



## ECONOMIC RECOVERY JUST AHEAD, BUT THERE ARE RISKS by Mark Schniepp

### Are the risks significant enough to delay the recovery?

The economic recovery is now “scheduled” for August/September of this year (yes that’s right, next month or the month after). That’s the consensus among economists including the prestigious Blue Chip Indicators forecast. However there are risks, which are noted frequently on CNBC and in other daily media. I have identified a few of the more evident ones:

- Rising gasoline prices
- Rising 10 year treasury yields
- Consumers are still holding back.
- Higher mortgage rate resets and/or payment recasts
- Commercial real estate refinancings as office vacancies soar and retail vacancies move sharply higher

We don’t believe that gasoline prices will rise high enough to pre-empt the recovery. Consumer saving rates have surged recently, but households are still spending and they will need to reload delayed purchases of vehicles, appliances, and healthcare no later than next year. The commercial real estate market will prove to be problematic, beginning this summer as refinancing under new credit standards becomes a growing issue. However, the

larger risks to the recovery are now thought to be principally associated with the recovery in housing.

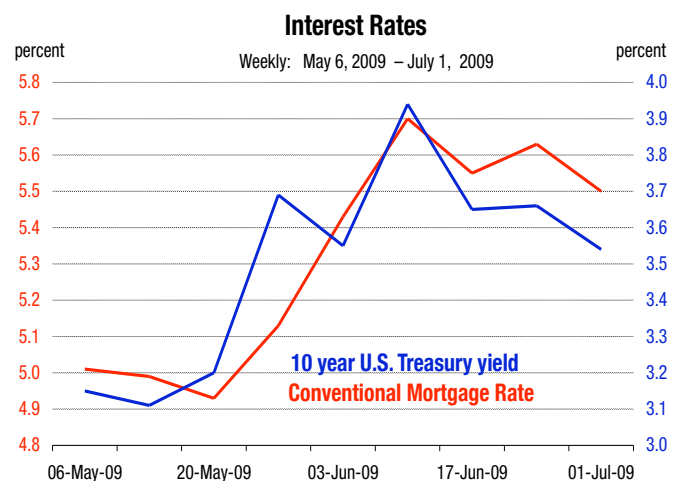
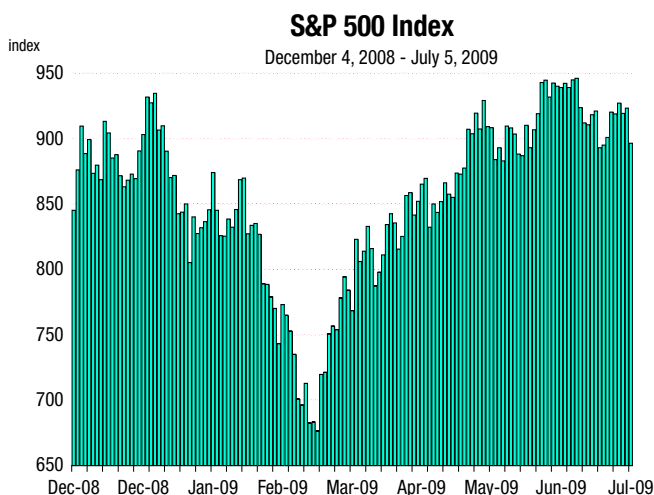
A healthy housing sector will lead to more job creation, more consumer spending, more investment in new structures, and a rebound in state government revenue streams which are sorely needed, especially in California.

### The Recent Interest Rate Surge

The Federal Reserve is allowing treasury yields to rise. This in turn is causing mortgage rates to drift higher jeopardizing the housing recovery which could delay the broader economic recovery. Instead of pledging to buy more securities, the Fed is hoping bond traders will do their work for them . . . but the economy is getting better and investors have been substituting out of bonds and into stocks. The equities market was up 40 percent between March 9 and June 2, though it fizzled in June, giving back 7 percent.

Higher treasury bond yields will not sink the economy, but they would delay the recovery, mainly because of the interruption to the housing sector recovery caused by sharply higher mortgage rates over the last 4 weeks.

The recent increase in long-term interest rates poses a new threat to optimism that the recession will end soon.



Higher rates during June cut off refinancing and slowed the local housing market. Over the last 4 weeks however, bond yields have retreated, but mortgage rates have not followed the decline in bond rates.

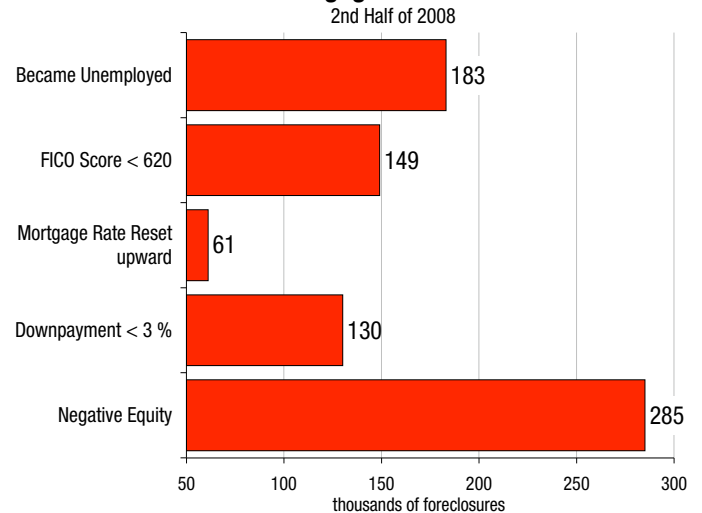
The factors now driving rates higher include heightened worries about future inflation and record government borrowing. Both concerns are overdone, or at least premature. A glut of capacity throughout the economy makes deflation—and not accelerating inflation—a bigger risk for the next 12 months.

Existing home sales are critical to the recovery of housing and the general economy. The existing home market precedes the new home market, which is expected to recover in 2010. Without new home construction, the economic recovery will have a difficult time gaining traction. Furthermore, refinancings are critical in helping homeowners reduce debt and free up additional income for spending on general goods and services.

### Mortgage Rate Resets

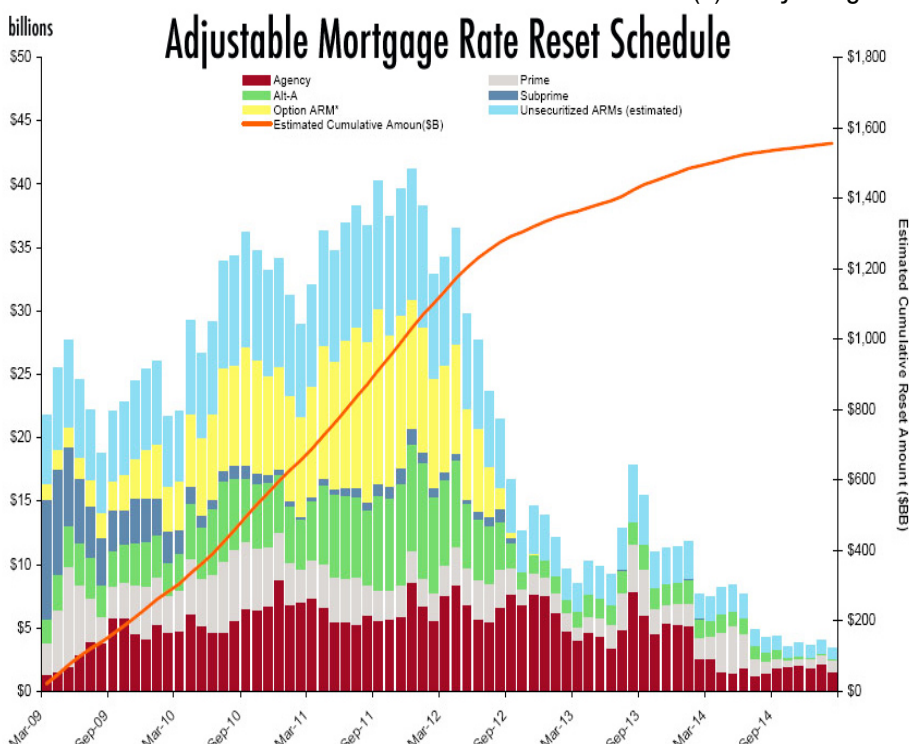
More than 2.3 million homeowners faced foreclosure proceedings in 2008, up more than 80 percent from 2007. A huge wave of ARM (Adjustable Rate Mortgage) resets started this year and will continue into early 2012. The updated Mortgage Reset chart also shows that subprime resets are fading away quickly and will be insignificant after this year. However, prime resets

### Causes of Mortgage Foreclosures / U.S.



and resets on loans to people with decent credit scores but special circumstances, such as stated income, are heading straight up through early 2012.

This growing concern over the coming “second wave” of foreclosures, generated by the recasting of Option ARM mortgages is used to dash any hopes that the housing market could recover this year, or anytime soon. Large numbers of foreclosures keep many eligible buyers from buying and many eligible sellers from selling. They also cause more foreclosures by lowering appraised housing values in neighborhoods where foreclosed properties are liquidated at fire-sale prices. Clearly, a second coming of mortgage rate resets and recasts would appear to be exactly how to (1) prevent a housing market recovery and (2) delay the general economic recovery.



Since the housing bust began, rising defaults by homeowners have been attributed to payment shocks, caused by resetting subprime and prime adjustable mortgage rates.

The first wave in 2007 and early 2008 did occur in tandem with record levels of defaults and foreclosures, but the correlation between these events may have been more spurious than we originally thought. Are mortgage rate resets actually doing most of the work in generating homeowner defaults and foreclosures?

Source: Credit Suisse

Recent analysis of foreclosure data indicates that, by far, the most important factor related to foreclosures is the extent to which the homeowner now has or ever had positive equity in a home.

Negative equity or a high loan-to-value ratio is the most important factor in explaining foreclosures. Although only 12% of homes analyzed had negative equity, they comprised 47% of all foreclosures.

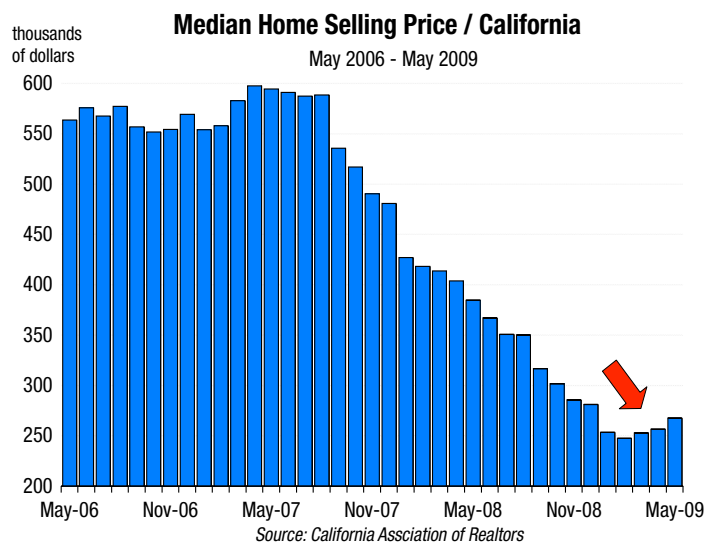
Furthermore, it was found that interest rate resets did not measurably increase foreclosures until the reset was greater than four percentage points. Only 8% of foreclosures had an interest rate increase of that much. Therefore the overall impact of upward interest rate resets is much smaller than the impact from equity.

Many other factors such as FICO scores, income levels, unemployment rates and whether the house was purchased by investors are more related to foreclosures than mortgage resets. Moreover, liar loans and loans with initial teaser rates had virtually no impact on foreclosures.

In summary, the most important factor is whether or not the homeowner currently has or ever had a meaningful financial stake in the house. Because

an individual has a home with negative equity does not imply that he/she cannot make mortgage payments; it implies that the borrower is more willing to walk away from the loan.

Housing prices already appear to be stabilizing. Recent data from a myriad of sources including the California Association of Realtors validates the notion that the housing market is now in transition, amidst a V-shaped recovery in sales (mostly REOs) and flat to slightly increasing selling values.



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