

>: Beware of Sub-Prime Mortgage Stocks

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Very interesting news today coming out of HSBC! They announced that their sub-prime credit mortgage portfolio is vastly underperforming expectations. (Sub-Prime borrowers are borrowers who have either impaired or less than stellar credit ratings.) In fact, their non-performing sub-prime loans ballooned an additional 20% above expectations from \$8.8 Billion to \$10.56 Billion. That's BILLION with a capital B!

The horrendous thing about all this is that the brainiacs at HSBC have expressed genuine surprise about the rate of deterioration of their sub-prime mortgage portfolio. Had they read The Tycoon Report, it wouldn't have been a surprise. Dylan Jovine laid out in crystal clear detail last year exactly what we are seeing today, and he did it just weeks before the real estate market started to show visible signs of cracking.

What they also would have read is that all we are seeing now is the other side of the cycle. Real estate lending follows a highly predictable boom and bust cycle.

Let me explain. The beginning of the real estate bull market cycle is the lowest risk time in which to lend money to sub-prime buyers. This is because in a rising real estate market, buyers that get into financial difficulties can simply refinance at a higher valuation on their homes or simply sell their homes, usually for more than the mortgage amount owed.

This is the time in the cycle when the smartest operators will loosen their credit standards dramatically because this is the only time in the cycle where this approach is a no-lose strategy for the above mentioned reasons.

Problems start occurring later in the cycle, when real estate exits its ascension phase, enters its flattening phase and then goes into its descent phase.

The pros in the space, by this time, will have long sold off the sub-prime portion of their credit portfolio while at the same time will have dramatically tightened their lending standards. The Munsons (http://www.thetycoonreport.com/past_issues/949867001) in the space, faced with a declining credit portfolio and declining earnings, begin to loosen their standards even more to try to recoup the lost income from the non-performing section of their loan portfolios. In essence, they "Double Down" at the EXACT WRONG TIME IN THE CYCLE!

They pile on more and more risk in the hope of a real estate turnaround or, more likely, in the hope of being able to securitize the loans and dump them in the mortgage-backed securities market.

We are clearly now entering the descent portion of the real estate cycle. This is the absolute worst time to have exposure to sub-prime mortgage loans. The reason is that, as a lender, you no longer have the principal protection that a rising market provides.

You now have to rely on the credit-worthiness of your borrowers (hey, they are called sub-prime for a reason!) Additionally, you have to rely on a strong economy to provide jobs for the people who borrowed money from you.

So, what happens when housing prices start going down and mortgage payments start going up?

That's the double whammy that mortgage lenders are faced with right now. Millions upon millions of sub-prime borrowers utilized adjustable rate mortgages. Now, that's great when rates are going down, but when you have 17 straight rate hikes by the Fed, you feel that one right in the pocket!

Matched with the general credit shakiness of a sub-prime borrower, and you can see that we are setting up for a perfect storm of sub-prime credit defaults. If the US economy were to stumble here, and we were to experience even a mild recession, it could lay waste to the sub-prime mortgage lenders.

We are talking about losses that could run well into the hundreds of billions. Long story short, at the very least, you want to remove any stocks from your portfolio that have substantial sub-prime mortgage exposure. This is an excellent area to look at for shorting opportunities, and I urge you to take a look at this group.

Whenever I go long a group, I'm looking for a sector that is either currently or about to embark upon a period of sustained above average earnings growth. When I go short, the converse of that is true. I want to be short stocks in sectors where the earnings are peaking or have peaked and are about to enter a protracted period of earnings decline.

Perfect timing is a myth. I wish I possessed perfect timing, but I don't. What I do possess is a strong understanding of the effects of long-term macro business, political and economic trends. When you have a macro trend at your back, it's not a question of IF you will make money, it's purely a question of WHEN.

Short of a sudden and dramatic series of interest rate cuts or a new leg of outstanding US economic growth, the sub-prime mortgage market is a

dead man walking.

A handwritten signature in black ink, appearing to read 'Teeka Tiwari', with a stylized flourish at the end.

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