



January 2008

Dear Gamble Jones Client:

The dreaded 'R' word has been bandied about in the media more than a little bit in recent months. Fear of a recession has created a lot of volatility in the financial markets over the second half of the year. At Gamble Jones, we believe that the U.S. economy will likely be able to avoid a recession, but will continue to experience relatively slow growth over the coming quarters. At the heart of this economic slowdown is the sub-prime mortgage debacle. We feel that this is an opportune time to focus on both what has caused this problem and the recently proposed solution to help mitigate its damage.

As is usually the case in breakdowns such as that occurring in the sub-prime arena, there is plenty of blame to go around. During the buildup of the housing bubble over the first half of the decade, many mortgage lenders sought to ride the housing wave to the fullest extent possible by generating as many loans as possible. In many cases, they did so by lowering their lending standards and approving loans to individuals with poor credit histories. Many loans were also extended without requiring either a down payment or verification of the buyer's income. Lenders also offered a variety of alternative loans, such as adjustable-rate and interest-only mortgages. These types of mortgages were attractive to many homebuyers because they offered low rates for the first 2-3 years of the mortgage, which allowed many people to pay for homes that they otherwise wouldn't have been able to afford. Once the initial period ended, the rate ballooned and many homeowners could no longer make ends meet.

Mortgage investors and credit rating agencies must also shoulder part of the blame for the current sub-prime predicament. Mortgage investors helped to finance the mortgage lenders by buying many of these questionable loans that had been packaged into securities. Many of these securities garnered AAA credit ratings, but offered higher yields than other similarly rated securities, thus making them attractive to investors. Many of these investors put too much faith in the high credit ratings of these securities without performing enough due diligence of their own. The credit rating agencies, for their part, dramatically underestimated the risks inherent in many of these securities. They relied too heavily on the historically low delinquency rates occurring at the time, not realizing that the rates were so low mainly because home prices were rising so rapidly that borrowers who fell behind could easily refinance. That game quickly ended in 2006 when home prices stopped rising, and actually began to fall in some regions. That resulted in a dramatic increase in the delinquency rate, a massive amount of downgrades by the rating agencies, and an eventual drying up of the entire sub-prime securities market.

Lastly, the sub-prime borrowers themselves also played a significant role. There is no doubt that some of these borrowers can truthfully claim that they were duped by their mortgage lenders and did not fully understand the terms of the exotic mortgages that they entered into. However, many just made the decision to live beyond their means, gambling that the price of their home would continue to rise, and hoping that this would ultimately bail them out should they run into difficulty making their monthly payments.

Unfortunately, the housing market is now in a period of decline and real estate values are depreciating. The sub-prime space, in large part due to the aforementioned errors in judgment, has completely collapsed. Many sub-prime borrowers are “upside-down” with their mortgages, meaning that their home values are less than the loan amount due. The crisis is also now spreading beyond the sub-prime universe and is threatening the economy as a whole. Home foreclosures hit their highest rate since 1972 in the third quarter and the delinquency rate is the highest since 1986.

In addition, 1.8 million adjustable-rate mortgages are scheduled to reset at significantly higher rates during the next two years. These ballooning payments threaten to severely exacerbate the housing crisis as foreclosures would dramatically increase. In an effort to prevent this from occurring, the Bush administration, working in conjunction with the mortgage industry and investors, recently unveiled a plan to help many of these sub-prime borrowers who can afford the current starter rate, but will not be able to make the higher payments once the rate balloons. Under the plan, it is estimated that 1.2 million homeowners could be eligible for voluntary assistance from the mortgage industry in one of three ways: refinancing an existing loan into a new private mortgage; refinancing a loan into a Federal Housing Administration loan; or freezing the current interest rate for five years. It remains to be seen how effective the plan will be at helping to stabilize the housing market. While it may help to reduce the wave of sub-prime foreclosures expected over the next couple of years, it is far from a cure-all.

While the sub-prime collapse has served to increase the odds that we will have a recession in 2008, the economy has remained resilient to date, and we continue to believe that we will narrowly escape a recession. We believe that, unlike before the 2001 recession, common stocks today are reasonably priced for an economic slowdown. Should a recession occur we do not anticipate anything near the type of stock market we had in 2001-2002.

We wish you a happy and prosperous 2008.

Sincerely,

Gamble Jones Investment Counsel

P.S. The Securities and Exchange Commission requires that we annually offer to our clients our Form ADV, Part II. We would also like to offer a copy of our Proxy Policy. Please contact us should you desire a copy of either document.

P.P.S. If you are in a broker-directed relationship, the SEC requires us to advise you that other brokerage firms may charge lower commissions.

Also, in order to comply with a section of the Investment Advisers Act of 1940, we are required to state the following: should any change occur in the future with respect to the organization of this firm, now a corporation, we shall advise all clients whom we are then serving of such change either prior to its effective date, or within a reasonable time thereafter; and no agreement with any client will ever be assigned to others without the full knowledge and consent of all parties thereto. Please be assured that the foregoing is a bureaucratic requirement. We do not anticipate nor are we contemplating the sale of Gamble Jones Investment Counsel.