MARCH 26, 2007

Assessing the Effect of the U.S. Mortgage Credit Crunch on High Yield Bonds

According to a monthly sentiment index released by the National Association of Home Builders, only one-third of builders in the United States have confidence that the housing market is healthy. The U.S. home builders' index, a significant market indicator, fell in March, the first decline in the index since September 2006.

Markets slid considerably amid concerns about the sub-prime mortgage lending sector, which makes a business of making loans to people with poor credit. The Mortgage Bankers Association showed that U.S. homeowners were unable to keep up with their mortgage payments in the fourth quarter, the rate of homes entering the foreclosure process was hitting a record high, and the delinquency rate on U.S. home loans was soaring.

The U.S. Senate Banking Committee has convened a hearing probing the mortgage meltdown and whether rising mortgage defaults and lender failures in the U.S. could hurt America's financial markets.

Investors are trying to determine if the U.S. economy can pull off a so-called soft landing or whether areas of weakness such as the housing sector could drag the economy into a pronounced slowdown.

Mark Kanar, vice president of global fixed income for CIBC Global Asset Management and the head of its high yield bond team, says that the most immediate effect of the sub-prime mortgage concerns is that it heightens the awareness of risk across all forms of securities. Since high yield bonds is a riskier asset class than others it receives greater scrutiny in any uncertain environment.

In Mark Kanar's view:

1. It is unlikely that any mainstream issuers of high yield bonds were major players in investing in the sub-prime market.
2. Any fallout in the debt market will restrict access to capital in general, so liquidity could become an issue.
3. The housing and automobile sectors make up approximately 10% of the U.S. gross domestic product, according to estimates from Merrill Lynch, so the comparison between housing and autos is a good starting point in assessing a sub prime fallout. The sub-prime problems will likely be contained in much the same fashion as the issues with General Motors and Ford Motors were when the automakers experienced their credit difficulties towards the end of 2005 and the beginning of 2006.

4. What might be different this time? While the auto sector endured significant job losses, consumer spending still held up. However housing is a much larger percentage of most individual net worth so any financial hit could lead to a deeper reining in of spending.
5. Finally, we are deeper into the economic cycle than we were at the start of 2006 and a positive offset to a protracted housing decline may be less likely to counterbalance its negative impact.