

# Themes on the Economy®

## Hitting a Bottom in Housing Special Housing Market Edition

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### A Ray of Light Amidst the Clouds

An unexpected jump in new and existing home sales, a fairly sharp increase in mortgage applications, and a surprise increase in pending home sales prompted many to declare the bottom in housing in the month of February. Even home prices, which had been falling like a rock, showed some signs of stabilizing during the month.

Moreover, speculators appear to be re-entering the market, picking up properties on the cheap. In Michigan, some investors are buying and turning \$15,000 properties into HUD-approved affordable housing. The guaranteed rents that they then receive more than cover their mortgages and real estate tax costs.

That said, the housing market is still a long way from healthy: home sales are still down substantially from the lows they hit during the turbulence of the fourth quarter;

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pending sales were at such low levels, there was really nowhere to go but up; and more than 70% of the mortgage applications we saw in March were refinances instead of purchases.

Moreover, a high percentage (45%) of existing sales were distressed sales—short sales or homes being sold out of foreclosure—which is more a reflection of overall weakness than of strength in the market. Indeed, much of the increase in sales occurred in areas that had been hit the worst by the sub-prime crisis—California and Nevada.

This special report takes a closer look at the outlook for housing, and what housing shifts suggest for the broader economy. Special attention will be paid to the role recent policy changes are playing to create a bottom.

### Anticipating a Turnaround

*The Housing Market Outlook Table* provides a summary of the forecast for 2009:

- Housing starts are expected to drop from 903,000 in 2008 to 605,000 in 2009. The bulk of those losses, however, occurred during the second half of 2008 and the first months of 2009.

- Home sales are forecast to drop only modestly from 5.4 million in 2008 to 5.2 million in 2009. Much like starts, the bulk of those losses were already felt in late 2008 and early 2009.
- And, home prices are expected to continue their downward slide on a year-to-year basis. Very sharp declines across the three key indices (Median Existing, Case-Schiller, and the Federal Housing Finance Agency) at the start of the year, however, may allow for some pickup later in the year.

On net, the housing market is expected to bottom sometime in late spring or early summer. Overall market conditions are expected to remain near recession lows well into 2010.

### Underlying Fundamentals

The fundamentals that drive everything from sales and construction activity to pricing in the housing market have become much more positive for the industry in recent months:

- Incomes have stabilized in response to falling energy prices and an increase in unemployment insurance. (One would hope, however, that people receiving

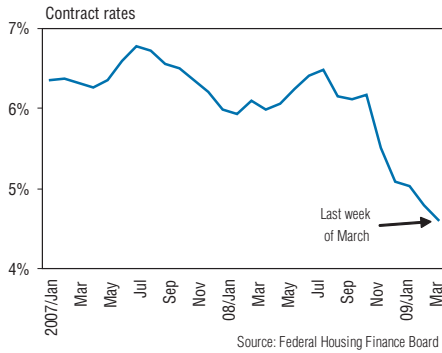
### The Housing Market Outlook

	2008	2009(f)
Starts*	903	605
Single-family	617	416
Multi-family	286	187
Sales*	5,375	5,204
New	482	442
Existing	4,893	4,762
Prices		
Median Existing	-9.0%	-15.0%
Case-Schiller	-15.8%	-16.0%
FHFA**	-5.6%	-3.5%

\* Thousands

\*\* Federal Housing Finance Agency

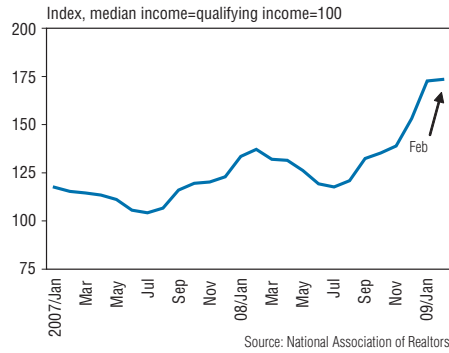
CHART 1

**30-Year Mortgage Rates Plummet**

more unemployment insurance do not qualify for a mortgage, given our recent run-in with sub-prime mortgages.) This is to say nothing of tax cuts, which should provide a small lift to incomes in the second quarter.

- Mortgage rates have dipped to new lows in recent weeks, largely in response to the Federal Reserve's use of its balance sheet to buy everything from mortgage-backed securities to agency debt (Fannie Mae and Freddie Mac), which enables banks to turn the deposits they are holding into loans. Separately, the Fed has begun purchasing long-term Treasury debt, which has brought down the base rate—the 10-year Treasury yield—for mortgages. (See *Chart 1*.)
- Expansion of the Fed's balance sheet to buy commercial real estate loans should start to unfreeze credit markets for larger home developers.
- The fiscal stimulus package includes up to \$8,000 in tax credits for first-time homebuyers, which could increase incentives for the low end of the market.
- Tax credits for energy-efficient home improvements—insulation, windows, etc.—have been sweetened, which could make older and vacant homes that have fallen into disrepair somewhat more attractive to buyers.
- Household formation remains positive, despite a cyclical slowdown. We are probably creating about 750,000 new households per year instead of the million or more expected by demographers before the recession turned ugly last fall.
- And, housing affordability has reached an all-time high. Rents and home ownership costs have actually equalized in some of the worst-affected parts of

CHART 2

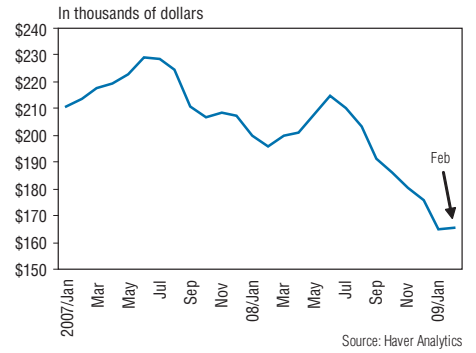
**Housing Affordability Surges to Record High**

California, which is helping to trigger an upswing in sales of homes to first-time home buyers, especially in the \$400,000 and under market. (See *Chart 2*.)

That said, not all is well:

- Household wealth continues to drop, and the saving rate is on the rise, which is curtailing spending on all types of purchases, most notably those that require debt to finance.
- Credit conditions remain relatively tight, which means that you may not qualify for a mortgage even if you are still gainfully employed and can “technically” afford to buy. (I recently searched the Internet for the lowest interest rate I could get on a \$200,000 mortgage. The best response was close to 4% if I was willing to put at least 30% down and pay more than \$5,000 in closing costs. Yeah, right.)
- Unemployment is expected to continue to rise well into the start of 2010, which will raise mortgage defaults and limit the pool of “credit worthy” borrowers to whom banks are willing to lend.
- The shadow banking system—GMAC, the non-bank unit of Countrywide, etc.—which underwrote the majority of mortgages in recent years, has essentially disappeared. This will limit the pool of potential lenders, even as our banking system heals.
- Housing prices are expected to remain under pressure, which could keep some buyers on the fence, at least during the first half of the year. (See *Chart 3*.)
- And, consumer confidence remains near record lows, which is working with falling home prices to keep all but the most secure of buyers on the sidelines. Few feel confident about buying a house

CHART 3

**Median Price of Existing Homes Fall**

when they are not sure they can maintain the paycheck they get, let alone their job. (See *Chart 4*.)

On net, buyers are expected to maintain an upper hand, with much of the activity initially concentrated in short sales and foreclosures. Buyers who can negotiate directly with the bank that owns a foreclosed mortgage are getting particularly good deals. Some smaller banks are offering 4% for jumbo mortgages just to get bad mortgages off their balance sheets.

Movement back into the owner-occupied and new home market will be a little slower, as the downward pressure on prices is expected to persist. Realtors are complaining that sellers still haven't adjusted to the declines in values that occurred last year, let alone to where the market is clearing today. This is especially a problem in Manhattan, where foreign investment (largely European) kept housing prices on the rise well into 2008.

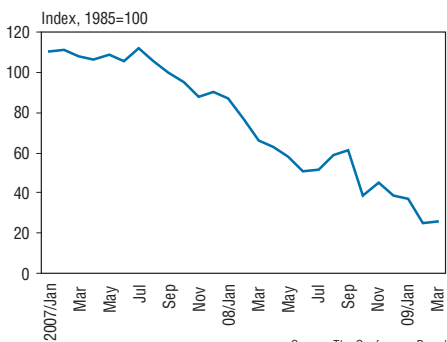
**A Breakdown of the Outlook****Starts**

Housing construction has come to a virtual standstill in recent months:

- Starts of single-family home sales, in particular, are already close to zero, and can not fall much further. In January and February, single family housing starts averaged an annualized 355,000, off more than 80% from their 2005 peak, and down more than 20% from their average in the fourth quarter of 2008. Moreover, the overwhelming majority of those starts—about 250,000—are build-to-suit (commissioned and already financed by buyers), which means that speculative builders have all but disappeared from the market.
- Multi-family starts are also exceedingly low, averaging an annualized 174,000

CHART 4

## Consumer Confidence Hits a Record Low



during the first two months of the year, off more than 50% from their 2005 high.

On net, overall starts are expected to decline again in the second quarter, and then begin a gradual rebound in the second half of the year.

**Regional Differences:** The West and the South are expected to remain the weakest markets when it comes to construction activity, as they are still suffering from the greatest overhang of vacant new properties. That said, we are not expecting to see a major bounce in any region of the country. The best case scenarios only take us back to the levels of housing construction experienced in the fourth quarter, which were already exceedingly low.

## Sales

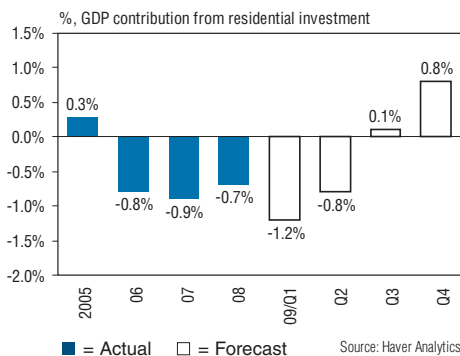
Home sales are expected to bottom sooner than starts. They may have even hit their turning point in February, although a safer bet is probably May. This should not be a surprise, given the fact that it is easier (albeit not "easy") to get a mortgage to buy a home than to get funding to build a housing development.

Much of the early gains are expected to be in the existing market, as appraisal and comps (comparative home sales) are easier for banks to find than in the new construction market. The existing market is also where the bulk of the "deals" for first-time buyers and speculators can be had (e.g., a home must have been lived in, at least for a short period of time, before its owner can default and the bank can foreclose).

Separately, builders are complaining that banks have been more reluctant to lend to buyers in the new home market than the existing home market. This shouldn't be a surprise, as new homes, built in new

CHART 5

## Residential Investment Reverses Course



developments, are harder to appraise than homes in more established neighborhoods.

**Regional Differences:** The hardest hit areas in the West, which includes California and Nevada, are expected to post the strongest gains, as they currently offer buyers the best deals from short sales and foreclosures. The Midwest is expected to perform close to the national average, while the South and the Northeast remain laggards. New York, in particular, is expected to bottom much later than the rest of the country, as the housing correction came late to Wall Street.

## Prices

Home values plummeted as the economy slipped deeper into recession and credit markets seized last fall. By January, most indices were showing double-digit declines from a year ago.

There are some signs, however, that the downward pressure on prices may be abating. Median home values actually increased on a month-to-month basis between January and February for the first time in eight months.

The best bet is that prices will end the year lower than during the bulk of 2008, but will come up slightly from the lows of the first quarter. We can expect an additional double-digit decline across two of the three indices listed in the table on the first page.

If we use the Case-Schiller index, which is currently the most popular index to quote, home values will have dropped close to 30% from their peak by the end of the year. That is clearly significant, given the fact that most households consider their home their largest asset, but a far cry from the 92% loss in home values experienced during the Great Depression.

**Regional Differences:** The Northeast is expected to experience the greatest downward pressure on prices, as it was late into the correction. Declines in New York could be particularly large as the number of foreclosures balloon. The downward pressure on prices in the South, particularly in Florida, is also expected to remain fairly intense, given the overhang of vacant homes. Hurricane insurance is also a problem for the coasts of Florida, as it is now more expensive than real estate taxes in some areas of the state.

The downward pressure on prices in the West, where prices have already dropped substantially, and in the Midwest, where prices never surged that much, is expected to be more moderate. Detroit is the exception. (One anecdotal report suggests that median home prices in the city of Detroit dropped to \$7,000 in March, which would imply that I could use my credit card instead of getting a mortgage to buy a home there.)

## Broader Implications

Housing is expected to swing from a drag to a push on overall GDP growth in 2009 for the first time in four years. (See Chart 5.) That shift, coupled with tax incentives to lower the carbon footprint of individual homes, is expected to provide a boost to spending on everything from furniture and appliances to building materials. Any gains that we do see in housing and housing-related activity, however, will pale when compared against previous recoveries.

Mortgage restructuring will also help to boost discretionary spending. Vehicle sales might even get a slight lift from reduced mortgage payments, although not nearly as much as we saw in the past. Homeowners don't have the equity in their homes that were once able to tap to finance vehicle purchases.

Finally, the federal government's push to limit foreclosures should help mitigate the write-offs for banks associated with falling home prices. The hope is that number of walk-aways (people who stop paying their mortgages and abandon their homes because the value of their home is now less than the size of their mortgage) will be limited. There is little a bank can do, however, to renegotiate the loans of the unemployed, which will be on the rise over the year.

## Mesirow Financial Economic Forecast (Numbers as of April 6, 2009)

	2008(A)	2009	2010	2008:3(A)	2008:4(A)	2009:1	2009:2	2009:3	2009:4	2010:1
<b>National Outlook</b>										
Chain-Weighted GDP	1.1	-2.5	2.1	-0.5	-6.3	-5.8	-0.6	1.1	1.3	2.1
Personal Consumption	0.2	-0.7	1.7	-3.8	-4.3	0.5	0.8	1.7	1.3	1.6
Business Fixed Investment	1.6	-14.8	-3.4	-1.7	-21.7	-24.4	-12.9	-9.6	-8.0	-3.0
Residential Investment	-20.8	-20.5	22.6	-16.0	-22.8	-35.5	-28.2	2.8	35.0	29.4
Inventory Investment (billions)	-29.0	-68.5	-8.3	-29.6	-25.8	-88.0	-90.8	-53.1	-42.0	-24.1
Net Exports (billions)	-390.2	-371.3	-412.4	-353.1	-364.5	-353.2	-354.6	-379.9	-397.5	-408.6
Exports	6.0	-18.7	3.6	3.7	-32.0	-43.3	-4.2	1.1	1.6	5.0
Imports	-4.1	-13.4	6.5	-4.7	-19.6	-33.2	-2.4	8.1	6.7	7.8
Government Expenditures	2.9	2.0	1.9	5.8	1.3	-2.5	5.9	1.8	2.6	1.3
Federal	6.0	7.5	5.0	13.8	7.0	2.4	12.7	6.7	5.3	4.4
State and Local	1.1	-1.2	-0.1	1.3	-2.0	-5.4	1.8	-1.2	0.9	-0.7
Final Sales	1.4	-2.1	1.5	-1.3	-6.2	-3.7	-0.6	-0.2	0.9	1.5
<b>Inflation</b>										
GDP Deflator	2.2	1.4	0.2	3.9	0.5	2.4	0.3	0.3	0.3	0.7
CPI	3.8	-0.9	0.6	6.2	-8.3	-2.3	0.4	0.9	0.7	0.7
<b>Special Indicators</b>										
Corporate Profits*	-21.5	-10.3	10.8	-9.2	-21.5	-24.6	-25.7	-25.2	-10.3	-3.6
Disposable Personal Income	1.3	2.2	1.7	-8.5	2.7	5.2	3.6	2.1	-0.9	3.3
Housing Starts (millions)	0.90	0.61	0.98	0.88	0.66	0.52	0.50	0.65	0.75	0.83
Civilian Unemployment Rate	5.8	8.9	9.5	6.0	6.9	8.1	8.9	9.2	9.3	9.4
Employment	-1.3	-4.3	-0.2	-2.6	-6.4	-6.4	-4.5	-1.3	-0.3	0
<b>Vehicle Sales</b>										
Automobile Sales (millions)	6.8	5.2	5.5	6.6	5.2	4.7	5.3	5.3	5.5	5.9
Domestic	4.5	3.3	4.1	4.3	3.5	3.0	3.4	3.4	3.5	3.8
Imports	2.3	1.9	2.2	2.3	1.7	1.8	1.9	1.9	2.0	2.1
Lt. Trucks (millions)	6.5	5.1	6.0	6.3	5.4	4.7	4.9	5.2	5.4	5.7
Domestic	5.3	3.9	4.5	5.2	4.1	3.7	3.8	4.0	4.1	4.3
Imports	1.2	1.2	1.3	1.1	1.0	1.1	1.1	1.2	1.3	1.4
Combined Auto/Lt. Truck	13.3	10.3	12.3	12.9	10.6	9.5	10.2	10.5	10.9	11.6
Heavy Truck Sales	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.3
Total Vehicles (millions)	13.6	10.5	12.6	13.2	10.9	9.7	10.4	10.7	11.1	11.9
<b>Interest Rates/Yields</b>										
Federal Funds	2	0	0	1 <sup>7</sup> / <sub>8</sub>	1 <sup>1</sup> / <sub>2</sub>	0	0	0	0	0
10-Year Treasury Note	3 <sup>5</sup> / <sub>8</sub>	2 <sup>7</sup> / <sub>8</sub>	3 <sup>1</sup> / <sub>8</sub>	3 <sup>7</sup> / <sub>8</sub>	3 <sup>1</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	2 <sup>7</sup> / <sub>8</sub>	2 <sup>7</sup> / <sub>8</sub>	2 <sup>7</sup> / <sub>8</sub>	3
Prime Rate	5	3	3	4 <sup>7</sup> / <sub>8</sub>	3 <sup>1</sup> / <sub>2</sub>	3	3	3	3	3
Corporate Bond AAA	5 <sup>5</sup> / <sub>8</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>5</sup> / <sub>8</sub>	5 <sup>7</sup> / <sub>8</sub>	5 <sup>1</sup> / <sub>4</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>2</sub>
<b>Exchange Rates</b>										
Yen/Dollar	103	76	105	108	96	94	100	102	103	104
Dollar/Euro	1.37	1.32	1.28	1.50	1.32	1.30	1.34	1.32	1.30	1.28

A= Actual; E=Estimate

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 2008, GDP was \$11,652 billion in chain-weighted 2000 dollars.

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