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Is The Bull Dead?

After four straight years of stock market gains, many investors have been asking if the good times are nearing an end, at least temporarily. Questions about the housing market, the health of the economy, and increased stock market volatility have added to investor anxiety.

Recent worries about the economy have come mainly from concerns about the housing market. Huge losses in the sub prime (low quality) mortgage market has led to speculation that problems here will spill over to other parts of the economy. The recent collapse of New Century Financial, a large sub prime lender, illustrates the problem. As the housing boom grew, lenders made more loans to people who traditionally could not get a mortgage. Large Wall Street investment banks financed these lenders, bought the loans, packaged them into securities, and sold them to investors looking for high yields.

Like any other speculative boom, this only works as long as prices keep rising. Once housing prices peeked and started to decline, borrowers were faced with rising interest rates on a depreciating asset and defaults began to soar. In markets like California, most new mortgages were interest only, adjustable rate loans, and many of these had low teaser rates for the first year. When these loans adjusted their interest rates, borrowers were unable to meet the payment. The Wall Street Journal reported that 13% of all adjustable rate mortgages taken out during the last three calendar years are projected to ultimately end in foreclosure. Sensing trouble, the investment banks funding the sub prime lenders cut off their financing. To date, more than two dozen sub prime lenders have shut down.

The surprising thing is not that the housing boom ended but that so many people seem to be surprised that it did. Prices don't rise on anything forever, and housing is no exception. Booms and bubbles are as old as investing and rest assured, we will see others. A boom is not necessarily a problem. The problem comes from how much damage is done when it is undone. The slowdown in housing could cause an economic recession, but that is by no means a certainty. These fears are the cause of the current market volatility.

Market corrections are a normal part of stock investing, especially after a run to all time highs, and should not impact long term investment strategies. Market valuations are nowhere near their levels during the 1990's and we feel the risk of a prolonged sell off is small. We will let you know if our thinking changes. In the meantime, please call us if you have any questions.

Wabash Capital