Forecasts and Trends
The Housing Market - What To Expect Next
By Gary D. Halbert

We all know that we're in a housing slump - there's no longer any debate. Over the past three quarters, we've seen a 25% drop in new home sales, a 35% plunge in housing starts, and an estimated 110,000 jobs lost in the residential construction industry. Applications for building permits plunged over 30% last year to a nine-year low according to the Census Bureau.

The questions are: 1) have we seen the worst in the housing market; 2) if not, how much worse will the housing slump get; and 3) will it be bad enough to tank the economy in general? I would argue that it was largely the housing market that slowed economic growth from 5.6% in the first quarter of last year to 2.6%, 2.0% and 2.2% in the last three quarters of last year.

The latest data would seem to suggest that we haven't seen the worst of it. New home sales plunged 16.6% in January; the worst monthly drop in 13 years. The inventory of unsold homes rose from a 5.7 months supply in December to a 6.8 months supply in January.

It is important to keep in mind, however, that some of the negative news noted above is actually positive in terms of how bad the housing slump could get. For example, the huge declines in building permits and housing starts are definite indications that homebuilders have substantially cut back their activities. It is widely known that homebuilders are actively marketing their existing homes with deep discounts and extra incentives.

BCA believes that the inventory backlog of unsold homes is likely to decline in the months ahead, especially as we move into the spring and summer when home sales typically start to increase. Likewise, the latest drop in interest rates, especially the bond market, should make home financing more attractive in the months ahead. Mortgage rates are falling again. There was, in fact, a modest increase in sales of existing homes in January.

Thus, while the news for the housing market remains mostly negative, there are reasons to believe that the homebuilding industry is bottoming out and better news lies ahead, especially this spring and summer. However, that does not mean that home prices are about to bottom out. Because home prices increased so dramatically over the last decade, the median home price is likely to continue to fall (by differing amounts depending on the region) for at least the balance of this year. The median sale price for new homes was $239,800 in January, down 2.1% from the same period a year ago.

The greatest area of concern for the housing slump at the moment is the so-called **"sub-prime mortgage"** market, which I will discuss below.

Sub-Prime Mortgages - How Bad Can It Get?

One of the most hotly debated economic issues at present is the extent to which the current weakness in sub-prime mortgage lending, and rising sub-prime mortgage delinquencies and defaults, may spill over to the prime mortgage lenders, and to the economy as a whole.

Sub-prime lending is essentially the practice of extending mortgages to those who cannot qualify for traditional mortgages. As a general rule, a mortgage loan is considered to be sub-prime if the so-called **FICO credit score** of the borrower is less than 620. The sub-prime lender is compensated for taking this additional risk by charging a higher rate of interest and fees.

Over the course of the housing boom, literally millions of homes have been sold to families that would never have qualified for a traditional home loan prior to the emergence of the sub-prime mortgage industry. Estimates I have seen say that all sub-prime mortgage lending amounts to over $600 billion of the $5.5 trillion of total outstanding mortgages, approximately 11% of the total. So when you hear media reports on the "sub-prime crisis," keep in mind that these mortgages represent a very small part of the total mortgage market.

Many of these sub-prime mortgages were sold as ARMs (Adjustable Rate Mortgages), meaning that the interest rate would start low and be adjusted higher over time. Some were even "interest-only" loans, a very unwise practice where only the mortgage interest is paid in order to make homes more affordable. Mortgage industry analysts have long predicted that sub-prime mortgage defaults would skyrocket when interest rates rose and payments increased accordingly.

Sub-prime mortgage loan delinquencies and defaults have increased significantly recently, just as many had predicted. Morgan Stanley estimates that the overall sub-prime mortgage loan delinquency rate stood at 12.56% at the end of the 3rd Quarter of 2006, as compared to only 1.7% for prime mortgage loans. This, in turn, has put pressure on earnings of sub-prime lenders, and many have seen their stock prices plummet in recent weeks. Some have even filed for bankruptcy or folded. Consequently, the prices of asset-backed securities made up of sub-prime loans have also been pushed dramatically lower.

Thus, the question before us is, will the sub-prime mortgage problems be limited to just that industry, or will they spread to prime lenders and the economy as a whole?

On February 12, **Morgan Stanley** published a very good analysis of the sub-prime mortgage dilemma. I found it to be very informative because it presented both sides of the issue. On one side, **Stephen Roach** presented a scenario where the problems in the sub-prime lending could spill over to the economy as a whole, especially when combined with other market factors. **Richard Berner**, also of Morgan Stanley, presented the

opposing view that the damage of rising sub-prime mortgage defaults will be contained to that industry. I'll summarize both views below, and then cap it off with BCA's outlook.

Roach seems to think that the problems in the sub-prime lending industry will spread to other areas of the economy. While he doesn't dispute the fact that default rates for higher-quality mortgage loans are still largely unaffected and credit spreads are still small, he points to the recent profit warnings by larger, main-stream mortgage lenders to be an omen that the problems occurring in the sub-prime markets could spill over to the prime lenders.

Roach argues that sub-prime defaults and delinquencies could lead to a "credit crunch" where all lenders put on tighter restrictions, and fewer homebuyers will be able to qualify for mortgage loans. Roach believes that tighter credit restrictions will exacerbate the housing slump, and thereby negatively affect the overall economy.

Roach is wary of the market's tendency to shake off major negative events such as rising energy prices, softening in the housing market, increased terrorism activity, etc. He says that investors have now come to largely disregard any spillover risk of major negative events because of the "Teflon-like" view of the world economy, and that history does not tend to treat such complacency kindly.

Richard Berner, on the other hand, points to sub-prime mortgage industry practices as more of the major cause of its problems, and therefore tends to think that any carnage will be limited to that segment of the industry. Sub-prime mortgage lenders have become increasingly more aggressive to remain competitive in recent years, which very likely has accounted for some of the increase in sub-prime defaults. In other words, the wounds may be largely self-inflicted.

For example, Berner cites the statistic that early-payment defaults, which are loans that default shortly after their origination, have increased dramatically. However, he thinks this is largely because of the aggressive practices of some lenders that push the envelope of good business sense. For example, some aggressive sub-prime lenders originate "stated income" loans, where the borrower need not provide documentation of earnings, but merely provide a statement of annual income. **Is it any wonder then that many borrowers fraudulently report a higher income than they actually earn to qualify for a mortgage, and then default on the loan? No.**

Berner also points to the relatively small proportion of the sub-prime market to the total outstanding mortgage debt as an insulation of sorts from a spillover effect. He readily admits that credit spreads are likely to widen further, that more sub-prime lenders will likely go under, and that sub-prime lending rules will tighten in the near future, but he does not foresee tight credit spilling over to the prime lending markets.

BCA's view of the effects of the sub-prime mortgage lending problems tend to be more in line with Richard Berner's scenario. They do not anticipate much, if any, spillover effect in the overall economy that would create a credit crunch. While the liquidity so

necessary in the sub-prime mortgage business model may dry up, BCA does not see this spreading beyond that industry. BCA states:

"Sub-prime lenders are heavily reliant on liquidity and can remain in business for only a limited time once access to credit dries up. Ultimately however, we expect the damage will be contained to the sub-prime market. Most homeowners have little reason to fall behind in their mortgage payments so long as they have a job, and their income is growing. Corporate bond spreads confirm there has been limited contagion so far."

The biggest unknown, in my opinion, is the possibility of Congressional action to address the problems in the sub-prime lending industry. Berner and BCA seem to put a low probability on Congress stepping in to restrict credit by tightening the lending standards. However, I'm not so sure. Whenever there is a high-visibility problem, there's always a politician or two (or ten, or fifty) that want to pass laws to address the problem.

If left alone, I think the markets will eventually take care of the abuses by overly aggressive sub-prime lenders by forcing them to tighten up their lending practices and/or go out of business entirely. This, in turn, may have some minor effect on the housing industry, but it's important to not overstate this effect, since sub-prime loans account for only 11% of the current market. Before the market has time to work through its solution, however, we could see grandstanding politicians proposing to make the world safe from "predatory" mortgage loan originators, only to make matters worse.

Stock Market

It remains to be seen if the stock market correction is over. It will not surprise me if we see some additional weakness over the next few days or weeks. However, BCA continues to believe that US equity prices will recover and deliver relatively attractive returns over the next year. According to Legg Mason research, the broad equity indexes have returned an average of at least 14% over the next year following days where the Dow, the S&P 500 and the Nasdaq all lost 3% or more in a single day. So I would consider this pullback to be a buying opportunity.

The Economy

The US economy remains on sound footing, even though recent reports have been mostly on the negative side. Consumer confidence hit a 5½-year high in January, and consumer spending remains robust. Overall, I would expect another 2-3 quarters of growth in the 2-2½% range in GDP. If so, the Fed is not likely to raise interest rates anytime soon, especially in light of the housing slump.

Housing

The Housing market remains in a downturn, but there is plenty of evidence that homebuilders have put on the brakes. With interest rates lower, and with the home buying season just ahead, the inventory of unsold homes should start to fall. The

problems in the sub-prime mortgage market, which accounts for only 11% of all outstanding mortgages, are not likely to spill over into the prime mortgage market, and should not tank the economy. All of this assumes, of course, that there are no major negative surprises lurking out there this year.

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