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YIELD SIGNS: REAL ESTATE

U.S. housing bubble has the potential to blow up real good



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I don't subscribe to the theory that because of a couple of benign recent U.S. housing statistics, there's going to be the fabled "soft landing" and now is a good time to buy a house. I mean in the United States, of course, since Canada so far has neither the myriad variants of exotic mortgages that our American cousins are so fond of (though there are ominous signs of some pushing of the traditionally staid mortgage envelope up here), nor the perverse incentives of interest deductibility. (If you're frugal and pay off your mortgage principal faster, your income taxes go up, so why not extract your equity instead and buy a TV the size of a Cineplex screen?)

No, I'm in the camp that thinks we're only seeing the first leg down in what BMO Harris's chief strategist Don Coxe refers to as a Triple Waterfall Event (see http://www.donaldcoxe.com/triple_b.html). The portents of that parlous occurrence are not to be found in the official stats, but rather, on the margins of the housing market.

Official statistics are so massaged and seasonally adjusted and weighted-averaged and smoothed that I often find them hard to believe. It seems like only yesterday (Dec. 12, 2005, actually) that the National Association of Realtors was predicting that the U.S. national median house price would rise about 6.1 per cent in 2006. After all, gushed NAR, over a full year, the national median price "has never declined since good record keeping began in 1968."

After the recent "good" news about the U.S. housing market, the median price was still down about 2 per cent for the first 11 months of 2006. That makes that NAR forecast fairly embarrassing, but the market has discounted the actual small drop as a mere healthy correction, hardly the harbinger of an incipient downward cascade in house prices -- or at least, not yet.

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Still, out on the margins, where the positive feedback mechanisms that inflated the bubble were born, out where the interest-only and 120-per-cent loan-to-value mortgages, the negative amortizers with "teaser" rates and the option ARMs (adjustable-rate mortgages) live. This is "subprime" country. "Prime" loans are ones where the odds favour eventual repayment. With subprime loans, that's not necessarily the case.

From 1994 through 2003, subprime mortgage lending grew at an annual rate of 25 per cent, up tenfold in nine years. In 2005 and the first three-quarters of 2006, lenders made \$900-billion (U.S.) in subprime loans. As of September, 2006, 80 per cent of all subprime mortgages were "Option ARMs." ARMs usually have features like "minimum payment options" (the principal you owe gets bigger over time), or "interest-only" payments (you never pay it off and had better hope house prices only ever go up). One out of every three home buyers in the first eight months of 2006 got some kind of pay-option mortgage -- that's up from one in five in 2005 and only eight out of a thousand in 2003.

Usually ARMs are referred to as 2/28, meaning payments are low for the first two years, and then increase by 40 or 50 per cent for the next 28 years. There is at least \$1-trillion worth of option ARMs (41 per cent of the total outstanding) whose payments will increase in 2007, though I've seen estimates as high as \$2-trillion.

Adding spice to the mix is that a staggering 45 per cent of these subprime loans required "low documentation," real estate parlance for don't ask, don't tell. ("You want a half-million-dollar loan to buy a house, have no down payment, and you haven't worked in five years? Okay, we didn't hear that last part. You're approved."). Fully 38 per cent of all subprime mortgages in 2006 were for 100 per cent of the price of the house.

In the third quarter of 2006, 12.5 per cent of all subprime loans were already delinquent on their payments after nine months. In the past month or so, seven subprime lenders have gone belly up. Perhaps a level of documentation greater than "low" would have been more appropriate?

Lenders don't want to keep these high-risk loans on their books, so it is not surprising that the majority of these mortgages are securitized, packaged and sold to investors. Naturally, there are all kinds of sophisticated hedges, derivatives and other methods for offloading this risk onto the credulous (see Harry's First Law of Capital Markets, "Make the Stupid Pay"), but none of them, as Don Coxe might say, have ever tried to shoot the rapids of a Triple Waterfall.

This is scary because, according to a recent study by the Center for Responsible Lending (a U.S. non-profit), one out of every five subprime mortgage loans made in the past two years will go into foreclosure. That would mean 1.1 million houses getting repossessed by banks, vaporizing \$74.6-billion in homeowners' equity.

The banks will sell the repossessed properties as quickly as possible, driving house prices lower, triggering more foreclosures, putting more excess properties on the market, driving prices lower and, well, you get the idea -- a negative feedback loop, the mirror image of the one that built the bubble.

Now, I'm not saying this is going to happen -- only that it could, and while bubbles are lots of fun when they are inflating at exponential growth rates, let's hope we don't have to find out just how ugly this one can be when it is deflating exponentially.

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