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The worst is yet to come, say subprime experts

At the end of August, about $46 billion in subprime loans had defaulted; that number is expected to triple in 2009 By Lisa Kassenaar, Bloomberg News

They dubbed it "The Survivors' Conference." In early November, 2,000 people who handle asset-backed securities for a living crowded into a ballroom at the JWMarriott hotel in Orlando, Fla., just 3 miles from Disney World, to hear speaker after speaker explain why 2008 may be their worst year ever.

The subprime crisis, which has claimed the jobs of three chief executive officers and prompted more than $45 billion in writedowns at the world's biggest banks, may end up spilling into 2009.

"These events tend to become deeper and play out longer than most people initially expect," says Michael Mayo, an analyst who covers securities firms at Deutsche Bank AG in New York. "This is one of the slowest-moving train wrecks we've seen."

The tumbling U.S. housing market will continue to inflict the damage. Mortgage-backed securities and collateralized debt obligations containing those securities are falling in price and won't find their footing anytime soon. That's because most of the subprime mortgages, which provide collateral for $800 billion "The collateral is not yet problematic," Whalen says. "That's the next big shoe to drop."

Whalen says defaults will soar as the rates of low-interest "teaser" mortgages held by borrowers with poor credit move up. At the end of August, about $46 billion in subprime loans, representing 225,000 homes, had defaulted, according to Credit Suisse Group. The number will more than triple to $143 billion by the middle of 2009, the bank forecasts. Total subprime loan defaults will top out at about $270 billion, or 1.52 million homes, in 2010 or later. Home builders are also facing headwinds. U.S. housing starts rose in October as an increase in condominium projects offset the weakest construction of single-family homes in 16 years. Builders broke ground on 1.229 million homes at an annual rate last month, up 3 percent from September, the Commerce Department said in Washington on Tuesday. Building permits, a gauge of future construction, fell 6.6 percent to a 1.178 pace, the lowest since 1993. Companies can't trim their inventories because sales of single-family homes are declining as fast as construction, suggesting the real-estate recession will linger into 2008.

"Until housing prices bottom out, the writedowns won't stop," says Peter Kovalski, who helps manage more than $12 billion at Purchase, N.Y.-based Alpine Woods Investments. "The Street wants things right away, but it doesn't work that way." Banks' writedowns include assets that they classify as level 3, an accounting category which indicates the holdings are so illiquid that they can only be priced using the firm's own valuation models.

Goldman Sachs Group Inc.'s level 3 assets rose by 33 percent in the third quarter of 2007 from the prior period because it was stuck with loans when the leveraged buyout market froze. Level 3 assets accounted for 6.9 percent of the firm's $1.05 trillion total at the end of August, according to a government filing. Citigroup Inc. classified 5.7 percent of its assets as level 3 on Sept. 30.

The total global loss from the subprime mess, Deutsche Bank's Mayo said Nov. 12, may reach $400 billion.
Rating companies, under fire from investors for applying their highest ratings to CDOs that included securities backed by subprime loans, are downgrading the debt. Late last month, Moody's Investors Service cut ratings on CDOs tied to $33 billion of subprime mortgage securities.

The ratings firm also threatened to downgrade structured investment vehicles with CDOs managed by Citigroup and HSBC Holdings Plc after two SIVs defaulted in October. Moody's says it assumes the SIVs are unwinding their assets, selling at distressed prices, to refinance their maturing commercial paper. The so-called Super SIV, a fund set up by banks at the urging of the U.S. Treasury to buy the highest-rated securities, will seek to prevent a meltdown of the 30 SIVs globally holding $320 billion as of Oct. 5.

Wall Street profits are also plunging in the fourth quarter. Citigroup, the second-largest CDO issuer in the first half of 2007, may post a loss in the final period, according to the average estimate of 23 analysts compiled by Bloomberg News. That's after the bank reported a writedown of as much as $11 billion, which cost CEO Charles Prince his job. Merrill Lynch & Co., which replaced CEO Stan O'Neal with New York Stock Exchange head John Thain on Nov. 14, may report that profit fell 49 percent in the fourth quarter. Bear Stearns Cos. also may have a loss.At the five biggest securities firms—Lehman Brothers Holdings Inc., Morgan Stanley, Bear Stearns, Goldman Sachs and Merrill Lynch—earnings are expected to fall 8.3 percent in 2007 from a record $30.6 billion in '06, according to analyst estimates. Lower profits mean more firings.

Bank of America Corp., JPMorgan Chase & Co., Bear Stearns, Citigroup, LehmanBrothers and Morgan Stanley announced more than 24,000 job cuts in the first 10 months of 2007. Gustavo Dolfino, president of New York- based executive search firm Whiterock Group LLC, says he expects the firms to fire another 5,000-10,000 people in '07.

The subprime debacle may echo through the economy the way the popping of the Internet bubble did—hurting consumers and growth years later. The 39 percent drop in the Nasdaq Composite Index in 2000 eventually led people to yank money from their mutual funds, Mayo says. The U.S. economy fell into recession in March '01.

At the conference in Orlando, investors concerned about another recession were in no mood for the usual festivities. The party thrown by Bear Stearns—the first Wall Street bank to have a subprime blowup—was almost empty at 9 p.m., with 10 people commiserating over beer and calypso music. Bose George, an analyst at Keefe, Bruyette & Woods Inc. attending the conference for the first time, has an equally glum outlook on the already slowing U.S. economy. He says a decline in home equity loans will curtail consumer spending.

"Credit is a huge driver of growth, and it's hard to see how this isn't going to have an impact on the economy," George says. "Things are going to get worse."

There's one bright spot for George: He'll have more time for research. Six of the 15 companies he used to cover, including American Home Mortgage Investment Corp. and New Century Financial Corp., have gone out of business.