Agincourt Capital Management, LLC

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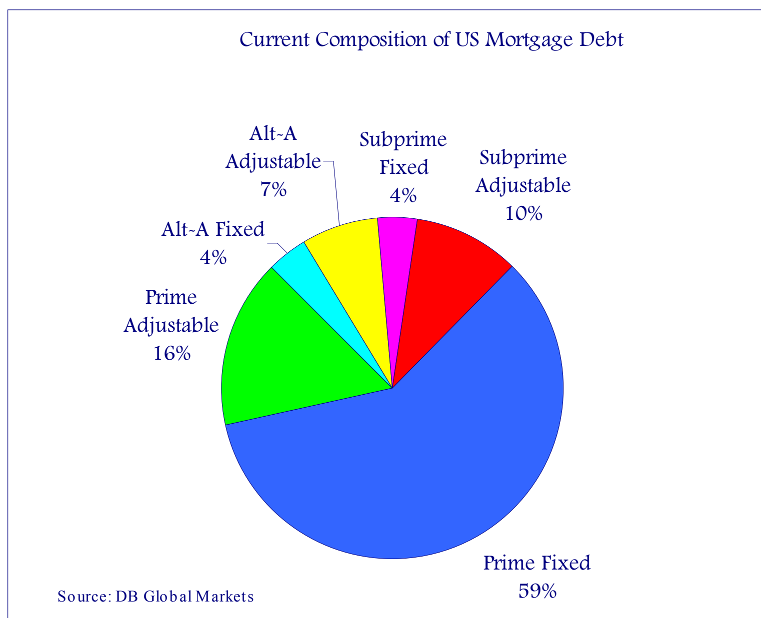
INVESTMENT UPDATE

During the recession of 1999-2001, the US housing market remained surprisingly healthy, as distrust of "paper assets" after the dot-com bust, combined with low interest rates, drove demand for housing. This strong demand kept home prices moving up, spurred homebuilders to keep pumping out new homes, and encouraged lenders to add staff and systems to allow homebuyers to move through the pipeline quickly.

With all this productive capacity, and encouraged by the ever-rising prices of real estate, lenders lowered credit standards. Where a previous generation could buy a home only after assiduous savings (a 20% down payment was the norm, at least until the mid-1980's) and an income level that would assure that the lender could sleep easily at night, the US now had a New Real Estate Market. We were led to believe that, like the New Economy which preceded it (in more ways than one!), this new and improved market was nothing short of a *paradigm shift* for US homeowners. With real estate prices on a new, "permanent" uptrend, lending standards could be relaxed, and the dream of home ownership could be extended to everyone, no matter how tenuous their employment or thin their savings book.



Thus we witnessed the proliferation of mid-risk "Alt-A" and high-risk "subprime" lending—borrowers with checkered credit histories would be offered loans, sometimes for the entire sales price of the home, by a new type of lender. These lenders used a combination of science (FICO scores, credit matrixes) and wishful thinking ("A 100% loan-to-value mortgage today is only a 90% loan next year with these skyrocketing home prices!") to, at least at the margin and if only for a short while, change the face of the US housing market. Creative financing and ultra-low teaser rates (especially in 2002-2005 when short interest rates hit their lowest levels in four decades) meant that almost anyone could afford to buy a house, or move up to an even bigger house. Risk be damned!

There was one other significant, if overlooked, player in this game—namely, the buyers of this credit risk. As anyone who follows the mortgage market will tell you, mortgage lenders—the Countrywides, the GMACs, etc.—choose not to hold onto the vast majority of the loans they create. Most mortgage loans are either sold by the lender to one of the Government Agencies (GNMA, FNMA, or FHLMC) who repackage the loans into mortgage-backed securities (MBS), or the lender repackages the loans themselves and issues a "private label" MBS. But the Agencies don't typically repackage subprime loans, and the traditional buyers of private label MBS are fairly risk-averse. Who's left to buy? Why, the hedge funds and other risk-loving, leveraged investors, of course.

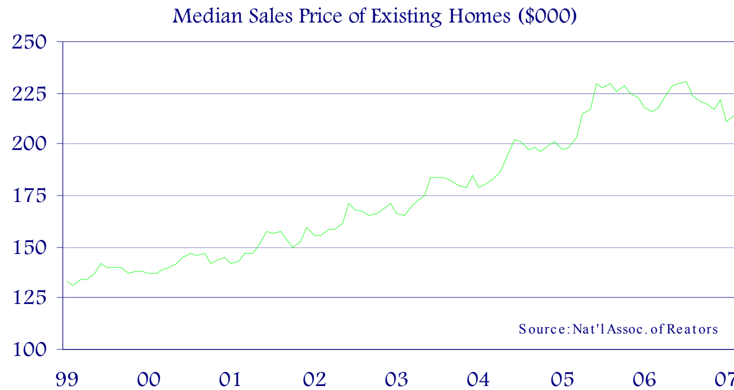
What we've just described is an oversimplification, but nonetheless identifies the main players and the motivations of each. Lenders make big fees from extending credit to those with shaky credit, and lay off most of the risk with hedge funds who need high risk/high payoff investments to justify their stratospheric fees. Borrowers, even those at the margin of creditworthiness, can stop paying rent and have a shot at home ownership. Speculators looking for a quick flip can buy properties they have no intention of ever living in, secure in the myth that real estate prices can only go up. Homebuilders increase profitability by building more houses for ever higher prices, even if they're selling houses to those who can barely afford them.

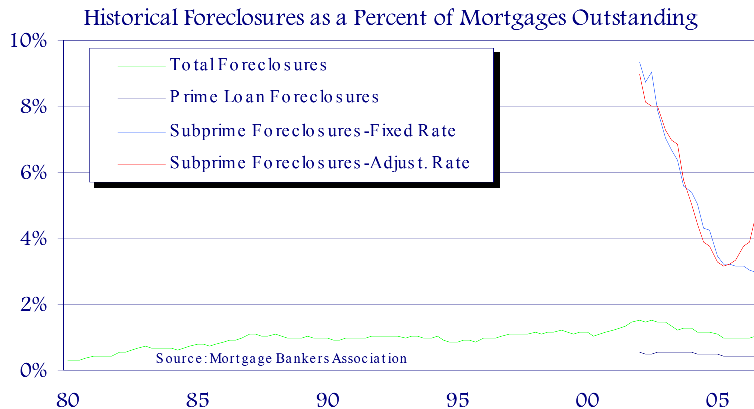
But the seeds of destruction had already been sown, and over the past year two facts became all too evident: First, there was a growing glut of homes, and secondly, those teaser rates were rolling off. Both of these factors are now exerting their own unique leverage on the housing market, and, in particular, the subprime market.

With an overabundance of homes (currently at eight months' supply and rising for new single-family houses) and essentially every last potential homeowner in America now holding a mortgage, home prices are now dropping as sellers try to attract buyers (see next chart). Falling home prices alone

are bad enough—again, lenders need prices to rise on these new, high LTV (loan-to-value ratio) loans, otherwise there's no equity for the lender to fall back on if the borrower hits a rough patch. Right now, the rough patch is looking like a massive pile up, as rising rates and the resetting of adjustable mortgages are putting a giant squeeze on these marginal borrowers. The results are predictable: rising delinquencies and defaults by borrowers, plummeting profits for lenders, and a mad scramble for credit protection for buyers of low-grade mortgage loans.

The bottom chart on this page tells the story, although a word or two of explanation may be in order. The chart shows, since 1980, total foreclosures as a percent of US home mortgage loans, as well as detailed data for different types of loans since 2002 (when the data first became available). The chart demonstrates how foreclosures, from a very low base, rose through the 1980's, leveling out after the recession of '89-'91 at a rate of approximately 1%, where they remained until the late 1990's. This is where things began to change, as consumers loaded up on debt during this period and lenders began offering subprime and Alt-A (medium quality) loans. While there wasn't much discussion at the time, subprime foreclosures exceeded 9% by 2002, well above where they stand today.





Yet things are different today than in 2002. The economy is much healthier, with unemployment at 4.5%, a full 1.5% lower than in '02. But interest rates, especially short-term rates, are far higher today, including the all-important benchmark rate for adjustable rate mortgages, which is up approximately 4% from its lows of four years ago. As the chart demonstrates, the greatest pain in the mortgage market, as measured by current foreclosures, is coming from adjustable-rate subprime mortgages, whose owners are being hammered with monthly payments that are, in some cases, more than double what they were originally faced with. Keep in mind that these are the same folks who were barely credit-worthy when interest rates were hundreds of basis points lower.

Unfortunately, the worst may be yet to come. Even while home prices seem to be bottoming out, the mechanics of adjustable rate mortgages mean that recent homebuyers (prime and subprime alike) holding ARMs have yet to feel the pain. Most adjustable rate mortgages, prime and subprime alike, place limits on how much the rate can change in a year, with the result that it can take years for the initial teaser rates to become "fully indexed." In addition, loans originated in the 2005-2006 period were made at prices at the absolute top of the market; whoever owns the rights to cash flows from these adjustable loans are likely to be bitterly disappointed, not just by delays in cash flows when delinquencies rise, but by additional losses they will incur upon default. Bottom line: buyers of mortgage credit based on subprime loans made late in the game, especially for adjustable rate mortgages, will continue to see increasing defaults and poor recovery rates on their investments for the next few quarters.

Is there any good news in all this? Fortunately, yes. As we saw earlier, three-quarters of the US mortgage market is made up of "prime" mortgage loans, while only one in ten are both subprime and adjustable. Furthermore, even if defaults of these adjustable subprime loans double from their previous highs, we are looking at an increase in the overall foreclosure rate of less than 2% from current levels.

The other major development that may mitigate some of the pain in the subprime market is the initiative that lenders are undertaking to keep borrowers "current." While the weakest lenders in the subprime market are now out of business, those that are left are the strongest and most experienced competitors, and include the traditional mortgage bankers whose subprime and Alt-A business is a small part of their portfolio. Nevertheless, they are actively working with their low-quality customers, offering extensions and renegotiated terms, to keep them on the books and current.

In any case, as Betty Davis once famously said, "Fasten your seatbelts, it's going to be a bumpy night!"