

# UNDERSTANDING THE SUB-PRIME CRISIS AND HOW IT WILL AFFECT YOU

Wow, it's hard to believe that we're already a few weeks into 2008 – and what a year it's shaping up to be. 2007 went out with a bit of a whimper in the markets, especially in Alberta – with listings in the last few months rising dramatically and prices dropping slightly. All this after a record-setting pace that didn't look like it would end. Well, if the first few weeks are any indication, 2008 has ushered in a fresh start. Activity in the markets has risen sharply and it seems evident that investors feel the market has hit its bottom and seem to be jumping back in again.

And while the continued fallout of the Sub-Prime crisis and the Asset Backed Commercial Paper (ACBP) fiasco may well spell doom and gloom for some, the impact on rates will be a positive one for real estate investors. It's becoming increasingly more evident that 2008 will bring about a drop in interest rates – both Variable and Fixed. This will be brought about by a very logical and predictable series of events that are expected to take place over the next few months.

First off, the real impact and fallout of the US Sub-Prime crisis hasn't even hit us yet. The truth is 2006 was a year in which millions of Sub-Prime loans were written in the United States. Now the key to understanding the problem is knowing four things:

1. The majority of the mortgages that were written were offered to people who were high risk and arguably shouldn't have been given a mortgage in the first place – i.e. no job or poor credit. In California a popular product was termed the NINJA mortgage which stood for No income/No Job/ No problem

–apparently they thought the lack of a means to pay back the loan would be no problem.

2. The bulk of these loans were variable rate mortgages that offered a two year 'teaser' rate – kind of like buying furniture at the Brick 'don't pay now!!!' Well, the teaser rates are expiring this year and in many cases the face rate of the mortgage will jump by as much as 4%. Imagine your home mortgage going up by 4% this year? In the meantime, nothing has changed for the majority of these 2 million Sub-Prime mortgage holders in terms of increasing their incomes and as such the majority will go into foreclosure.

3. The prospect of 2 million American homes going into foreclosure will seriously hurt the US housing market and as such, the US economy. So much so that many are predicting a recession down south.

4. And the reason why this is not simply an American problem is because of the global appetite for higher returns. American Sub-Prime mortgage lenders have done an excellent job of bundling all of these mortgages and selling the bundled package to potential investors (remember that a mortgage is simply a 'promise to pay so much over a period of time' – thus creating an income stream at a potentially higher rate of return to the purchaser). These bundles of Sub-Prime mortgages were packaged along with credit cards and other miscellaneous debt instruments and sold for very attractive rates of return to hedge funds and other inves-

tors all over the world. Since there was little or no regulation regarding disclosure of exactly what was in the 'Bundle' many hedge funds and other unsuspecting investors were buying a bundle of what they assumed was secure mortgages with a high rate of return. They had no idea what real exposure they had to the time bomb called 'US Sub-Prime mortgages'. It is only now that everything is coming out in the wash that their true 'exposure' is being exposed.

It all seems quite ludicrous in hindsight doesn't it? Well, that's how markets work sometimes. As long as the price of homes continued to go straight up there was no problem. Could be a lesson there for all of us – never make a decision based on the fact that the value of what you're buying has to go up. Always have a contingency plan in case it doesn't.

So how is all of this going to play out and what does it mean to you as a Canadian? Well, it is quite predictable and doesn't take a rocket scientist to figure out that if 2 million Americans go into default this year on their mortgages, the US economy will take a major hit. This will push the US onto the verge of a recession (if they aren't already there). In order to counter recessionary fears, the Fed will be forced into a round of rate cuts down south. The US dollar will also likely weaken as a result. Consequently, our dollar will remain at or near par levels, if only because of a weaker Greenback. In order to pull the reins in on the Loonie, the Bank of Canada (BOC) will be pressured to lower interest rates (BOC governs Prime rate).

Aside from watching the level of the Ca-

nadian dollar, David Dodge and the BOC have made it very clear that their first and foremost duty is to keep a pulse on inflation. To do so they have established what Benjamin Tal calls 'speed limits'. The speed limit for inflation is 2%. In other words, the BOC does not want to see inflation go above 2%. If it does they will feel the need to increase rates in an effort to slow the economy down. If, on the other hand, inflation falls below 2%, they have room to lower rates in an effort to stimulate the economy. With the pending economic woes anticipated south of the border, it would be naïve to assume that our economy would not be impacted. As such, predictions are that the Canadian economy will grow by only 1.5 to 1.7% this year down from the 2.6% growth we saw last year.

Translation – the combination of a high dollar combined with low inflation will give the BOC all the incentive it needs to lower rates this year. The only thing left to see is by how much? Economist David Wolf sees a 125 basis point cut meaning prime would drop from 6% to 4.75% - that may be a bit aggressive, but either way it is sure to drop – personally, I'd love to see it back down to 5%.

Now remember, when we're talking about the BOC and interest rates, we're talking Prime rates. In order to predict what's going to happen with the long-term fixed rates, you need to follow the bond market. Historically, the long-term fixed rates were priced no more than 1.3% higher than the bond rates. For example, if the 5 yr bond was at 4.5%, then the 5 yr fixed rates should be no higher than 5.8%. Well bonds did a free-fall last week and dropped to a recent low of 3.5%. In the pre-Sub-Prime crisis days this would have translated to a corresponding drop in the 5 yr fixed rate down to 4.8%. But banks have hardly budged at all on their

long-term rates and they are still sitting at or near 6%. That is a spread of nearly 2.5%. Their explanation for not dropping rates is the increased cost of borrowing money given the global credit crunch – but that should only account for .5% at most – how do they explain the other 2%? I'm chalking this one up to a change in the rules. The true shakeup and fallout of the Sub-Prime crisis and consequential global credit crunch has not been seen yet and as such, the old rules don't necessarily apply any more. The proverbial dust must settle sometime though and I suspect that when it does, the banks will have made enough profit from having kept the current spread that they will have to start moving the long-term fixed rates closer in line with the bond rates and the spread will become less. The one question I can't answer on this is when. My prediction is that we will start to see a slight lowering of the long-term rates over the next six months, but not as drastic a drop as we will witness with the Prime rate.

So what does all of this mean to you in terms of your mortgage? Well, many will see the current market conditions as a great buying opportunity and as such will be wondering whether or not to go with a fixed or variable rate mortgage. The answer depends on your risk tolerance. If you want to avoid all risk then definitely take a long-term fixed rate today. It may go down, but it is still historically low where it is now and if the idea of floating on a variable rate mortgage keeps you awake at night, then lock it in now and forget about it. If however, you can tolerate a little uncertainty, then my recommendation is to take a 'front-end loaded Variable Rate Mortgage (VRM)'. This is a mortgage that takes the usual spread on a VRM of .5% and instead of spreading it evenly over 5 years, loads the first 6 months or year with a heavier discount. For example, the first 6 months could be a

whole 1% off of Prime and then the last 4.5 years could be Prime - 0.1%.

If our predictions are correct, you could very well end up having your cake and eating it. That is, if the Prime rate drops below 6% and you have a 1% discount off of Prime for the first 6 months, then your interest rate will be floating below 5%. If the long term rates follow suit and drop lower as expected, you can wait till your 1% discount expires and then lock in a 5 year rate that is lower than the one you could have gotten today. To take this a step further, set your payments at today's 5 yr rate, even though you have the Prime discount. This will accelerate the amount paid towards your principle balance and ensure that you don't have any 'payment shock' when you convert to the 5 yr rate 6 months later.

If all the rate predictions hold true – this will look like a great strategy a year from now. But predictions are just that – predictions! No one has a crystal ball, but I hope you can now make your decisions empowered with a bit more information. Personally, I don't think you could go wrong either way (Variable or Fixed) but remember, the definition of a bad investment is the one that keeps you up at night.

Hope you had a great 2007, and we look forward to helping you have a great 2008!

In the meantime, happy investing.

Peter Kinch