

A TIMETABLE *for* RECOVERY

BY DAVID W. BERSON

The next housing expansion should begin in 2009, although look for it to be modest at first.

Both the housing and mortgage markets had dismal years in 2008, after an already bad 2007 and a down 2006. Through October 2008, existing-home sales had fallen by more than 31 percent from their peak in 2005, while new-home sales were down by more than an incredible two-thirds (see Figure 1). ● Single-family housing starts slipped in October to their lowest levels since 1981—a time when yields on 30-year fixed-rate mortgages (FRMs) spiked to more than 18 percent and the unemployment rate climbed to more than 8 percent. Moreover, the multiyear falloff in housing demand has created the biggest decline in national house prices since the Great Depression. The national Standard & Poor's (S&P)/Case-Shiller® Home Price Indexes plummeted by more than 21 percent in the third quarter from its all-time high in early 2006, pushed down by a combination of rising home foreclosures and record numbers of homes for sale. ● The mortgage market has been hit as well. PMI estimates that single-family originations will fall to around \$1.8 trillion in 2008—the lowest level since 2000.

Entire segments of the mortgage market have been eviscerated over the past year, with the subprime and alternative-A markets down to about 2 percent of the total (from a peak in 2006 of approximately 33 percent) and jumbos at around 5 percent. In their place, the Fannie Mae/Freddie Mac and Federal Housing Administration (FHA)/Department of Veterans Affairs (VA) shares have soared—up to more than 85 percent of the market.

Given the poor backdrop of the past few years, what is PMI's view of the housing and mortgage markets for 2009? Is there any hope that housing will rebound? Will mortgage market volumes continue to plummet?

There are three separate, but related, problems weighing on the housing and mortgage markets:

- The current glut of homes for sale, leading to record home-price declines.
- The credit crunch, which makes it difficult for current homeowners to refinance their existing mortgages and for potential homebuyers to get new mortgages.
- The downturn in the economy, which is leading to rising unemployment rates and lower demand for housing.

For the housing market (and the general economy) to

recover, all of these factors will need to be corrected. The corrections are likely to occur at different times, with financial markets healing first, followed by the housing market and then the general economy.

There is evidence that financial markets, especially for mortgage finance, are already beginning a slow recovery. Specifically, with the Federal Reserve's announcement of a special facility to purchase up to \$100 billion of Fannie Mae, Freddie Mac and Federal Home Loan Bank (together, the government-sponsored enterprises [GSEs]) debt and up to \$500 billion of GSE mortgage-backed securities (MBS), GSE borrowing costs have dropped sharply and mortgage rates (at least for prime conventional conforming 30-year FRMs) have plummeted by about 50 basis points. And this is just in the few business days after the Fed's announcement.

If necessary, the Fed would probably increase the size of this program in order to push mortgage rates lower—and it is possible that it will expand the program to include some jumbo MBS. Moreover, long-term interest rates in general have slipped dramatically in recent weeks, especially for Treasury securities, as the magnitude of the economic slowdown becomes clearer and investors seek safe assets. This will put additional downward pressure on mortgage rates.

According to Freddie Mac's Primary Mortgage Market Survey, yields on 30-year FRMs fell to 5.53 percent on Dec. 5 and were moving lower. The low for mortgage rates, at least since the 1950s, was in June 2003 at about 5.2 percent, and there is a reasonable chance that mortgage rates will fall below that in the next few months.

While the downturn in the housing market was not primarily mortgage rate-related, the sharp run-up in house prices (combined with higher mortgage rates after the Fed began tightening monetary policy in 2004) resulted in a substantial reduction in housing affordability—especially in high-cost areas such as California and the New York and Washington, D.C., metropolitan areas.

As the housing recession hit in full force, however, house prices fell and the composite housing affordability index computed by the National Association of Realtors® (NAR), Chicago, began to rise. It had already increased substantially in September 2008, primarily because of lower house prices (see Figure 2). This is likely to have been the case when the October figures are released, but this will be too soon for the latest dramatic drop in mortgage rates to have an impact. Even the November affordability figures will only be affected for the few days at the end of the month after the Fed's announcement pushed mortgage rates down.

As a result, it won't be until the December affordability figures are released at the end of January that we'll get a good reading on how much affordability has risen in response to this recent decline in mortgage rates. It is likely that when these figures are available, affordability will increase to levels not seen since the early 1970s—and perhaps will even move above that to record highs.

Affordability is not the whole story with respect to home sales, of course; people have to be willing to buy. The downturn in the economy has caused consumer confidence to plummet, reducing the willingness of households to buy and especially to buy big-ticket items.

Figure 1 New-Home and Existing-Home Sales

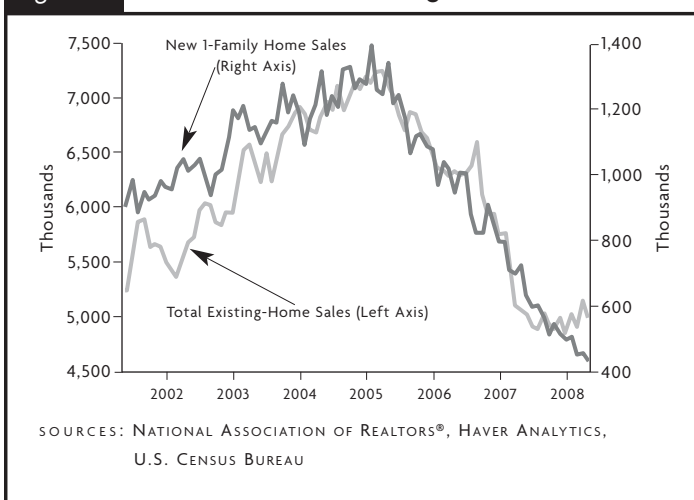
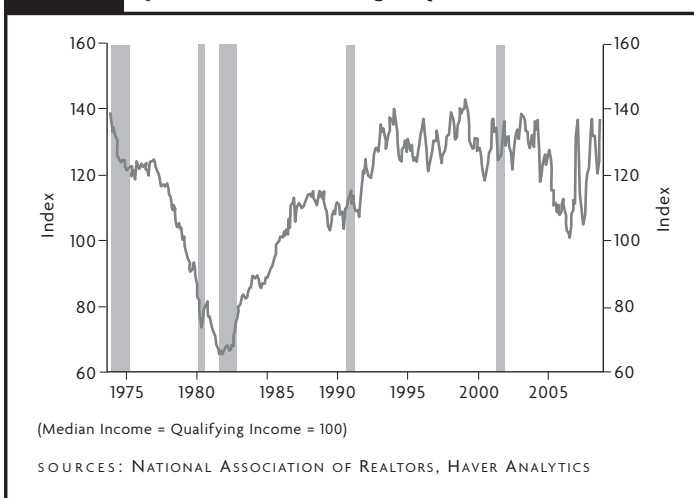


Figure 2 Housing Affordability Is High Today (And Will Move Higher)



According to the Business Cycle Dating Committee at the National Bureau of Economic Research (NBER), the current recession began in December 2007. PMI's current forecast is for falling real gross domestic product (GDP) growth through the middle of 2009, with modest growth in the second half of the year.

While real GDP growth doesn't correspond perfectly with the beginning and end dates of recessions, it is close enough to make an estimate that the recession should end around June 2009, given our current outlook. The resulting 18-month downturn would be the longest in the post-war period. Moreover, job growth usually lags the turnaround in the economy, suggesting that payroll employment will continue to decline throughout 2009.

At first blush, this long-lasting jobs decline would seem to indicate that the housing market wouldn't begin to recover until 2010. Historically, however, the housing market has always turned up before the overall economy has—and well before the bottom has been reached in employment (which typically lags the economic turnaround).

In each of the six recessions before the current one (home-sales data are not available for earlier recessions), the trough for existing single-family home sales occurred on average four months before the end of the recession and about seven months after the beginning of the recession. In the current downturn, existing single-family home sales bottomed (at least thus far) in June 2008, six months after the start of the downturn—about the same as the average for the prior six recessions.

If we are correct in our view that the recession will end around June 2009, however, that would imply that the bottom in existing-home sales would have occurred 12 months before the end of the downturn—the longest lead measured. Previously, the eight-month lead in the 1969–1970 recession was the longest.

So, either the bottom in home sales will occur earlier in this downturn than we have seen in prior downturns or the bottom in home sales hasn't yet occurred. If the latter is correct, then the bottom in home sales would occur in February, given the average four-month lead time in past recessions from the trough in sales to the end of the downturn. This could vary within a range of October 2008 (eight months of lead time) to May 2009 (only one month of lead time). But given the brisk sales of foreclosed properties (at bargain prices) and the surge in affordability, we think it is likely that the bottom in existing-home sales is behind us.

There are other factors that may act to hold the housing market down, suggesting that the recovery in home sales won't begin until later in the recession. Specifically, the sharp drop in house prices may act to keep potential buyers on the sidelines until conditions improve, as buyers prefer to purchase appreciating, rather than depreciating, assets. Additionally, banks have tightened lending standards by an unprecedented degree, making it more difficult for potential homebuyers to get mortgages even if rates are down.

As a result of the sharp oversupply of homes for sale today, we expect downward pressure on prices to continue well into

2009. The drop in home values, however, varies significantly depending upon the type of measure that is used.

Most analysts prefer to use repeat-transaction house-price indexes to measure home values, as they eliminate the difficulty in estimating underlying values when there is a change in the mix of homes sold. But even here, there are substantial differences, with the Federal Housing Finance Agency (FHFA) House Price Index (HPI) down by 7.9 percent in September 2008 from its peak, and the S&P/Case-Shiller 20-city index off by 22.1 percent over the same period (the S&P/Case-Shiller national index is only available quarterly).

The composition of these indexes is quite different, with the FHFA index based only on data from Fannie Mae and Freddie Mac. As a result, it has no data on houses financed by jumbo and FHA/VA loans, and it has a significantly smaller sample of subprime and alt-A loans than the national average. The S&P/Case-Shiller index, on the other hand, is based on a broader sample of houses that include those financed by jumbo and FHA/VA loans, as well as a market average measure of subprime and alt-A loans.

Given the differences in their compositions, it is no surprise that the FHFA HPI has fallen by substantially less than the S&P/Case-Shiller HPI. We project an ultimate peak-to-trough decline in the FHFA HPI of 10 percent to 12 percent, with price declines finally ending toward the end of 2009. Our projection for the ultimate peak-to-trough S&P/Case-Shiller HPI is 30 percent to 32 percent.

For both measures, we estimate that as of this writing house prices have fallen by about two-thirds of their ultimate total declines. Of course, these averages hide significant regional variation—with house prices in many states still above year-ago levels, but with far worse declines than the national average in others (especially California, Nevada, Arizona, Florida and Hawaii).

According to the Fed's Senior Loan Officer Opinion Survey, banks have tightened credit standards substantially for all types of mortgage loans. This has been especially true for subprime and non-traditional mortgages. Because the vast majority of mortgage loans today are originated and then sold to Fannie Mae or Freddie Mac, or are insured by the FHA/VA, it is the credit standards of these organizations that are the binding constraint for most borrowers today—and they generally have not tightened lending standards unreasonably. As a result, borrowers with at least some down payment as well as reasonable credit scores and debt-to-income ratios still can get mortgage loans—at least if their loan amount is below the conforming loan limits. This all suggests that homebuyers who require subprime, alt-A or jumbo financing are finding it far more difficult to get mortgages, if they can get them at all, thereby reducing housing demand in those sectors.

While these factors would act to hold back the economy and housing market, there are other factors that should help to offset these. Specifically, the Fed has eased in an unprecedented manner, and substantial Fed easing has never failed to

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boost the economy. Moreover, the policy actions of the Treasury Department, Federal Deposit Insurance Corporation (FDIC) and other government entities have been large, and a second fiscal-stimulus bill is likely early in the first term of President-Elect Barack Obama.

Together, these expansionary fiscal and monetary policy moves will eventually prove very powerful and should keep the current recession from becoming something worse. In addition, energy prices have collapsed in recent months, with crude oil prices about one-third what they were just five months ago. In response, gasoline prices have dropped by nearly 60 percent from their peak, and now are at levels not seen since the beginning of 2005.

Taking all of these factors into account, we project existing-home sales (supported in part by foreclosure and short sales) to rise by about 5 percent in 2009 to 5.22 million units, while new sales (unsupported by foreclosure and short sales) are forecast to slip by another 2.5 percent to 490,000 units (although that is above the recent monthly annualized sales pace).

Mostly as a result of the additional house-price declines discussed previously, purchase originations should decline by 11.8 percent in 2009, down to around \$840 billion. The sharp drop in mortgage rates, however, will allow many homeowners to refinance their loans—at least if they have the incomes

to support repayment and some equity. We forecast an increase of 7.7 percent in refinance originations in 2009, bringing them up to \$911 billion.

Total originations are projected to slip by about 2.7 percent to \$1.75 trillion in 2009. Most of the originations market should continue to go to the GSEs and FHA/VA loans, although the jumbo market may start to recover later in the year as financial markets continue to heal and the economy begins to recover. Subprime and non-traditional mortgages should continue to be just a very small part of the market.

In conclusion, we expect the next housing expansion to begin in 2009, although it will be modest at first. Still, a combination of high (perhaps record-high) affordability and building pent-up demand (with sales below trend for more than two years) should allow home sales to increase.

Unfortunately, the still-high number of homes for sale will continue to put downward pressure on prices for a while longer, with national home-price gains probably not occurring until late in the year (but with significant regional variation). Finally, the mortgage market will probably be a bit smaller in 2009, although refinancing activity should expand. **MB**

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