Will Mortgage Delinquencies Derail the Economy?

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This week, the Mortgage Bankers Association (MBA) released their quarterly survey on mortgage delinquencies and foreclosures for the fourth quarter. This set off a rash of stock market selling in the U.S. that spread around the world. The media, always quick with alarmist rhetoric, fanned the fire and heightened fears with front page stories of how a crisis in sub-prime mortgages was going to sink the economy and the financial markets. The good news is that, historically, when the press is trumpeting calamity and investors are throwing the baby out with the bathwater, that has often been a sign that the markets are getting close to a buying opportunity. Although there may be some more near-term pain in the equity markets, we believe opportunities are often created at the point of maximum pain. Investors should be looking to buy, rather than to sell.

Correction in a bull market

At times like these when anxiety is high, it is useful to take a deep breath, step back and regain perspective. We do not believe the recent pull back is the start of a bear market but rather a correction in a bull market. The stock market has merely retreated to the levels we saw in November after a huge run-up during the summer. In our opinion, by late October of 2006, the market had become overextended and overbought as investors became overly optimistic. From that perspective, the market was due for a correction. In late October and again in December, we reduced our recommended allocation to stocks out of concern that the market had become too one-sided and increasingly vulnerable to bad news. The bad news came in February, when the market was hit first with a big drop in Chinese stocks, then with concerns about the yen carry trade and more recently, with worries that the sub-prime mortgage market problem would spread and trigger a recession. Weaker than expected economic reports have aggravated these recession concerns.

Recession concerns are overblown

We believe that recession concerns are overblown and that unseasonably cold weather is playing havoc with many of the economic statistics. As we move into the spring, economic growth data should firm, assuming that fears do not undermine the economic environment. Even if you accept the current economic numbers at face value, they are consistent with GDP growth at or slightly below 3%. Moreover, we do no see any fundamental reason to expect a recession at this time. Consumer incomes and balance sheets are solid. Corporate profits, although likely to slow, are healthy. There are signs that housing has stabilized, which should remove a 1.2% drag on economic growth. Finally, exports are growing faster than imports. The greatest risk to future economic growth is that fear undermines consumer, business and investor confidence.

Anxiety over sub-prime loans is overdone

There have been a lot of horror stories over the last few weeks about the risks posed by the sub-prime mortgage "meltdown." Although we expect more bad news on this front, we believe it is mostly a problem for lenders who issued this debt and not for the economy in general. These lenders deserve to get clobbered. If a company's business plan is to make low variable rate loans with nothing down to unqualified borrowers with lousy credit histories, it shouldn't be surprising when these borrowers don't repay or are slow to pay their debt. However, some perspective is in order. Prime (higher credit quality) mortgages still make up about 75% of mortgage originations. While sub-prime lending has grown over the last four years from about 4% to 13.6% of originations, it has largely taken market share away from FHA and VA loans, which have fallen from about 20% to less than 10% of originations. This is because government-backed loans became tougher to qualify for as homes appreciated faster than the lending caps on these loans. The median home price in many markets rose well above the FHA loan limit of $362,790. Sub-prime lenders filled the void left by the failure

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of government lending requirements to keep up with market changes. Government loans, like sub-prime loans, tend to be of lesser quality and are often made to low income borrowers. We have always had low quality loans; this is not a phenomenon specific to just this cycle. In essence, the composition of loans has changed, but the quality of loans has not. The delinquency (30 days past due) rates of FHA and sub-prime lenders at the end of the fourth quarter were essentially identical at 13.46% and 13.33%, respectively. We are probably hearing more about the sub-prime mortgage market's problems because Wall Street, and not government, is feeling the pinch.

Although the trends in the number of high-risk mortgage delinquencies and foreclosures have been rising, they appear to be no worse than in prior housing cycles. Of the nearly six million sub-prime loans in the MBA survey, 7.8% were seriously delinquent (90 days or more late). While up from 6.5% a year ago, this delinquency rate is still considerably below the peak of 11.5% set in 2002. Seriously delinquent loans plus foreclosures rose to 2.1% of total mortgages outstanding, which is still below the record peak of 2.4% in 2002. Housing has been in a severe recession for over a year, much worse than in 2002. As a result, it is surprising that delinquency and foreclosure rates are not higher. Rising delinquencies should be expected and are part of the cycle. The good news is that they are lagging indicators and tend to spike as the housing cycle begins to turn up.

We are not looking for an imminent upturn in the housing sector. However, we would not be surprised if housing were on a firmer footing in the second half of the year and at least not a drag on economic growth. In the meantime, delinquencies, foreclosures and loan write-downs are likely to continue to rise. Nevertheless, we don't think there is much risk of financial contagion or a credit crunch. The high risk mortgage area is not that large, and foreclosures, even assuming unprecedented default rates, are not that significant in a $21 trillion housing market with $9.5 trillion in mortgage debt. There should be considerable residual property value behind foreclosed properties, and loans should not be total write-offs even if discounted significantly.

Most major lenders tend to have well diversified portfolios of loans and investments, allowing them to manage the risk of exposure to sub-prime loans. Major lenders also securitize their loans, repackaging and selling loans to investors, to help spread risk. In addition, most major lenders hedge their exposure and are very adept at managing risk.

In summary, we do not believe there is a systemic risk to the economy or the stock market from higher risk loans. The composition of the mortgage market is not much riskier than in the past. The risk in the higher risk area of the market is not that significant, even assuming much higher foreclosure rates. Major lenders are well insulated from a serious meltdown. The housing market has been in a long, severe recession. Rising delinquency rates are normal and typically a sign that we are near the bottom of the cycle. It would not be surprising to see a housing recovery later in the year. Outside of much higher interest rates and massive job losses (which we don't think is likely), the greatest risk to the economy is a contagion of fear that undermines confidence.

Sources: Bailard Research, Yardeni Research, Mortgage Bankers Association, National Association of Realtors, Ned David Research.

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