Forecasts & Trends
Is a Subprime Recession Inevitable?
By Gary D. Halbert

The title above is indeed the question on the minds of investors around the world. In the wake of the market turmoil over this past year and the troubles in the credit markets, it is certainly fair to say that the odds of a U.S. recession this year or early next year have increased. I find little disagreement on that point. Likewise, it is still uncertain just how bad the credit crunch will become. So, it is naïve to rule out the possibility of a recession in the months ahead.

At the same time, I think it is equally naïve to assume that a recession is inevitable, just because of what's recently happened in the markets. There's an old saying: ***The stock market has accurately predicted nine of the last three U.S. recessions.*** Think about that. Along that line, might the latest plunge in the stock markets merely be the long overdue downward correction we have all been expecting, rather than a harbinger of recession?

While it remains to be seen just how widespread the subprime and related problems are (although most estimates are still generally in the $50-$150 billion range) and how bad the credit crunch might become, we have been through several similar periods over the last 20 years. In the pages that follow, we'll look back at those prior credit crunches and see what happened.

We'll also look at the estimates of the current subprime mortgage carnage. I will present some information you may not have seen elsewhere. For example, you may not know that mortgage lenders historically have assumed that 10 – 11% of all subprime mortgages granted will default. We don't hear that in the media. Also, the Federal Reserve indicates that only about 30% of all subprime loans are of the type likely to experience a large increase in payments in the near future. The media doesn't talk about that either.

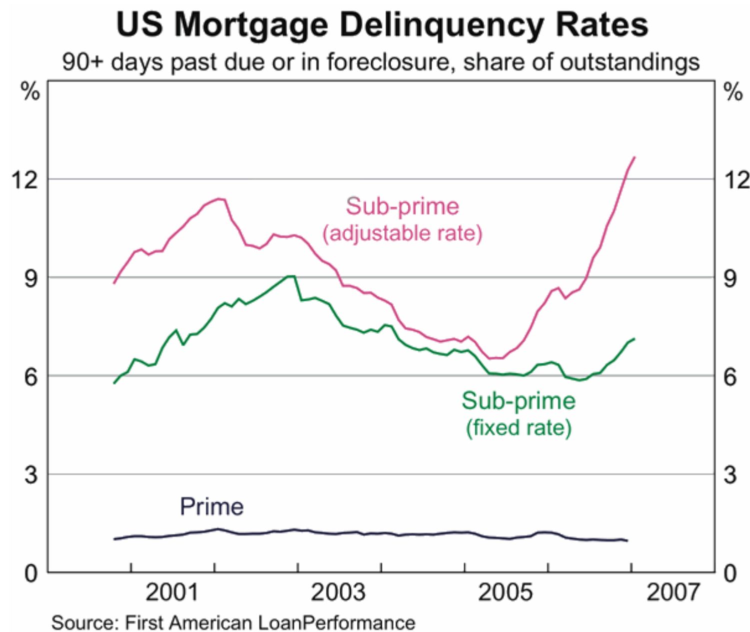
How Bad is the Subprime Mortgage Problem?

As is usually the case with any real or perceived credit crunch, there are always those who spew fear, warn of calamity and inflate the estimates of potential losses. The gloom-and-doom crowd is having a field day with the subprime mess. Having said that, there is no question that the subprime and related mortgage dilemma is a serious problem that has negatively affected almost all areas of lending, and the equity markets as well.

There is no shortage of market analysts and respected research groups that failed to see the magnitude of the subprime meltdown, including The Bank Credit Analyst. Many believed that the subprime problems would not spill over into the broader financial markets. But as we all know now, the subprime contagion has negatively affected not only the prime mortgage market but also the banking system and the U.S. and global equity markets.

Given the volumes of materials that have been written and disseminated on the subject of subprime mortgages (just Google it, and you'll see), I will not attempt to go into detail on how the subprime train wreck developed. Not unlike some past credit crunches that involved real estate, the subprime problem is the result of greed on the part of mortgage lenders that offered home loans to people with weak (or no) credit history that could not

qualify for a traditional mortgage. The default rates on subprime loans have always been higher than prime mortgages.
Making matters worse, over the past couple of years, millions of these subprime loans were made with no down payments, and at very low "teaser" interest rates that were set to increase, in most cases significantly, after the first year or two. Add to that the fact that we entered a housing slump last year. As a result, delinquency rates on subprime mortgages began to skyrocket last year, as you can see in the chart below.



The question is how big is the subprime dilemma? It is generally agreed that there are approximately 50 million outstanding home mortgages in the US, and of that, approximately 15% are subprime mortgages. What is not known for certain is what percentage of the outstanding subprime loans have defaulted already and how many more will default in the near future. What we do know is that the numbers are large, but how you define "large" is a matter of great contention. To help us understand, let's look at the graphic below which was produced by **H&R Block.**

There are approximately 110 million households (HH) in the United States.

30% of households reside in an apartment = 33 million HH
70% of households reside in a home = 77 million HH.

Of the 77 million HH residing in a home…
35% own their home outright = 27 million HH
65% have a mortgage = 50 million HH

Of the 50 million HH that have a home mortgage…

Subprime ARMs OR

7.9% of mortgage holders have a Subprime ARM = 3.95 million HH
Or, in terms of total U.S. Households – 3.95 million is 3.6% (i.e., 3.6% of all U.S. households have a Subprime ARM)

Given the $9.68 trillion in mortgages outstanding in the U.S. at the end of 2006…Subprime ARMS (equal to 7.9% of mortgages outstanding) = about $764.4 billion as an approximate total dollar value

Historically, Subprime ARMs have had an AVERAGE delinquency rate of 11% to 14%. Recently, this rate had risen to 15.75%. So, if a lender conservatively assumed only 10% would go delinquent this would equate to… $76.4 billion

If we aggressively assume 20% go delinquent… this equates to $152.9 billion

Thus, the "risk" is the difference between the assumed delinquency rate and the actual rate or in this example, a risk of **$76.5 billion**. A large number, but not exactly earth shattering

Total Subprimes

13.7% of mortgages are Subprime (both Fixed and ARM) = 6.85 million HH
Or, in terms of total U.S. Households – 6.85 million is 6.2% (i.e., 6.3% of all U.S. households Subprime mortgage either Fixed or ARM)

Given the $9.68 Trillion in U.S. mortgages outstanding at the end of 2006…Subprimes in total (equal to 13.7% of mortgages outstanding) = about $1.326 trillion as an approximate total dollar value

Historically, all Subprime mortgages have had an average delinquency rate of 10% to 11%. Recently, this rate had risen to 13.8%. So, if a lender very conservatively assumed only 10% would go delinquent this would equate to… $132.6 billion

If we aggressively assume 20% go delinquent… this equates to $265.2 billion

Thus, the "risk" is the difference between assumed delinquency rate and actual rates or in this example, a risk of **$132.6 billion**. Again, a large number but not economically threatening.

Data Sources: HRBFA, Federal Reserve, Mortgage Bankers Association, U.S. Dept. of Census

There are countless ways to analyze and dissect the many different statistics surrounding the subprime meltdown. What the analysts at H&R Block point out, in a nutshell, is that there has always been an assumed delinquency/default rate with subprime loans, just as there is with prime mortgages. What the graph above illustrates is what the potential incremental losses would be if subprime defaults rise from 10-11% to 20%.

If the subprime Adjustable Rate Mortgage (ARM) default rates rise to 20%, then the potential loan losses – in excess of those already planned for - would be in the neighborhood of **$76.5 billion**, as noted above**.** If the default rates for subprime ARMs and subprime fixed rate mortgages rise from 10-11% to 20%, then the potential loan losses – again, in excess of those already planned for – would be in the neighborhood of **$136.2 billion.** These are H&R Block's numbers, but you can see their sources noted below the graph. It is also worth noting that not all mortgages that become delinquent end up defaulting.

Estimates of the subprime carnage are all over the board, but most of the estimates I have seen are in the $50-$150 billion range. Granted, $50 billion or $150 billion *is* a big number. **But either number is not enough to sink the mortgage industry at large, or the big banks, or the economy – in my opinion.** Loan losses have sunk a lot of mortgage lenders, and others are likely to follow. However, an argument can be made that these entities needed to fail in light of their ridiculously lax lending policies.

Fed Chairman Ben Bernanke estimated recently that subprime losses could be as much as $100 billion, the mid-point of the range noted above. $100 billion equates to approximately 0.7% of GDP – not enough by itself to send the economy into a recession. By comparison, in the Savings and Loan debacle in the early 1990s, the total loss in bad debt was estimated to be around $185 billion, which equated to 3% of GDP at the time.

Crisis in Confidence

If we agree that subprime losses of $50-$150 billion are not life-threatening to the economy, then what is driving all the fear and heightened volatility in the marketplace? Basically, it is a crisis in confidence. Everyone is concerned with everyone else. Who is holding subprime debt? How much do they hold? We read that the big banks are reluctant to lend to each other.

We also read that these same banks have sent "margin calls" to the many hedge funds they deal with. To meet margin calls, many hedge funds have been forced to sell their liquid securities because they can't unload their subprime portfolios. Many hedge fund investors, understandably, have grown wary of their fund managers, fearing that the fund(s) they are in may be the next to blow up due to subprime issues. Some hedge funds have been forced to suspend redemptions. **The Economist** magazine described it as follows:

"…the swings in almost all financial markets this month have made dispersed risk suddenly morph into dispersed mistrust. The uncertainty has been magnified by the way that bad risks have become so hard to value. Investors have bought asset-backed securities that use shaky subprime mortgages in America as collateral, but as defaults

have risen, the value of that collateral has tumbled. Meanwhile, collateralised-debt obligations (CDOs), made up of clumps of those securities and laced with leverage, have become almost impossible to trade. So none of the players really knows how much he has lost. While this uncertainty lasts, investors are taking it out on the banks that peddled the securities by dumping their shares; and the banks are taking it out on those they sold them to by demanding more collateral on their loans. The banks have even grown cagey about lending to each other."

There has been a huge flight to safety over the last month as the crisis in confidence has grown more intense. People have flocked to the safety of US Treasuries. At the beginning of August, the 90-day T-bill rate was near 5%. But in the last half of the month, huge demand for Treasuries caused the 90-day T-bill rate to plunge to 2.6% at the low. It has since risen back to near 4.2%.

Fortunately, confidence seems to be recovering, but no one knows if the worst is past.

Are Subprime Fears Overblown?

To hear the media reports and the gloom-and-doom crowd, you might assume that *ALL* subprime loans are in trouble. That is certainly not the case. Likewise, not all subprime loans were made with no money down. Not all subprime loans were interest-only loans. Not all subprime loans had "negative amortization," which means the borrower paid even less that the stated interest rate. And not all subprime loans included "resets" to a substantially higher payment after the first 12-18 months.

You might not be aware (because it is rarely pointed out) that there are "fixed rate" subprime mortgages that do not reset, and there are subprime mortgages of all types that are paying on time and may well continue to do so. I looked long and hard to find statistics on this issue, and finally found them at the Federal Reserve Bank of St. Louis. Read the following carefully.

According to the St. Louis Fed, only apprx. 30% of the total subprime mortgages were of the riskiest type – interest only, negative amortization, etc. - based on data from 2004 through 2006. Of the remaining 70%, 45% are ARMs where both principal and interest are being paid. The other 25% of the subprime market are fixed-rate mortgages, which will experience no increase in payments at all over time. So, the biggest risk is in the 30% of subprime loans that may experience a significant increase in payments, not in the 70% that will either have no, or moderate, payment adjustments.

Keep this information in mind as we are deluged daily with media reports that would have us believe that all, or substantially all, subprime mortgages are going to default. That is simply not the case. In fairness, the St. Louis Fed data above does not include the significant number of subprime loans that were made in 2007. The data above does not ignore the fact that large numbers of subprime mortgages will reset to higher (in some cases much higher) interest rates in the next 12-18 months. **But remember, we are talking about only apprx. 30% of all outstanding subprime mortgages, plus whatever percentage of problem subprime loans that were added this year.**

The discussion and data noted above are not meant to minimize the problems that we will experience as a result of the subprime dilemma. The news cycle surrounding subprime

debt, and especially increased numbers of defaults and foreclosures, will get worse before it gets better. And the reporting of the subprime problems will not go away anytime soon, especially when the interest rate resets kick in over the next 12-18 months or longer. I merely bring the data above to your attention because you are not likely to hear it elsewhere.

Conclusions

To answer my own question in the title of this article **No, I don't believe a recession is inevitable** in this cycle. While the subprime and related mortgage problems are very serious, I think the odds are relatively low that they will tank the economy, especially in light of the St. Louis Fed data I have presented above. The crisis in confidence seems to be getting better, especially with the cut in the discount rate and some encouraging language from the Fed.

If the US is to avoid a recession, US consumers have to remain reasonably confident. In July, consumer confidence hit a six-year high, but then took a major hit in August. It will probably take another hit before recovering. So we have to watch and see if consumer spending holds up reasonably well.

The other thing we have to watch closely is the default rates on subprime and related mortgages. Loan losses in the $50-$150 billion range are bad, but are very likely manageable as discussed above. But if default rates more than double their historical norms, it not only increases the losses, but it also means many more homes on the market, which could depress home prices. And that puts us right back to consumer confidence.

Needless to say, the months ahead could be dicey. The markets will very likely continue to be very volatile just ahead, but hopefully we have seen the lows in the broad equity indexes.

Remember, the fasten seatbelt light is still on. Wishing you profits.

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is $197 for 12 issues and may be obtained by visiting his website at www.profutures.com.