FORECASTS & TRENDS
What's Happening With the Economy and Housing?
by Gary D. Halbert

Most economists and market analysts agree that the U.S. economy has been through the worst of the recession. The economy clearly rebounded in the fourth quarter of last year. Some economic reports suggest that the economy will continue to strengthen through the balance of this year, such as the Index of Leading Economic Indicators which has risen for the last 10 consecutive months.

Unfortunately, two reports released last week were extremely negative. First, consumer confidence unexpectedly plunged in January. No analysts I read saw this large a drop coming. Second, the Federal Deposit Insurance Corporation (FDIC) released its quarterly report which showed that lending by U.S. banks plunged last year in the sharpest decline since 1942. We also saw new unemployment claims spike higher for the week ended February 20.

It is widely agreed that consumer spending accounts for approximately 70% of GDP. With the Consumer Confidence Index unexpectedly plunging almost 20% in February alone, this raises serious doubts about economic growth going forward in 2010. Likewise, spending by businesses is also a big part of GDP, but if bank lending to businesses remains hamstrung, this is not a good sign for the overall economy.

I have argued for some time that the nice rebound in the economy in the fourth quarter was largely due to inventory rebuilding. I have likewise argued that inventory rebuilding would be only a relatively short-term boost to the economy, and that economic growth would be upward but disappointing in 2010. I have also suggested that we could well be in for a double-dip recession in 2011, if not sooner.

The latest reports on consumer confidence and bank lending, along with continued high unemployment, virtually assure my arguments for disappointing growth in 2010 and support my suggestion of a possible double-dip recession in 2011. We will discuss all this plus another possible negative shock to come from the housing market. Sorry to be so negative, but things are what they are.

Economy Continues to Recover, But Slowly
Before I get to the discussion of plunging consumer confidence and bank lending, let's first review the latest routine economic reports. The US economy continues to struggle to dig out of the recession. The Commerce Department's second estimate on fourth quarter GDP came out last Friday, and it came in at 5.9% (annual rate), up from 5.7% in late January, and in-line with the pre-report consensus.

The Commerce Department again confirmed that inventory rebuilding accounted for much of the advance in GDP in the fourth quarter, followed by exports and consumer spending in third place. Real personal consumption expenditures increased 1.7% in the fourth quarter quarter, compared with an increase of 2.8% in the third quarter.

The Index of Leading Economic Indicators (LEI) registered its 10th consecutive monthly increase in January, rising 0.3%. The continued rise in the LEI is a strong indication that the economy is in recovery; however, the January rise of 0.3% was far short of the December rise of 1.2%. The tepid rise in January added fuel to the argument that GDP growth will be disappointing in 2010.

Retail sales rose a better than expected 0.5% in January following a loss of 0.1% in December. On the manufacturing front, the ISM Index rose again in January to 58.4 from 54.9 in December. Any reading above 50% in the ISM Index suggests that the economy is expanding, at least slowly in this case.

Orders for durable goods (big-ticket items) rose a better than expected 3% in January, up from 1.9% in December. Industrial production rose 0.9% in January, up from 0.7% in December. And the factory operating rate (capacity utilization) rose modestly in January. That's about it for the good news of late.

The US unemployment rate fell from 10% to 9.7% in January, even as businesses cut another 20,000 jobs last month. The drop in the headline unemployment rate occurred primarily because a large number of Americans gave up on looking for work late last year and in January and were therefore not counted in the official unemployment rate. And as we learned last Thursday, the number of Americans filing for state jobless benefits is still increasing at the rate of almost 500,000 a week.

Consumer Confidence Falls Off a Cliff

The markets got a shock when the Conference Board announced that its widely followed Consumer Confidence Index basically fell off a cliff in February. The Index plunged to 46.0 in February from January's 56.5, a drop of approximately 20%, following several months of increases. This is the largest monthly plunge in consumer confidence in recent history, and was totally unexpected.

At the risk of going political, I happen to believe that millions of Americans have recently turned negative because the "hope and change" that President Obama promised has not happened. Instead, they see the government spending outrageous sums of money and running $1+ trillion deficits as far as the eye can see. No wonder consumer confidence is in the tank.

Speaking of falling off a cliff, have you seen the latest polls on how the American public views the job Congress is doing? ***The latest Rasmussen poll last week found that 71% of Americans believe that Congress is doing a "bad" job,*** while only 10% believe they are doing a "good" job. This is the lowest approval rating ever recorded by Rasmussen and was up from 61% just one month earlier.

Bank Lending Continues to Plunge

The FDIC reported that bank lending shrank at a record pace in 2009. The lead article in the Wall Street Journal read: ***"Lending Falls at Epic Pace."*** How true, unfortunately. Last year, US banks posted their sharpest decline in lending since 1942, suggesting that the industry's continued slide is making it harder for the economy to recover.

While top-tier banks are recovering at a faster clip, the rest of the industry is still suffering, according to a quarterly report from the Federal Deposit Insurance Corp (FDIC). Banks fighting for survival, especially those plagued by losses on commercial real estate (as I have written about often recently), are less willing to extend loans, siphoning credit from businesses and consumers.

Besides registering their biggest full-year decline in total loans outstanding in 67 years, US banks set a number of other grim milestones last year. According to the FDIC, the number of US banks at risk of failing hit a 16-year high at 702. More than 5% of all loans were at least three months past due, the highest level recorded in the 26 years the data have been collected.

The FDIC said that the decline in loan balances in the fourth quarter of 2009 hit all major categories—from construction to commercial loans and residential mortgages. Only credit-card loans increased in the fourth quarter.

None of this is good for the economy, and this is a big reason why I expect GDP growth to disappoint this year. While the credit markets may not be frozen as they were in late 2008, they are still at least frosty.

More Really Bad News on the Housing Front

Let me begin with the only bit of positive news. In January, housing starts rose 2.8%, the best pace in six months. But that is where the good news ends and the really bad news begins.

New home sales in January plunged by 11.2% from December levels to a seasonally adjusted annual rate of 309,000 units, the Commerce Department said last Wednesday. The decline brought sales to their lowest level since the government began tracking the numbers in 1963. Sales were 6.1% lower than in January 2009.

The drop in sales in January triggered an increase in the backlog of unsold new homes on the market, pushing it up to the equivalent of what would normally be sold in 9.1 months versus eight months in December. And the abundance of homes on the market continued to bring prices down. The median sales price for new homes fell 2.4% to $203,500 in January, compared with a year ago.

Faltering demand in the housing market also led to a drop in mortgage applications for both new and existing homes. The Mortgage Bankers Association's seasonally adjusted purchase index fell 7.3% for the week ending February 19th from the prior week. It is the index's lowest level since 1997.

Existing home sales in January were also sharply lower, down 7.2%, well below expectations, to a seven-month low. This was the second consecutive monthly decline in existing home sales. And remember that this is happening at a time when there are tax rebates of $6,500-$8,000 for home purchasers. What do you think will happen to home purchases when these tax breaks go away?

Much of this bad news is no doubt related to the plunge in consumer confidence last month and the continued tightness in the credit markets, as discussed above. Unfortunately, weak home sales in January are not the industry's only problem.

Are "Option-ARMs" the Next Subprime Crisis?

Some housing analysts believe that the option adjustable-rate mortgage market may be the next subprime disaster. Recent analysis from Standard & Poor's (S&P) anticipates that a full 37.5% of such loans, referred to as "option-ARMs," that were written in 2007, at the height of lax lending, will eventually go bad.

The problem with option-ARMs begins with the fact that people who took out these loans were given the option to make ultra-low payments for the first few years, and many of them did exactly that. Borrowers who took advantage of these ultra-low payments, mostly middle and upper-class with good credit scores, were allowed to make payments that didn't even cover the interest owed (let alone the principal), with the understanding that payments would go up later on to make up for the shortfall.

That allowed people to buy bigger, more expensive houses than they would have been able to qualify for otherwise. Most of these families banked on a good economy and rising incomes by the time the resets took place five years later. Likewise, many assumed they could just sell the house in five years in the unlikely event they couldn't make the higher payments. Thanks to the recession, the credit crisis and the housing crash, these people are now stuck in their ARMs.

Some option-ARMs have already reset (more on this below), but the bulk of these loans don't reset until the last half of 2010 and the first half of 2011. By the middle of next year, more than $10 billion worth of option-ARMs will reset higher each month, according to data from mortgage tracker Loan Performance. That comes close to the figures we saw during the subprime crisis.

As noted above, some people with option-ARMs have already seen their payments spike, thanks to caps on "negative amortization" - that is, a loan balance that grows, instead of shrinks, over time. Austin-based Amherst Securities, a big player in mortgage-backed securities, dissected one such loan, which was written in 2007 for $465,000 over 40 years. A minimum monthly payment that started at $1,260 soon rose to $1,354 and then to $2,806, more than twice the original amount. The borrower quickly defaulted.

Even without negative amortization, many borrowers will see their monthly payments jump by 50% or more. According to an S&P study of loans originated in 2005, borrowers who have undergone a higher reset are nearly three times as likely to default as those who haven't. S&P managing director Diane Westerback warns, "Some of the damage has already been done but the loss projections are increasing."

With the housing market as it is, borrowers will find few good alternatives for rescue should they run into trouble. The traditional response of refinancing into a more affordable loan is off the table for many homeowners, considering that property prices have plummeted. More than 85% of option-ARM holders owe more on their loan than their house is worth, a situation known as negative equity or being "underwater." Typically, a refinance is impossible without the borrower having at least 20% equity in a house.

The Obama administration's big loan-modification effort, the Housing Affordability Modification Program (HAMP), does little to help such borrowers since in many cases lenders will recoup more by foreclosing (the test any loan modification must pass) than refinancing. A recent Bank of America / Merrill Lynch study of loan modifications at IndyMac, which provided the template for broader modification efforts, found that only about 20% of subprime loans had been rewritten, while fewer than 8% of option ARMs were refinanced.

The good news, if you can call it that, is that these loans are very concentrated geographically. About 75% of all option-ARMs were written in California, Florida, Arizona and Nevada, with the vast majority of those in California. People living in Phoenix, Las Vegas and California's Inland Empire, which have high concentrations of option ARMs, can expect to see renewed downward pressure on home prices. Home prices in some of these areas are already down 30-40%.

Clearly, foreclosures are going to skyrocket again as the bulk of the option-ARM resets kick in later this year and next year. The question is whether or not these will negatively affect home prices around the country, since most option-ARMs are concentrated in only four states. Time will tell but this is not good news for the housing market or the credit markets.

Gary D. Halbert is the president and chairman of Profutures, Inc. Subscription rates for Forecasts & Trends is $197 for 12 issues and may be obtained by visiting his website at www.profutures.com.