



834 Chestnut Street · Suite 315  
Philadelphia, PA 19107  
215.875.8666 · 215.701.8745 FAX

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There are the subprime “crisis” headlines, and then there are the macroeconomics and the numbers that reveal the actual overall impact of subprime mortgage defaults. The headlines say that the situation is a really big deal with broad implications for the economy and financial markets. The economics and the numbers tell a different story. Here are some numbers: Total U.S. credit market debt is about \$46 trillion. Take out Federal, state and local government debt, and the private sector debt total is about \$23 trillion. Total subprime mortgage debt outstanding is about \$1.3 trillion, and about 16% of these subprime loans are in default. Suppose (very conservatively) the lenders only get about 50% of the value of the defaulted loans by selling the collateral (the houses) or giving new loan terms. Then we would have a \$100 billion loss. Now that may sound like a big number, but as a percent of total private debt it is less than one half of one percent.

The ball park \$100 billion loss number is a big deal for some companies and some investors, but it is, in my opinion, nowhere near big enough to have broad macroeconomic or investment consequences. The total bond and equity markets have market value swings exceeding one percent all the time. The Lehman Aggregate Bond Index has dropped more than one percent in one month 41 times in the last 31 years; the latest instance was in September 2005. And, of course, one percent or more losses in value in the overall U.S. equity market are quite common.

Think back to Katrina. The dollar losses exceeded \$100 billion and with much real devastation and destruction, not just paper losses; yet the macroeconomic and broad market impacts were relatively minor and short lived. The U.S. economy is very large, well diversified and, I think, well positioned to deal with these crises and keep on ticking. I do not see a recession developing from these mortgage problems.

To that point, on Friday, November 2, we got the employment report. It shows a gain of 166,000 in payroll employment in October, following a gain of 296,000 over the third quarter. And third quarter real GDP rose 3.9%, despite another big drop in home construction. Inflation does not appear to be a problem, with the GDP price index rising at an annual rate of 0.8% in the third quarter. Given the low inflation, I think the Federal Reserve did the right thing in cutting the fed funds rate to 4.5% on October 31.

I, David Waters, continue to watch credit markets closely and will report if I see signs that point to worsening conditions, but for now I think these problems are contained and that economic and market prospects remain sound. As always, please call me with any questions or concerns.

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