



March 31, 2008

Dear Gamble Jones Client:

Somehow the hangover is never quite as pleasant as the revelry that preceded it. Many who overindulged in the cheap and easy credit of the last decade are now dealing with the consequences of those excesses, and the fallout is taking a toll on the credit markets and the economy as a whole. What started out with rising defaults on subprime mortgages a year ago has led to a credit crunch that has victimized notable firms such as Bear Stearns and Countrywide and has most likely pushed the economy into recession.

When easy money was plentiful, borrowers ranging from homeowners to hedge funds loaded up on debt. In the U.S., the ratio of debt to gross domestic product (GDP) soared from 160% in 1975 to 342% in September of 2007. This increase in leverage occurred at a particularly rapid rate after the turn of the millennium, during which time the increase in debt outpaced GDP growth by almost 4% per year. Bubbles soon developed in several categories of debt including credit cards, car loans, commercial real estate loans and, of course, subprime residential mortgages.

As the housing market was booming earlier in the decade, many banks and other lenders lowered their credit standards, allowing people with poor credit records to purchase homes that they could not afford. This further fueled the rise in home prices, causing borrowers and lenders alike to become even more complacent. Billions of dollars in complex securities tied to these loans were packaged and sold to investors throughout the financial system as investors bet that the boom would continue. In addition, many aggressive hedge funds and other financial institutions borrowed large amounts of readily available short-term debt to fund their purchases of these higher-yielding, long-term securities in an effort to boost their returns.

All of this worked well for several years as housing prices and economic growth continued to surge. However, once the music stopped and housing prices began to fall, the entire process began to work in reverse. While leverage had served to fuel both home price appreciation and economic growth, this deleveraging process that we are currently mired in has led to a drop in housing prices and an economic slowdown.

The deleveraging started last summer when lenders began to recognize that a higher than expected amount of their subprime mortgage loans would not be paid back in full. This forced lenders to adopt more stringent credit standards, which led to the beginning of the decline in housing prices. Just as rising housing prices led lenders to become too complacent in extending credit, falling asset prices have made them extremely cautious. Banks and other holders of subprime mortgage securities have been forced to take large

write-downs on the value of their holdings. In an effort to remain in compliance with their capital ratio requirements and protect themselves from further possible write-downs, banks have pulled in their reins and sharply reduced their lending. This has forced housing prices to fall even further, which has led to a reduction in the value of the mortgage-backed securities serving as collateral for many of the loans that lenders made to hedge funds and other investors. That in turn has forced those investors to sell assets to raise money to meet margin calls from the lenders, causing a further reduction in asset prices and leading to an unpleasant deleveraging spiral. This spiral has resulted in more than \$200 billion in write-downs on securities tied to subprime mortgages. It has also caused the mortgage-backed securities market to become extremely illiquid as demand for such securities has dried up due to fears of further price declines. This fear and illiquidity have also largely spread to the credit markets as a whole.

The recent swift and dramatic collapse of Bear Stearns, the fifth largest investment bank in the U.S., illustrates the gravity of the current credit crunch. The firm's downfall culminated with its government-assisted fire sale to J.P. Morgan for a small fraction of its value from just a few days earlier. Market turmoil such as we are currently experiencing has a way of sifting out those firms that are ill-prepared to meet its challenges. Bear Stearns was less diversified than its Wall Street peers. It was far more reliant than others on creating and trading mortgage-backed securities, leaving it more heavily exposed to those faltering securities when the credit markets began to freeze. In addition, it was insufficiently capitalized to withstand such a crisis. While it did have an emergency cash reserve of \$17 billion, that was less than adequate considering that it had \$102 billion in collateralized borrowings. As the value of the collateral fell, Bear began to receive margin calls from its lenders. However, much of Bear's mortgage-backed assets proved to be impossible to sell in the current environment, and the firm's liquidity soon came into question. As is often the case when fear is in the air, the problem was inflamed by rampant rumors and speculation. Despite a frenzied effort, Bear was ultimately unsuccessful in reassuring its customers and lenders that it was on sound financial footing, and confidence in the firm's ability to make good on its obligations soon waned. That set off a classic run on the bank, with customers rushing to withdraw their assets and lenders refusing to provide the short-term funds upon which Bear had grown to rely, ultimately leading to its downfall.

Given the serious nature of the credit crunch, the Federal Reserve has taken increasingly aggressive action in recent months to prop up mortgage-backed securities and provide liquidity to the credit markets. The Fed has slashed short-term interest rates by a full three percentage points since September, the fastest pace of such an amount of easing in decades. It has also taken more creative measures to infuse liquidity into the credit markets such as agreeing to take billions of dollars of mortgage-backed securities as collateral from financial firms in exchange for short-term loans. The Fed has also begun to allow investment banks to borrow from its discount window, a benefit previously reserved for commercial banks. In addition, federal regulators recently reduced lending restrictions placed on both Fannie Mae and Freddie Mac, allowing the firms to provide up to \$200 billion in immediate liquidity to the troubled mortgage-backed securities

market. Although these measures will not in and of themselves provide an immediate fix to the troubles in the credit markets, over time they should help to restore order.

As pervasive and unsettling as the credit crisis has been, it too shall pass. While it will take some time for the deleveraging process to run its course, at some point banks and other lenders will once again see profitable opportunities to lend and will become more willing to do so. Strong companies with solid balance sheets will successfully navigate this period of tight liquidity and many will end up in better shape at its conclusion, with weaker competitors likely on shakier ground or having fallen by the wayside altogether. Ultimately, the entire financial system will be healthier for having gone through this trial.

Sincerely,

Gamble Jones Investment Counsel

P.S. We are very pleased to announce the opening of a new office in Portland, Oregon effective April 1, 2008.