



A RECOVERY THIS YEAR, BUT WHAT ABOUT FORECLOSURES? by Mark Schiepp

The worst of the recession is over

Relative to the economic news that portrayed an economy in financial crisis, consumer shock, and investor panic from last September through February of this year, the latest reports clearly show the recession is no longer intensifying.

The stock market is providing the most encouraging sign that the recovery is near. Since hitting its lowest value in 12 years on March 9, the Dow Jones Industrial Average has gained 33 percent. Stock market rallies normally precede an economic recovery by between 5 and 8 months. The current rally has now been sustained for nearly 3 full months.

With the attendant rise in consumer confidence to its highest level since September, it appears that the panic and shock that ensued from the series of events starting with the takeover of Fannie and Freddie, is fading. The other events that clearly pushed the economy to the brink included the bankruptcy of Lehman Brothers, the proposed \$700 billion federal bailout program, and the failure to use that program as originally intended—to purchase troubled assets from ailing banks.

Now, banks appear healthier as evidenced by higher corporate earnings and rising stock prices. Credit spreads are also in steady decline, and mortgage rates will benefit largely from shrinking spreads. Home loans, both new and refinanced, will remain attractive and that will help push the housing market towards a conventional recovery this year.

Latest data suggest recession is abating

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WASHINGTON — Fresh signs emerged Monday that the recession was letting up. Manufacturing's slide is slowing. Builders are boosting

And businesses' inventories shrank, suggesting supplies will soon need to be replenished. That would boost factory production, aiding overall economic activity.

"The data add to mounting

Los Angeles Times, June 2, 2009, page B2

The Threat of Foreclosures

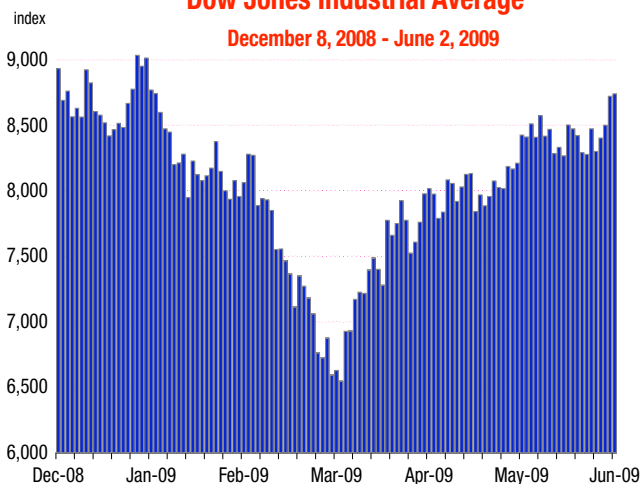
Though the number of foreclosures has been steadily falling in California, notices of homeowner default—the first step in the foreclosures process—have rebounded. The rise in NODs is disturbing if they convert into a new surge in foreclosures.

To date, home prices appear to be stabilizing in California because foreclosures have declined since September. If foreclosures begin to rise sharply again, the housing sector will not recover this year as scheduled.

Most homeowners in foreclosure will lose their homes. Because foreclosed property is sold at steep discounts, foreclosures drive down everyone's home values. As fore-

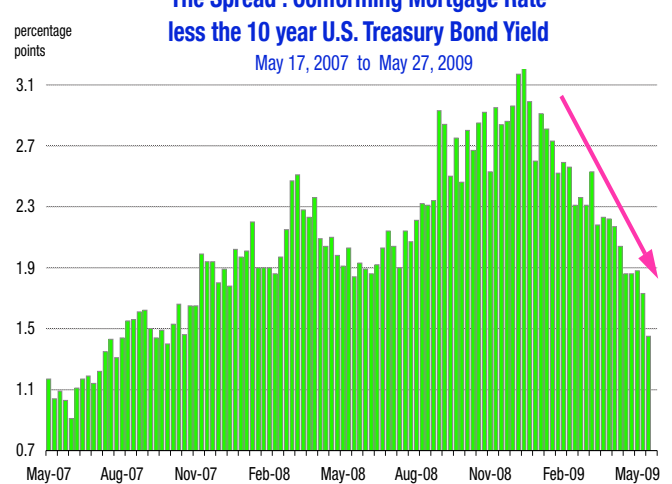
Dow Jones Industrial Average

December 8, 2008 - June 2, 2009



The Spread : Conforming Mortgage Rate less the 10 year U.S. Treasury Bond Yield

May 17, 2007 to May 27, 2009



closure sales push down house values, that translates into more and more homeowners going under water—that is, their homes are worth less than is owed on them.

In this situation, the homeowner cannot refinance at lower mortgage rates and may ultimately walk away from the home, creating another default and another foreclosure.

As home values decline, home equity evaporates, and that means everyone's wealth declines.

Less wealthy households will spend less than households whose home values are stable or rising. What the economy needs today is more spending, not less. Consequently, the threat of rising foreclosures will do at least three undesirable things:

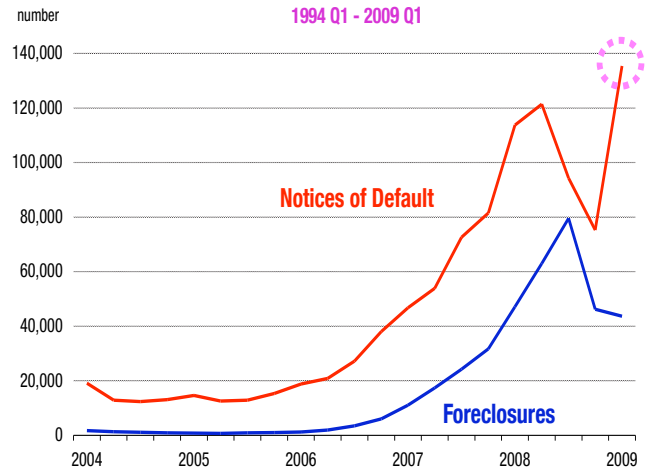
- (1) cause more foreclosures
- (2) keep values from stabilizing and the housing market from recovering, and
- (3) postpone necessary consumer spending that will help to revive the economy this year

Another problem is the reduction in the values of securities associated with mortgages. As long as home prices keep falling, the market for mortgage backed assets won't recover, and that keeps spreads higher, meaning higher mortgage rates.

We can't forecast just how high the second surge in foreclosures will get this year and into 2010 but there is a chance that it could be smaller than the first wave. There are more home sales today than a year ago when the wave was nearly at its peak. A sale of a home in default can prevent it from going into foreclosure.

Homeowner Distress / California

1994 Q1 - 2009 Q1



There are more loan modification and restructuring programs out there today than a year ago, and these would remove the default from the foreclosure process.

The Make Home Affordable program has not had much of an impact yet, and experts claim that it will prevent maybe 15 to 20 percent of future foreclosures. That's not enough given the size of the problem. Therefore, more bold programs that aggressively modify loans in default may be on the way from the Obama Administration.

If not, the general economic recovery scheduled for August or September of this year may be compromised by a housing sector that remains rife with foreclosure activity, depressed prices, and continued lack of non-distressed sales. A more conventional home sales market is now needed to help to push selling values higher.

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