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Perspective: Housing Bottom Nowhere in Sight

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The market will undoubtedly over-correct to the downside.

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Normal: Being approximately average or within certain limits; typical.

Abnormal: Not typical, usual, or regular; not normal; deviant.

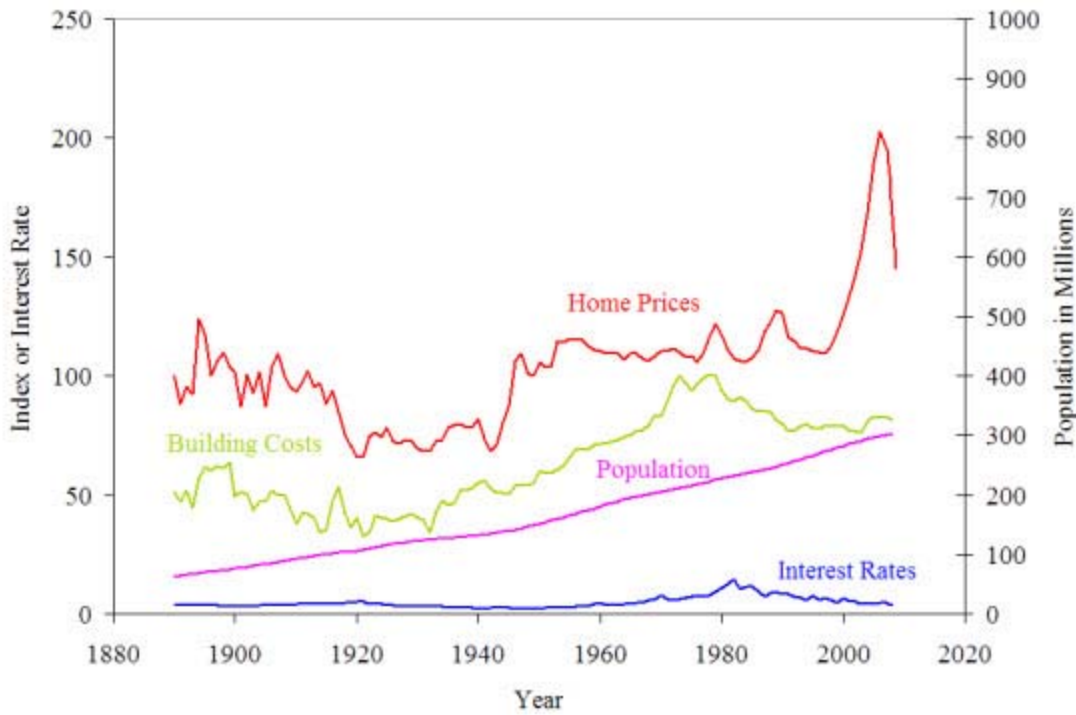
Which definition is the best represents our economic situation today?

Housing Normality

As soon as we can stabilize housing, all of our troubles will be solved. This is the mantra we hear night after night from financial pundits. The chart below unmistakably paints an abnormal picture of home prices.

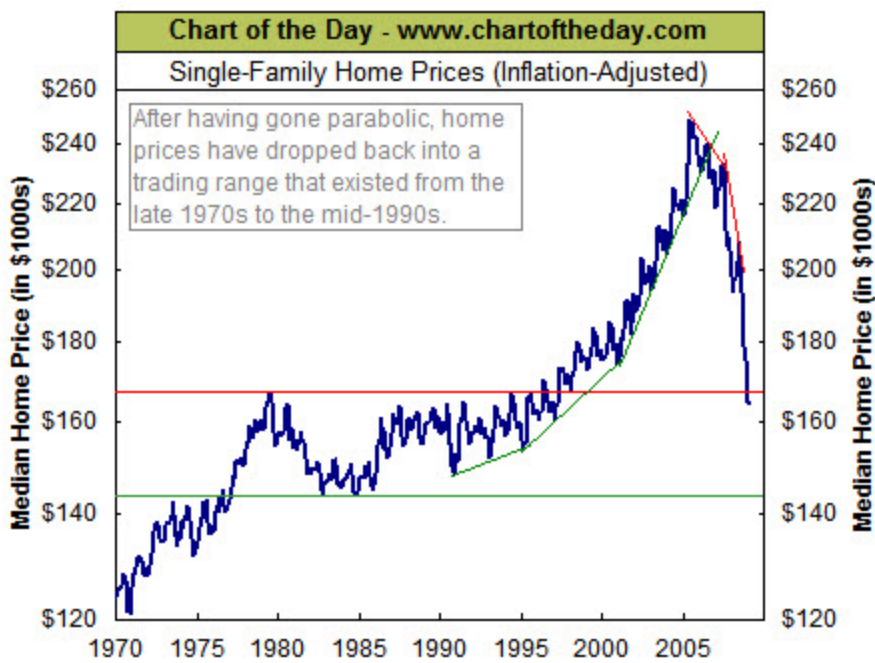
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Karl Case, of the **S&P/Case-Shiller Home Price Indices**, has studied US house prices going back to the 1890s. Over the long run, he says, home prices tend to increase on average at an inflation-adjusted rate of 2.5% to 3% a year, about the same as per-capita income.

The American population has steadily increased from 100 million to 300 million over the last 120 years. Home prices gained at an uneven rate from 1890 until 2000. But -- thanks to the greatest bubble in history -- prices after 2000 doubled in many places in 6 years, versus a 15% expected historical return.



Prices have now declined back within the range seen during the period from the 1970s through the 1990s. That's why the eternal optimists are proclaiming a housing bottom. What they don't understand is that the current downturn will over-correct to the downside.

The most respected housing expert on the planet, Robert Shiller, recently gave his opinion on the future of our housing market:

"Even the federal government has projected price decreases through 2010. As a baseline, the stress tests recently performed on big banks included a total fall in housing prices of 41% from 2006 through 2010. Their "more adverse" forecast projected a drop of 48% -- suggesting that important housing ratios, like price-to-rent, and price-to-construction-cost -- would fall to their lowest levels in 20 years. Long declines do happen with some regularity. And despite the uptick last week in pending home sales and recent improvement in consumer confidence, we still appear to be in a continuing price decline."

"After the bursting of the Japanese housing bubble in 1991, land prices in Japan's major cities fell every single year for 15 consecutive years. Even if there is a quick end to the recession, the housing market's poor performance may linger. After the last home price boom, which ended about the time of the 1990-91 recession, home prices did not start moving upward, even incrementally, until 1997."

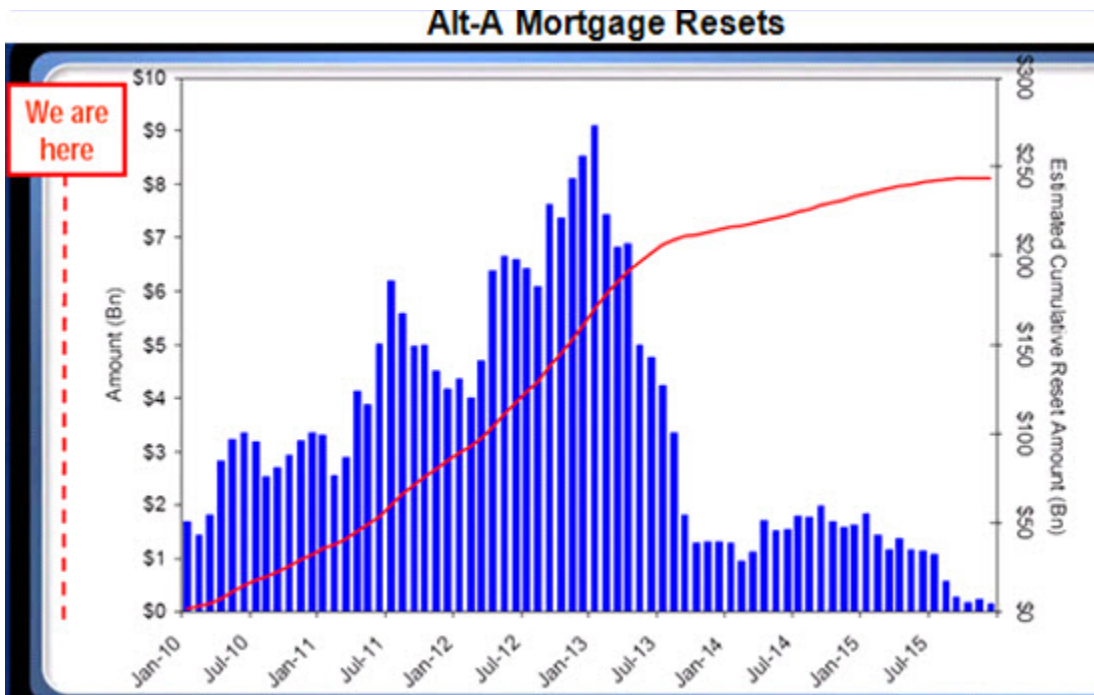
Residential investment and home improvement expenditures have averaged 1.07% of GDP over the last 50 years. This is the fourth time it has peaked above 1.2%. After the 3 previous peaks, it bottomed below 1%. Based on history, it will bottom out at .8% in the middle of the next decade. This would be a reduction of \$70 billion in housing investment from the peak. Not the best news for **Home Depot** (HD) and **Lowe's** (LOW).

A housing rebound is a virtual impossibility. Homeowners currently have the least amount of equity in their homes on record. Overall, the number of borrowers underwater climbed to 20.4 million at the end of the first quarter, up from 16.3 million at the end of the fourth quarter. The latest figure represents 21.9% of all homeowners, up from 17.6% in the fourth quarter and 14.3% in the third quarter.

There are 75 million homes in the United States. One-third of homeowners have no mortgage, so that means that 41% of all homeowners with a mortgage are underwater. With prices destined for another 10% to 20% drop, the number of underwater borrowers will reach 25 million.

There are over 4 million homes for sale in the US today. This is about one year's worth of inventory at current sales levels. You can be sure that another one million people would love to sell their homes, but have yet to put them on the market. And there's a tsunami of Alt-A mortgage resets now approaching our shores. That will get under way in 2010, and won't peak until 2013. These Alt-A mortgages are already defaulting at a 20% rate today. There are \$2.4 trillion Alt-A loans outstanding.

Alt-A mortgages are characterized by borrowers with less than full documentation, lower credit scores, higher loan-to-values, and more investment properties. There are more than 2 million Alt-A loans in the US; 28% of these are held by non-occupant investors. That includes interest-only home loans and pay-option adjustable rate mortgages. Option ARMs allow borrowers to pay less than they owe, with the rest added to the loan principal. When the debt exceeds a pre-set amount, or after a pre-determined time period has passed, the loan requires a bigger monthly payment.



How can housing

return to “normal” with this much toxic debt still in the system? It can’t, and it won’t.

Mortgage delinquencies as a percentage of loans stayed between 2% and 3% from 1979 through 2007. I would categorize this as normal. The Mortgage Bankers Association just reported a delinquency rate of 9.12% on all mortgage loans, the highest since the MBA started keeping records in 1972. Also, the delinquency rate only includes late loans (30 days or more), but not loans in foreclosure.

In the first quarter, the percentage of loans in foreclosure was 3.85%, an increase of 55 basis points from the prior quarter and 138 basis points from a year ago. Both the overall percentage and the quarter-to quarter increase are records. The combined percentage of loans in foreclosure and at least one payment late is 12.07%, another record.

Delinquencies on subprime mortgage loans rose to 24.95% from 21.88% in the fourth quarter of 2008. Prime loan delinquencies rose to 6.06% from 5.06% one quarter ago, a significant and disturbing increase among borrowers who aren't expected to default.

With the 30-year mortgage rate approaching 5.7%, mortgage refinancing activity has plunged about 60% in the last 2 months. Mortgage applications for new home purchases collapsed at a 20% annual rate in May, too. Normality in the mortgage market appears to be years away.