



## Where is the Bottom in the Housing Market?

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The epicenter of the global financial crisis was the US housing market. As aftershocks from its collapse ripple throughout the global economy, attention has shifted to fears the US economy's consumer foundation will crumble and to the possibility of an imminent worldwide recession.

But housing remains a critical variable in projecting the duration and severity of any recession. On October 30, a panel of experts addressed the question of whether the housing market is near its bottom. At the same time, the panelists addressed the broader economic picture and its implications for investors.

The discussion, billed as "The Deflating Mortgage and Housing Bubble, Part IV: where is the Bottom?" was sponsored by the American Enterprise Institute for Public Policy Research (the AEI).

The five panelists, whose presentations are summarized below, offered only the faintest glimmer of hope. Their consensus was that housing prices will continue to fall, perhaps by as much as 20% beyond today's levels, and there are clear and obvious policy interventions that could prevent this.

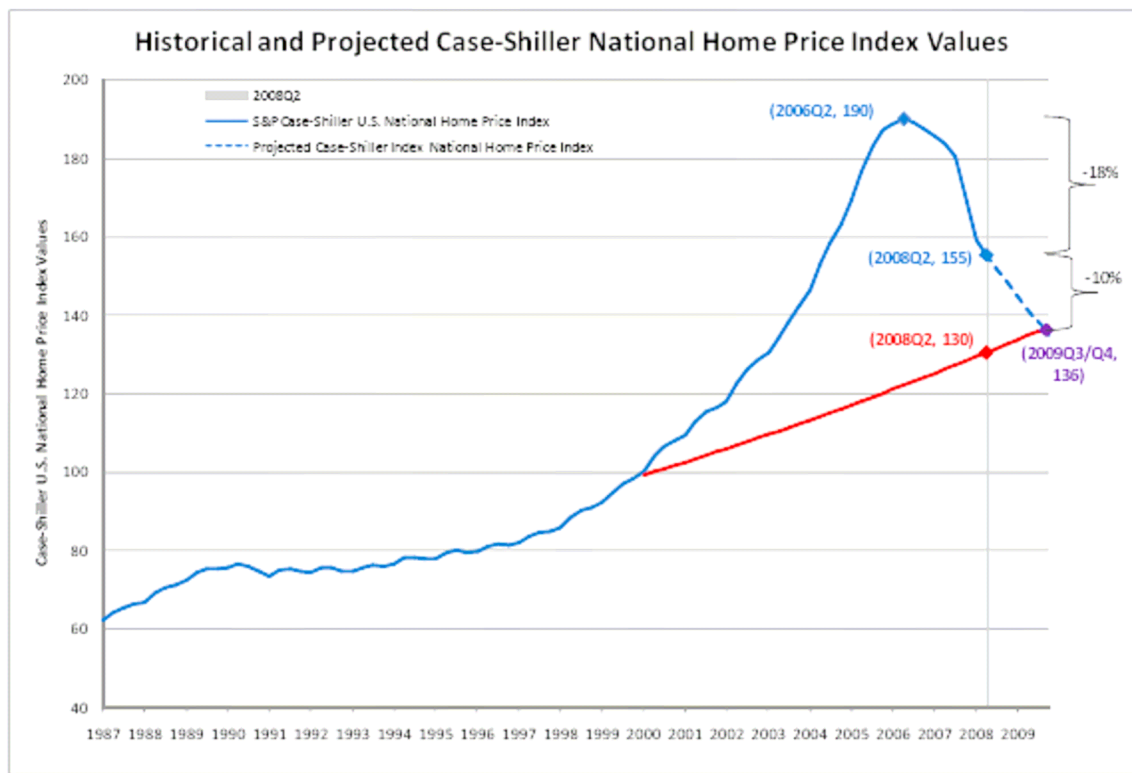
The AEI is a conservative think tank, but the presenters represented a range of ideologies.

### Desmond Lachman



Lachman is a resident fellow at the AEI who previously served as a managing director and chief emerging market economic strategist at Salomon Smith Barney. He has also been deputy director in the International Monetary Fund's (IMF) Policy and Review Department.

Lachman began by showing the all-too-familiar graph of the Case-Shiller housing price index. Even though prices have already fallen about 18% peak-to-trough, the data show, they have about another 10% to go before they return to the long-term trend line.

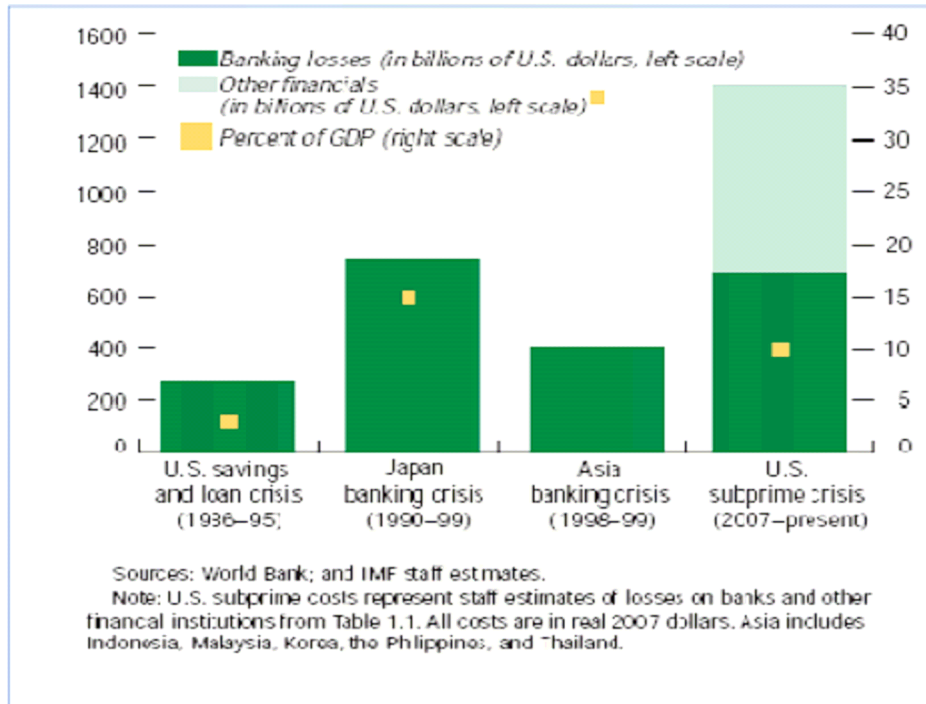


But, setting a somber tone for the ensuing discussion, Lachman said that there is “no logical reason why the housing market will not undershoot this trend line” and fall even further. The only hope of preventing that undershooting is a massive government intervention.

Lachman identified five factors that are creating downward pressure on housing prices: a deepening economic recession, rising unemployment, a huge amount of inventory overhang, widespread foreclosures, and scarce mortgage financing.

Early on in the credit crisis, many claimed it was not as severe as the S&L crisis of 1986-1995. Lachman debunked this myth with the following data:

## Comparison of Financial Crises



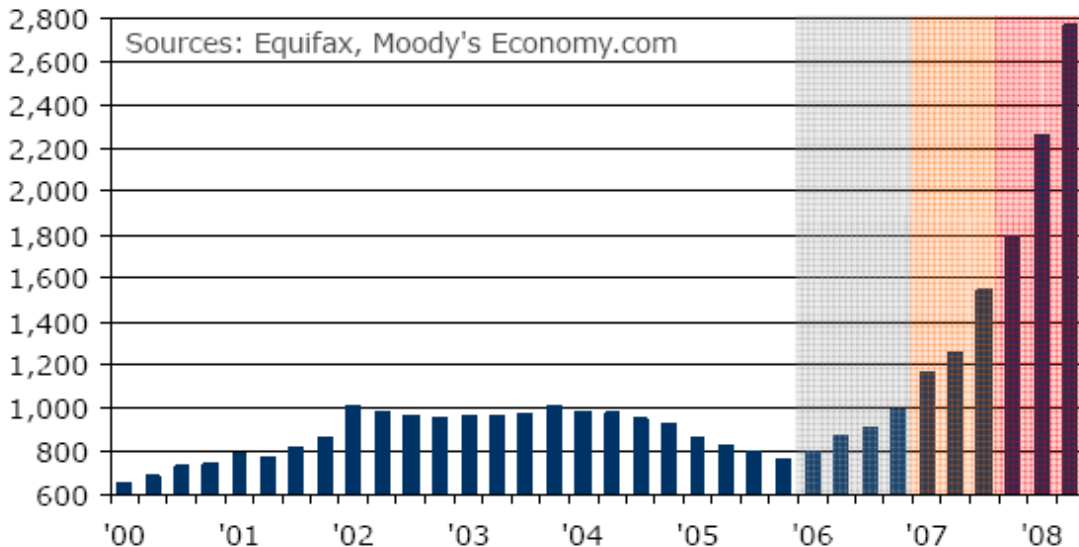
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Whether measured in absolute, inflation-adjusted dollars or as a percentage of GDP, this crisis already “dwarfs all others,” said Lachman.

Lachman noted that futures markets in the Case-Shiller indices imply a 15% drop in housing prices from today’s levels, but he was hesitant to endorse that forecast. He noted that inventories are still at a record 11-month supply (approximately two million homes) with demand declining. Supply is surging due to foreclosures, with approximately one-third of houses with mortgages now underwater. Defaults are occurring at an annual rate of approximately 3 million units, as shown in the graph below:

## Foreclosures Surge...

First mortgage loan defaults, ths, SAAR



Lachman said that “stabilizing the housing market is a necessary condition to stabilizing the economy, but it is nowhere near a sufficient condition.” He suggested a general outline of policy alternatives, including buying home mortgages, resetting the terms of mortgages, a large fiscal stimulus and monetary easing. Without such actions, he cautioned that the current crisis will “morph into something a lot more horrible to contemplate.”

### Nouriel Roubini



Nouriel Roubini is a professor of economics at New York University’s Stern School of Business and the cofounder of Roubini Global Economics. He is an internationally known expert in the field of international macroeconomics, and he served as a senior adviser to the President’s Council of Economic Advisers and the US Treasury Department under the Clinton administration. (We previously [interviewed](#) Roubini on September 16 of this year.)

On the panel, Roubini took a broad view, beginning by stating the now-common belief that the economy is in its worst shape since the Great Depression. He said the consequences of the economic downturn are “quite unbelievable.” According to Roubini, what began as a subprime problem has metastasized to the credit



card, automobile, and student loan sectors, as well as to leveraged loans. It has also exposed excessive borrowing by municipalities. Roubini said corporate default rates will soon surge in a “major way”.

Roubini expects total losses from the credit crisis to be \$1-2 trillion, as we noted in our previous interview with him. He said the \$700 billion of funds allocated for the TARP will be insufficient. Roubini expects brokerage, insurance and automobile companies to be eventual recipients of TARP funds. He described a “vicious cycle” where credit contraction leads to economic contraction, which leads to credit losses, which initiate the cycle anew. That negative feedback will create a further need for TARP-like bailouts, he said.

Roubini, as he has in the past, forecast a “very severe recession — the worst in the last few decades.” He said that post-War recessions have typically lasted around 10 months, although the past two were only eight months long. Roubini specifically forecast GDP contraction of 4-5% during the course of a 24-month recession, one he believes began in the first quarter of this year.

“Housing is not at the bottom,” Roubini said: Demand is falling and there is still excess inventory. Roubini expects another 20% decline in housing prices, resulting in a cumulative peak-to-trough decline of 40%. We asked him why he was confident prices would decline *only* 20%, and, given his bleak economic outlook overall, he explained that his analysis of rental prices and affordability indices led him to identify that floor.

By contrast, in the 1990-1991 recession housing prices declined by only 5%. Not since the great Depression have housing prices declined by anything close to what we may now be experiencing.

Roubini noted that 40% of households have mortgages that exceed the value of their homes (21 out of 50 million households). There is a “huge walkaway incentive.” Assuming that 20% of the homeowners who are underwater walk away (i.e., abandon their homes), the losses to the financial system would be an additional \$400 billion. “This would wipe out a good chunk of the capital in the financial system,” said Roubini.

Roubini said the crisis — as recently as the second quarter of 2008 — looked like it would be confined to the US. But the crisis quickly spread to rest of the world, as the Eurozone, the UK, Canada, New Zealand, and Japan are now experiencing or expecting GDP contraction. “We are experiencing a global recession and a re-coupling of markets, which has already happened in the financial markets,” Roubini said. The next phase, already begun, is the transmission of the slowdown to emerging markets through credit and trade



contraction. Roubini expects global GDP contraction in both the third and fourth quarters this year.

At least a dozen emerging market countries are in a state of crisis already, Roubini said, including Hungary, Iceland, Pakistan, and the Ukraine.

Roubini also observed a growing disconnect between events in the financial markets and the ability of policy makers to respond effectively. In March there was an eight-week rally following Bear Stearns bailout. In July, following the IndyMac failure, there was a four-week rally. In September, as after Paulson engineered the Fannie and Freddie rescue, the rally lasted only a day. The next week, when Lehman failed and AIG was bailed out, the market fell dramatically. When the TARP was announced, the market again fell sharply.

Roubini summarized five principles the authorities established, following the Lehman failure, to deal with the crisis:

- (1) no institution will be allowed to fail
- (2) unlimited liquidity will be available to the system
- (3) banks will be recapitalized with public money
- (4) a wide variety of liabilities will be guaranteed for the banking system
- (5) anything else that is necessary will be done

In October, when officials in Washington announced these principles, Roubini said a short rally was followed by further declines.

“The financial markets are dysfunctional,” said Roubini. “Fundamentals do not matter any more.” He said there is a flood of sellers that cannot be stopped by policy decisions.

“The markets are not at the bottom,” said Roubini, citing three factors. First, he expects more surprises — all on the downside. New data for consumer spending, housing, employment, and industrial production will bring more bad news. Second, corporate earnings (not just among financial firms) will prove unexpectedly low. Third, the ingredients for a further meltdown still exist. These include corporate defaults, a blowup in the CDS market (which Roubini called a “ticking time bomb”), hedge funds going bust and being forced to de-lever and sell assets, and emerging markets that are at risk of a financial crisis.

“For the last three months there have been calls of a market bottom, but each time the shorts rallied,” Roubini said, and it hasn’t bottomed yet. We face more problems in housing, mortgage finance, banking, he said – all pointing to a severe economic recession.

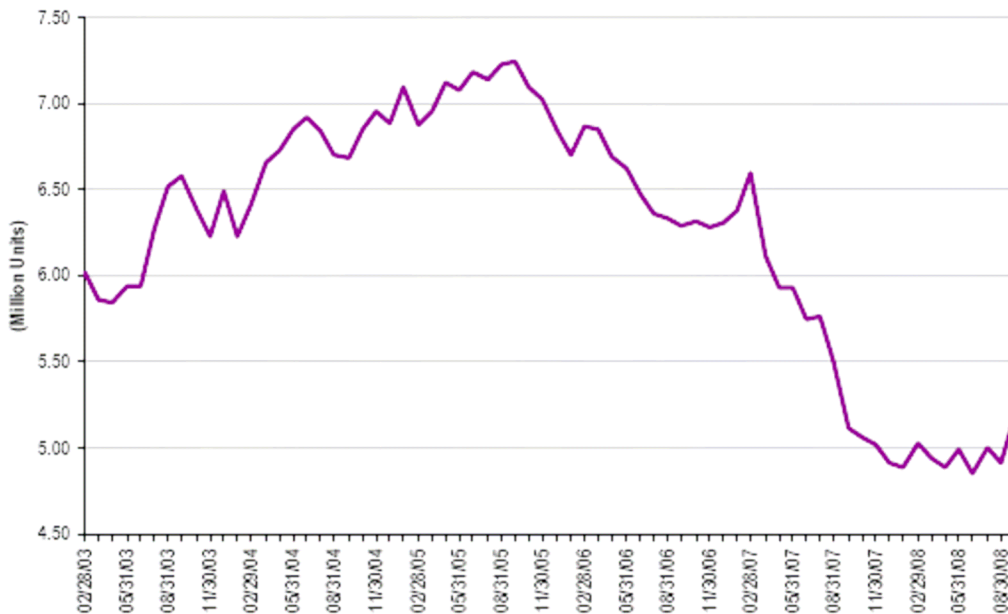


John Makin (below) echoed Roubini’s views that the primary concern for the Fed over the next six months will be stag-deflation – a combination of slow/negative growth and deflation. He said there is already price deflation in consumer goods, automobiles, and commodities, and deflation will accelerate as unemployment rises.

### Thomas Zimmerman

Tom Zimmerman is a managing director in the securitized products strategy group at UBS, where he manages the Firm’s asset-backed security (ABS) and mortgage credit research. Previously, he was head of ABS research at Prudential Securities, and he has also worked at Chemical Bank and Salomon Brothers.

Zimmerman was the only speaker to identify positive signals in the housing market. He noted that data show existing and new home sales are “near bottom.” His evidence is from the chart below, which shows existing home sales:



Source: Bloomberg

He also noted that “in some markets” — he cited Stockton, CA as one — home price depreciation has slowed or even reversed. Stockton has also been identified as the site of many of the most abusive sub-prime borrowing and

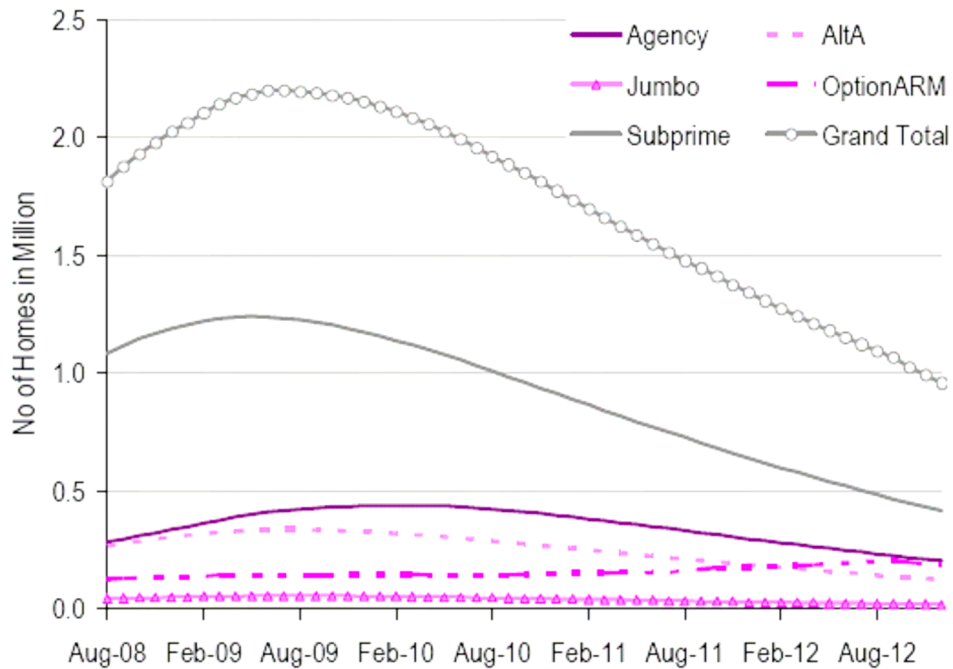


lending practices. He noted that investors are buying homes in these few markets and renting them, suggesting that the return on capital they see must be “15% or 20%” to justify the investment. Zimmerman also said that the “acceleration of decline [in housing prices] is behind us.”

Zimmerman’s few upbeat remarks were quickly tempered by a litany of indicators that he characterized as “very negative.” He said delinquencies are spreading to other sectors beyond subprime and Alt-A, and “roll rates” are up sharply. Roll rates measure the progression of loans from 30- to 60- to 90-days delinquent; higher roll rates imply mortgages are becoming increasingly delinquent. “Loss severities,” which measure the degree of loss experienced by the lender when a foreclosed property is sold, are also continuing to climb, he said. He also cited a marked slowdown in voluntary prepayments of mortgages.

Over the next six to 12 months, Zimmerman expects deteriorating conditions in the housing market, as the recession causes more foreclosures. He expects foreclosures to peak sometime near mid-2009. The graph below illustrates this peak:

## Foreclosure & REO Schedule – All Sectors (# of loans)



Source: Loan Performance, UBS



Zimmerman noted that, in the past six months, subprime delinquencies have gone down, although foreclosures have gone up. He said that 70% of subprime loans made in 2006 and 2007 are in default, and he believes the recession “can’t make this much worse.”

Zimmerman also touched on the relationship between unemployment and defaults, noting that a 1% increase in the unemployment rate historically translates to a 20% increase in home ownership defaults. But this data offers little guidance for the future, he cautioned, since subprime loans are a new phenomenon.

Access to mortgage financing is also worsening. Zimmerman said the securitization markets have shut down, as no subprime, Alt-A, or jumbo loans are being issued. Banks are tightening credit standards, as are Freddie and Fannie. Although FHA financing is growing, it represents a small portion of the market. In total, he estimated that 40% of the sources of capital for mortgage financing have been lost over the last year.

Agreeing with the other speakers, Zimmerman said Federal intervention is necessary to stabilize the housing market. Freddie and Fannie are not being used to solve the housing crisis and they could be, he said. Their goals are unclear and they have not been given a mandate to provide aggressive financing to qualified borrowers. To the contrary, their mandate appears to be to reduce risk in their portfolios, which has resulted in decreased lending.

Zimmerman concluded by noting the core of the problem is approximately three million homebuyers “that should have been renters.”

### **John H. Makin**



John Makin is a visiting scholar at AEI and a principal at Caxton Associates, a New York-based hedge fund with approximately \$10 billion under management. Makin has been an advisor to the Federal Reserve System and the Bank of Japan.

Makin, an expert in central banking policies, said that policy decisions to date have not made a difference in addressing the credit crisis. He cited efforts to lower interest rates to stimulate lending, and over the last two weeks, he noted, even though LIBOR has come down there is still very little inter-bank lending. “Banks are unwilling to lend to each other at increasingly lower rates,” he said wryly.



Makin said the capital which is being injected into the banking system has not stimulated lending activity, and, in fact, there is some evidence that banks like JP Morgan are planning to use their capital for mergers and acquisitions.

Makin discussed the increase in the value of the dollar, which he said owed, at least in part, to the introduction of widespread deposit insurance – he called that “best policy decision in the last month.” The dollar’s increase is being abetted by “short dollar structures,” such as carry currency trades, being unwound.

But currency appreciation is a deflationary shock, he said, and it brings with it further economic hazards.

One is the “zero bound problem” – the Fed cannot lower interest rates below zero, despite the fact that excess demand for cash is not being satisfied by the central bank. Makin referred to the Taylor Rule, which is a guideline for targeting Fed interest rates based on inflation and GDP growth. Based on current economic conditions, the target Fed Funds rate, according to the Taylor Rule, is -2.0%. The difference between this and the actual rate (1.0%) is a “red alarm” for Makin — it signals a need to print money to arrest deflation.

“This is a dynamically unstable and dangerous situation and could result in a disaster,” said Makin.

Makin said the only solution for the Fed is to make “a rapid, almost instantaneous transition from their current stance of leaning away from preventing inflation to a proactive stance of leaning into avoiding deflation.” He advocates a zero interest rate policy combined with direct purchases of long-term government bonds, mortgage-backed bonds, and equities. Makin said a similar policy was followed successfully by Japan from 2001 to 2003.

## **R. Christopher Whalen**



Chris Whalen is the cofounder and managing director of Institutional Risk Analytics, and he co-organized the panel discussion. Whalen has worked as an investment banker, research analyst, and journalist for more than two decades, and he is an expert on the banking system. (We also [interviewed](#) Whalen on September 30 of this year.)

At Thursday’s panel, Whalen discussed the banking industry, where he said the “credit adjustment process is nearing half way.” That process has three phases, he said. The first phase was about “loss recognition”



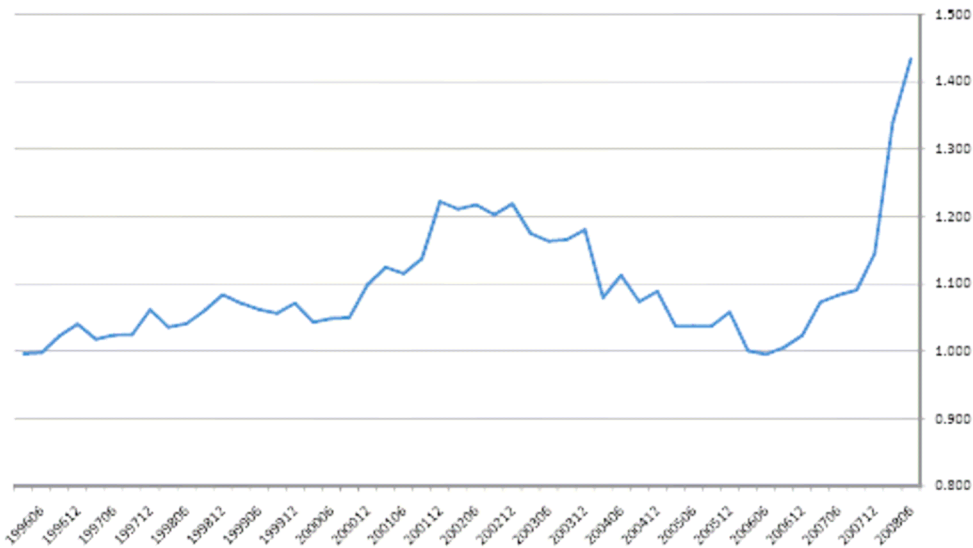
— it centered on the issue of mark-to-market. The second phase — which we are experiencing now — is about loss realization, the sale or writeoff of distressed assets. The loss rates on banks already reporting Q3 2008 results are “climbing rapidly,” Whalen said. The third phase will involve a broadening of losses beyond mortgages to a “more general credit loss peak cycle affecting the entire economy.”

Whalen spoke specifically about the credit default swap (CDS) market, which he described as the “next crisis for the financial system, as it has to make good on \$55 trillion of CDS contracts.” He said that “even the best-case scenario for corporate defaults would suck the liquidity out of the banking system for years.” Whalen described the CDS market as a “liquidity black hole.” He predicted that dealing with CDS issues will be a policy focus for the next year.

The CDS problem is not well-understood, according to Whalen, as evidenced by the fact that much of the government’s bailout money for AIG appears to have gone to settle CDS contracts. As politicians realize these funds did not benefit Main Street, and will not be eventually repaid to the Treasury, there will be a strong political backlash — one which, according to Whalen, will “burn people’s heads off.”

Whalen presented the graph below to illustrate problems in the overall banking industry:

## Credit Crisis Index



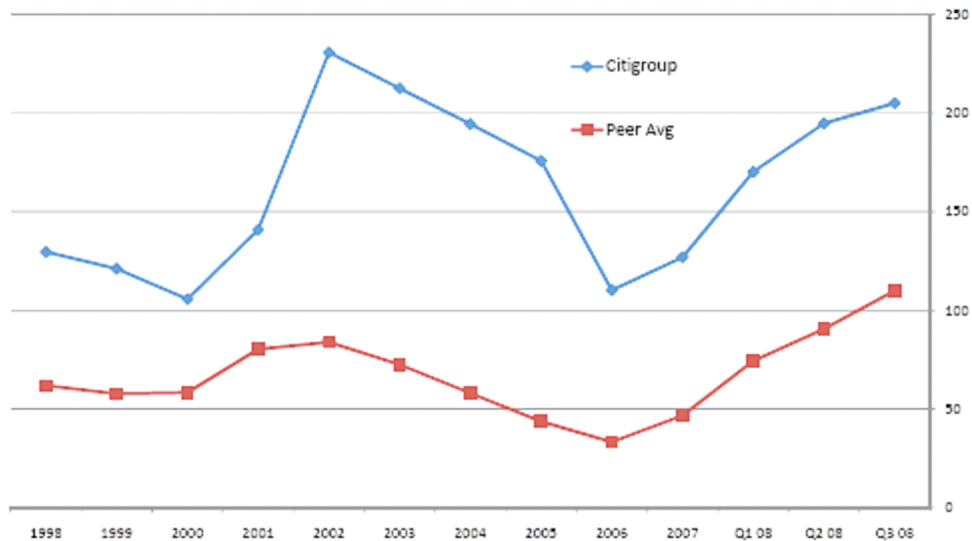
Source: FDICIRA Bank Monitor

The Credit Crisis Index combines standard measures of bank performance, such as profitability, default experience, capital adequacy, loan exposure, and operating efficiency. The industry-wide data above shows that the index is at its worst level in 20 years.

But the majority of problems are in the larger banks, Whalen said. “The vast majority of the 8,400 smaller, community banks are under-leveraged and under-exposed to risk,” said Whalen.

Still, the problems with some of the larger banks may be severe. He presented data for Citibank, showing that its gross defaults are at a rate nearly twice its peers:

## Gross Defaults: Citi vs. Peers (bp)



Source: FDIC/IRA Bank Monitor

Citibank's exposure is consumer-oriented, and it is more vulnerable to a slowdown in consumer spending and a rise in unemployment.

Whalen also pointed to problems with banks that have commercially-oriented exposure, such as JP Morgan. In JP Morgan's case, Whalen said a 15-basis-point move in their "swap book" (CDS contracts they have underwritten) would wipe out their Tier 1 capital. By contrast, for banks without such commercial exposure, a 1,500-basis-point move would be required to have the same effect, according to Whalen.

Whalen expects both Citibank and JP Morgan to get additional injections of capital. "If the severity and duration forecasts for the recession are true, the government will end up owning these banks," said Whalen.

Whalen forecasts a much different business model for banks in the future. Returns on equity (ROE) will decrease from 20% to 10% as risk exposure is curtailed. (One of the panelists pointed out that a lot of the 20% ROE should have been booked as loan loss reserves.) Perhaps more significantly, as the government ends up owning some of the larger banks, its best strategy may be to break them up and sell them, in order to avoid the "too big to fail" syndrome in the future.



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