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## **Subprime Lending - - What Have We Mortgaged?**

Japan's Nikkei 225 Average, similar to our Dow Jones Industrials, reached almost 39,000 in the last days of 1989. What followed was a crash of 62% over the next two years. Since then, the Nikkei has gone over 20,000 a few times, but now, more than 17 years later, it is below 17,000, only 44% of its record high.

What fueled Japan's 1980's boom, and what caused its puncture, was the inflation of real estate values. At one point, the Ginza shopping district of Tokyo had an appraised value exceeding the value of all real property in Florida. Banks were lending funds based on these values, and Japanese borrowers were buying properties all over the world, from the Pebble Beach golf course in California to Rockefeller Center in New York. The rubble from the crash is still being cleaned up.

Reading this history, one scratches his head and asks how it could have happened. Yet we have been witnessing many developments here at home that may be different in degree but not in kind from what went on in Japan's 1980's. Last week, the Mortgage Bankers Association reported a number of bad developments, principally that 0.54 percent of home loans entered foreclosure in the last quarter of 2006, the highest in the 37 year history of its survey. The problem was particularly acute in the "subprime" mortgage market, where past due loans and foreclosures reached 17.86 percent. The Dow Jones average fell 242 points the next day.

Subprime mortgages are those taken by borrowers who have marginal credit-worthiness as judged by traditional lending standards. Typically, the mortgages have been issued with no down payment, with low "introductory" fixed rates that become variable in two years or so, and with lax investigations of the capability to repay. The practice is to bundle many of those mortgages and to issue interests in those bundles to investors, a kind of mutual fund for the mortgage market.

Several aspects of the subprime market have come to light in recent weeks:

- Subprime mortgages accounted for some 35% of all mortgage securities in 2006, up from 13% in 2003.

- One bank has estimated that, in 2006, the average subprime loan was 82% of the value of the underlying property, up from 48% in 2000.
- The Mortgage Asset Research Institute conducted an analysis of 100 loans and found that 60% of the borrowers overstated their income by more than half.
- The low introductory rates for many subprime loans have converted to higher adjustable rates that are beyond the budgets of many borrowers. At the same time, the declining housing market meant that the underlying properties couldn't be sold, at least at prices that would cover their mortgages. This problem was, of course, more acute where the borrower was not required to make any down payment.
- Wall Street firms, who do the bundling and selling, conduct about 60% of the mortgage financing market (all types). They work hand in glove with the lenders, but they also opine on the worth of those same lenders' stock values. On March 1, 2007, one such Wall Street firm, Bear Stearns, told its clients that the stock of one such lender, New Century Financial, presented a downside risk of \$10 (it was then selling at \$15). A few days later, New Century announced that it would stop making loans, and its stock fell to \$3.21. On March 13, the company reported that its lenders had cut off its credit and were asking it to repurchase \$8.4 billion of its mortgages; its stock traded at 85¢. The next day the stock was delisted. Sound familiar?
- Holders of interests in bundled mortgages (largely pension funds and other institutional investors) do not revalue them on a daily basis, but await periodic ratings by a rating service, like Moody's and Standard and Poor. Thus, there may be a good deal of overvalued investments in the hands of those holders.
- Never ones to remain silent in the face of an open barn door, the Congress is calling for reform of lending practices and, perhaps, some help to hapless home owners.

Some specifics on the steel market:

- Scrap and Pig Iron. We are seeing an explosion in these prices. Number 1 dealer bundles and #1 busheling were at \$363 and \$370 per mt respectively, up \$60. These prices are now at levels not seen since the closing months of 2004. Meanwhile, the spot price for Brazilian pig iron (cif New Orleans) jumped \$30 to \$375 per mt, a new record.

- Natural Gas. Despite the cold February and the increase in gasoline prices, the Nymex contract price for natural gas fell last month to \$7.36 per mcf, a decline of 11¢.
- Exchange Rates. As of this writing, the euro is at \$1.32, up a penny from last month, the pound is worth \$1.94, down a penny, and the Canadian dollar is unchanged at 85¢.

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