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Short Remarks on the Current Credit Squeeze and Its Impact on the Mortgage Market

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It's far from over. The news from the US subprime space will get much worse in the coming year, with default rates surging to unprecedented levels. But what really counts for the market is how much of this bad news is already reflected in current prices. It turns out that not only did the barrage of negative headlines of recent months raise the level of market immunity to adverse subprime news, but in fact, even after its recent improvement, the mortgage-backed market is currently pricing in a darker picture than the one likely to emerge when the smoke clears.

Based on this information and our main case macro scenario, we predict that the cumulative default rate on subprime mortgages for the 2006 and early 2007 vintages will reach 25% with the loss rate averaging just over 12%. To put things in perspective, this outcome is 35% worse than the losses seen in the 2000 vintage loans from Michigan, Indiana and Ohio—the worst performing vintage and geographic locations to date, and roughly in line with the performance of the 99^{th} percentile of regional default rates in the recessionary vintage of 2000-2001.

That's what we believe to be the most likely scenario. But what does the market think? Based on information obtained from various sources we calculated the market implied default rate for US subprime debt. Current credit-default swap prices suggest cumulative default rates ranging between 28% for the BBB- rated tranche and 32% for the A rated tranche—for a weighted average of close to 30%. Those implied default rates are roughly 20% higher than our projection—suggesting that the market is currently pricing in a much more draconian outcome than our main case scenario suggests.

So far the correction in the market is not an equity market story. It's definitely a credit market story. Risk premiums on both high and low quality bonds rose notably over the past month. However, a closer look suggests that current premiums are consistent with their long-term average, and much lower than premiums seen in crisis such as the 1998 Long Term Capital Management crisis. In other words, the correction that we have seen in credit markets is a move from an abnormal situation to a normal situation. Until now the price on risk was simply much too low.

What does it mean for mortgage rates? The very important Prime-BA spread fell from its long-term average of around 160 basis points to 120 basis points. This is a direct 40 basis points hit to Banks' profit margins on certain products. Note that the Bank of Canada did not cut rates despite a 50 basis points rate cut by the Fed. And given that until a month ago the Bank was planning to raise interest rates by at least 25 basis points—the current tightening in monetary conditions can be seen as a substitute to a rate hike. Put differently, the market is doing the Bank of Canada's job.

So Canadian banks, facing this squeeze in margins can either raise the prime rate (in the past, we have seen situations in which the prime rate moved independently of the Bank of Canada's rate), adjust their discretionary rates, or do nothing—with the hope that the Prime-BA rate will return to normal soon.

In recent days, the Prime-BA spread improved to 140 basis points—a sign that the market is starting to return to normal. Clearly the market is reacting to the 50 basis points rate cut by the Fed, and to the possibility that the Fed will cut rates even further.

So given the possibility of a recession in the US (or a very sever slowdown), the likelihood is that Canadian rates will, at the minimum, remain relatively stable over the next 3-6 months with a possibility of some softening in rates. Beyond that, as the US economy recovers, it is possible that both the Bank of Canada and the Fed will start (resume) a cycle of rate increases.

What does the crisis mean for the Canadian subprime business? There is little doubt that in the coming months we will see a significant slowing in originations (as of July originations were still rising by more than 30% a year). But from a longer term perspective, we believe that this segment of the market is still likely to rise strongly—but probably with more reasonable and accurate pricing.