

# REECON ADVISORY REPORT

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*A Weekly Source of Insight and Intelligence on Residential Real Estate*

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# Caution and Hope for the New Year

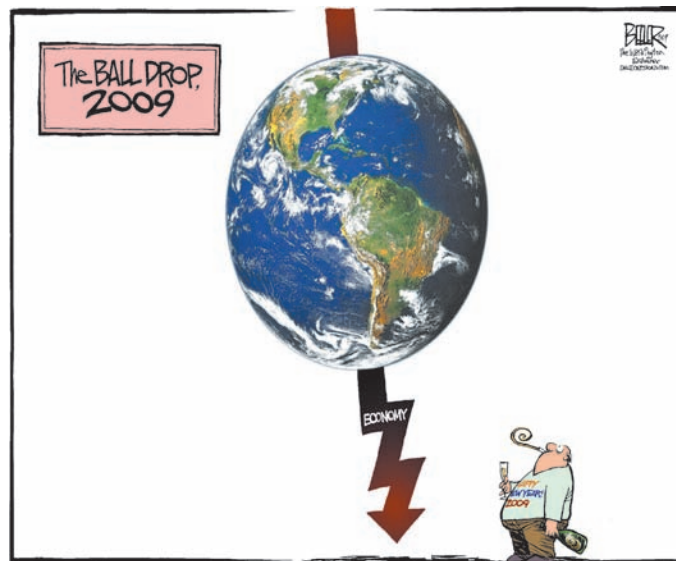
As we begin the New Year, we look back before we look forward. Not since the Great Depression has America experienced such economic and financial deterioration.

The U.S. financial system collapsed in 2008 with the flow of credit virtually frozen throughout the financial markets. Two of the nation's most respected investment banks--Lehman Brothers and Bear Stearns failed and the nation's largest mortgage lender--Countrywide--went belly up. The two mortgage funding giants, Fannie Mae and Freddie Mac, were taken over by the Federal government and are now under conservatorship. Goldman Sachs and Morgan Stanley sought safer harbor by becoming bank holding companies. The government bailed out our nation's largest insurer, AIG, and then handed a bailout package to two of our largest automakers, General Motors and Chrysler.

## **The Government Mounted Massive Rescue Efforts**

Government rescue efforts were massive during 2008. The Treasury and Federal Reserve combined to spend trillions of dollars bolstering the credit markets and a struggling economy in an attempt to keep businesses and financial institutions afloat. The Federal Reserve also cut the Federal funds rate 10 times in 15 months and the rate now hovers in the unthinkable 0 to 0.25 percent range. The Treasury convinced Congress to approve a \$700 billion rescue package called the Trou-

bled Asset Relief Program, TARP, originally designed to purchase problem assets from financial institutions with the funds. But Treasury Secretary Paulson used some of the money to inject capital into the financial institutions instead. The TARP program has yet to be implemented.



A host of housing stimulus and foreclosure mitigation programs were tried or proposed throughout the year. FHA Secure, Hope Now and Hope for Homeowners were some and none of them seemed to be effective.

Senator Barrack Obama was elected the nation's 44th President based partly on his message of change and an inspirational message of hope. The President-elect inherits

a nation facing challenges of historic proportions not faced since Franklin D. Roosevelt was inaugurated in the depths of the Great Depression in 1933.

## **Confidence Plummeted**

According to official data, the U.S. economy was in recession throughout 2008. The economy lost an alarming 1.9 million jobs last year (not including December). Most industries and geographic regions of the nation experienced economic contraction. Consumer and business confidence plunged throughout the year resulting in weak consumer spending on both durable and non-durable goods and services and weak business investment spending as well. The dramatic drop in aggregate demand also exerted downward pressure on both con-

## Caution and Hope for the New Year--Continued

sumer and producer prices on goods and services. Deflation is now a serious concern as we enter the New Year. Falling oil prices contributed to deflationary pressures. At its peak, oil topped \$147 a barrel in 2008, only to plummet to about \$40 a barrel by the end of the year.

The stock market experienced its worst performance in 2008 since the 1930s (during the Great Depression). As of this writing, the Dow Jones Industrial Average was down 34.7 percent for the year, while the S&P 500 and Nasdaq were down 39 percent and 41.5 percent, respectively. Similarly, home values in 2008 also experienced their worst performance since the Great Depression. According to the Case-Shiller 20 city index, home prices fell by 18 percent in 2008 (October 2008 compared with October 2007). It is now estimated the over 12 million homeowners have negative equity in their homes. Falling home prices have reduced homeowner wealth by over \$3 trillion. In addition, the falling stock market has reduced household wealth by almost \$7 trillion. Over one million homes have been lost to foreclosure since the housing crises hit in August of 2007. Simply stated, households lost a great deal of wealth last year, shattering their confidence as they enter the New Year.

### Real Estate in Recession

The real estate business experienced a sharp recession in 2008. Residential construction (housing starts) plunged by over 45 percent during the year as builders suffered their worst year since World War II. With the economy in recession, home values falling, and foreclosures mounting, demand for new homes fell off dramatically. Existing home sales were off about 12 percent last year, but over 30 percent of those sales were foreclosure properties. Even with foreclosure sales, existing home sales are currently hovering at cyclical lows.

Mortgage originations fell 25 percent in 2008 compared to a year earlier. We estimate that mortgage originations will total about \$1.5 trillion in 2008, compared to \$2.3 trillion in 2007. Of course, there were significant changes in the composition of originations by year end. FHA/VA market share rose to about 30 percent from as little as 3 percent earlier in the year, while subprime and Alt A loan shares fell to almost nothing. Similarly, fixed-rate loan shares surged at the expense of variable-rate shares.

### Caution and Hope in 2009

Looking ahead, 2009 promises to be a year filled with caution and hope. The economy is mired in a deep recession and the financial markets remain broke, but that could change later this year. President-elect Obama and Congress have promised to put together a significant stimulus package approaching \$1 trillion to re-start the economy. We expect that package to be in place during the first quarter. In addition, the Federal Reserve and Treasury have promised to provide the necessary liquidity in the financial markets so that consumers and businesses can have adequate access to borrowed funds. We expect interest rates to remain

at relatively low levels throughout the year. Most economists are projecting fourth quarter GDP to fall about 4.5 percent on an annualized basis, which would be the largest decline since the first quarter of 1982 when real GDP fell 6.4 percent annualized. It is likely that GDP will fall in the first quarter, the second quarter and maybe in the third quarter as well. If the stars are aligned (and that is hoping for a lot), an economic recovery is expected in the latter part of



## ***Caution and Hope for the New Year--Continued***

the second half of the year. There are some positives: household debt is improving and households are saving more; the Obama stimulus packages promise to eventually energize the economy; households are likely to receive tax breaks early this year; consumer and business borrowing costs are expected to remain relatively low; and inflationary pressures are at bay.

### **Outlook for a Limited Recovery**

However, the recovery is likely to be limited and weak for a number of reasons. First, consumers have lost a great deal of wealth during this recession due to large home price and stock market declines and thus will find it difficult to return to more normal spending patterns. Second, it is likely to be a long process for banks to recapitalize and rid their toxic assets from their balance sheets. Third, after experiencing a severe credit crisis, it is likely that credit will remain tight long after the recession is over. And finally, the government has spent trillions of dollars in attempts to rescue the financial

system and the economy over the past several quarters. There will likely be a huge hangover cost to this excessive spending.

If the economy experiences a slow recovery in the second half of this year, so will real estate. So even when home sales eventually bottom out, do not expect an energetic rebound in sales activity. Similarly, when excess inventories return to more normal levels and home prices begin to stabilize, do not expect home price appreciation to return to the historical norms of 3 to 5 percent any time soon. However, even modest price appreciation and home sales growth would present a favorable picture for the housing marketplace. We note that the National Association of Realtor's affordability index is at its highest level (most affordable) since the early 1970s. And if mortgage rates can drop further via additional government action, we could experience a meaningful uptick in sales activity. We will take what we can get.

– David Lereah

### **Market Insight**

## **Indicators Do Not Bode Well for First Half of 2009**

The U.S. economy enters the New Year with momentum of a recession getting deeper, not shallower. Most economic indicators reflect an economy contracting at an accelerating pace. Certainly, the recession has pushed down home sales and home prices at faster rates than otherwise would have occurred if the economy had been expanding. Historically low mortgage rates and relatively low home prices combined with an excess of foreclosed properties for sale at discount prices have not been enough to bring potential buyers into the market. That has forced home prices down more. Both consumers and businesses enter the New Year nervous and with deteriorating confidence. Consumer spending is very weak and businesses have markedly cut their investment in plant, equipment and inventories. The labor market continues to deteriorate, shedding over 500,000 jobs in just November alone.

### **Record Low in Consumer Confidence**

The Conference Board's consumer confidence index fell to a record low 38 in December from 44.7 in the

previous month. This was disappointing news and suggests a negative outlook for future consumer spending. This does not bode well for first quarter GDP growth. Jobless claims were down sharply to 492,000 for the week ending December 27 from a 26-year high of 586,000 claims a week earlier. Although the decline was welcome news for the labor markets, we note that the claims data has been extremely volatile during holiday weeks. We will reserve judgment until the second week in January when the holiday effect has passed.

Durable goods orders fell 1 percent in November, while shipments fell by 2.6 percent. The numbers continue to reflect a contracting manufacturing sector. Finally, the Institute for Supply Management (ISM) purchasing managers' index fell to 32.4 in December from 36.2 in November. Over the past six months, this index has fallen almost 18 points to 32.4 in December from 50.2 in June. The manufacturing sector is clearly contracting sharply, contributing to a more prolonged recession.

## ***Indicators Do Not Bode Well for First Half of 2009--Continued***

On the housing side, there were a number of indicators portending unfavorably for the first half of this year—home sales were down; prices were down and inventories were up. Existing home sales fell 8.6 percent to an annualized 4.49 million in November from an annualized pace of 4.91 million in October. This report was again disappointing news for the housing markets and the November number is now a new cyclical low. The drop-off in November's existing homes sales was somewhat surprising given that the October pending home sales release (contracts) was relatively strong. It is likely that a meaningful percentage of the pending contracts did not close because of tight underwriting conditions. Perhaps more disappointing was that the months' supply rose to 11.2 in November from 10.3 in October. The sharp rise in months' supply reflects a slower pace of sales plus an increase in the number of foreclosed homes available for sale.

### **New Homes Supply Remains High**

New home sales fell by 3 percent in November to 410,000 from 420,000 in October. The recession, job losses and foreclosure sales are placing severe pressure on the new home marketplace. Builders are rationally responding to these pressures by reducing housing starts. The months' supply for new homes remains at stubbornly high levels at 11.5 months. The new home market is entering 2008 in poor shape. According to the Case-Shiller monthly home price index, home prices posted a record 18 percent drop in October compared with a year earlier. In October, 14 of 20 cities posted new year-over-year price decline records.

Weekly mortgage applications for the week ending December 26 continue to reflect the positive influence that falling mortgage rates are having on purchase and refi applications. The purchase index was 320.9 for the week compared to 316.5 the prior week. The refi index was 6,733.8 for the week, compared with 6,758.6 in the prior week. However, it is clear that many of these applications are not turning into actual home sales because of a relatively high fallout rate due to tight underwriting restrictions and financial pressure on household balance sheets.



## **The Threat of Deflation**

Asset values and the prices of goods and services are falling steadily, raising concerns about the threat of deflation. Home prices posted a record decline in October, falling 18 percent compared with a year earlier, according to the Case-Shiller home price index. Similarly, the stock market lost about \$7 trillion in value during 2008.

### **Recession Has Reduced Demand**

On the other side of the economy, prices of goods and services have declined considerably over the past several months. The consumer price index decreased 1.7 percent in November and has now declined for four consecutive months. Similarly, the producer price index declined 2.2 percent in November and has now declined for four consecutive months. The recession and reduced demand for goods and services have forced businesses to discount their products to stimulate sales. Also contributing to price declines has been the dramatic drop in oil prices over the past half of year.

## *The Threat of Deflation--Continued*

Price deflation has already inflicted a great deal of pain on the nation's housing sector over the past 18 months. As measured by the Case-Shiller indices for 20 cities, home prices have declined between 22 and 26 percent since its descent. In a deflationary environment, households tend to postpone purchases because they anticipate purchasing items at a lower price in the future. That type of behavior has crippled the housing marketplace. A meaningful percentage of households have postponed home purchases due to this "postponement" reasoning. Home sales have tumbled, inventories have built up and home values continue to decline.

Today, deflation is expanding beyond the housing sector and is now threatening to cripple the entire economy. If consumers postpone purchasing goods and services because they believe future prices will be lower, businesses earn less, cut production and lay off workers, aggravating our economic downturn.

Our most recent bout with deflationary pressures occurred in late 2002. The economy was weak and the inflation rate was low. The Federal Reserve expressed

concern over deflationary pressures after a Federal Open Market Committee (FOMC) meeting in May of that year. The statement said that "the economy faced a small, but real, prospect of deflation."

### **Collapse of Demand Driving Deflation**

The primary source of today's deflationary pressures is obvious—a collapse of aggregate demand. The economy is experiencing a sharp and deep recession and businesses must now cut prices in order to find buyers. The good news is that the government has already taken steps to prevent ongoing deflation. It is using monetary and fiscal policy as needed to support aggregate spending. The Fed has cut the Federal funds rate close to zero and the Treasury and Fed together have provided trillions of dollars of liquid funds to jump start the financial markets and the economy. And a fiscal stimulus package from the incoming Obama Administration is on its way. So far, nothing has worked. Aggregate demand has plummeted despite government efforts. But the pieces are in place to eventually quell deflationary pressures. All we need is patience.

## *Industry Intelligence*

### **Industry Players Nervous Entering the New Year**

For most real estate businesses, 2008 was a year to painfully forget. It is hard to imagine a worse year for builders, lenders, real estate brokerage companies and settlement service companies. The real estate business was locked in a severe recession, sales plummeted, earnings dried up, and business failures and consolidation were rampant.

#### **Construction Fell Over 44 Percent in 2008**

Homebuilders experienced the most pain with new residential construction falling by over 44 percent during the year, representing the worst year since World War II. Builder activity virtually ground to a halt and earnings fell dramatically. Builder stock prices were battered throughout the year. The S&P homebuilder index tumbled 34 percent during 2008. The good news is that the worst may be over for builders. At some point during the first half of this year, investors will begin to an-

tipaculate a rebound in the economy and combined with a low mortgage rate backdrop, homebuilder stocks may rebound, albeit slightly.

Mortgage lenders and brokers also experienced a difficult 2008. Originations were down over 25 percent last year and many large lenders and servicers were dealing more with problem assets, delinquencies and foreclosures than with serving new customers. Countrywide, IndyMac and Wamu are now gone and others like Citigroup are dealing with serious balance sheet problems. And it might get worse for the large financial institutions this year. Aside from problem mortgage loans, these institutions are facing more problems with other types of loans as the economy deteriorates. Many banks have already experienced significant problems with their credit card and home equity portfolios and we expect these portfolios to worsen in the first half of

## *Industry Players Nervous Entering the New Year--Continued*

this year. In addition, we anticipate the quality of other loan portfolios like commercial real estate and business loans to deteriorate as well.

The lending landscape for 2009 promises to be very different than the landscape that began in 2008. Lenders and mortgage brokers who specialize in the FHA/VA mortgage business now have more favorable earnings outlooks than companies that were built on the jumbo and subprime mortgage business. Also, the smaller lenders who did not inherit toxic mortgage assets are more favorably positioned entering the New Year. We also expect refinancing transactions to comprise a large percentage of the origination business during the first half of this year. Fixed-rate FHA/VA and Fannie Mae and Freddie Mac mortgage loans will likely dominate product lines. However, lenders and mortgage brokers will continue to face higher fallout rates due to tighter underwriting standards and lower appraisal valuations.

### [Affordability is Favorable](#)

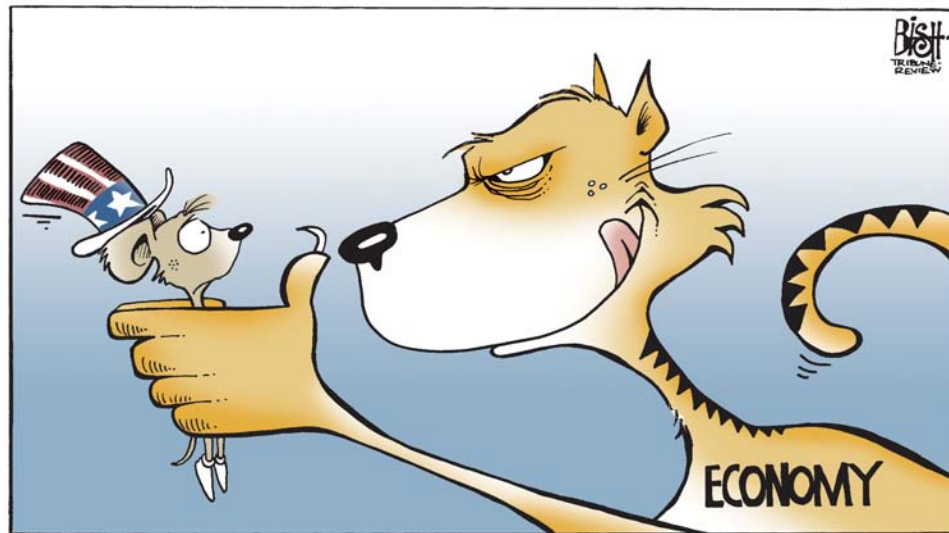
Hopefully, the second half of 2009 will provide lenders and brokers with more purchase origination business as the economy begins to recover from recession. Affordability conditions should be favorable entering the second half of the year with home values at relatively

low levels and mortgage rates remaining at historically low levels. That backdrop should provide an opportunity for the jumbo business to regain some market share.

The real estate brokerage business did not fare well in 2008 but there is a cautious optimism about 2009. Home sales were down over 12 percent for the year but that number is misleading because of an unusual number of foreclosure sales. We expect foreclosure sales to continue to dominate purchase transactions this year. As of this writing foreclosure sales comprised about 35 percent of total home sales. Brokerage companies and agents specializing in foreclosure and short sales are in a more favorable position to conduct business this year.

### [Consolidation in Real Estate Brokerage](#)

We expect further consolidation in the real estate brokerage industry this year as surviving companies look to gain market share and quality agents. We also expect a decline in the number of active real estate agents in the industry due to a relatively low number of non-foreclosure purchase transactions expected in the New Year. On a positive note, purchase transactions are expected to pick up in the second half of the year, generating needed revenue for real estate brokerage companies and their agents.



### **Industry Briefs**

#### ***Loan Mods to Continue Following IndyMac Sale***

The sale of the banking assets of IndyMac, whose demise was the fourth largest bank failure in history, to a group of private investors for \$8.5 billion to \$9.4 billion will not stop the FDIC's model program of modifying troubled IndyMac borrowers by reducing payments to levels borrowers can afford.

Under terms that will be a model for future FDIC sales, the agency will limit the buyer's potential losses on a portfolio of IndyMac's outstanding loans by promising to cover almost all losses in excess of 20 percent of the portfolio. In exchange, the buyer must offer mortgage modifications to IndyMac customers on terms specified by the FDIC.

In the time it has controlled the company, the FDIC has modified mortgages for 8,500 IndyMac customers, generally by reducing interest rates to as low as 3 percent to make monthly payments more affordable. The agency said 9,500 modifications are in process and at least another 28,500 IndyMac borrowers are eligible. The FDIC, which wants the program adopted nationwide, said it calculates the modifications will save \$423 million by avoiding foreclosures.

The investment group, IMB Management Holdings LP, will inject \$1.3 billion into the bank when the deal closes, which is expected to happen at the end of the first quarter. The new owners will bring in an experienced senior management team to run the day-to-day operations of the bank, which still has 33 branches, largely in Southern California.

#### ***Bank of America Completes Purchase of Merrill***

On January 1, Bank of America completed its purchase of Merrill Lynch, creating what it is calling "the largest wealth management business in the world" with approximately 20,000 financial advisors and more than \$2 trillion in client assets. Global investment management capabilities will include approximately 50 percent ownership in BlackRock Inc., which at September

30 had \$1.26 trillion in assets under management. Bank of America had \$564 billion in assets under management in the same period.

The combination also adds strengths in debt and equity underwriting, sales and trading, and merger and acquisition advice, creating significant opportunities to deepen relationships with corporate and institutional clients around the globe.

Under terms of the agreement, shareholders of Merrill Lynch received .8595 shares of Bank of America common stock for each common share of Merrill Lynch. Bank of America expects to realize \$7 billion in pre-tax expense savings over the next three years. Cost savings will come from layoffs announced in December and the reduction of overlapping technology, vendor and marketing expenses. In addition, Bank of America is expected to benefit by cross-selling its products to existing Merrill Lynch customers.

# Five Tipping Points for 2009

## Critical Issues for Real Estate

If Rip Van Winkle went to sleep three years ago and awoke today, he would have a hard time recognizing the seismic changes that have taken place in real estate. Perhaps the most unexpected and also most important is the unprecedented power the Federal government exerts today over the housing markets.

We're not so brave as to predict how the Federal presence will manifest itself during the next 12 months, but we will be watching closely certain points of friction, tipping points if you will, where decisions made in Washington will have an extraordinary impact on real estate, creating both challenges and opportunities for those who are paying attention. Here are five you might watch closely in the new year.

**1. Fateful Rates.** It's axiomatic that interest rates move the real estate market--the lower they go the better for buyers and sellers alike. In 2009, however, interest rates will be more critical than ever because if they stay low enough, they will do double duty. First, they might put a little life into sickly home sales by encouraging chary buyers to act now or lose out when rates rise. Second, they'll make it easier for homeowners to refinance into a more affordable 30-year fixed rate loan, especially those holding Alt-A and Option ARM loans that are due to reset.

*Sixty Minutes* raised alarms in Washington with a scary piece on December 14. The segment described a pend-

ing tsunami of Option ARMS and Alt-A resets, based largely on the widely cited Credit Suisse research that estimates some \$1.8 trillion Alt-As and Option ARMs will reset in the next few years. What the CBS report failed to mention is that low interest rates could take the sting out of resets for both borrowers and real estate markets already awash in foreclosures.

Keeping rates at record lows may not be a difficult assignment for Bernanke's Fed during this moribund economy. With both the economy and the financial fortunes of the Federal government increasingly dependent on the value of residential real estate, the Fed will have no shortage of motives to do so.

**2. Investor Backlash is Here.** It had to happen. Bank investors—long silent sufferers in the foreclosure crisis—have decided not to go quietly into the night. A

potential class action suit to stop the modification of troubled loans originally underwritten by Countrywide and now owned by Bank of America was filed in the New York State Supreme Court in December, and it may be the first of many.

The lawsuit is further proof of how complicated it will be to restore the real estate markets to health. A web of investors, securitizers and second-mortgage lenders holds stakes in most every mortgage. If successful, the suit could lead to a raft of investor litigation, driving borrowers deeper into trouble until they have no choice



## *Five Tipping Points for 2009--Continued*

but default. It could also keep lenders away from voluntary participation in government solutions like Hope for Homeowners where participation could mean significant losses and make future government fixes even more difficult.

The New York suit challenges an \$8.4 billion settlement negotiated by Bank of America and the State of North Carolina and other states that alleged Countrywide had practiced predatory lending. A self-styled investor advocate named William Frey argues that most of Countrywide's loans are not Countrywide's or Bank of America's to modify, but rather are owned by trusts that bought them through securitization. While the loan modifications called for in the settlement may help to keep struggling borrowers in their homes today, Frey says those alterations will short bondholders and run the risk of permanently damaging the secondary market. The lawsuit, which seeks class action status, covers 374 Countrywide securitizations.

If Frey wins, litigation may become infectious. Frey's attorney estimates that 385 trusts, representing hundreds of investors and outstanding debt originally worth \$465 billion, could be eligible to participate in the class action lawsuit they are assembling. In addition to the securities investors, other parties—like lenders that make second-mortgage loans and often get left in the cold in a loan workout—may join the party.

**3. Fix Housing First?** “Fix Housing First” is the housing industry's battle cry in Washington. It's also the name of a new coalition spearheaded by homebuilders that is pushing a round of new tax credits to lure buyers back into the market place along with lower mortgage rates subsidized by the Federal government.

For a variety of reasons, it's hard to disagree with the notion that reviving the real estate industry is in the national interest, not the least of which is that, with the takeover of Fannie and Freddie, the Federal taxpayers are more exposed than anyone else. Aside from their political clout, it's hard to understand why other hurting industries like the auto industry should be allowed to butt into line ahead of housing.

Housing First solutions can't be housing-only solutions like those that failed last year. Tax credits for first-time home buyers didn't do a thing for sales, though some argue they weren't large enough to make a difference.

In final analysis, the marketplace will make the only decision that counts. Survey after survey of buyers have made it clear that it's all about confidence in the economy. Not many buyers today are paying attention to incentives, whether they are tax credits or bargain prices. Buyers are worried about their jobs, their 401Ks and their savings. They'll put off that second home, that larger home or that first home until they feel safer. The reality is that health won't return to the housing sector until confidence is restored.

**4. The Barney and Timothy Show: Amity or Antagonism?** We'll miss the entertaining dueling between Barney Frank, chair of the House Financial Services Committee, and Treasury Secretary Hank Paulson when Paulson turns over his office to Timothy Geithner in January.

Last year, Frank emerged as a powerful advocate for using TARP money to stem foreclosures, a policy Paulson bitterly opposed. President-elect Obama has promised repeatedly that the foreclosure crisis will be at the top of his agenda, but students of Geithner's are wondering whether there will be much of a real difference when it comes to policies.

Geithner doesn't see the crisis as a housing crisis but the emergence of a parallel financial system of lending institutions unregulated by banking laws. Their risky and relatively illiquid assets were financed by very short-term liabilities that made them vulnerable to a classic run like the one we experienced in 2008. His answer is better and more universal regulation of financial services institutions.

Can Geithner turn over a new leaf with Frank, carry out his President's dictates, and still maintain the power base Paulson will turn over to him? Stay tuned. New bailout legislation will be on the Congressional agenda once the Inaugural parties end.

**5. Future of Freddie and Fannie.** By the end of this

## *Five Tipping Points for 2009--Continued*

year, if not sooner, we should know whether Freddie Mac and Fannie Mae will become wholly owned subsidiaries of the Treasury Department or destined for re-privatization.

In the waning hours of the Bush Administration, they resemble the former more than the latter. Most recently, Treasury forced them to take huge losses by turning them into the Bush Administration's two primary vehicles to mitigate foreclosures. Fannie and Freddie have been buying up mortgages in the marketplace and issuing securities, which helps to keep the conventional conforming market liquid and mortgage rates low, and modifying the hundreds of thousands of

delinquent mortgages that they own.

Re-creating these organizations may be more difficult than creating them in the first place. Political constituencies will weigh in on every decision. Old habits may be hard to beat and despite all that has happened, change will not come easily. However, they will never be allowed to return to their former autonomous lives when they were regulated by OFHEO. Few decisions will be more important for housing than the long-term fate of the housing GSEs.

--Steve Cook

## **Majority Opposes Using Bailout Funds To Help Defaulting Homeowners**

As a new Congress and the incoming Obama Administration prepare to tackle record numbers of foreclosures that have depressed real estate values, a new national survey by the *Reecon Advisory Report* found that a majority of Americans, 51 percent, opposes using Federal bailout funds to help pay the mortgages of homeowners who are in default. Forty-three percent of those surveyed favor helping homeowners in trouble.

The survey found that opposition to using bailout money to help defaulters is greatest among men (58.3 percent), elderly (56.2 percent) and those living in the Northeast (56.1 percent). Support for helping defaulting homeowners is greatest among young people age 18 to 24 (69.1 percent) and those earning less than \$20,000 a year (60.1 percent).

"These findings indicate that there are significant political barriers to proposals now being drafted in Congress to use some of the remaining \$700 billion of bailout funds to help stem foreclosures by helping defaulting homeowners with their mortgages," said David Lereah, president of Reecon Advisors, an independent real estate economics and information company.

The survey also found that consumer confidence in real estate is significantly higher than the stock market, de-

spite the depression in property values. By a margin of 53.7 percent to 30.8 percent, those surveyed think real estate is a better long-term investment than the stock market, considering the current economic situation. Confidence in real estate is highest in the South (58.6 percent) and West (58.4 percent), and among young people 18 to 24 (63.8 percent). The stock market ranks highest with those age 35-49 (34.7 percent).

However, public opinion on whether the stock market or real estate will recover first is much more evenly split and falls within the survey's margin of error. Forty-six percent predict the stock market will recover first; 43.2 percent believe real estate will be first. Real estate ranked highest with young people 18 to 24 (57.3 percent) and Southerners (50.6 percent).

The telephone survey, by GFK Custom Research North America, was conducted December 19-21, 2008. A total of 1,004 interviews were completed, 524 with female adults and 480 with male adults. The margin of error on weighted data is +3 percentage points for the full sample. All completed interviews are weighted to ensure accurate and reliable representation of the total population, 18 years and older.

The poll is the first in a series of opinion surveys on issues critical to real estate markets to be conducted by Reecon Advisors, Inc. for the *Reecon Advisory Report*.

# New CBO Head Questioned MBS Purchases

## *Will Elmendorf Oppose Activist Role for the GSEs?*

The newly named head of the Congressional Budget Office, Douglas Elmendorf, may become a powerful opponent of using the government-sponsored housing enterprises—Fannie Mae and Freddie Mac—as instruments of economic strategies to bolster the housing markets.

In an interview on the Brookings Institute's Web site last September, Elmendorf questioned the wisdom of the Bush Administration's primary strategy to improve real estate values—ordering Fannie and Freddie to increase the size of their portfolios by buying up mortgage backed securities on the open market.

He said the purchase of additional mortgage-backed securities for the Fannie and Freddie's portfolios (up to roughly \$150 billion) and for the Treasury (in unspecified amounts) will have short-term benefits by offsetting some of the recent fall in demand caused by a pullback of foreign and domestic investors.

“Moreover, direct Treasury purchases of mortgage-backed securities are a significant new step toward a larger government role in supplying funds for housing, which may complicate an appropriate long-run resolution of the (GSEs') public-private hybrid problem,” Elmendorf said.

Testifying before the House Financial Services Committee last spring, Elmendorf criticized legislation that became the Hope for Homeowners program not going far enough to meet the needs of defaulting borrowers. He advocated reform of the bankruptcy law to allow judges to write down principal amounts owed on mortgages and a significant expansion of the role of the Federal Housing Administration.

Elmendorf was named to the CBO post December 31. The previous CBO director, Peter Orszag, resigned to accept President-elect Obama's nomination to become Director of the Office of Management and Bud-

get. CBO's mandate is to provide the Congress with objective, nonpartisan, and timely analyses to aid in economic and budgetary decisions on the wide array of programs covered by the Federal budget and the information and estimates required for the Congressional budget process.

## **Loan Limits Fall and Rates Rise on Jumbos**

The maximum size of a home-mortgage loan that Fannie Mae and Freddie Mac can buy or guarantee in high-end housing markets will fall to \$625,500 from \$729,750 as of January 1.

Economic stimulus legislation lifted the loan limit in high-cost areas to nearly \$730,000 from \$417,000, though only through the end of 2008. However, the limit prevailing in most areas of the U.S. will remain the same in 2009, at \$417,000. The loan limits will affect all loans purchased or guaranteed by Fannie or Freddie in 2009, except for loans originated while the higher 2008 loan limits were in effect. For those loans, the roughly \$730,000 high-cost limit will apply.

The drop in the high-cost limit is likely to push up rates on jumbo mortgages that will no longer qualify for purchase by Fannie or Freddie.

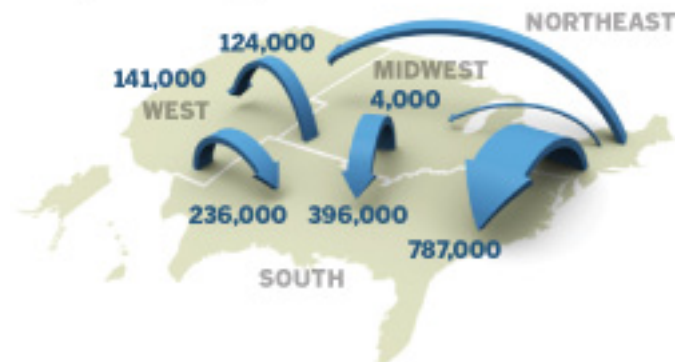
The *Washington Post* reported last week that even before the lowered loan limits took effect, the average rate on jumbo mortgages hit 7 percent for a 30-year fixed loan, even as rates for much smaller loans plunged to 5.28 percent, their lowest level in years.

Lawmakers representing high cost markets as well as the housing lobby are protesting the new limits, seeking to make permanent the roughly \$730,000 limit for high-cost areas that was in force for most of 2008.

## The Housing Crisis: Americans are Moving Less

### Net Regional U.S. Migration, 2007

South, West make gains



Arrows show data from sum of three one-year flows, 2005-2007

*Though mobility dropped 12 percent in 2007, the South and West made gains.*

The housing crisis is contributing to major changes in the national lifestyle, especially a decline in mobility. According to the latest Census data, only 11.9 percent of Americans changed residences between 2007 and 2008, the smallest share since the government began tracking this trend in the late 1940s.

Analysts say the long-term decline in migration has occurred because the U.S. population is getting older and most moves are made when people are young. Another brake on moving is the rise of two-career couples, because it is more difficult to coordinate a relocation when two jobs are involved. On top of these long-term trends, the current economic downturn has led to a further decline in migration, because jobs are typically one of the key magnets that induce people to move. Another factor may be that falling property values are forcing many families to forego moves for fear they cannot sell their homes.

A new Pew Social & Demographic Trends survey found that most Americans have moved to a new community at least once in their lives, although a notable number--nearly four in ten--have never left the place in which they were born. The most popular reason that they choose a new community, selected by a 44 percent plurality, is job or business opportunities, according to the Pew survey.

The Census Bureau's Current Population Survey indicates that the number of people who moved between 2007 and 2008, 34 million, was the lowest since 1959-60, when the population of the U.S. was 41 percent smaller than it is now. The annual migration rate, which held at about 20 percent through the mid-1960s, has drifted downward since then to its current low of 11.9 percent.

## Bankruptcy Attorneys Campaign for Cram Downs



*Bankruptcy attorneys seek new legislation to reduce loan principal through the bankruptcy process.*

“A strip-down--otherwise known as a cram-down--is when a bankruptcy judge modifies the interest rate or principal payments on household debt. Here's the straight story: Foreclosure is costly to homeowners and society, so we need to start paving the way for mortgage strip-downs now.”

That's the message being broadcast by the National Association of Consumer Bankruptcy Attorneys in a heightened effort to halt public and private sector efforts to modify defaulting mortgages and force them into bankruptcy. With over 2,500 attorneys in all 50 states and Puerto Rico, it is run by and for the benefit of bankruptcy attorneys.

NACBA cheers when studies find voluntary loan modifications failing. Its latest hero is Professor Alan White, Valparaiso University School of Law, whose latest research shows that:

- Less than 10 percent of the time do voluntary modification programs result in a reduced principal loan balance with more than half of modifications capitalizing unpaid interest and fees into larger and more drawn-out debt on the back end of the mortgage; and
- Only about a third (35 percent) of voluntary mortgage modifications reduce monthly payment bur-

dens for homeowners, with nearly half (45 percent) actually saddling distressed homeowners with increased payments under the modifications.

NACBA's latest priority is legislation sponsored by the chairman of the House Judiciary Committee, Rep. John Conyers Jr. (D-Mich.). Bankruptcy judges would be able to reduce payments and principal for homeowners with troubled mortgages under a proposal that appeared to be gaining momentum Wednesday.

The plan to allow the courts to order lenders to modify upside-down home mortgages appeared all but dead on Capitol Hill last fall when it was struck from the Federal financial bailout bill.

The proposal was pulled from the bailout bill in September, when it was opposed by housing groups, including the Mortgage Bankers Association. The MBA contended that allowing judges to force mortgage write-downs would lead to higher interest rates--as much as 2 percentage points--for all mortgages.

## *Looking Ahead*

There are a number of things to look for in the week ahead to help us assess conditions in the U.S. real estate markets.

First, we will continue to monitor the vital signs related to credit flows in the U.S. financial system like the Libor/Treasury spread.

Second, we await a number of economic reports that will likely provide us with further evidence that our economy is seeking deeper into recession. Factor orders likely fell for a fourth consecutive month in November, reflecting severe weakness in the manufacturing sector. The ISM nonmanufacturing survey index is expected to post another weak number in December consistent with the previous two months. And the employment report is expected to display further deterioration in the labor markets for December. We expect the employment sector to shed at least another 500,000 jobs in December.

On the real estate side, pending home sales are expected to post a flat number in November after having fallen 0.7 percent in October. We believe that falling mortgage rates are increasing the number of contracts for home purchases. However, there is still a great deal of fallout going from contract to closing. Weekly mortgage applications are also expected to fair relatively well due to a

favorable mortgage rate situation. But again, there will be fallout going from application to closing.

Finally, The House Financial Services Committee meets this week to discuss how President-elect **Barack Obama's** administration should use the second \$350 billion of the Troubled Asset Relief Program.. Federal Reserve Chairman **Ben Bernanke** and Federal Deposit Insurance Corp. Chair **Sheila Bair** are scheduled to appear along with representatives from banking and housing trade associations.

### *Reecon Advisory Report*

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The *Reecon Advisory Report* compiles the most vital and current real estate economic data for your convenience. This wealth of data is on the next three pages.

Our weekly indicators include mortgage rates from Freddie Mac, the MBA Purchase and Refi Indices, and libor and mortgage spreads from the Treasury. Our monthly reports include the monthly inventory supply, Existing Home Sales and Pending Homes Sales Indices from the National Association of Realtors, new home sales from the Commerce Department, and new home starts and permits from the Census Bureau. Quarterly data from ten leading markets consolidate information from NAR, S&P/Case-Shiller, and OFHEO.

To illustrate conditions and trends in real estate markets, we've created two portfolios of representative property values from multiple listing services, and one portfolio consisting of stocks of publicly traded securities of companies in whose fortunes are closely tied to real estate markets, such as builders, lenders and home supply retailers.

Every issue of the *Reecon Advisory Report* concludes with a forecast page listing monthly mortgage rates, sales and price forecasts from economists at five leading national real estate organizations, including Fannie Mae and Freddie Mac. The final column in light green lists average forecasts consolidated from the listed sources.

## Equity Portfolio

### PORTFOLIO COMPONENTS

For the past year Reecon Advisers has been tracking an equity portfolio consisting of two banks, two home-builders, two private mortgage insurers and two home improvement retailers. Reecon assumed a total portfolio worth of eight thousand dollars in the beginning of the year, one thousand per company

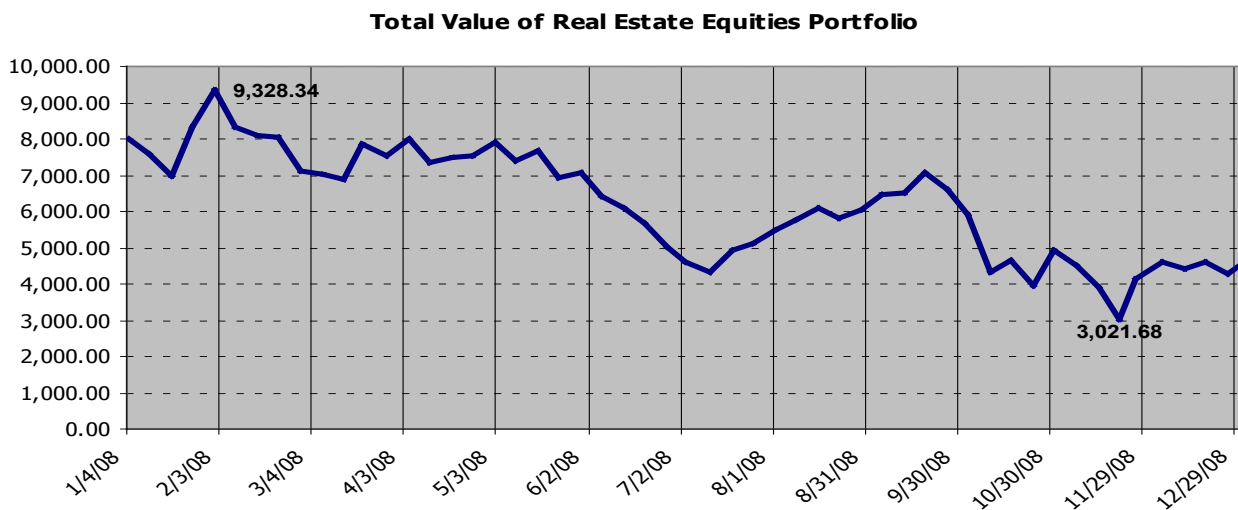
	<b>Bank of America</b>	<b>Sun Trust Bank</b>	<b>Centex</b>	<b>Lennar Homes</b>	<b>Lowe's</b>	<b>Home Depot</b>	<b>PMI Group</b>	<b>Radian</b>
<b>Price of stock on 1/4/08 (\$)</b>	39.85	58.80	20.91	63.25	21.08	24.96	11.09	10.11
<b>Number of shares purchased</b>	25	17	48	63	47	40	90	99

### PERFORMANCE OF THE PORTFOLIO

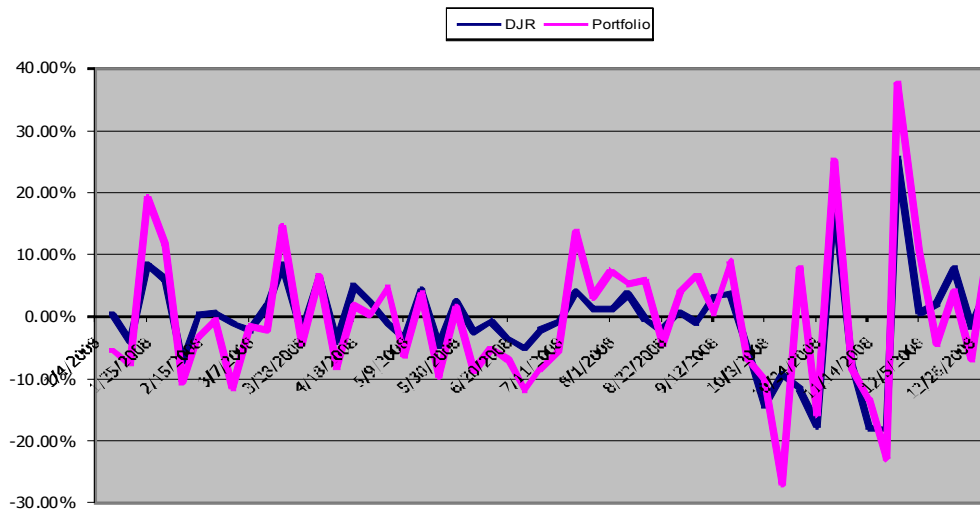
Initially, the value of the portfolio fell but then increased to \$9,328.34 in the week ending February 1, which was the highest value of the portfolio for the year. For the next four months the value of the portfolio fluctuated in the seven and eight thousand-dollar range but in early June it significantly declined. By mid-July the value had reached \$4,342.42.

Over the next two and a half months the value of the portfolio reached the 7,000-dollar range again. However, the stock market crisis in the autumn of 2008 significantly reduced the value of the portfolio. The lowest value was recorded in the week ending November 21 with the portfolio worth only thirty-eight percent of the initial investment -- \$3,021.68.

The portfolio closed the year at \$4,581.11, which was a 7.3% increase over the previous week but a significant drop from the beginning of the year (-42.7%).



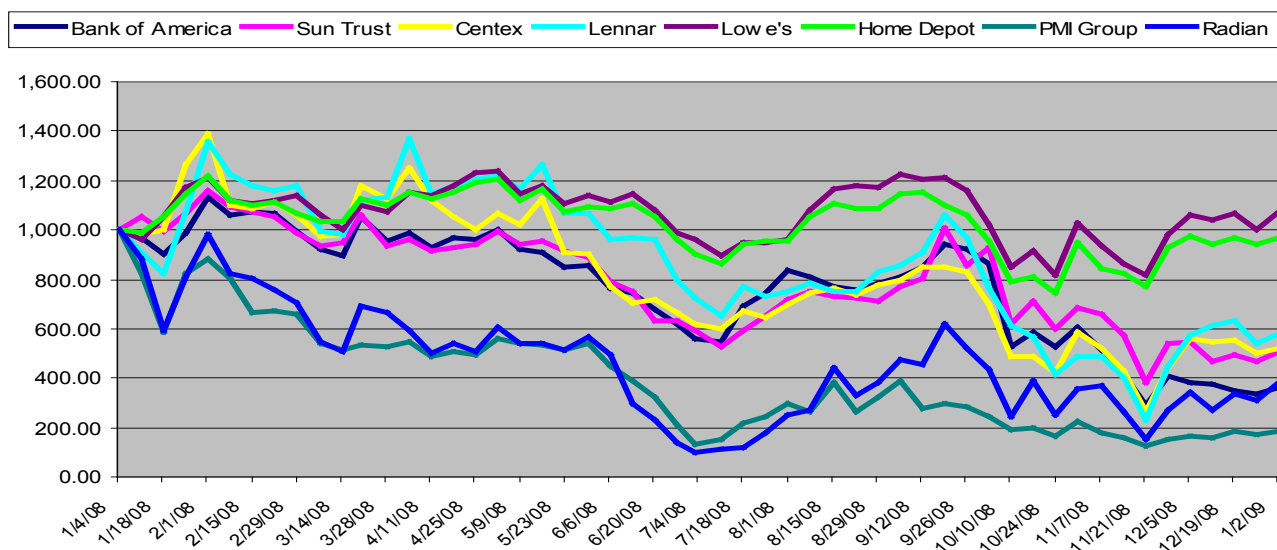
To compare the performance of the portfolio we looked at the performance of the Dow Jones Equity REIT index (DJR). The chart below shows the percentage change from prior week in the value of the portfolio and the value of the index. The chart depicts that both the portfolio and DJR moved closely together with the portfolio recording larger swings.



## WINNERS AND LOSERS

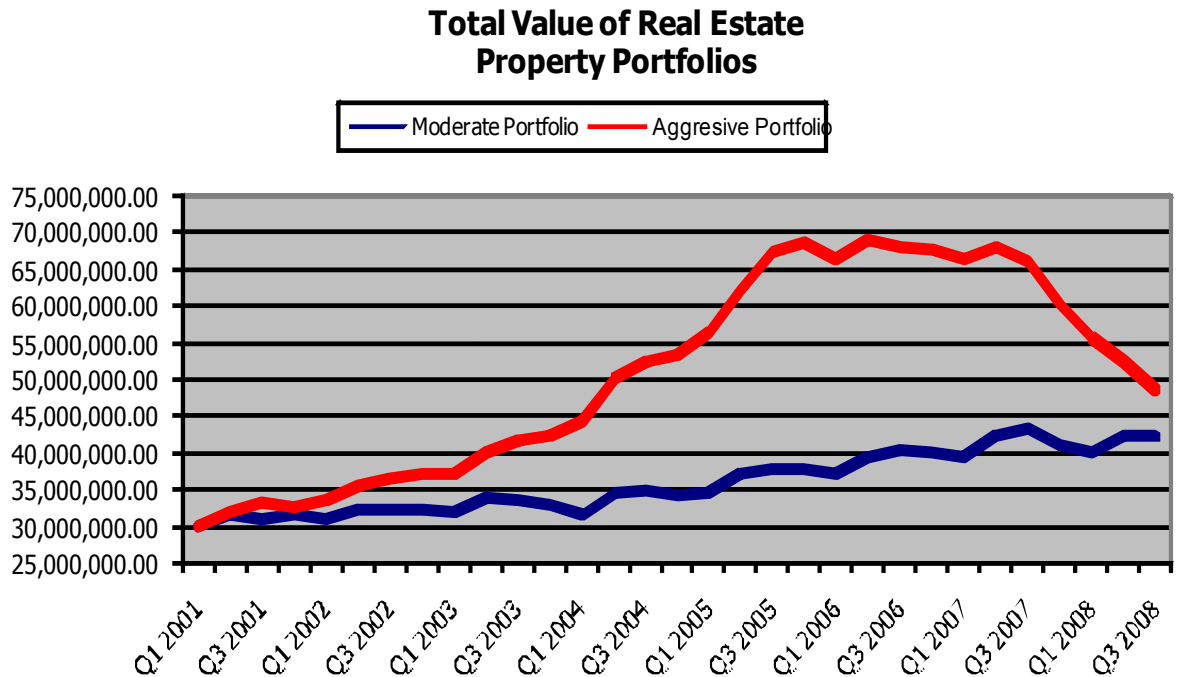
The mortgage insurers, Radian and PMI Group, were the primary losers of the eight companies in the portfolio. The range of the PMI Group stock price was 9.72 (highest value=\$11.09; lowest value=\$1.37) while the range of the Radian stock price was 9.09 (highest value=\$10.11; lowest value=\$1.02).

Home Depot and Lowe's were the two companies that roughly kept their value while the rest of the companies – Bank of America, Sun Trust, Centex and Lennar Homes – moved very closely together and recorded their major losses in the last quarter of the year. Their value fell by almost half most likely due to the financial turmoil and the significant slowdown in housing.



## Property Portfolios

Reecon has been tracking two property portfolios – an aggressive and a more moderate one. We assumed a \$5 million investment per market for a total of \$30 million per portfolio.



In the boom years, from about the third quarter of 2003 up until the first quarter of 2006 the value of the aggressive portfolio consisting of Tampa (FL), Ft. Myers (FL), Washington (DC), Orlando (FL), Los Angeles (CA), and Las Vegas (NV) more than doubled its value. Then, between early 2006 and the second half of 2007, the value of the portfolio leveled off at the \$65-70 million range and later started its downfall. The most recent data shows that at the third quarter of 2008 the property portfolio was worth \$48.5 million. The significant price declines were a result of the need for a housing correction in those markets due to the excess supply and the struggling local economies.

The moderate portfolio consisting of Charlotte (NC), Dallas, TX, Salt Lake City (UT), Houston (TX), Albuquerque (NM), Charleston (WV) has showed moderate returns with its highest value of 43.2 million at the third quarter of 2007. Its most recent value was 42.2 million. The local economies of these markets have been slightly stronger and these markets don't have the excess supply that the markets in the aggressive portfolio have.

## Indicators

### WEEKLY INDICATORS

Indicator	Release Date	Latest Release	Previous Release	Change from Previous Release	Next Release
30-Year Fixed Mortgage Rates	12/31/08	5.10	5.14	▼ -0.04	01/08/09
1-Year Adjustable Mortgage Rates	12/31/08	4.81	4.95	▼ -0.14	01/08/09
MBA Mortgage Purchase Index	12/31/08	320.9	316.5	▼ -1.4%	01/07/09
MBA Mortgage REFI Index	12/31/08	6,733.8	6,758.6	▼ -0.4%	01/07/09
3-Mo LIBOR/Treasury Spread	01/05/09	1.34	1.33	▲ +0.01	01/06/09
30-Year Mortgage/Treasury Spread	02/05/09	2.88	2.93	▼ -0.05	01/06/09

Sources: Freddie Mac, Mortgage Bankers Association of America

### MONTHLY INDICATORS

Indicator	Release Date	Latest Release	Previous Release	Change from Previous Release	Next Release
Existing Home Sales (in million, SAAR)	12/23/08	4.49	4.91	▼ -8.6%	01/26/09
New Home Sales	12/23/08	407,000	419,000	▼ -2.9%	01/29/09
Housing Starts (in million, SAAR)	12/16/08	0.625	0.771	▼ -18.9%	01/22/09
Housing Permits (in million, SAAR)	12/16/08	0.616	0.730	▼ -15.6%	01/22/09
Pending Home Sales Index (2001=100)	12/09/08	88.9	89.5	▼ -1.0%	01/06/09
Months' Supply	12/23/08	11.2	10.3		01/26/09

Sources: National Association of Realtors, Census Bureau

### QUARTERLY PRICE DATA (% Change from a year ago)

MSA	NAR Median Home Prices	OFHEO Price Index	Case-Shiller Price Indices
	Q3 2008	Q3 2008	Q3 2008
	Next Release: 02/03/09	Next Release: 02/24/09	Next Release: 04/06/09
Boston	-10.0	-4.1	-4.8
Chicago	-12.4	-3.8	-10.8
Denver	-11.4	-1.0	-5.8
Las Vegas	-28.4	-26.8	na
Los Angeles	-35.1	-18.8	-29.6
Miami	-16.9	-17.9	-32.4
New York	-5.0	-4.6	-7.6
San Diego	-36.0	-17.6	na
San Francisco	-25.3	-8.0	-15.8
Washington	-24.0	-12.5	-18.4

Sources: National Association of Realtors, OFHEO, S&P/Case-Shiller.

## Forecasts

Every month Reecon compiles the forecasts released by the National Association of Realtors (NAR), National Association of Home Builders, Mortgage Bankers Association of America, Fannie Mae and Freddie Mac in order to check the pulse of the real estate industry. Once compiled we average the forecasts of all those organization and closely look at the major housing indicators -- existing home sale, new home sales, housing starts, mortgage originations, and home prices. We also pay attention to key mortgage rates – 30-year fixed and 1-year adjustable.

### Existing Home Sales

The consensus forecast is that the sales of existing homes will rebound in 2009 (slightly surpass 5 million units) and reach 5.5 million units in 2010. The availability of discounted properties along with the low mortgage rates will act as a significant impetus for a lot of first-time buyers.

### New Home Sales

The consensus forecast is that new home sales will decline in 2009 to about 435,000 and improve in 2010 to about 550,000. The large supply of significantly discounted existing homes available for sale will continue to push down the new home market. In addition, the increased number of properties in foreclosure that are still relatively new will further weaken the demand for new homes.

### Housing Starts

It won't be until the required housing correction happens that we see an increase in housing starts. In 2009, the major industry groups expect a decline in residential construction to about 750,000. As the demand for homes begin to pick up later this year builders will respond with increased starts in 2010.

### Mortgage Originations

The availability of significantly discounted properties for sale along with a very low mortgage rate environment will lead to an increase in mortgage originations. The consensus forecast is that mortgage originations will increase by about 3% from their 2008 level.

### Home Prices

Despite the quite optimistic forecast from the National Association of Realtors, the consensus forecast is that both the prices of existing homes and prices of new homes will fall to \$202,600 in 2009 and slightly improve in 2010 (\$203,700). However, given the turmoil in the financial markets and the weakness in the economy, the housing demand will continue to be soft which in turn will continue the downward pressure on prices.

# Forecasts

Market Forecasts, December 2008																			
	NAR				NAHB			MBAA			Fannie Mae			Freddie Mac			Average		
	2007	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>Mortgage Rates</b>																			
30-yr FRM	6.3	6.1	5.8	6.2	6.1	5.6	5.7	6.1	5.4	5.5	6.1	5.5	5.4	6	6	6.6	6.1	5.7	5.9
1-yr ARM	5.5	5.2	5	4.9	5.2	4.7	4.8	5.1	4.8	5.3	5.2	4.8	4.6	5.1	5.2	4.9	5.2	4.9	4.9
<b>Housing Measures</b>																			
(0,000)																			
EHS	5,652	4,958	5,190	5,551	4,372*	4,475*	5,037*	4,964	5,161	5,580	4,949	4,937	5,343	4,870**	4,810**	5,600**	4,957	5,096	5,491
NHS	774	486	393	446	500	450	625	497	447	566	499	464	626	na	na	na	496	435	546
Housing Starts	1,354	934	731	772	924	694	909	934	820	1,034	933	798	1,060	930	720	1,000	931	783	955
Mortgage Orig	2,423	na	na	na	na	na	na	1,824	1,981	1,917	1,909	2,034	1,837	1,781	1,600	1,800	1,838	2,008	1,877
<b>% chg- yr ago</b>																			
EHS	-12.8	-12.3	4.7	7.0	-22.6	2.4	12.6	-12.2	4.0	8.1	-12.4	-0.2	8.2	-13.8	-1.2	16.4	-12.3	2.8	7.8
NHS	-26.3	-37.2	-19.1	13.5	-35.4	-10.0	38.9	-35.8	-10.1	26.6	-35.5	-7.0	34.9	na	na	na	-36.0	-12.3	25.6
Housing Starts	-24.8	-31.0	-21.7	5.6	-31.8	-24.9	31.0	-31.0	-12.2	26.1	-31.1	-14.5	32.8	-31.3	-22.6	38.9	-31.2	-15.9	22.0
Mortgage Orig	-16	na	na	na	na	na	na	-24.7	8.6	-3.2	-21.2	6.5	-9.7	-26.5	-10.2	12.5	-24.1	9.2	-6.5
<b>Median Prices</b>																			
(\$0,000)																			
Existing Prices	218.9	198.5	199.2	208.3	na	na	na	200.7	196.9	199.5	228.7	211.8	203.2	na	na	na	209.3	202.6	203.7
New Prices	247.2	227.9	230.4	241.8	na	na	na	230.5	220	221.3	199.5	184.8	177.3	na	na	na	219.3	211.7	213.5
<b>% chg- yr ago</b>																			
Existing Prices	-1.4	-9.3	0.4	4.6	na	na	na	-8.3	-1.9	1.3	4.5	-7.4	-4.1	na	na	na	-4.4	-3.2	0.5
New Prices	0.3	-7.8	1.1	4.9	na	na	na	-6.8	-4.6	0.6	-19.3	-7.4	-4.1	na	na	na	-11.3	-3.5	0.8
*existing single-family home sales, excludes condos																			
**existing plus new home sales																			

