



## **The Bubble Unburst: Housing Woes Persist**

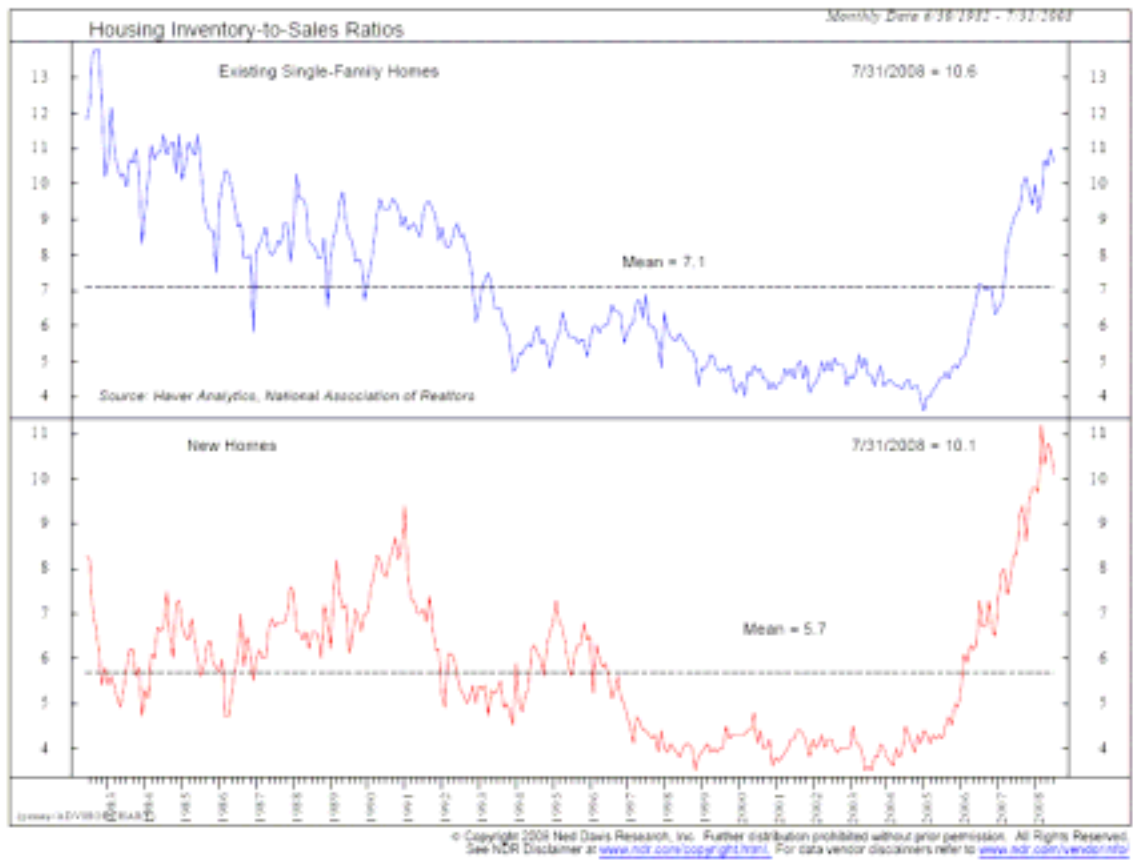
By Robert Huebscher

September 23, 2008

When the dust settles from the landslide of bankruptcies and mergers on Wall Street, we will still be left with the fundamental problem that created this mess – the housing bubble. Only true stabilization in housing prices can bring long-term relief to the financial sector. As we have said in the [past](#), current housing prices reflect the gross imbalance between supply and demand, and it appears we are far from reaching equilibrium.

In a conference call with investors on September 17, Jeffrey Gundlach, Chief Investment Officer of The TCW Group and portfolio manager of the TCW Total Return Bond Fund (TGLMX), provided some insightful observations on the continued ill health of the housing sector.

Gundlach agrees the essential problem is an oversupply of housing, which remains uncorrected by market dynamics. He provided the following data:



Even though housing starts are down appreciably from their peak levels earlier in this decade, inventories of both new and existing homes still far exceed average levels from the last 25 years. Many experts (see [here](#), for example) believe the slowdown in housing starts is insufficient to appreciably diminish housing inventories, given escalating foreclosures.

On the subject of foreclosures, Gundlach offered less-than-encouraging news. Subprime delinquencies are now at 32.4%, up from 11.9% in March of 2007. Alt-A delinquencies are at 13.6%, up from 2.6% in March of last year. Most telling, prime delinquencies, which stood at a mere 0.3% in March of 2007, have spiked to 2.0%, and they are climbing at a rate of nearly 25 basis points per month. Gundlach also said that the default rate on second homes and investment properties is now about 50%.

To provide some perspective, Gundlach noted that during the Great Depression, the non-farm real estate mortgage foreclosure rate peaked in 1933 at 0.14% (14 foreclosures per 1,000).



Gundlach believes the secondary mortgage market is correctly incorporating current delinquency and default data into market prices, but that the ratings agencies maintain a striking disconnect from reality. There were 1,033 residential subprime tranches originated between 1Q05 and 3Q07. Only 17% of these have been downgraded. Of those that were downgraded, only a third have been downgraded to BB+ or below.

Gundlach estimates we are about halfway through the housing crisis. He cites credit losses and asset writedowns to date of \$506 billion, and expects this number to eventually top \$1 trillion. He expects the ultimate decline in the S&P Case Shiller index to be 30%. (The index is now down approximately 15% from its peak in 2006.)

Gundlach was not upbeat on the health of the overall financial services sector. He cited a recent Bloomberg [article](#) noting that the 100 largest banks have raised \$352.6 billion in capital against their \$506 billion in writedowns. Wachovia is particularly vulnerable, he said, because of their exposure to option ARM portfolios.

For advisors, Gundlach offered two points of unequivocal guidance. First, he said advisors should exit any funds invested in non-cash instruments, such as derivatives or swaps. Second, he was bearish on REITs because of their vulnerability to the commercial real estate market. Although this market has not deteriorated to the extent of the residential real estate market, Gundlach believes the risk of this deterioration is too great.

The current environment has created very attractive opportunities for Gundlach's fund. He sees opportunities in prime and Alt-A securities that have been mis-priced due to a lack of liquidity. Many of the bonds he likes are trading between 70 and 80 cents on the dollar, a discount he sees as an over-reaction to a limited risk of default. But, he cautions, it may take time for market prices to correct for these securities.

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>