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Can Subprime Mortgage Problems Crash the Car Business?

Auto sales have been struggling for years but now that the housing market is stalling, things could get even worse

by Jim Koscs

The housing slump has been placing some weight on the U.S. economy this past year. Last Friday, the federal government reported that overall economic growth slowed to a sluggish 1.3 percent rate in Q1 of 2007, marking the weakest performance in four years.

And so, it seems like a fairly easy and obvious prediction to make: that the housing market slowdown in many parts of the country, coupled with variable-rate mortgages resetting to fully indexed rates for millions of homeowners, will have a negative impact on automobile sales. Late last month, General Motors Vice Chairman Bob Lutz became perhaps the first high-profile car industry executive to make that connection "official."

Quoted by Reuters, Lutz said, "The market as a whole has been a little weakish. That has come as a result of the housing market problems and the mortgage industry meltdown. A lot of people are finding themselves in a position of reduced affordability and that has had an impact, not just on us, but across the industry."

Is what was bad for GM in April also bad for the broader market? April auto sales figures coming out this week are expected to be down for much of the industry, and others do share Lutz's concern, if not his tone. Ian Beavis, vice president of marketing for Kia Motors America, told AIADA that yes, April would show a downward blip for many brands. But he is not ready to blame it all on housing, and he is definitely not hitting the panic button.

"Any upset in the equilibrium in the housing business definitely starts to concern us in the car business," Beavis said. "April will be a fairly weak month for the industry, and there is some uncertainty. Overall, we do see a cooling, but not something to react dramatically to. Is there more of a problem? We don't know yet."

It may be a bit early to project the impact of the housing sector's woes on the car industry, in part because what Lutz called a "meltdown in home mortgages" is just one part in a confluence of events affecting housing. For much of 2006, the slowdown in new-home building and slowing sales of existing homes grabbed headlines. More recently, attention has turned to variable-rate mortgage "resets" and the resulting pressure of higher monthly payments for homeowners. Yet, last year's bad news in housing has not gone away and is combining with this year's bad news to create a "perfect storm" in many markets.

Foreclosures on the Rise

At the eye of that storm, according to foreclosure information specialist RealtyTrac, are subprime home loans, with the hardest-hit markets in California and the Midwest—but for different reasons. In California, subprime lending has been feeding off slipping affordability by offering variable-rate, high loan-to-value mortgages. In the Midwest, rising unemployment has been putting more pressure on homeowners and is especially hard-hitting for those facing rising monthly home payments from variable-rate loans.

In either scenario, variable rates have gone up while in many cases home values have declined. Homeowners are left with higher monthly payments, yet with reduced or even negative equity. For some, the option of selling the house to escape debt is not available.

By some estimates, more than two million homeowners across the country could find themselves facing foreclosure. According to RealtyTrac, foreclosures in March soared to nearly 150,000, *a 47-percent increase* over March 2006, and a seven-percent increase over this past February. RealtyTrac bills itself as "the nation's number one source of foreclosure listings" and makes its information available to consumers by Internet subscription.

Declining Home Values Dragging Down Consumer Spending?

A drop in home values in many markets could also be crimping consumer spending, which was fueled for several years by borrowing against home equity. That has been the common wisdom, but now someone has put a number on it. Former Federal Reserve Chairman Alan Greenspan co-authored a paper saying "home equity extraction" boosted personal consumption expenditure (PCE) by three percent—or an average of $115 billion annually—between 2001 and 2005. Greenspan did not go so far as to predict that consumer spending would drop in lock step with declining home values and available equity, and his earlier prediction of a "one third" chance of a recession in 2007 has not been widely echoed. Meanwhile, on April 25, the Dow Jones stock index crossed the 13,000 threshold for the first time.

Despite a media focus on variable-rate and subprime mortgages, some in the auto industry say the real boogeyman is lurking 60 or 72 months out: growing loan terms. Asked if the subprime mortgage problems were affecting car sales, David McKay, director of auto finance and insurance for J.D. power and Associates, said, "There might be slightly fewer people who come to the stores because of other pressures." McKay's bigger worry, however, is that auto buyers are digging deeper into debt with ever-longer auto loan terms and a growing reliance on subprime auto financing.

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