



Investment Strategy Group

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# Investment Strategy Bulletin

## Subprime... the sequel

The current financial crisis has its root in the mortgage issuance boom that began in 2001 and peaked, with the net issuance of USD 1.1 trillion of household mortgages, in the first half of 2006. For much of the post-war period, net new mortgage origination by households averaged about 3% of GDP but peaked close to 9% in the second quarter of 2006. It is reasonable to assume that the borrowers early in the cycle represented the comparably high quality part of the borrower spectrum (hard as it seems to describe "subprime borrowers" in that way), with the credit quality of borrowers deteriorating markedly as the boom approached its peak.

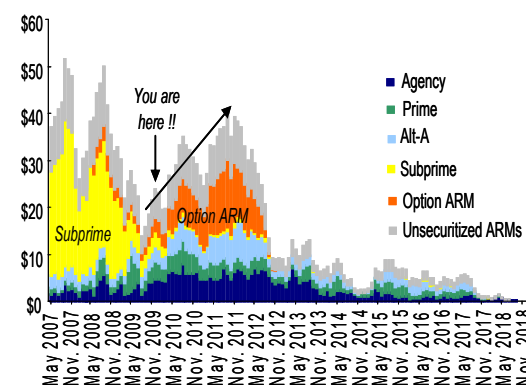
At the peak in 2006, a record 50% of total mortgage applications were for Adjustable Rate Mortgages (so called, ARMs, with very low teaser rates that would generally reset 5 years forward). The upper chart shows the huge wave of subprime ARM resets in 2007/08: the resets cycle for the sub prime mortgage genre peaked in late 2008 and accounts for the sharp decline in overall resets in 2009 that has given respite to banks and a degree of relief to borrowers. Unfortunately, as the chart shows, the lull in ARM resets hits its low point now, before the surge of a second wave of resets in 2010/11. In fact, the lower chart shows almost USD 750 bn of resets in the next two years, concentrated this time in the Option ARM and Alt-A genre of mortgages. Option ARMs are mortgages that required little or no documentation, where borrowers had the option of making monthly payments (with the interest rate generally negatively amortizing on the mortgage) and, given the shocking borrower quality, the hope was that house prices would continue to rise and homeowners could simply "flip" the property when the mortgage came to reset. There are almost USD 200 bn of Option ARMs to reset in the years ahead (Fitch estimate that 90% of those have yet to reset) and, given that delinquency rates are already running near 40%, the scale of this reset time-bomb is equal in magnitude to that of subprime in 2007/08. Alt-A mortgages sit somewhere in quality between prime and subprime.

Looking at the lower chart, in excess of USD 1 trillion in mortgages reset in the next 3 years: resets in the next 3 years are equal in magnitude to those of the last 3 years. Whoever said the credit crisis was over is severely misguided!

Whilst taxpayers will remain in their wrongful place in the capital structure of banks, the much needed debt for equity swap process absent, the consequence of "subprime the sequel" is that further substantial losses will be taken by the government purse and the financial sector is a long way from being able to function normally. It may, also, be premature to allow banks to escape TARP constraints, simply to pay staff bonuses.

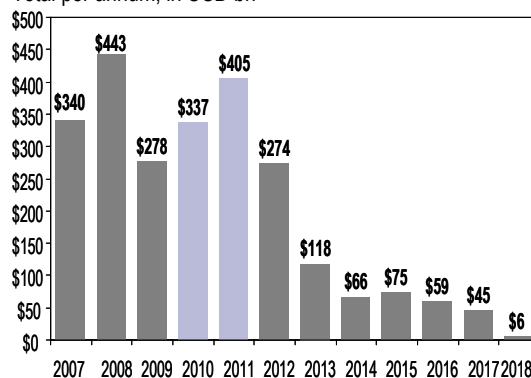
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United States: monthly ARM resets, per category (USD bn)



United States: ARM resets

Total per annum, in USD bn



Source: Credit Suisse

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## SWITZERLAND

### Geneva

**Lombard Odier Darier Hentsch & Cie**  
Private Bankers regulated by the FINMA.  
Rue de la Corrairie 11 · 1204 Genève · Suisse

### Fribourg

**Lombard Odier Darier Hentsch & Cie, Bureau de Fribourg**  
Rue de la Banque 3 · 1700 Fribourg · Suisse

### Lausanne

**Lombard Odier Darier Hentsch & Cie**  
Place St-François 11 · 1003 Lausanne · Suisse

### Lugano

**Lombard Odier Darier Hentsch & Cie, Agenzia di Lugano**  
Via Vegezzi 6B · 6900 Lugano · Svizzera

### Vevey

**Lombard Odier Darier Hentsch & Cie, Agence de Vevey**  
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse

### Zurich

**Lombard Odier Darier Hentsch & Cie**  
Utoquai 31 · Postfach 1457 · 8032 Zürich · Schweiz

## EUROPE

### Amsterdam

**Lombard Odier Darier Hentsch & Cie (Nederland) N.V.**  
"Weteringpoort" Weteringschans 109 · Postbus 58007 ·  
1040 HA Amsterdam · Nederland  
*Holds a bank license from De Nederlandsche Bank and is registered with the Autoriteit Financiële Markten.*  
E-mail: amsterdam@lombardodier.com

### Barcelona

**Lombard Odier Darier Hentsch & Cie (España) S.V., S.A.**  
Avenida Diagonal 399 · 08008 Barcelona · España  
*Investment company supervised by the Comisión Nacional del Mercado de Valores (CNMV).*  
E-mail: spain@lombardodier.com

### Brussels

**Lombard Odier Darier Hentsch & Cie (Belgium) S.A.**  
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium  
*Bank supervised by the Banking, Finance and Insurance Commission.*  
E-mail: brussels@lombardodier.com

### Düsseldorf

**Lombard Odier Darier Hentsch Deutschland, Niederlassung von Lombard Odier Darier Hentsch & Cie (Nederland) N.V.**  
Düsseldorf-Stadtter · Stadtter 1 · 40219 Düsseldorf · Deutschland  
*Branch of Lombard Odier Darier Hentsch & Cie (Nederland) N.V. regulated by De Nederlandsche Bank and the BaFin.*  
E-mail: dusseldorf@lombardodier.com

### Gibraltar

**Lombard Odier Darier Hentsch Private Bank Limited**  
Suite 921 Europort · P.O. Box 407 · Gibraltar  
*Bank supervised by the Gibraltar Financial Services Commission (FSC).*  
E-mail: gibraltar@lombardodier.com

### Jersey

**Lombard Odier Darier Hentsch (Jersey) Limited**  
P.O. Box 641 · N° 1 Seaton Place · St Helier · Jersey JE4 8YJ · Channel Islands  
E-mail: jersey@lombardodier.com

## London

**Lombard Odier Darier Hentsch (UK) Limited**  
Queensberry House · 3 Old Burlington Street · London W1S 3AB · England  
*Wealth Management Services company authorized and regulated by the Financial Services Authority (FSA).*  
E-mail: london@lombardodier.com

## Madrid

**Lombard Odier Darier Hentsch & Cie (España) S.V., S.A.**  
Paseo de la Castellana 66 · 28046 Madrid · España  
*Investment company supervised by the Comisión Nacional del Mercado de Valores (CNMV).*  
E-mail: spain@lombardodier.com

## Paris

**Lombard Odier Darier Hentsch & Cie (France)**  
8, rue Royale · 75008 Paris · France  
*Investment company approved by the Comité des Etablissements de Crédit et des Entreprises d'Investissement (CECEI).*  
E-mail: paris@lombardodier.com  
**Lombard Odier Darier Hentsch Gestion**  
8, rue Royale · 75008 Paris · France  
*Portfolio management company approved by the Autorité des Marchés Financiers (no. GP 01-011).*  
E-mail: paris@lombardodier.com

## Prague

**Lombard Odier Darier Hentsch & Cie - Representative Office Prague**  
Praha City Center · Klimentská 46 · 110 02 Praha 1 · Czech Republic  
E-mail: prague@lombardodier.com

## MIDDLE EAST, AMERICAS, ASIA | PACIFIC

### Bermuda

**Lombard Odier Darier Hentsch (Bermuda) Limited**  
**Lombard Odier Darier Hentsch Trust (Bermuda) Limited**  
3rd Floor, Victoria Place · 31 Victoria Street · Hamilton HM 10 · Bermuda

### Dubai

**Lombard Odier Darier Hentsch & Cie - Representative Office Dubai**  
The Fairmont - 25th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE

### Hong Kong

**Lombard Odier Darier Hentsch (Asia) Limited**  
1501, Two Exchange Square · 8 Connaught Place · Central · Hong Kong

### Montreal

**Lombard Odier Darier Hentsch (Canada), Limited Partnership**  
1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) ·  
Canada H3A 3R7

### Nassau

**Lombard Odier Darier Hentsch Private Bank & Trust Limited**  
Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau ·  
Bahamas

### Singapore

**Lombard Odier Darier Hentsch & Cie (Singapore) Ltd.**  
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619

### Tokyo

**Lombard Odier Darier Hentsch Trust (Japan) Limited**  
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan