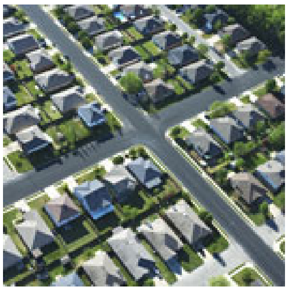
The Second Wave of Mortgage Defaults

By Jim Nelson



12/21/09 Baltimore, Maryland – Our economy is about to relapse into the disease that sent us into the Great Depression: Part Deux. Subprime loans caused the initial illness. Option-ARMs will cause the relapse.

In the first half of the past decade, subprime loans were king. They were cheap and easy to get approved. Along with the subprime boom came subprime adjustable-rate mortgages (ARMs), which were equally easy to afford…for a while.

Of course, the "A" and the "R" in ARM meant that the interest rate borrowers pay changes, or resets. The majority of these resets occurred between the summer of 2007 and the summer of 2008.

This period saw a massive amount of mortgage interest rate hikes, which caused millions of foreclosures. Things spiraled down from there, eventually freezing nearly all credit and causing the panic of 2008.

Of course, that's the 50-cent version of recent history. There were plenty of other financial calamities that went along with this, including the bundling of mortgage-backed securities and risky derivative products.

If you believe the Obama White House and the glass-half-full press corps, you'd think this mess is now behind us. We are, after all, in a recovery…right?

Unfortunately, no one is talking about the second wave of ARM resets and foreclosures…

You see, this second wave will come crashing even harder than the first. It's made up of a type of mortgage called "Option ARMs." These give borrowers the option of how much they want to pay during the first five or 10 years of repayment:

1) The full amortized rate, including interest and principal.
2) Interest only, or…
3) A token payment, well below the amount needed to cover the interest on the loan.

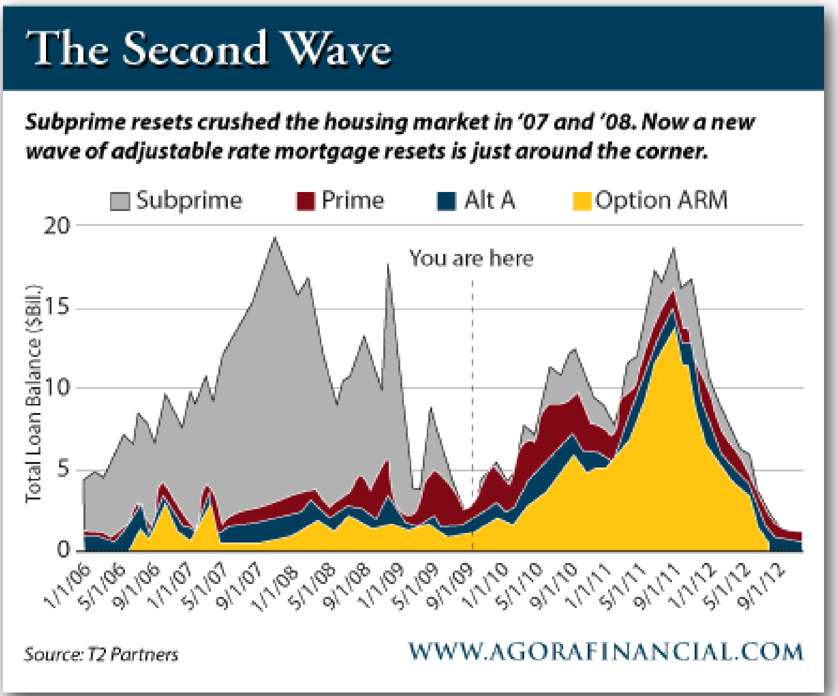
This third option causes the mortgage balance to INCREASE instead of decrease. And usually, the borrower can continue to make minimum payments until the mortgage balance increases to 125% of the original amount. That's when the trouble begins…especially if the interest rate increases at the same time.

This is the exact situation in which many homeowners now find themselves.

Obviously, these option ARMs were supposed to be reserved for customers with better credit than those who took out subprime mortgages. But apparently, they were handed out to almost anyone who wanted them.

According to Whitney Tilson and Glenn Tongue of T2 Partners, who are experts on this subject, about 80% of option ARMs are negatively amortizing. Meaning these so-called top-tier borrowers are heading further into the hole. Once their rates reset, they could be in serious trouble.

And that could be happening very soon:

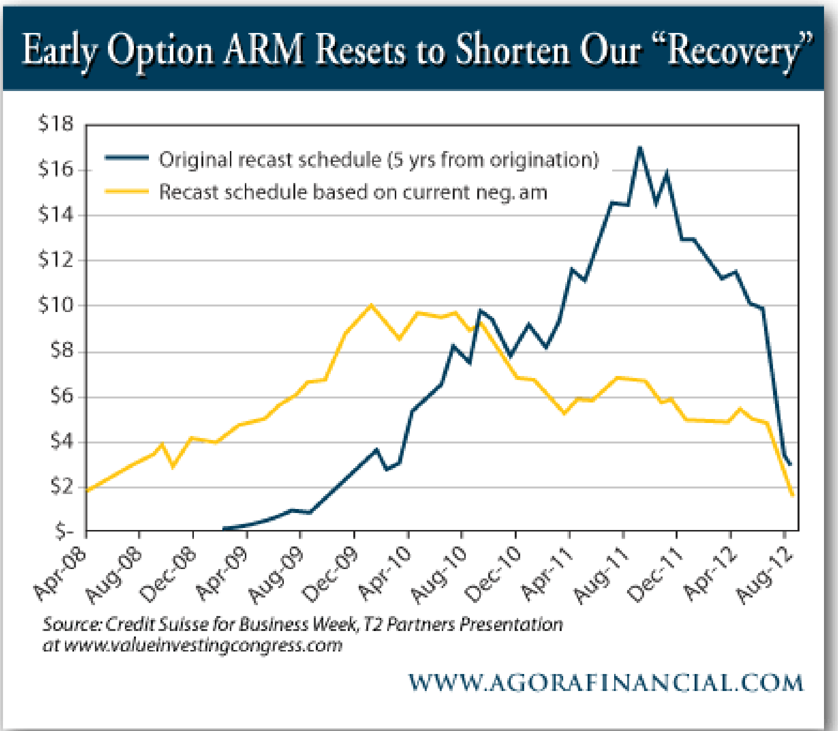


The chart above shows the two peaks in the mortgage-reset wave. The first peak is comprised of subprime ARM resets. And the second is mostly constructed of option ARM resets. We appear to be in the eye of the storm.

That fact alone shook our nerves when we first discovered it. But it was a different chart in Tilson and Tongue's most recent presentation that really got us startled… It's also the reason I'm predicting the dollar spike in 2010.

Instead of resetting as expected after the first five years, many option ARMs are so negatively amortized that they are hitting their automatic reset cap.

That means they are resetting early…like right now.



As you can see from the second chart, the expected reset peak was to occur in 2011. But the real peak is happening now. You can also see that the amount of mortgages resetting is spread over a longer period of time than originally thought, but is peaking much earlier. Unfortunately, it's not the peaks that matter.

You see, those are just resets. But with unemployment reaching quarter-century highs every month, and the massive number of homeowners about to receive mortgage bills for two to three times what they are used to paying, we find ourselves in an even scarier environment than this time last year.

It takes anywhere between 3-12 months for most homeowners to actually go into foreclosure. Therefore, the wave of Option-ARMs that are now resetting could cause a major wave of foreclosures over the next 6 to 18 months.

It’s tough to say exactly when the storm will come. But my guess is the second half of 2010.

This second wave of foreclosures will not be good news for the economy or the stock market…At least that’s my guess.

Regards,

Jim Nelson,
for *The Daily Reckoning*

http://dailyreckoning.com/the-second-wave-of-mortgage-defaults/