INVESTMENT UPDATE
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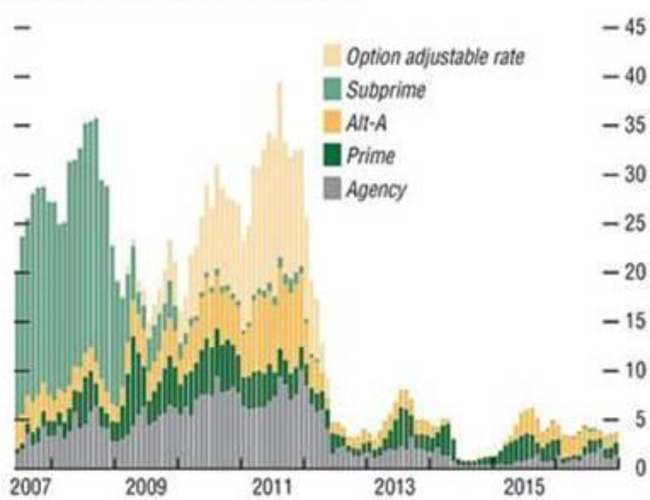
A New Mountain of Mortgage Resets

This month's first graph comes to us from Credit Suisse by way of John Hussman, Ph.D. It nicely illustrates some concerns we've shared before.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Secondary source: www.hussmanfunds.com

The first mountain – massive subprime loan resets in 2007-2008 – is behind us. For the better part of a year now we've been in a happy valley where there have been fewer resets altogether, and the bulk of them have been Prime and agency mortgages (i.e. higher quality credits to start with).

Now, though, a craggy peak heaves into view: two years of Alt-A and Option ARM resets dead-ahead. "Alt-A" refers to loans whose quality at origination was deemed better than subprime but worse than Prime. Option ARMs enable borrowers to choose whether or not to pay principal for a teaser period, or even to pay less than full interest, thereby increasing (negatively amortizing) the loan balance. I'll focus on the latter.

In an early autumn report, Fitch Ratings found the following:

- Nearly half of Option ARMs are 30+ days delinquent, and over a third are 90+ days delinquent, in foreclosure or REO process
- The average Option ARM loan-to-value has deteriorated to 126% (i.e. loan balances are a quarter higher than what their underlying properties are worth).
- $134 billion in Option ARMs are expected to reset in the next two years, which means that borrowers accustomed to paying interest only (or just partial interest!) will have to start paying full principal and interest, in some cases at higher reset rates (initial teaser rates having expired).

All of which leads to a simple equation:

negative equity + payment shock = rising defaults

There are some good things to note, however. The Option ARM resets are a smaller proportion of the overall mortgage market than were the subprime loans that started flying apart back when the stock market was still climbing towards its all-time highs. The reset period for this vintage of Option ARMs has a built-in expiry; it will come and go within 24 months. Lastly, everyone from policy makers to bankers to investors should know by now that this ugly hump lies right ahead; it should come as no surprise, right?

Then again, subprime was never that big a part of the overall mortgage market either, which led to a false sense of confidence at the time (though not on these pages!) that the problem was "contained." Also, while this reset bulge will come and go, it's likely to do so at a time of acute stress for household incomes – even if the recession is over, unemployment can rise for the next 6-18 months without straying from precedent (jobs typically lag recovery): resets and unemployment look like they may peak uncomfortably close on the calendar. The subprime deterioration and resets were no surprise either; yet plenty of smart, well-informed people chose not to walk away from the party but rather joined Citigroup's Chuck Prince in "dancing for as long as the music plays."

We remember other times when bad things were sure to happen but didn't (Y2K, anyone?). Even so, with credit still shrinking, we don't see how this plays out free of pain or volatility.