Economic Update

Broadleaf Partners, LLC

Weighing in on Subprime Lending
Rainstorm or Tsunami?
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In our February 22nd Economic Update On Warts and Princes, we casually commented that "the biggest macroeconomic worry continues to be the state of the housing market and while we have moved past fears that it could drag the rest of the economy down with it, the emergence of troubled subprime loans has certainly raised some eyebrows." Eyebrows, hands, feet and everything in between, indeed!

For much of the past week, CNBC has been laser-focused on subprime lending concerns as a major source of the market's recent volatility. While we aren't experts in the area of subprime lending, we thought we'd weigh in with our opinion on what the issue could mean for you as an investor and owner of real estate.

What, Exactly, is a Subprime Loan?

While there may be some gray areas, a subprime loan is essentially one which is granted to a borrower with an objectively measured, subpar credit score. We suspect, however, that they may also occur when a borrower doesn't answer credit related questions entirely truthfully and an aggressive mortgage broker knowingly looks the other way in order to complete the deal. While the former type is perfectly legal, the second is fraudulent especially in light of the view that most home loans are ultimately securitized and sold to the public.

Before we go any further in discussing housing and subprime lending, it would probably be useful to step back a minute and determine what typically happens when an asset bubble in any given economic sector finally deflates. After a rapid deceleration in business, questionable financing activities are typically discovered. Sometimes, criminal investigations ensue and new government legislation is sponsored and passed. While well intentioned, these new policies are rarely effective in preventing the next bubble, since they usually surface in a different area of the economy. Sometimes – depending on the size, breadth and depth of the bubble – the whole economy is dragged into a recession while at other times, it merely softens as the problem area is digested.

The Technology and Telecom Bubble as a Recent Example

At the beginning of the decade, the telecom and technology bubble burst after several years of torrid growth. It quickly became apparent in the aftermath, that a great deal of tech and telecom gear had been sold to companies that had gone public during the dot.com boom. Many of these companies had well intentioned business plans, but they didn't ultimately have the revenues or earnings to survive. Several equipment companies ended up writing off bad loans and receivables and some customers, even very big ones like WorldCom, declared bankruptcy and disappeared altogether. Excess capacity and

inventories showed up in places like eBay and took quite sometime to work down. In this case, criminal accusations followed, with some high-profile figures ultimately thrown behind bars. Congress enacted Sarbanes Oxley which increased the burdens on public company officials to file accurate and fair financial reports. As a side note, the rising popularity of private equity may partly be related to passage of Sarbanes Oxley.

While the economy as a whole did indeed fall into a shallow recession, technology companies, their employees and equity investors felt the brunt of the hangover, and perhaps justifiably so, as the party had been largely their own. Today, six years later, some areas of the technology market continue to feel the lagged effects of excess capacity, ultra competitive pricing and damaged earnings multiples. The Dow and S&P have approached or exceeded all time highs as non-tech areas recovered from the brief side effects, and yet the Nasdaq remains substantially below its 5000 level peak.

How the Housing Bubble and Subprime Could Play Out

As my friend, economist, and former co-worker Ed Yardeni has described it, the housing bubble has so far deflated with a hiss rather than a bang and the hangover has been pretty well contained to the housing sector. While the Toll Brothers CEO has tried to call the bottom several times, if history is a guide, it's likely going to take more than a year or two before those that enjoyed the party are in any shape to drink again.

Yesterday, the Mortgage Banking Association reported that delinquencies surged to their highest levels since Q2 2003. But, as we mentioned in our last update, statisticians can paint almost any picture with numbers and words that they'd like to while still being truthful. Yardeni points out this morning that "record foreclosures in the fourth quarter amounted to a mere 1.19% of all outstanding mortgage loans."

It is our belief that hedge funds and private equity players may find themselves the most exposed to the downside of subprime lending. History shows that the intense pressure to perform coupled with limited transparency often leads to a fertile environment for aggressive and sometimes unethical risk taking practices. The investment and commercial banks will likely share in the pain, but their broader diversification and more publicly scrutinized operations should likely help them shoulder the blow.

What has happened with the housing bubble has been relatively predictable thus far. The stock market's decline in recent days in spite of a strong bond market suggests to us that investors are more concerned about the risk of a recession at this time than the risk of inflation. We stand by our view that though painful, the subprime lending issues are a symptom of the same issue – the housing bubble -- and are not likely powerful enough to carry the rest of the economy into a recession.

On Goldman Sachs conference call yesterday, management confirmed that subprime issues were relatively contained and had not trickled into other parts of the mortgage industry. We believe the same will prove true for the economy as a whole, a belief which is currently supported by low unemployment levels and record government tax receipts.

With history as a guide, the housing market will take longer to recover than most expect. The subprime lending issues are not a new problem, however, but are merely

symptomatic of an existing and widely known one, a troubled housing market. In perfect fashion, a Democratic Senator recently suggested that new legislation in the form of a bailout may be necessary. Now, if we could only get some criminal investigations, we'd have the perfect trifecta!

If you own a home, that's great. And unless you've got your own subprime issues, you should be just fine. We suspect we're headed back to a more normal environment where a home is once again, just home.

Kindest Regards,

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