

# WEEKLY MARKET MONITOR APRIL 9, 2007

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## SUBBING OUT THE HOUSING MARKET

The single-family home mortgage market and its current problems have fallen off the front pages, replaced by more favorable economic news, such as recent jobs growth numbers and stock market gains. However, mortgage-market woes are still with us and their effects will be working their way through the economy for some time to come.

This week we focus on:

- The current status of the subprime and Alt-A mortgage markets
- Origins of the current subprime malaise
- Potential effects on the economy and the markets

Over the last five years, the subprime market has grown from about 3% to about 20% of total newly issued single-family home mortgages, with Alt-A mortgages now accounting for another 20%. (The Alt-A market lies between the subprime and regular mortgage markets in terms of its rules, risk and rates). Although the total mortgage delinquency rate has risen during that time from nearly nothing to about 2%, over 14% of subprime loans and 3% of Alt-A loans are now delinquent.



These figures imply that the delinquency rate for conventional mortgages is still extremely low. The conventional home mortgage market works with familiar rules and procedures, including buyer documentation, financial checks, minimum down payments and other forms of due diligence. These requirements make it possible for originating lenders to sell mortgages to Fannie Mae, Freddie Mac and other organizations that package huge numbers of single-family mortgages together as mortgage-backed securities (MBS), which they then sell to investors.

In contrast, the rules are relaxed in the subprime and Alt-A markets. There we find little to no required documentation, financial checks, or down payments. In exchange, borrowers often face low “teaser” rates that automatically ratchet up after a certain period of time, or in response to market interest rate changes, or both. These mortgages are also often packaged with conventional mortgages and other credit enhancements and sold as MBS. Compared with MBS without any subprime loans, these securities have the potential for higher returns but come with intrinsically more risk. So, higher risks of various kinds are borne by home buyers, subprime lenders and purchasers of MBS containing subprime loans.

Why have the subprime and Alt-A markets grown so rapidly, despite these increased risks? First, in the 1990s there was a concerted push by the federal government as well as Fannie Mae, Freddie Mac and other mortgage intermediaries, to encourage increased homeownership in the U.S., especially among groups that were traditionally underrepresented. Second, capital markets are arguably awash in liquidity thanks to savings by corporations around the world as well as individuals in many countries other than the U.S. So, many investors looked for ways to put their money to work. Third, conventional bond and MBS yield spreads—the extra yield that fixed-income securities provide over and above U.S. Treasuries—dropped in the 1990s and have remained very low. So, some investors sought opportunities to increase yields and turned to higher returning but higher risk securities. And fourth, the Fed lowered interest rates in the first part of the decade to nearly all-time lows. Long-term interest rates remained low even when the Fed began to raise short-term rates in 2003.

All of these factors helped to fuel a sustained boom in many of the country’s single-family housing markets that indeed included many of those who had never been homeowners before. The percentage of households owning their own homes, which for decades had been in the low 60s, rose to 70% in 2005. And the subprime market took off as lenders—often new companies set up for this purpose—and home buyers alike gambled that constantly rising home prices would enable buyers who couldn’t qualify for conventional mortgages to grow their way to solvency.

Of course, this story didn’t quite play out as many homeowners and subprime lenders expected. The automatic ratchet feature for many subprime mortgages began to kick in, energy costs and other price increases began to drain homeowners’ pocketbooks, home equity borrowing tailed off, home price increases moderated or even turned negative in some areas, and economic growth moderated. These factors led to the loan delinquency rate increases and subprime lender bankruptcies that hit the papers in February and March. Fortunately, TIAA-CREF investment professionals anticipated many of these changes by reducing or eliminating exposures to the stocks and bonds of subprime lenders in its active accounts and funds and by focusing on higher rated MBS in the TIAA General Account.

The subprime and Alt-A mortgage story isn’t over yet. It is likely that subprime delinquencies and defaults will continue to rise as interest rates for more of these loans automatically reset. The effects may spill over in the conventional housing market, as price pressure is more likely to be downward than upward due to problems in the subprime and Alt-A markets. Home prices, which many expected to begin rising again, are unlikely to do so in 2007 in many local markets and some markets could experience a continued downtrend. New construction will likely remain in the doldrums. So housing may not be a contributor, as it has been, to stimulating U.S. economic or job growth. In fact, jobs in housing—construction, lending, brokerage, furnishing, and related industries—are likely to decline in the year to come. For these reasons, along with our macroeconomic modeling work, we expect the overall economy, as measured by U.S.

GDP growth, to climb only about 2% in 2007. Note, however, that the commercial real estate markets—retail, industrial, office, and multifamily rental—have been robust in terms of both opportunity for job and economic growth and show few negative signs at present.

What do these trends tell us about the markets? After a short hiccup, equity and bond markets seem to have shrugged off the housing news, since so far the news has seemed to some observers to be confined to the subprime arena. But if effects on the broader housing market continue and job growth slackens, and other sectors are not able to pick up the slack, investors could feel a bit less optimistic about domestic markets as compared to those where lending practices have followed a more consistent path.

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