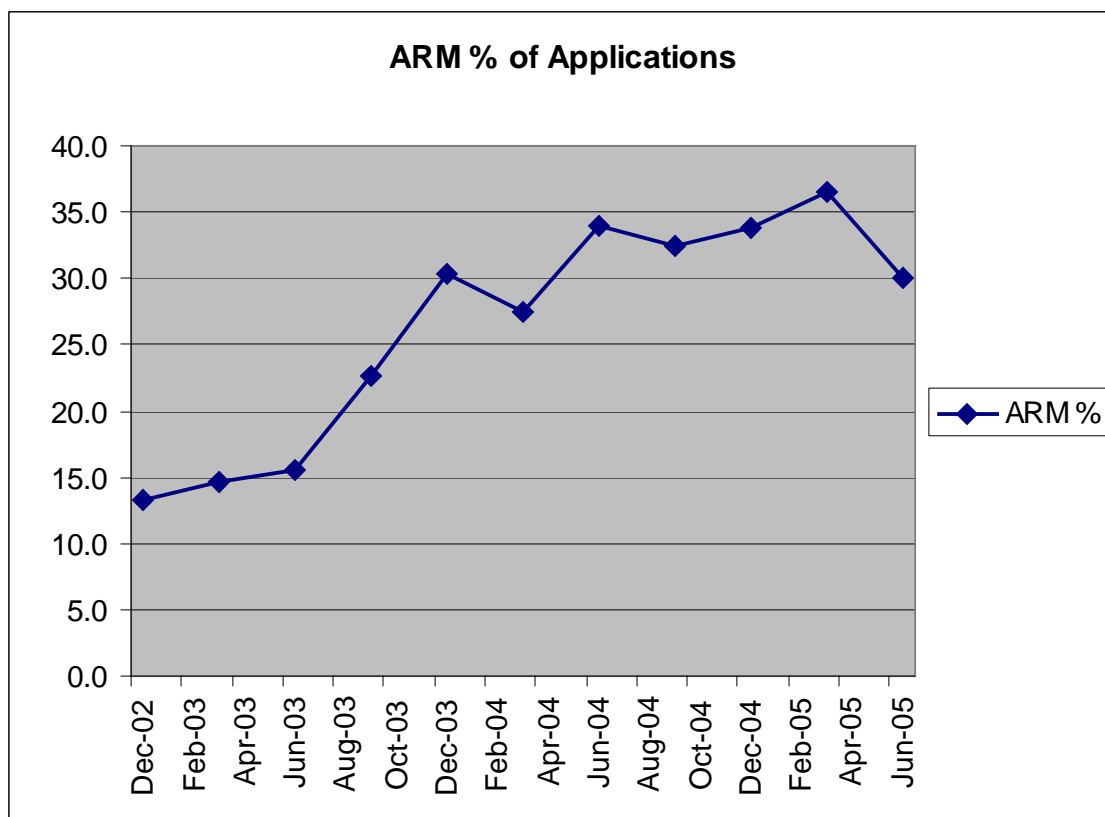




A Squeeze Play on ARMs?

We've all been aware of the growth in popularity of adjustable-rate mortgages (ARMs). As seen in the first chart below, ARMs as a percentage of total loan applications have grown nearly steadily since the beginning of 2003. According to the MBAA survey data, ARM volume has grown from less than 15% in December 2002, to over 30% in recent surveys. Only in the last quarter has the popularity seemed to have slipped some. Does the recent slip point to a more pronounced decline in ARM volume in the future?

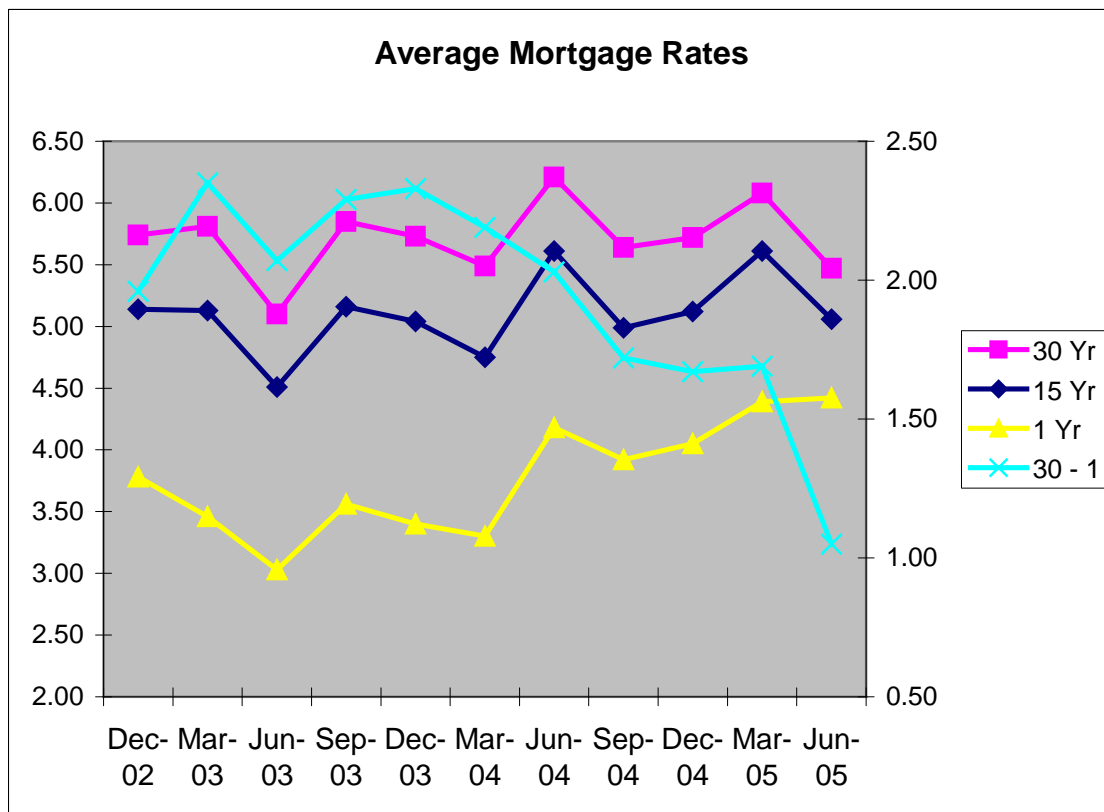


To help answer that question, it's important to look at the factors that helped lead to the growth in ARM volume over the last couple of years. One major factor in determining whether borrowers are relatively attracted to ARMs is the comparative level of rates available for different borrowing terms. If ARM rates are relatively low compared to fixed rate products, it can be assumed that ARMs will gain market share of total applications. Generally speaking, a flattening yield curve environment, like the one we've been in since the Fed began raising the Fed Funds rate, makes ARMs less attractive in relation to fixed rate products. The flattening curve describes one where short-term rates, like those backing ARM products are rising in relation to long-term rates, like those backing fixed-rate products.

Oddly enough though, over the last couple of years, ARMs have gained volume percentage in an environment where they were becoming relatively more expensive based on average rates. As seen in the



MBAA survey information below, average 1-yr ARM rates have increased in relation to 15-yr and 30-yr fixed-rate mortgages. The spread between 30-yr fixed and 1-yr ARM rates (light-blue line on the chart below) dropped sharply from 2.35% in March 2003 to only 1.05% last month. In the same timeframe, the average 30-yr rate has fallen over 30 basis points while the average 1-yr rate has increased by nearly 100 basis points.



Then, if it's not the relative attractiveness of ARM rates on the whole, what other factors may help explain the increase in market share? The answer may lie in the new ARM products that have become available. The advent of products like monthly option ARMs have given borrowers new ways to get into properties cheaper and keep monthly payments low. In addition to buyers of primary homes, this loan program has been beneficial to the growing number of short-term real estate investors and property "flippers". The low start rates for some of the new ARM programs are providing attractiveness, as is the ability to pay an interest-only or even a neg-am payment.

Given that it's reasonable to expect further Fed tightening and, quite possibly, further curve flattening, it's also reasonable to expect ARM volume percentages to decline. But with property prices high, the desire of borrowers to lower their start rates and monthly payments provides some counter-balance. It seems likely that the drop in ARM production relative to fixed-rate production will not occur at the quite the pace that it has increased over the last couple years. – *Lindsay Hill*