



Mark Zandi: I am an optimist

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On the key economic and housing issues, Mark Zandi is a recovering pessimist. In a conference call with clients on February 5, he predicted housing prices would bottom in mid-2009 and unemployment would peak shortly thereafter.

And he stuck his neck out a bit farther to say that we have already seen the bottom in the stock market.

Zandi is the Chief Economist at Moody's Economy.com, an economic research and consulting firm he co-founded. Zandi, a prominent economic pundit, recently provided Congressional testimony on the Obama stimulus plan and the automaker bailout.

"It used to be that we were more negative than the consensus," Zandi said. "Now we are optimistic. This is an unusual position to be in, but appropriate given the facts."

Zandi forecasts a 3% peak-to-trough decline in GDP – clearly in the camp of the optimists. He projects an additional decline in housing prices of 10% or slightly more, on top of the 25% decline since their peak in early 2006. After prices bottom mid-year, he predicted, they will level off in 2010 and rise appreciably in 2011.

But it will be another decade – sometime around 2020 – before housing prices return to their 2006 peak values.

Zandi outlined six broad factors underlying his forecast:

- (1) **Affordability.** Zandi said affordability is a "necessary but not sufficient" condition to stabilize the housing market. The price-to-income ratio has returned to its long run (since the late 1980s) average, suggesting that houses are now affordable once again. But a second metric – the price-to-rental-fee ratio – still suggests housing may be overpriced. "It is falling quickly," said Zandi, "but it is not back to its long run average." Another 10% price decline, consistent with Zandi's forecast, is needed to return this ratio to its long-run average and establish affordability.
- (2) **Inventory.** Breaking with the prevailing consensus, Zandi said housing inventory "has peaked." Normally, approximately 1.25 million vacant

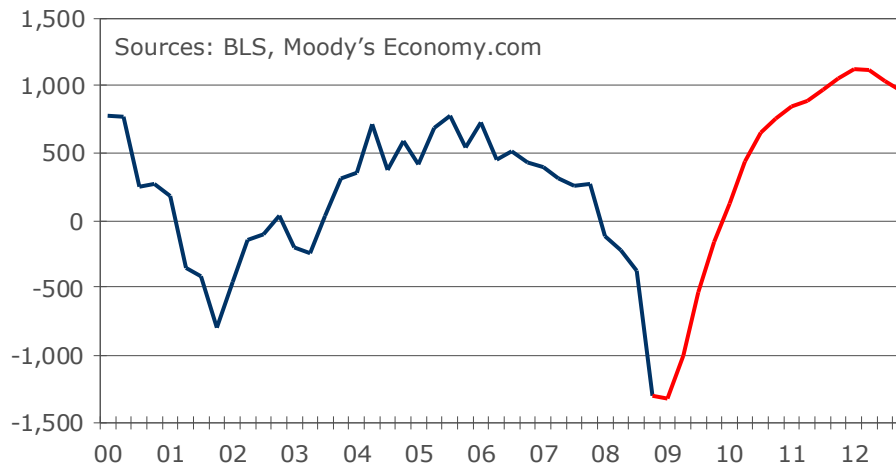


homes are on the market, but currently that number is 2.25 million, where it has stood for nearly two years. With demand at approximately 1.3 million units per year and housing formation at 800,000 units per year, the excess inventory will finally begin to come down over the next two years, according to Zandi. “We should be working off that inventory pretty quickly,” he said, adding that “despite significant progress, we still have a lot of work to do.”

- (3) **Mortgage Rates.** Rates for 30-year fixed rate mortgages will come down to 4.5% from current levels of just over 5%, Zandi said. He predicted rates will fall in the next several months due to the Fed buying long-term Treasury bonds, which lowers rates on the key 10-year Treasury benchmark. Spreads between mortgage rates and the 10-year bond will compress from their current level of 275 basis points, he said, and Fed purchases of agency debt and mortgages will “ignite a very significant mortgage refinancing boom.” The proposed \$15,000 tax credit for home purchases (which is not just for new home buyers) will further accelerate refinancing, especially since the credit is temporary and homeowners will need to act quickly to take advantage of it.
- (4) **More credit.** Even though “we are at a low point with respect to the availability of residential mortgage credit,” credit is starting to flow, Zandi said. Zandi cited data showing that the FHA is now handling approximately one-third of all home purchase volume, which is dramatically more than it has over the last decade. Other policy measures will address the shortage of credit, including new “warehouse funding” to provide liquidity for the mortgage banking industry.
- (5) **Foreclosures.** “We are at the peak of distressed sales as a share of overall housing sales,” Zandi said, and, correspondingly, we are at the maximum rate of decline in housing prices. “Declines may continue, but at a slower rate,” he said.
- (6) **Employment.** “Jobs are the most difficult factor to get our arms around, and it is the factor with the highest uncertainty,” said Zandi. “All the other factors are important, but nothing works if we continue to lose jobs.” Unemployment will continue to rise into early 2010, he predicted, peaking at approximately 9%. By 2011, he said, there will be a “measurable pickup in job creation.” Zandi’s optimism is most evident in his v-shaped recovery projection for unemployment:

Jobs Are the Missing Ingredient

Change in payroll employment, ths



Two of the preceding assumptions are critical to Zandi's forecast of a housing recovery: that unemployment will peak at 9% in 2010 and that mortgage rates will decline to 4.5% by late spring or early summer of this year. If those predictions prove wrong, Zandi said, his forecast goes out the window.

Turning his attention to the big picture, Zandi said the only way out of the wider crisis is through a proactive government stance. His forecast incorporates his expectation that aggressive policy action will be forthcoming.

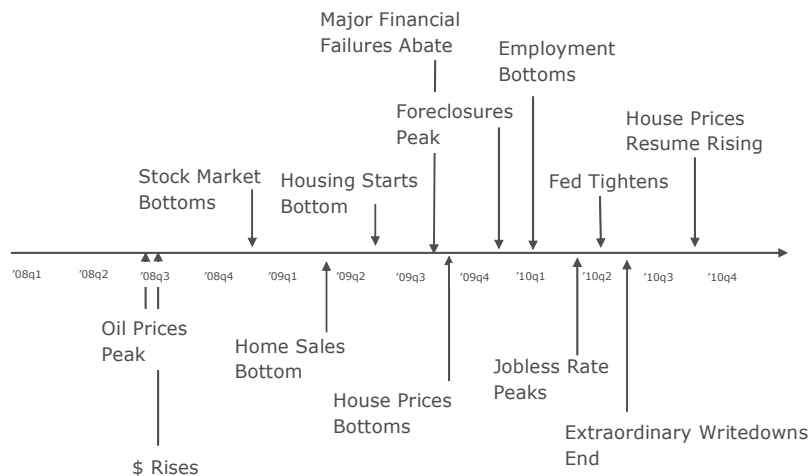
Aggressive policy, as Zandi envisions it, boils down to three elements. Passing the Obama stimulus package, especially its housing tax credits, is "very important," according to Zandi. He also called for more tax cuts, especially payroll tax relief.

Second, a significant financial stabilization plan must be enacted. Zandi estimates that US banks will recognize another \$600 billion in losses, including both mark-to-market losses as well as write-offs on loans (roughly half the amount [cited](#) by Nouriel Roubini). "The capitalization hole must be filled with equity infusions, loan guarantees, or the purchase of troubled assets," said Zandi. He predicted that more financial institutions will fail and investors will see their existing shares diluted further, but that "the system will get enough capital to return to health sufficient to allow more credit to become available."

Lastly, Zandi said, a foreclosure mitigation plan is necessary to address rising delinquency rates. “To date, the response to foreclosures has been insufficient,” he said. Zandi called for rate reductions and term extensions as part of a “big plan” that may include some degree of bankruptcy reform to allow judges to restructure loans. Zandi estimates a \$400 billion price tag for the foreclosure mitigation plan.

Zandi spelled out his projected timeline to recovery:

A Timeline to Recovery



[Note: The horizontal scale in this timeline may be difficult to read. It shows the period from Q1 of 2008 through Q4 of 2010, in one-quarter intervals.]

He believes the stock market bottomed at the start of 2009, while housing prices will bottom in the fall of this year, just after the peak in foreclosures. Unemployment will peak in the first quarter of 2010, after which the Fed will begin to tighten monetary policy. The write-off process will end in mid-2010.

Monitoring three key variables will show whether his timetable is realistic, Zandi said:

- (1) **The TED Spread.** The TED spread (LIBOR rate minus T-Bill rate) measures the general level of “angst” in the financial system. Currently at



100 basis points, Zandi said it should narrow to 50-75 basis points rather quickly.

- (2) **Unemployment insurance claims.** Unemployment is going skyward, and Zandi assumes we are seeing the worst of it now. His timetable calls for new monthly claims to moderate to 500,000 by this spring, 400,000 by summer, and to 350,000 by the end of the year. "If that does not happen, the script does not hold and the economy will weaken," he said.
- (3) **Consumer confidence.** "This environment is disconcerting and incredibly difficult to forecast, as the collective consumer psyche is shattered," Zandi said. "An element of irrationality has taken hold as consumers are running for the bunkers." As long as confidence is falling or remains low, the prospects for recovery are negative or, at best, uncertain. Unless key metrics like the Conference Board Consumer Confidence Index improve by this summer, Zandi said, "the 36% peak-to-trough forecast in housing price declines" will be a best case.

Zandi dismissed the risk of hyperinflation as a consequence of aggressive monetary policy for two reasons. First, excessive unemployment will depress wages and wage growth. Consumers will not be spending and businesses will be unable to raise prices. The economy will not get back to full employment until 2013, he estimated.

In addition, many of the recent monetary facilities enacted by the Fed are temporary and designed to become more costly as credit begins to flow.

One good thing to come out of this fiasco, according to Zandi, is that a long-standing debate among economists will be settled. One school of thought contends strong monetary growth is inevitably inflationary and others, including Zandi, believe inflation can be reined in.

"That debate will be settled," said Zandi.

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