

Themes on the Economy[®]

Chipping Away at the American Dream Special Housing Market Edition

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An Emotional Setback

It was a small, three bedroom brick house, identical in layout to most of those on the block. The street was Roseland Avenue, a name that evoked more grandeur than it deserved. But it was my home—the first and last home that my parents would ever own together. I don't remember much about moving there, but I do remember all that followed: the walk to my first day of kindergarten with my grandfather; the smell of fresh jam made with my mom in the avocado-colored kitchen; the sight of the moon while looking through a telescope with my dad; overnights shared with my friends, dreaming about our futures; being awakened by my parent's fights late at night; and, the day that I somewhat unknowingly walked out the door for the very last time. The house was sold just after I started college.

Homes are unique in the spectrum of assets that we own. They embody our dreams, our

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sorrows, and our achievements. They are both a nest for our children to flourish and a nest-egg for our futures. They are the largest asset that most people will ever own and, as a result, enable us to finance everything from cars to college degrees.

Homeownership also has inherent societal benefits. Households who own instead of rent at the lower end of the income strata report lower rates of teenage pregnancies and higher rates of high school attainment.

This is why the downturn in housing is so tragic, as it not only represents a hit to the economy, but it represents a hit to the American psyche. It is the straw that breaks the back of working class households who feel that they have already given more than their fair share in an economy that penalizes manual labor relative to educational attainment.

This special report takes a closer look at the outlook for housing, how close we are to a bottom, and what housing shifts mean for the overall economy. Special attention will be placed on the role that recent policy shifts will play in limiting the damage.

Lower interest rates and a lifting of the cap on jumbo mortgages should help to limit

the declines in both sales and starts over the course of the year. The downward pressure on prices, however, is expected to persist for some time to come.

In Search of a Bottom

The Housing Market Outlook Table provides the forecast for 2008. Buyers are expected to maintain the upper hand, as the inventory of unsold homes continues to balloon. Builders are expected to remain particularly aggressive in offering deals and upgrades as cancellations have surged at the same time that buyer traffic has dried up.

One development in Modesto, California, has dropped its selling price from \$400,000 a year ago to \$300,000 today. The downside for sellers, of course, is that many are now under water on their mortgages, even if they were able to put 20% down a year ago. (E.g., Price depreciation has wiped out the equity in the homes of even the most conservative of borrowers in those areas.)

Sales

New and existing homes sales are forecast to fall another 15% in 2008, about the same as 2007. The subprime and Alt-A mortgage market have all but disappeared, which has taken many speculative and low-income buyers out of the market entirely. Middle-

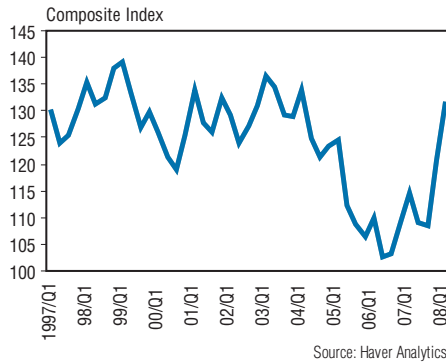
The Housing Market Outlook

	2007	2008(f)
Sales*	6,445	5485
New	773	585
Existing	5,672	4,900
Starts*	1,344	993
Single-family	1,038	699
Multi-family	306	294
Prices		
OFHEO**	1.9%	-5.0%
Median Existing	-2.4%	-9.0%

* Thousands.

** Office of Federal Housing Enterprise Oversight.

CHART 1

Housing Affordability

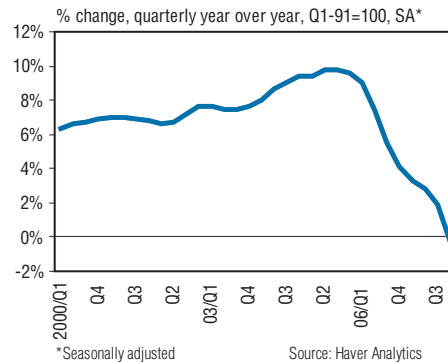
income buyers in California have also been squeezed, as many were forced to rely on subprime mortgages to qualify for the high cost of housing in that part of the country. Add to that, the recent credit market turmoil, and we should expect an additional weakening of sales come spring. Mortgage applications plummeted during the later part of February and March as credit conditions tightened, which is limiting the pipeline for sales in March and April.

There is, however, a light at the end of the tunnel. The Fed moved aggressively to ease in the first quarter, and will likely lower rates at least another quarter-point at their meeting in late April. This, coupled with efforts to reliquify the mortgage market in late March should make it a little easier for buyers to qualify for mortgages. Separately, Congress recently lifted the limit on the jumbo mortgages that Fannie Mae and Freddie Mac can purchase outright, which should increase mortgage availability in some of the most expensive markets, such as those in California.

Affordability has also increased in recent months in response to falling mortgage rates and prices. This should help to reopen the market to middle-income households, which were priced out of the market during the boom. (See *Chart 1*.) Moreover, affordability should improve further as income growth regains some momentum later in the year.

The only exceptions are the economically depressed regions of the industrial Midwest, largely Michigan and Ohio, where people are literally moving out of their homes and defaulting on their mortgages under the cover of night. Demand is so weak in some areas, that nothing seems to be bringing buyers in. One seller in Bloomfield Hills, Detroit recently complained that his house

CHART 2

OFHEO House Price Index: Purchase Only

was on the market more than a year before anyone even dared to look at it, let alone make an offer.

A Bias Toward Existing. That said, existing sales are expected to remain significantly stronger than new-home sales as buyers continue to gravitate toward more established neighborhoods with better track records for re-sales. Fire-sale pricing by builders in new developments has proven particularly dangerous, as it has shaken the confidence of buyers hoping to build equity in their home going forward. (Nobody likes to see the value of their home fall as the next buyer in line gets a better deal just a few weeks later.)

Starts

Housing starts are expected to drop a much more dramatic 32% in 2008, after declining almost 30% in 2007. Much of that correction has already occurred, as starts dropped at a 20.5% annualized rate between the fourth quarter of 2007 and first two months of the first quarter in 2008.

We could even see a dead cat bounce later in the year, as housing starts begin to find their bottom. Starts usually bottom near a 1-million-unit rate, which is close to where they are today. That said, there is still significant downside risk given the degree to which the market was overbuilt.

New home inventories have surged to a record high in recent months. Add to that, a surge in buyer cancellations (now running at about 40%) which are not counted in the official data on new home inventories, and the downward pressure on starts is even greater.

The only offset is a proposal in Congress, which would allow builders to redistribute current losses to previous year gains, and get

CHART 3

Mortgage Foreclosures Started

a bigger refund on their taxes. This will probably do more to keep builders solvent, however, than stimulate any new construction or stem the decline in new home prices. Indeed, one has to question the wisdom of subsidizing an industry that benefited most from the bubble.

Even the build-to-suit segment which accounts for about 20% of the market, has taken a turn for the worse in recent months. Mortgages for new home construction are even harder to get than those for existing homes. The same holds true for renovations, which are typically financed out of a home's existing equity.

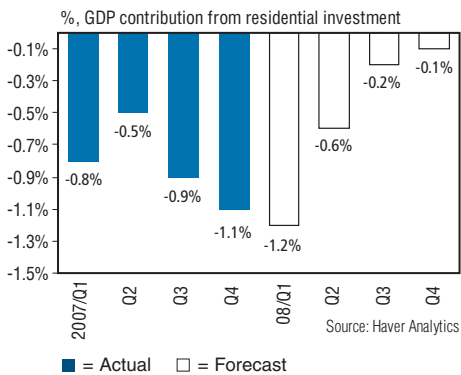
The multi-family market is particularly vulnerable. Not only is the stock of new condos rising rapidly, but there is still a fairly substantial amount of product under construction. Moreover, some new projects have been cancelled as the builder working on the project was forced into bankruptcy before ground could be broken and pre-construction sales could be completed.

The high end of the market will also share the pain, as many projects are due to be completed before year end, which will add to already bloated luxury condo inventories. Chicago has a particularly large number of luxury condos and condo hotels slated to come on the market in late 2008 and early 2009.

Depreciation

Home prices, as measured by the Office of Federal Housing Enterprise Oversight (OFHEO), are forecast to drop 5% in 2008, after rising an average 1.9% in 2007. Prices were already starting to decline on a year-over-year basis by the end of 2007. (See *Chart 2*.) Median existing home prices, which are produced by the National Association of Realtors, are expected to fall

CHART 4

Residential Investment: Drag on Real GDP

a more dramatic 9% over the year, after declining 2.4% in 2007.

The OFHEO index more closely tracks the resale values of homes, which is the most important statistic to watch when trying to gauge the impact that the current crisis will have on household wealth. The median price index is more sensitive to distribution of sales in any given month, and was driven down in recent months by sharp declines at the low end of the market.

Separately, there is the Case-Schiller price index, which declined a more dramatic 4.6% in 2007, and is on track for what could be a double-digit decline in 2008. However, this index is largely limited to the top 20 housing markets and doesn't give us much information about the direction of household wealth measures, which are based on movements in the OFHEO index. Those closest to studying the real estate market argue that the OFHEO index is the more reliable index to watch over time. This is especially true given the fact that the metro areas covered by the Case-Schiller index tend to correlate highly with those that experienced the most excessive appreciation and overbuilding in recent years.

An increase in foreclosures is a particular problem for some of the most overbuilt and economically suppressed markets. (See *Chart 3*.) Initially, most of the defaults were concentrated in subprime and Alt-A mortgages, with a sharp increase in early defaults—mortgages that were going bad within the first six months of origination. The foreclosure problem, however, is now spreading.

Depreciation, in particular, is raising the risk that “good” borrowers (those that can still service their debt) default as the value

of their home slips below the size of their mortgage. Fed Chairman Bernanke and Congress are both working to encourage lenders to renegotiate loans that might be at risk. The idea is that it is ultimately better for lenders and borrowers alike to renegotiate a loan than suffer the costs associated with foreclosure. Much of the burden of identifying those loans, however, rests on the homeowners themselves who must contact their lenders before they get to the point of default.

The good news, of course, is that subprime mortgages were halted last summer, which should limit those types of foreclosures in the second half of the year. Add to that mortgage repricing, which is now lowering the rate on adjustable rate mortgages and tax rebates, and at least a portion of the debt many people expected to slip into default is likely to remain good during the remainder of the year. (We are currently expecting about 40% of the tax rebates to be spent, and the remaining 60% to be used to pay down or service outstanding debt.)

Moreover, many sellers have pulled their homes from the market, waiting to see a pickup in conditions later in the cycle. This should help temper the decline in prices over the near term, however, it can not stop the market from correcting entirely. We could still be several years away from a bottom in prices. (A similar phenomenon occurred in Los Angeles, once that market went bust in the early 1990s.)

Regional Variations. The drop in home values across Florida is expected to remain particularly steep, given the added burden that rising insurance costs are placing on prices. Some insurers have pulled out of the state entirely in response to an increase in hurricanes in recent years, which has forced some coastal homeowners to self-insure.

Separately, home values have begun to soften in markets that were previously immune to the downward pressure on prices. Seattle and New York City are two examples.

Depreciation should slow a bit, however, in Arizona and Nevada, where the drop in prices has already been staggering and immigration continues. Indeed, construction has come to a virtual standstill in some cities, which should help accelerate absorption rates.

Economic Implications

So far, the direct cost associated with the housing bust—the decline in residential investment and housing-related spending—have had the largest impact on growth. The decline in residential investment shaved more than one percent from growth in 2007 alone.

The good news is that those direct costs are likely to abate in 2008 as the size of the decline in residential construction activity narrows. Indeed, the drag created by the drop in residential investment could all but disappear by year end. (See *Chart 4*.)

The bad news is that the other shoe of the housing bust has begun to drop. Everything from a loss in housing market wealth (via price declines) to the collateral damage created by the credit market crisis is suppressing overall economic growth. A seizure in lending in the commercial end of the construction market is particularly worrisome, as increases in commercial construction were the primary offset to losses on the residential side in 2007.

A modest improvement in employment and incomes in the second half of the year should help to partially offset those trends. A rally in equity prices is also expected to help dampen the pain associated with falling home values. The distribution of those gains, however, remains highly concentrated at the higher end of the income strata, which suggests that the bifurcation of consumer spending that has been occurring since oil prices surged in 2003 is likely to worsen. (E.g. Even more of the consumer spending is likely to be concentrated among the wealthiest households in 2008 than 2007.)

On net, stimulus provided by changes in fiscal and monetary policy will buy some time for the housing wounds to heal. They will also limit the collateral damages associated with the financial crisis triggered by the housing market bust. The bottom in housing is still ahead of us, however, and the residual pain of weak to falling home prices is likely to haunt us for some time to come.

Mesirow Financial Economic Forecast (Numbers as of April 9, 2008)

	2007(A)	2008	2009	2007:3(A)	2007:4(A)	2008:1	2008:2	2008:3	2008:4	2009:1
National Outlook										
Chain-Weighted GDP	2.2	1.9	2.3	4.9	0.6	0.5	1.7	3.1	1.6	1.7
Personal Consumption	2.9	1.5	1.6	2.8	2.3	0	2.2	2.7	-1.1	1.7
Business Fixed Investment	4.7	2.9	3.6	9.3	6.0	-5.0	1.8	2.7	11.3	-1.8
Residential Investment	-17.0	-19.8	0.4	-20.5	-25.2	-27.9	-17.5	-7.2	-2.3	3.2
Inventory Investment (billions)	4.6	6.2	24.1	30.6	-18.3	3.8	-8.7	6.1	23.5	20.6
Net Exports (billions)	-555.6	-442.1	-410.5	-533.1	-503.2	-467.5	-442.3	-433.1	-425.4	-415.5
Exports	7.9	7.3	5.1	26.2	3.9	4.7	5.3	5.6	5.1	4.6
Imports	1.6	-0.9	3.2	4.8	-2.6	-4.2	-1.7	2.9	3.6	2.4
Government Expenditures	2.0	2.1	1.8	3.8	2.0	1.6	1.2	1.8	2.0	1.9
Federal	1.7	3.0	2.0	7.1	0.5	4.1	1.4	2.0	2.2	2.0
State and Local	2.2	1.5	1.7	1.9	2.8	0.2	1.2	1.7	1.9	1.9
Final Sales	2.5	1.9	2.2	4.0	2.4	-0.3	2.2	2.6	0.9	1.8
Inflation										
GDP Deflator	2.7	2.3	2.3	1.0	2.4	2.7	1.8	2.6	2.6	2.7
CPI	2.9	3.5	2.4	2.8	5.0	4.3	1.8	2.7	2.9	2.6
Special Indicators										
Corporate Profits*	2.5	6.7	5.6	1.8	2.5	1.3	-2.9	2.1	6.7	7.3
Disposable Personal Income	3.1	2.4	1.4	4.0	0.1	1.3	15.3	-8.0	-0.6	3.1
Housing Starts (millions)	1.34	0.99	1.04	1.30	1.15	1.05	0.99	0.97	0.97	0.99
Civilian Unemployment Rate	4.6	5.2	5.7	4.7	4.8	4.9	5.2	5.4	5.5	5.6
Employment	0.8	-0.4	0.1	-0.4	-0.5	-0.6	-0.6	-0.5	0.4	0.3
Vehicle Sales										
Automobile Sales (millions)	7.6	7.5	7.9	7.3	7.8	7.3	7.4	7.5	7.7	7.8
Domestic	5.0	5.0	5.2	4.9	5.2	4.9	4.9	5.0	5.1	5.2
Imports	2.5	2.5	2.6	2.4	2.5	2.4	2.5	2.5	2.6	2.6
Lt. Trucks (millions)	8.6	7.9	8.2	8.6	8.4	7.9	7.8	7.9	7.9	8.1
Domestic	7.1	6.5	6.7	7.2	6.9	6.5	6.4	6.5	6.5	6.6
Imports	1.5	1.4	1.5	1.4	1.5	1.4	1.4	1.4	1.4	1.5
Combined Auto/Lt. Truck	16.1	15.4	16.1	15.9	16.2	15.2	15.2	15.4	15.6	15.9
Heavy Truck Sales	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Total Vehicles (millions)	16.5	15.6	16.4	16.2	16.5	15.5	15.5	15.7	15.9	16.2
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	2 ³ / ₈	5 ¹ / ₈	4 ¹ / ₂	3 ¹ / ₈	2 ¹ / ₈	2	2	2
10-Year Treasury Note	4 ⁵ / ₈	3 ³ / ₄	4 ¹ / ₄	4 ³ / ₄	4 ¹ / ₄	3 ⁵ / ₈	3 ¹ / ₂	3 ⁷ / ₈	4 ¹ / ₈	4 ¹ / ₄
Prime Rate	8	5 ¹ / ₄	5 ³ / ₈	8 ¹ / ₈	7 ¹ / ₂	6 ¹ / ₈	5 ¹ / ₈	5	5	5
Corporate Bond AAA	5 ⁵ / ₈	5 ³ / ₄	6	5 ³ / ₄	5 ¹ / ₂	5 ¹ / ₂	5 ¹ / ₂	5 ⁷ / ₈	6	6 ¹ / ₈
Exchange Rates										
Yen/Dollar	118	105	109	118	112	105	103	104	106	107
Dollar/Euro	1.37	1.51	1.43	1.38	1.45	1.50	1.56	1.52	1.50	1.45

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2007, GDP was \$11,567 billion in chain-weighted dollars.

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