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BEACON POINTE RESEARCH

SUBPRIME AND BEYOND
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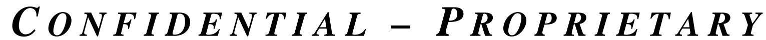

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Overview – Subprime and Beyond

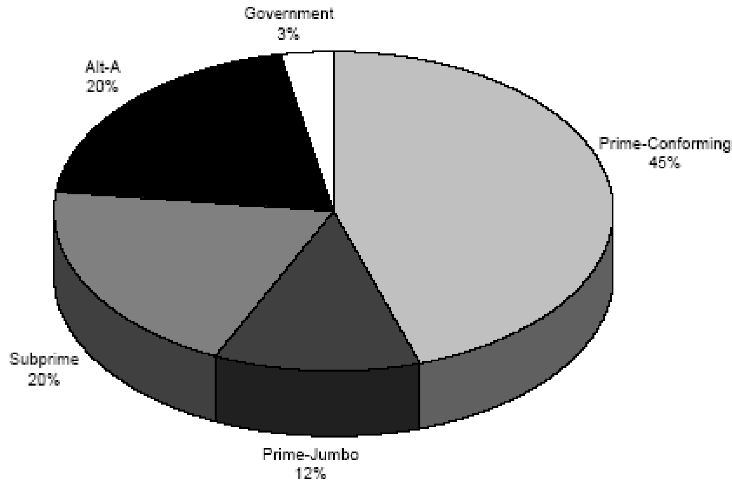
Newspaper headlines are constantly reminding us of the numerous financial institutions filing for bankruptcies due to high exposure to subprime borrowers who have now started defaulting on mortgage loans. However, the larger question is, will the decline in housing have a ripple effect on homeowners up the credit ladder to Alt-A and prime borrowers, and if so, what impact will it have on the US and global economy?

Beacon Pointe Research met with many money managers in recent times to seek their opinions as well as researched several publications in the industry to obtain a sense of what is in store for investors. At this point in time it is rather unclear as to whether or not there will be an impact on the economy because of subprime loans.

Subprime and Beyond

As mentioned above, in recent times, the newspapers have been flooding the market with dismal news regarding subprime lenders filing for bankruptcies or liquidating, resulting in many people losing their jobs in the industry. To obtain a sense of the scope of the subprime issue, let us review the mortgage distributions based on the credit profile shown below in Figure 1:

Figure 1



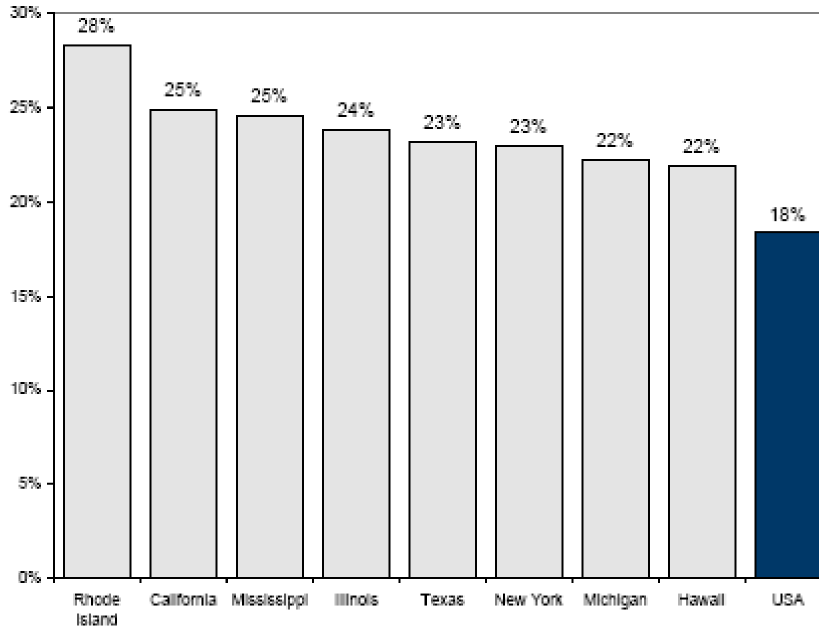
Source: Inside Mortgage Finance, MBA, LEHC, Credit Suisse U.S. Mortgage Strategy, Credit Suisse analysis

Adapted from Mortgage du Jour: Underestimated No More – Credit Suisse

As seen from above, the subprime borrowers comprise about 40% and the Alt-A borrowers (above subprime but below prime borrowers) another 20%, for a total of 40% of the borrowers. The subprime share of the market was only about 7% in 2001 and has since then steadily increased to a 20% share of the market.

The graph below (see Figure 2) shows the states with the highest subprime exposure:

Figure 2



Source: Loan Performance, Credit Suisse U.S. Mortgage Strategy, Credit Suisse estimates.

Many of these subprime borrowers have been able to purchase homes with little or no money down, sometimes with low or no documents verifying their ability to repay the lender.

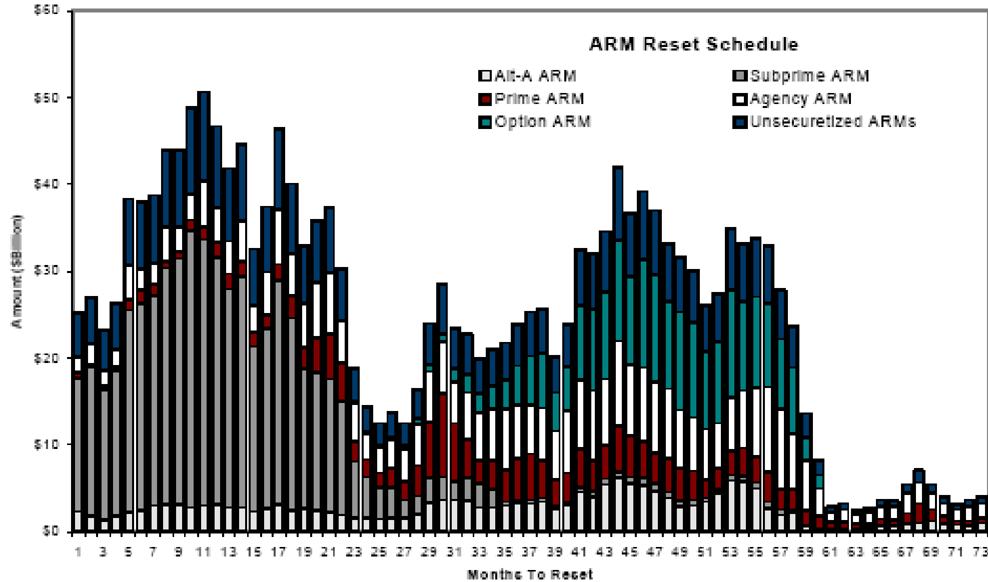
Several other issues have not garnered much attention due to all the noise surrounding the subprime issues. As Mr. Mark Kiesel from PIMCO puts it succinctly, prime borrowers will also be affected. The following is his quote taken verbatim from a recent interview:

"Everyone's looking at subprime. The rock they aren't looking under are the adjustable rate mortgages and teaser rates and low money-down loans. It's going to affect prime as well." – Mr. Mark Kiesel, a portfolio manager for Pacific Investment Management Company, Newport Beach, CA.

In 2007, there is an estimated $500 billion of loans that will be reset to higher rates from the lower, teaser rates. In addition, many borrowers have opted for the interest only and negative amortization loans that can pose a problem when the property value declines and these borrowers are forced to refinance due to resets at higher rates. Figure 3 on the following page shows the estimated loan amounts to be reset in the next few years.

Figure 3

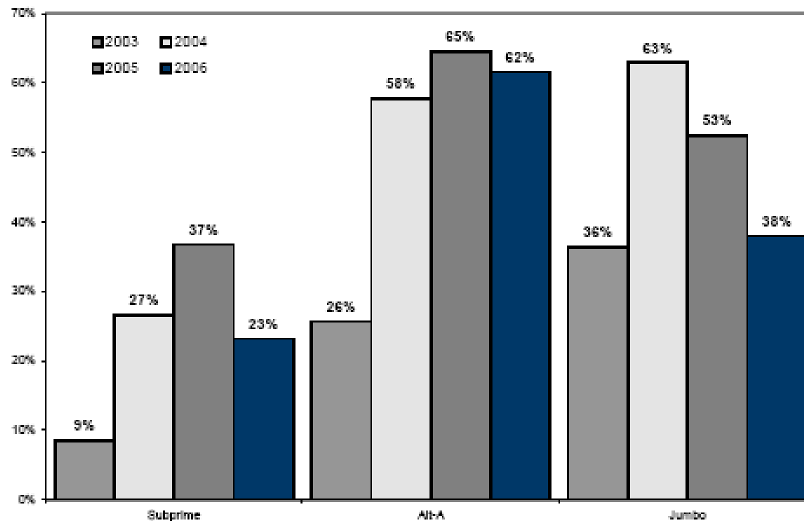
~$500 billion of ARMs (~5% of total mortgage debt outstanding) scheduled for first-time resets in 2007



Source: Credit Suisse Fixed Income

The chart below (Figure 4) shows the share of interest only and negative amortization loans among the various types of borrowers:

Figure 4

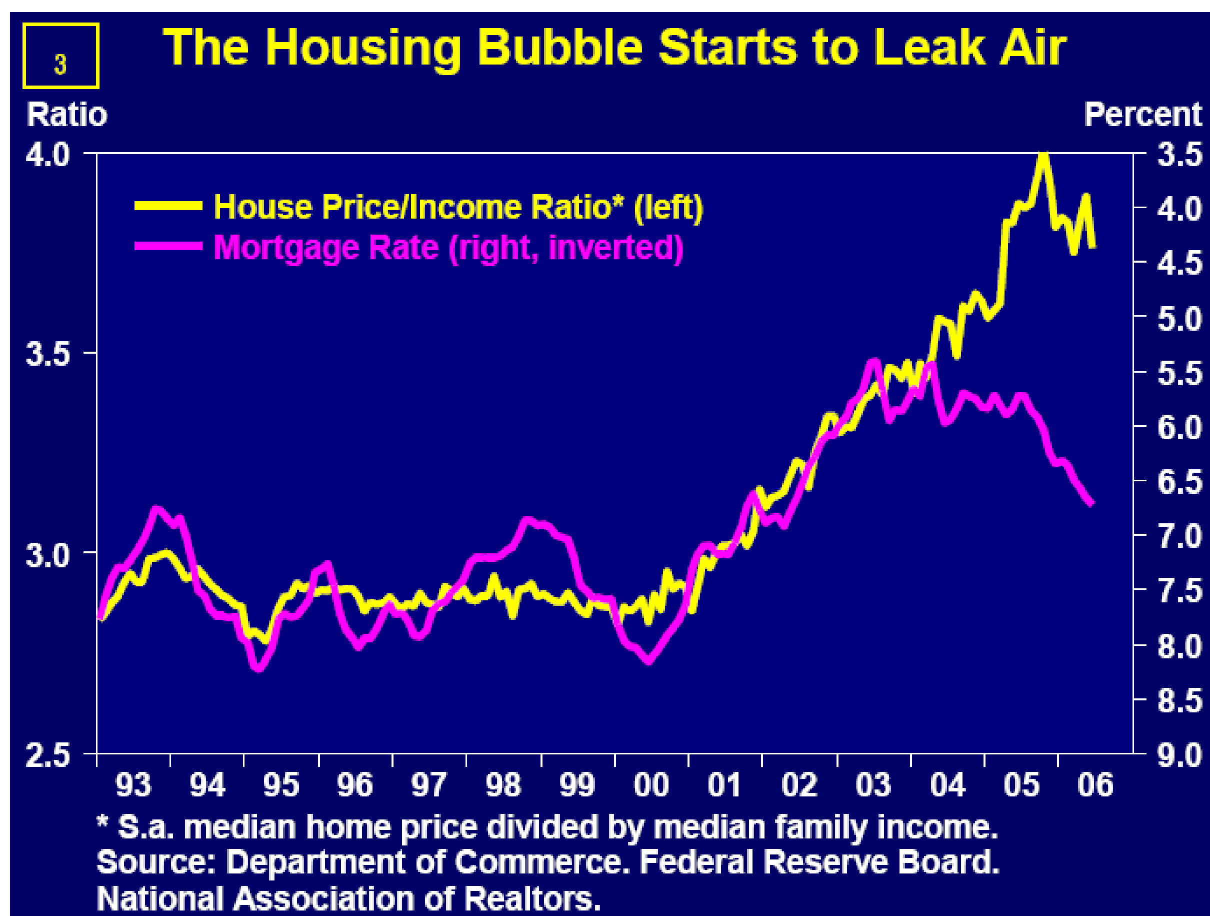


Source: Loan Performance, Credit Suisse analysis.

As a result of the increasing default rates, lending institutions have started tightening credit standards with fewer borrowers now qualifying for loans. Also, with the Fed increasing interest rates from an extremely low level of 1% to stroke the economy along in 2002, to the current 5.25%, along with higher home prices, the number of potential homeowners is decreasing.

As such, in many local markets, home prices have started declining. Many of the speculators who entered the game starting in 2004 in the hope of making a quick buck are bound to be disappointed. The chart below illustrates the disconnect in house price/income ratio and mortgage ratio and is indicative of the bubble like environment prevailing in the residential real estate markets in recent times.

Figure 5



Adapted from Goldman Sachs – US Economic and Financial Outlook – The Transition to Fed Easing

Ironically, Goldman Sachs and other well known firms have been predicting since last year, that the Fed would start easing as a result of the housing slowdown. The above chart has been taken from a presentation given by the Chief Economist at Goldman Sachs in August 2006. However, we believe that continuing inflationary pressures will more likely keep the Fed holding the interest rates steady for longer than most people think. The Fed is even likely to raise the interest rate moderately. This might roil the financial markets for a short while only to chug along as investors realize that global

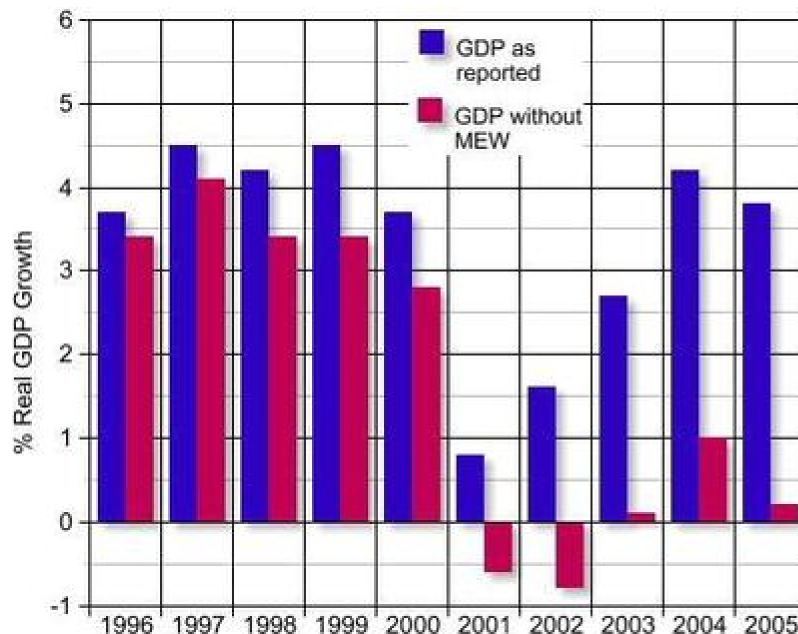
growth will continue to be fairly healthy due to the strong growth prospects in Asia and modest growth in Europe and Latin America. We believe that global growth will not be as US centric as it has in the past and thus it pays to have an allocation to international and emerging markets to achieve long-term financial goals.

Housing, though it comprises only 5%-6% of GDP, is crucial to the state of the overall economy. That is because as long as home prices go up creating a wealth effect, consumers will continue to spend. As we all know, consumer spending comprising about two-thirds of the GDP is critical to the state of the US economy.

Although long-term studies show more of a correlation between consumer spending and incomes, recently, mortgage equity withdrawals (MEWs) contributed significantly to the overall GDP growth. Figure 6 below illustrates what the GDP would have been without the contribution to GDP from consumer spending stemming from MEW. When this chart is updated to include 2006 data, we will forward it to our readers.

However, the clear takeaway from this is that economic growth in recent times in the US has not been as broad-based as most people believe. Over two-thirds of the growth came from housing related activities – primarily construction and consumer spending using MEW as a tool.

Figure 6



Source: Calculated Risk

We believe that the housing slowdown will materially affect MEWs leading to lower consumer spending. This slowdown in consumer spending will most likely lead to lower retail employment. In addition, loss of housing related employment is likely to decline in the next couple of years and this includes realtors, mortgage lenders, construction, and landscaping among others.

However, all is not doom and gloom. Although global growth is slowing, it is still growing at a healthy clip of approximately 5% (estimates range from 4.5% to 5.4%) and we expect large multinationals companies to benefit, many of which are located in the United States.

Large cap domestic companies have not performed well relative to small cap stocks in the past few years and are now trading at one of the lowest valuations relative to small cap names in many years. Figure 7 illustrates the differential in price-to-earnings between large cap and small cap stocks.

Figure 7

Strong global growth suggests investors will continue to be rewarded by having exposures to international equities and fixed income securities. In addition, having appropriate exposure to emerging markets equities and fixed income is likely to boost returns albeit at a slightly higher volatility.

Long-term investors can take advantage of the dips in these markets by adding to the asset classes to boost overall returns. Although currency depreciation is not part of our investment thesis for exposure to international markets, in the event it plays out, international allocations will boost returns for US based investors.

Conclusion – Subprime and Beyond

- Beacon Pointe believes that the slowdown in housing poses some risks in economic slowdown. Although housing comprises about 6% of GDP, the unknown factor in ascertaining the outcome of the housing slowdown is the impact on credit availability. If liquidity continues to be high, then other aspects of the economy should offset the housing slowdown.

- On the other hand, a credit crunch can be the prelude to a difficult economic environment and roil financial markets in the short-term. However, higher global growth prospects relative to US GDP growth will continue to benefit many US based companies, especially the large cap multinationals.

- Beacon Pointe is cautiously optimistic regarding equities and fixed income markets and expects higher volatility in the short-term. However, Beacon Pointe is optimistic for the longer-term as global GDP is still growing at a healthy pace. Staying invested using a diversified approach with exposure to international equities and fixed income securities at all times has proven to be a prudent approach as studies have shown that market timing does not work in practice. Most market moves happen in relative short periods and if an investor miss these periods, their financial goals may be at jeopardy.

- Please contact your Beacon Pointe consultant at 866-272-1272 should you have any questions.