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Downunder Daily

The Disease Spreads

There are tentative signs that household credit problems are starting to spread beyond the debacle of sub-prime mortgages.

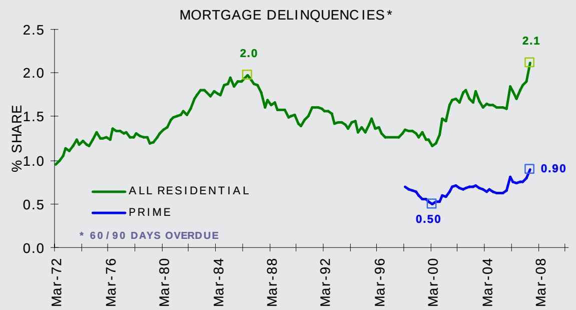
The clearest evidence is the Mortgage Bankers Association mortgage delinquency data, which showed the percentage of prime mortgages more than 60 days delinquent rising to 0.90% in the June quarter, from 0.74% a year earlier. (The 60 day-plus sub-prime delinquency rate hit 7.04% in the quarter.) This series has a relatively short history (see Exhibit 1), but it's noteworthy that prime delinquencies are now higher than in the early 2000's recession. The delinquency rate for all residential mortgages is at the highest level since at least the early 1970s.

This is important. The sub-prime debacle, while important, could be dismissed as reckless lenders losing money on feckless borrowers. But if prime mortgages start to falter, then the problem takes on larger significance. First, the pool of borrowers – and the assets their mortgages support – is far larger than the sub-prime equivalent.

Second, it's noteworthy that the prime mortgage delinquency rate is at its highest level in least a decade when unemployment is low and the average mortgage rate is at generational lows. This fits with my view that the American household sector has reached the limit of its debt-carrying capacity. It also suggests that if employment starts to weaken then the situation will get far worse.

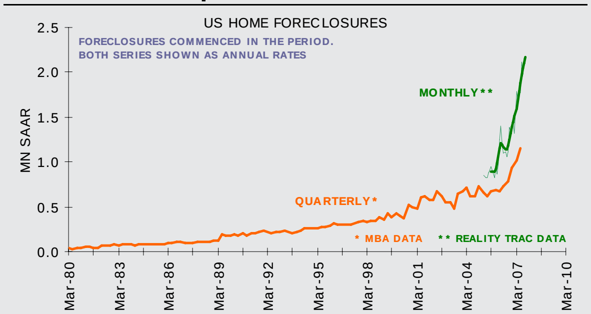
Falling house prices, now evident in some price series, would worsen this situation. The option of pre-emptively selling to clear a mortgage will disappear as falling house prices erode borrowers' equity in their property. Consequently, falling house prices will likely increase the delinquency rate and increase the ultimate loss faced by lenders.

Exhibit 1
It's Not Just Sub-prime



Source: MBA; Morgan Stanley Research

Exhibit 2
Foreclosure Exposure

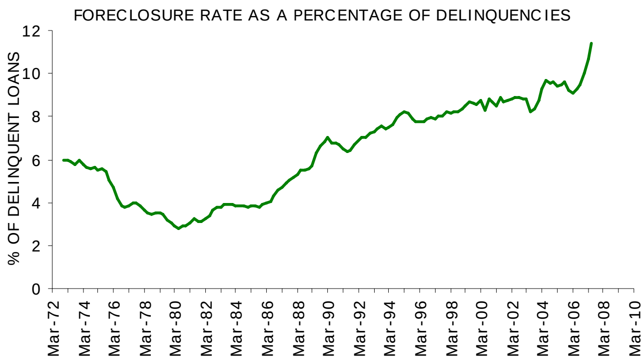


Source: MBA, Reality Trac; Morgan Stanley Research

Both these trends are starting to appear. The number of foreclosures is at an all time high (Exhibit 2), in part because delinquent borrowers are now much more likely to be foreclosed (Exhibit 3). The foreclosure rate (foreclosures commenced as a percentage of loans) is at an all-time high, including for prime mortgages.

Exhibit 3

Trouble Means Deep Trouble

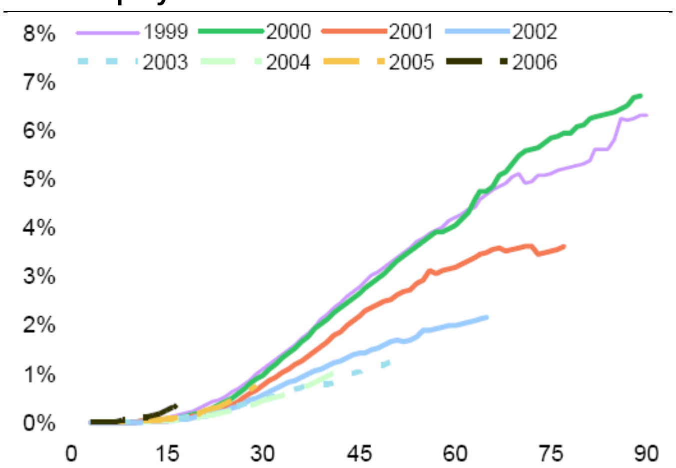


Source: MBA; Morgan Stanley Research

The prospect of more delinquents being foreclosed, and the prospect of forced sales in a falling house price market, all point to lower recovery rates on loans. The early evidence suggests that loss rates for 2006 vintage mortgages will be significantly higher than for prior years (Exhibit 4). (The loss rate, rather than the delinquency rate, is the critical variable for the mortgage-backed paper and the other derivative securities that sit atop.)

Exhibit 4

Home Equity Loan Loss Rates

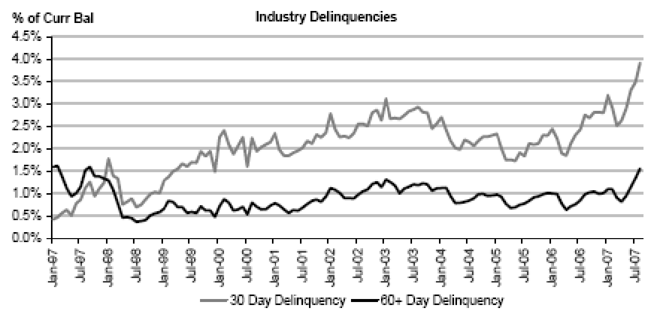


Source: Vishwanath Tirupattur, *State of the Market: ABS CDOs, CLOs and Structured* Credit, August 2007; Moody's; Morgan Stanley

Other areas of consumer credit are also now starting to deteriorate. Exhibit 5 shows auto loan delinquency rates are rising sharply.

Exhibit 5

Auto Stress Rising

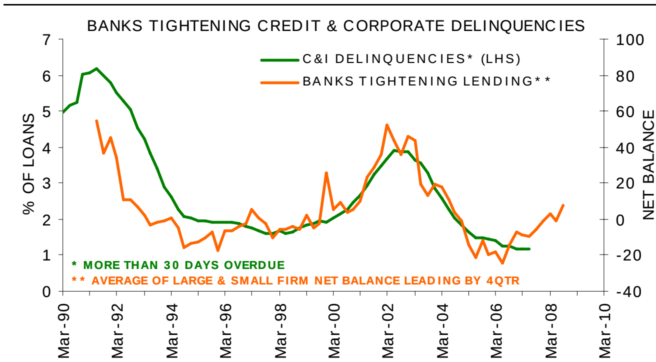


Source: Kenneth Lee, *ABS Data* Package, 10 September; Intex; Morgan Stanley

In contrast, commercial & industrial loans for now remain healthy, with delinquency rates at cycle lows. Even there, however, it is probable that conditions will deteriorate if growth weakens. In fact, the tightening in lending standards by commercial banks is usually a warning sign of rising delinquencies (Exhibit 6). Having said that, in this cycle, I expect the epicenter of the credit stress to households and the financial sector itself, not the corporate sector.

Exhibit 6

Corporates Conditions To Turn?



Source: Federal Reserve; Morgan Stanley Research

MORGAN STANLEY ModelWare	**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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