 10-year T-note is still in the 3.80s, mortgages 6.00%, 5.875%, 6.00%....

Two big speeches (Treasury Secretary Paulson and Chairman Bernanke) and the demise of Countrywide overshadowed news of a steadily weakening economy and credit trouble spreading outward from mortgages.

The newest consumer data arrived in December retail results, uniformly lousy, and ATT described a pullback in consumer spending on the most basic services. American Express -- good, tough, old outfit -- is the newest to announce rising defaults.

Countrywide. Its borrowers in process, and sellers and Realtors nearby all should feel relieved. Fundings are now secure.

However, BofA's acquisition has all the fingerprints of a liquidation, one in the interests of banking regulators to avoid the collateral scramble and firesale inevitable upon the instant of bankruptcy. The idiot stock market soared on the acquisition news on Thursday, and reality dawned today: BofA's stock is down, its credit-risk premium up, Moody's considering a downgrade.

So, what's the benefit of this deal to BofA, good money after the bonehead \$2byn infusion into Countrywide last September? First, good will and blessings from the whole regulatory apparatus. No other institution had the strength left to absorb the Countrywide wreck, and good deeds beget future favors. BofA's September infusion may have bought it control, but system conditions have deteriorated so badly since that it need not have paid a dime -- regulators would have come to call, hats in hands.

Deconstruct the deal. The prize inside Countrywide is its loan servicing portfolio;

right now a migraine, but \$1.4 trillion in mortgage customers is a huge base of clients who instantly become BofA pigeons. Loan servicing has a common market value in excess of 1.5%; even if this pool is discounted for bulk and trouble to 1%, that's \$14 billion in value.

BofA is paying \$4 billion for the overall wreck, meaning Countrywide minus its servicing portfolio has a negative value of at least minus \$10 billion. Its dinky "bank" (really an S&L, easier regulation) is leveraged to the eyeballs and probably has a net-loss portfolio; and the insurance and securities and other tacked-on businesses only have value if originations run hot (not).

The massive origination arm has negative value also. Absent the fee-rich subprime and option ARM game, Countrywide is a low-margin, commodity Fannie-Freddie shop just like the rest of us. BofA needs another brand name like a moose needs a hat rack, and assumes future losses from litigation, portfolio, and downsizing. A lot of branch landlords are going to have some re-leasing to do.

Thus an industry re-sizes capacity from all-time-fantasy down to actual demand. Expect Washington Mutual to follow the merge-out parade.

The speeches. Mr. Paulson offered nothing, and the no-show hurt the markets. His gratuitous advice that firms recapitalize ignored their grave difficulty in doing so.

Mr. Bernanke looked haggard. He has studied Class-A financial crises his whole life, but leading the Western banking system out of one is a different matter. The speech is an excellent read. He is under no illusions: "...The financial system remains fragile" [!!]. Long sentence, third para from end, after many promises to intervene

to save the economy: [compressed] "However... unmoored inflation or eroded Fed credibility could reduce the Fed's ability to counter shortfalls in economic growth."

He is stuck: slash rates and take the inflation risk? Or fight inflation and let the economy fend for itself -- and become the most hated man in America?

If he cuts dramatically to save the economy, look for mortgage rates to rise. That's the largest probability, now, political pressure on him too strong to withstand.

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