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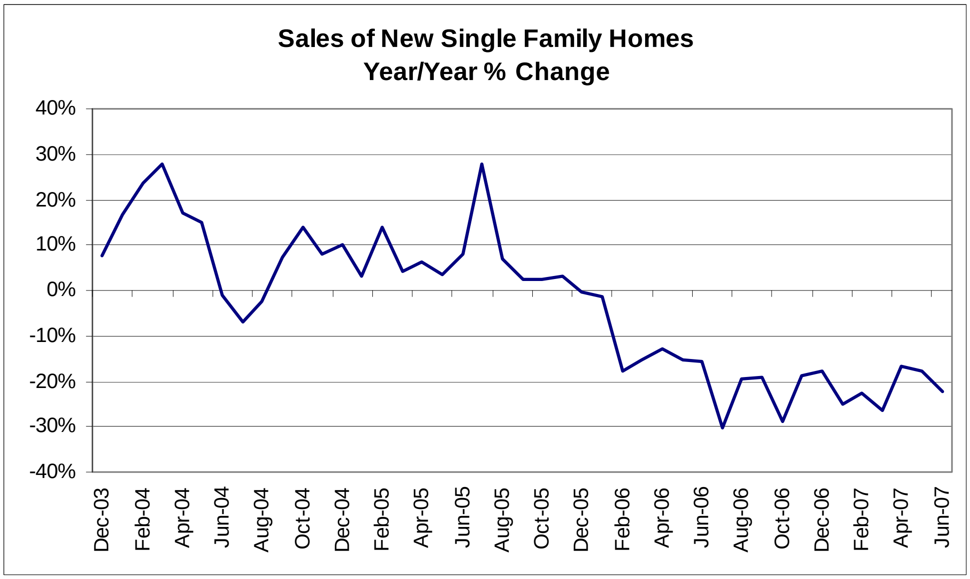
Market & Wealth Management Update

July 31, 2007

Subprime Loans, Tighter Credit and the Stock Market

The continuing slump in the U.S. housing market was not surprising in July. For months now housing data has shown declines in home prices, new and existing home sales, and indicators of future activity such as housing permits and starts. The chart below shows the trend in sales of new homes, which have been persistently weak.



Source: Bureau of the Census

The trend in housing therefore was unchanged in July, yet most equity markets declined between 3-5% from July 25th – July 31st, in large part because of spillover effects from the excesses behind the preceding housing boom.

What changed in July that triggered the decline in stock prices?

<u>There were two significant developments in the last few weeks of July that affected the markets:</u>

1. News from Mortgage Lenders: Countrywide Financial Corp, the nation's largest mortgage lender with over 20% of all U.S. mortgages lowered their earnings forecast significantly on July 25th because of a sharp increase in the number of mortgage delinquencies. Perhaps the most important aspect of their announcement was not the 24% delinquency rate in subprime loans, but the spike in late payments for higher quality "prime" loans. On the company's conference call, Countrywide's CEO described the home price depreciation they are witnessing as a phenomenon not seen since the Great Depression. This sentiment raised concern about the spillover of delinquencies to consumer activity in general and to stocks most affected by housing (home builders, retailers and financial stocks). Similarly, on the last day of the month, American Home Mortgage, the nation's tenth largest mortgage lender announced that it was running short of cash because of margin calls from its own lenders and might be forced to seek bankruptcy protection. That news, like Countrywide's announcement several days before, shook the confidence of stock and bond markets and heightened fears that higher delinquencies, mortgage loan failures and lower prices on mortgage debt could reduce both financial and consumer activity going forward.

2. Acknowledgement that "Easy Money" Was Becoming Tighter Credit: The second development at the end of July was the market's realization that deteriorating conditions and higher rates in the credit markets for mortgage bonds and riskier corporate bonds, combined with lower appetites for taking on risk in general, could be

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a drag on many kinds of financial activities as well as on stocks and bonds. The environment until recently has been one of "easy money" where borrowing rates were low, loan volumes high and risk appetites elevated. Ultimately, the change to lower risk tolerances and a tighter credit environment could be more directly significant to equity and bond markets than the slowdown in housing since it means that financing for a wide variety of activities, from mortgages to leverage buyouts and corporate debt issuance, are becoming more expensive. The change to tighter credit in the last days of July was most dramatic in the lower quality debt obligations engineered on Wall Street. Bonds associated with lower quality mortgage and corporate financing deals fell 5-15% overnight, raising a concern about large losses by both the issuers, holders and beneficiaries of such debt.

Market Statistics
<u>July 31, 2007</u>

	Level	YTD%
Dow Jones	13,212	6.0%
S&P 500	1,455	2.6%
NASDAQ	2,546	5.4%
MSCI EAFE	2,227	7.4%
Oil (WTI)		$77.80/bl
Lehman Agg Bond Index		1.8%
Federal Funds Rate		5.25%
6 Mos Treasury Bill		4.97%
2 Year Treasury Note		4.49%
5 Year Treasury Note		4.54%
10 Year Treasury Note		4.72%

Why was this second development significant to the equity markets? The ample sources of low rate, low quality debt have been providing fuel to the economy and markets for some time now. Higher rates on these types of debts will make financing less attractive. In the past week several high profile buyout deals for companies have been put in jeopardy because of the increase in rates. Meanwhile, deals that were previously announced and dependent on financing from banks may be cancelled.

Our bottom up valuation work saw these developments from a different view. While the growth of reported corporate earnings in recent years has been in double digit territory, we have increasingly noticed that the amount of real or "organic" earnings per share growth has been waning, replaced by currency effects on foreign earnings, easy credit terms for mergers and acquisitions, and massive amounts of share buybacks. Overall, most corporate balance sheets are in solid shape and companies are reporting good financial results, particularly from sales overseas, but domestically-derived earnings growth has been more tepid. The stock market's decline in July reflected concern that earnings growth could slow with tighter credit.

The bottom line for the markets in July was that investors perceived a greater amount of risk in equities and lower quality bonds because of the news related to subprime and other forms of debt financing, causing several days of more pronounced selling than in recent pullbacks, such as the Chinese stock market-led drop in late-February. At the same time, rates on safer U.S. Treasuries fell substantially as a "flight to quality" ensued.

We view the re-pricing of risk for corporate and mortgage debt as a positive development in seeking and holding quality stocks. In the meantime, the market may have to do more digesting of the change to higher borrowing costs and the perception that risk will be priced more rationally. One silver lining is that global economic growth is relatively strong, which may offer a cushion for the slowing U.S. economy and stocks with foreign earnings.

As we've written for several quarters, higher volatility may be one characteristic of this year's market. But the increased perception of risk and tighter credit will also create excellent value opportunities for patient investors.

We look forward to discussing these developments with you in the near-future.

Christopher H. Lyford

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Acadia Trust, N.A. is a Maine-based wealth management firm, with a research-based, value-oriented style of equity investing and a high quality approach to fixed income investing. As a trusted advisor to our clients, we provide portfolio management, trust, estate, financial planning and retirement plan services throughout New England.

At Acadia Trust, we distinguish ourselves through our disciplined investing, our team-oriented approach and our dedication to providing a client experience "second to none." For more information, please contact Tamara Gifford at (207) 775-3820 for Individuals, Trusts or Endowments; Connie Worcester at (207) 299-1320 for Retirement Plan Services.