Subprime mortgages trigger ABX sell-off

Investors in the subprime mortgage sector might have been expecting some kind of market correction after a jump in delinquency rates at the back end of 2006. What they weren't expecting was a full-scale stampede out of the ABX index. Credit reports

The 'other shoe' finally dropped in the US subprime mortgage market in February as a crop of lenders closed shop and major banks revealed they are expecting serious losses in their loan portfolios.

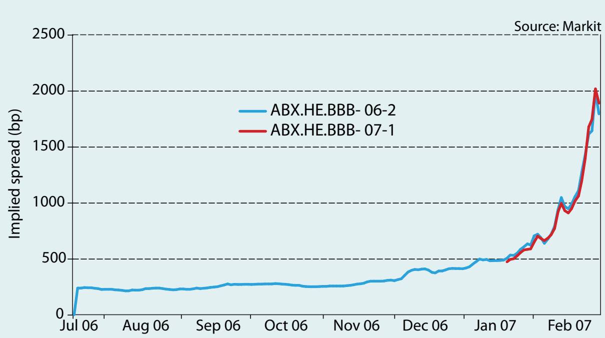
The market had been expecting weakness in the sector this year after delinquency rates on subprime mortgages reached record levels towards the end of 2006. Nonetheless when the latest news hit the market, the impact – most closely felt on ABS derivatives index the ABX – was nothing short of astounding.

Spreads on the BBB- tranche of the latest iteration of the ABX. HE home equity index, which launched at 471 basis points on January 19, jumped from 769bp to 919bp between February 8 and 9, after HSBC announced it would increase its allowance for loan losses by 20%, or $1.76 billion, due to exposure to subprime US mortgages.

By February 12, when California-based ResMae became the twentieth mortgage company by Bloomberg's count to close in the previous six months, they had shot to 994bp, and effortlessly passed through the 1,000bp mark four days later. By February 26, the day before more bad news hit the market in the shape of global stock market falls, the index had tumbled from its launch price of 97.47 to 67.27. Spreads were at 1,744bp.

While there are undoubtedly serious problems in the underlying subprime mortgage sector – and the worst may yet be to come – technicals appear to be at the root of the sell-off. "What appears to be driving it is a significant number of macro or equity players who have been using the ABX short as a hedge for other positions," says Jonathan Laredo, director at hedge fund Solent Capital in London. "There's no one on the other side of that trade."

ABX.HE BBB- spreads



Indeed Gyan Sinha, head of ABS research at Bear Stearns in New York, has conducted some research to determine the 'true value' of the ABX, based on default and recovery rates of each individual deal in the index. Speaking in mid-February, he arrived at a price of 90 for the index. "This market is trading purely on technicals. It's trading too cheap because the only thing people want to do is short it," he says.

For the dealers who use the index to hedge short positions in the single-name ABS market, the sell-off is bad news. But macro hedge funds, which flocked to the short ABX trade six to eight months ago in order to express bearish views on the US housing market, are making money. The question now is: will contagion spread to other credit markets?

New paradigm

The consensus among most market participants is that any impact on other markets is likely to be limited. An all-out capital markets contagion along the lines of the last major event in 1998 is unlikely, since the market has changed dramatically in the past decade, say Akiva Dickstein and Craig Perkins, MBS strategists at Merrill Lynch in New York. Amongst factors limiting the fallout, they cite higher and broader dealer revenues, and a much broader hedge fund community now. As such "losses at particular hedge funds are less likely to percolate through the broad financial markets", they say in a February research report.

What's more, in this instance – unlike the correlation crisis of May 2005 – hedge funds and bank prop desks are not in trouble. "This time, the fast money guys are on the right side of the trade," says Laredo. "If you're fast money and you're caught wrong, you sell your liquid assets." On this occasion, it's banks, who can sit on losing positions rather than sparking sell-offs in

Subprime stresses sound alarm bells for CDOs of RMBS

As investors have sought higher-yielding debt structures in a super-tight spread environment, CDO structurers have increasingly turned to subprime mortgage products over the past two years. As a result, CDOs of ABS are unlikely to escape fallout from the subprime market's current woes.

Charles Sorentino, credit analyst at Merrill Lynch in New York, says: "A natural concern is on the CDO side: liabilities are going to get stressed. We will definitely see CDO managers adapt and get more selective by moving up in the capital structure."

Howard Chen, financials analyst at Credit Suisse, says that there are signs that shift is already under way. "It comes as no surprise that the securitisation market's appetite for subprime product has waned, with the rating agencies now requiring higher levels of subordination and the spreads on triple-B pieces having widened by several hundred basis points."

In 2005 and 2006, however, residential mortgage-backed securities – and subprime mortgages in particular – were the collateral of choice for CDO managers, as attractive arbitrage opportunities diminished in other asset classes and then in other higher-quality mortgages.

At $177 billion of volume, CDOs backed by ABS broke new issue records in 2006, more than double the previous year's tally, according to industry body Sifma. Moody's CDO asset exposure report for October 2006 revealed that 39.5% of the collateral within the 678 deals covered by Moody's consisted of RMBS, just over 70% of that in subprime and home equity loans and the other 30% in prime first-lien loans.

"Demand for yield over recent years drove the issuance of high-yield CDOs and the structured products teams on the Street found that subprime home equity loans and residential subprime mortgages could be used to engineer attractive yielding products," says Brad Hintz, financials analyst at Sanford Bernstein in New York.

And while mortgage underwriting standards became more aggressive to feed the insatiable demand for CDO collateral, growing numbers of CDO of ABS buyers came from generalist hedge funds and private banks – investors who often lacked the sophisticated risk analysis and market insight of more traditional structured credit investors.

One fund of hedge funds manager based in Zurich says that the equity tranches of 2006 CDOs of ABS were often bought by high net-worth retail accounts, or by Asian institutional investors. He says this was a shift from previous CDO of ABS vintages, when the equity tranches had most often gone to specialist hedge fund buyers.

The challenge for this new crop of investors is that the effect of the subprime market's troubles on CDOs backed by subprime ABS is still difficult to assess. Part of the problem, explain analysts, is that the underlying collateral in CDO deals is not valued on a mark-to-market basis, but is instead dependent on credit ratings.

"Because many buyers of senior CDOs can only hold investment-grade assets, they may continue to hold deteriorating and increasingly illiquid assets as long as their ratings have not been downgraded," says Josh Rosner, managing director at investment research firm Graham Fisher & Co in New York. "And because the market is over-the-counter, investors may incorrectly value these assets in their portfolio and be forced to recognise large mark-to-market losses in a fast-moving liquidating market."

The rating agencies, however, have been slow to act. Among the 2005 and 2006 originations of subprime mortgage-backed

securities, Moody's has put only 62 tranches on review for possible downgrade. That's less than 1% of the total subprime deals rated in those years.

Standard & Poor's recently put 18 classes of securities from 11 residential mortgage pools on watch for downgrade, but S&P said its move to 'credit watch' status on these mortgages would have no impact on outstanding CDO ratings. However, the rating agency acknowledges that given the high concentration of subprime RMBS tranches found in later vintage mezzanine structured finance CDO pools, if subprime RMBS ratings perform worse than expected, it will have a "major impact on the CDO ratings".

Rosner believes it's only a matter of time before defaults in mortgage pools begin to affect returns in collateralised debt obligation pools – a development which he argues is likely to affect liquidity in the broader mortgage market, as CDO structurers once again migrate to more attractive asset classes.

"Favoured collateral types for [CDOs] can and sometimes do change rapidly over time. Those features create the potential for high volatility in sectors that rely principally on CDOs for funding," he says.

other markets by unwinding unrelated positions, that are on the wrong side of the trade.

One fear is that spread widening will spill over into other markets as investors perceive heightening credit risk as a result of wider ABS spreads. But Dickstein and Perkins think this unlikely. "Generally markets reprice risk when the risk becomes actualised, not simply because investors rethink their risk premia," they say. "All in all the impact of the widening in ABS on other fixed-income capital markets seems relatively limited."

Mark Adelson, head of structured finance research at Nomura Securities International in New York, agrees. "This is all about subprime mortgage lending and housing issues in the US," he says. "I see no reason for this to affect corporates; I don't even think it will spill over into prime mortgages."

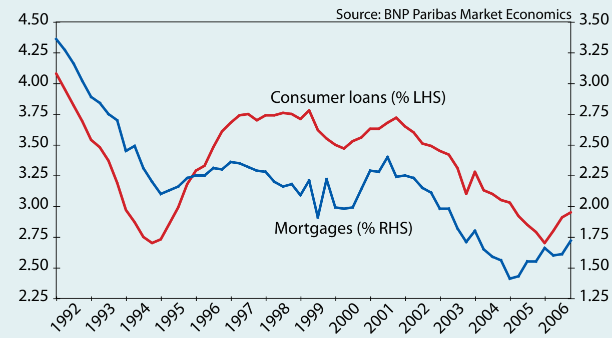
One market commentator, who has the wider economy to think about, was hedging his bets. Federal Reserve chairman Ben Bernanke, in his testimony to Congress on February 14, said: "To the downside, the ultimate extent of the housing market correction is difficult to forecast. Spillover effects from developments in the housing market onto consumer spending and employment in housing-related industries may be more pronounced than expected."

What now?

ABS experts are unanimous that while it looks cheap, the best trade is to stay away from the ABX. As Adelson at Nomura says: "There are people who will say this makes [buying the index] very appealing: exploit the technicals, trade to the fundamentals. But to do that you have to believe very firmly that this market will revert to fundamentals, and I'm not sold on the idea that it will be a reasonably smooth or imminent reversion."

He adds: "I don't want to be long or short; I'd rather be gone. I don't want to touch it with a 10-foot pole."

Delinquency rates begin to rise



Laredo at Solent agrees: "The technical view is very difficult to see right now. It would be a brave person who got involved before the technicals have played their course."

As the rate of delinquencies starts to level off there will be a better sense of predictability, says Sinha at Bear Stearns. "When that happens, and the bonds from a cashflow perspective have integrity, you'll start to see better correlation between trading and fundamentals."

However the end result could still go either way, warns Adelson. The underlying economy is still good, with healthy corporate profits, modest interest rates and a good US labour market. "We're not in a recession, GDP is growing, and if the economy stays good, that might bail everything out," he says. But he points to another financial market bubble: the South Sea bubble of 1720, in which the share price of the company that had a monopoly to trade the new-found riches of South America collapsed after overheated speculation, taking with it the fortunes of thousands of speculators. "That was a good time for the economy too," says Adelson, "and it blew everything to heck!"

THE 30 SECOND VIEW
Subprime mortgages and the ABX

Delinquencies (missed mortgage repayments) have been rising steadily for the past two years. While delinquencies have previously been closely linked to job losses, adjustable rate mortgages are now being blamed, particularly in the subprime market where investors may not understand the complexities of rate changes. "It is this class of homeowners and their lenders who are now facing the music as mortgages reset at higher rates in an environment of softer home prices," says Mehernosh Engineer, senior credit strategist at BNP Paribas.

The **ABX.HE** is a family of five indices referencing AAA, AA, A, BBB and BBB- tranches of home equity-based ABS programmes. Launched in January 2006, it's now on its third iteration, which started January 2007. The index widened from launch at 471 basis points, but its first major jump came after news of HSBC's projected loan losses on February 8, when BBB- spreads jumped from 769 to 919bp overnight. By February 27, the day China's stock market falls sent global markets reeling, the value of the index was at 62.25 and spreads on the BBB- tranche were at 2,017.

Likely impact of subprime weakness: adjustable rate mortgages facing rate increases this year amount to $1.5 trillion. This is likely to spill over into lower retail sales as consumers have less disposable income. Foreclosures are also likely to rise: nearly 20% of all subprime loans originating between 2005 and 2006, according to the Center of Responsible Lending. Ben Bernanke warned in his testimony to Congress on February 15: "The ultimate extent of the housing market correction is difficult to forecast and may prove greater than we anticipate. Similarly, spillover effects from developments in the housing market onto consumer spending and employment in housing-related industries may be more pronounced than expected."