

2008
Economic & Housing Report

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Factors Effecting and Affecting Housing

The Economy:

Over the past 12 months, our economy grew at a very healthy rate of 2.8% and created a \$11.52 trillion dollar economy. Since 2003, the U.S. has created over 5 million new businesses and almost 8.3 million new salaried jobs – employing 1.3 million more people over the past year. Add the 16 million self-employed and the 25 million part-time workers, and you can see why the government has received a lot of extra tax revenue this last year. Last year our government projected a deficit of \$177 billion dollars. That would have been a 28.7% reduction from the previous year's budget. As the government's fiscal year came to an end, the deficit was only \$162.7 billion dollars.

Since 1980, the Gross Domestic Product has risen 70% and helped to shrink our federal deficit. Today, our national debt is less than 1.2% of the GDP, compared with 6.0% in the 1980s and 4.7% in the 1990s. This current percentage level of 1.2% is below the 40 year average.

Forecast: GDP growth should be between 2% and 2.5% for 2008. This means the U.S. economy will not see a recession this year.

Corporate Profits:

The 3rd quarter numbers showed that U.S. corporations are still doing very well. They now have 21 straight quarters of double digit earnings, and corporate profits are running at an annual rate of \$1.62 trillion dollars. These profits have almost doubled during the past 5 years.

Forecast: Corporate profits will continue throughout the year. Corporations have very strong balance sheets which will help them through an economic slowdown. This strength will help to prevent a recession. In the past 6 recessions, corporations had weak balance sheets.

Financial Corporations:

The media only talks about their huge write-downs due to the sub-prime crisis, and fails to mention that the majority of these financial companies still have surprisingly strong cash flows, and continue to pay big dividends. Since the market has already driven down their share prices, they have very little to lose by writing off any potentially bad loan. These write-offs include bad: business loans, credit cards, leasing contracts, currency fluctuations, bond devaluations, collateralized debt obligations, structured investment vehicles, mortgages, and failed mergers. If they hold these securities to maturity, they will likely get 98 cents on the dollar.

During the 3rd Qtr. of this year, banks took write-downs of \$43 billion dollars, yet they still made a net profit of \$28.7 billion dollars – even after putting aside reserves (a 20 year high) for more potential loan losses. Here is a look as some of the larger banks' profit positions (in billions) from the 3rd Quarter: Citigroup: \$2.38; Bank of America: \$3.7; JP Morgan Chase: \$3.4; Wells Fargo: \$2.8; Morgan Stanley: \$1.54; and Goldman Saks: \$2.85 billion dollars.

Forecast: Banks will have more write-downs in 2008 but at a much smaller rate, and will begin showing some really big profits once again!

Source: Bureau of Labor Statistics, Bloomberg, Bureau of Economic Analysis, Federal Reserve

Income Growth:

In 2006, the IRS reported that wage earners in the U.S. had their highest income growth in 5 years, and that personal income grew more rapidly than spending in 2007. Since the housing slowdown began two years ago, personal income has risen 7%, leading to a \$1.35 trillion dollar rise in the nation's income.

Forecast: With 4 million new jobs created since the housing downturn, the pent-up demand for housing will fuel the next housing turn-around supported by growing personal incomes.

Employment:

December marked the 52nd consecutive month of job growth – this is the longest period of uninterrupted job growth on record. Over the past year, 1.3 million new jobs were created and the current unemployment rate is at 5.0%. Since 3% of the population won't work, even if you give them a job, we are near full employment. For 2007, the unemployment rate averaged 4.6%, the same as 2006.

Forecast: Even with a slowing economy, the unemployment rate should remain below 5.5% - a very healthy number for an economy as large as ours.

Interest Rates:

Current conforming rates for mortgages are within $\frac{3}{4}$ of a percent of historical lows. Last summer, rates rose to 6.75%, but by the end of the year they had fallen into a range of 5.75% to 6.12%.

With the benchmark 10-Year Treasury trading around the 4% range, interest rates for home mortgages should be around 5.5%. The reason they are higher is the lenders are still adding extra basis points for the *fear premium*.

Forecast: Expect the Federal Reserve to continue to cut the discount rate a couple more times before summer. These cuts, and the need for banks to get back into lending (big profit source), will continue to put downward pressure on interest rates for mortgages.

Lending:

The financial markets have been in turmoil since summer. This was largely due to an *over reaction* in the sub-prime market, whereby financial institutions had bundled all types of loans into mortgage-backed securities. With investors not knowing exactly how much of their portfolio was sub-prime, they panicked and pulled the plug on additional funds being available for mortgages. As the investors either put on hold or adjusted their lending criteria, the whole landscape of lending changed.

Forecast: This is not the first time there has been a crisis in the banking world. The good news is that it usually takes about 6 months for financial institutions to straighten out their mess. In the very near future, money will begin to flow once again into home loans.

Why do I say there was an over-reaction to the sub-prime mess? Here is an analysis of what is really happening in the mortgage market.

Source: Federal Reserve, U.S. Treasury, U.S. Bureau of Labor, IRS, Mortgage Bankers Association

The Sub-Prime and Prime Loan Market

Today's various media outlets play up bad economic news more than ever, which leads to misconceptions about economic reality. In dealing with the news about sub-prime loans, they have greatly over-exaggerated the true situation. David Wyss, chief economist at Standard & Poor's in New York said on January 4, 2008: **"You look at the magnitude of the sub-prime problem, and it's just not that big relative to the size of the economy or the financial market."**

It may surprise you to know that including Alt-A loans (less than prime but better than sub-prime) with sub-prime loans only makes up 13.1% of mortgage market.

<u>Market Share of Loans:</u>	<u>Sub-Prime:</u>		<u>Prime Loans</u>		<u>FHA/VA</u>
	<u>Fixed</u>	<u>ARMs</u>	<u>Fixed</u>	<u>ARMs</u>	
U.S.	6.3%	6.8%	63.1%	14.5%	9.3%
C.A.		15%		83%	2.0%

Delinquencies – 3rd Quarter Findings:

A delinquency in a mortgage payment occurs when just one monthly payment has been missed. In California, 21% of the loans that are delinquent are non-owner occupied home loans. The U.S. average is 13%.

<u>Sub-prime: Fixed & ARMs</u>	<u>Prime: Fixed & ARMs</u>	<u>FHA</u>	<u>VA</u>	<u>Combined</u>
U.S. 16.31%	3.12%	12.92%	6.58%	5.59%
CA. 12.6% 14.20%	1.00%			3.25% (2Q)

Notice that the combined rate of delinquencies for all loans in the U.S. is 5.59%. The media never asks, "What was the all-time low delinquency rate?" The answer is 4.0%, which occurred in the 4th Qtr. of 2005! Also notice that 84% of sub-prime buyers have never missed a payment!

Notices of Default – 3rd Quarter Findings:

Notices of Default are filed when lenders' loans have been delinquent for a specific period of time. This begins the foreclosure process. Most of the rise in this process is due to Florida, Ohio, Michigan, and California loans.

<u>Sub-prime: Fixed & ARMs</u>	<u>Prime: Fixed & ARMs</u>	<u>FHA</u>	<u>VA</u>	<u>Combined</u>
U.S. 1.38% 4.72%	0.22% 1.02%	2.22%	1.03%	1.69%
CA.	Figures for California could not be found			

Although the four states of California, Florida, Nevada and Arizona currently have the largest amount of loans in foreclosure, in the 1st Qtr., 24 states saw a *decline* in foreclosure starts. By the 2nd Qtr., 36 states saw a decline. California and Florida hold 28.1% of all sub-prime ARMs, yet 33.7% are in the foreclosure process.

The media will report that 72,571 notices of default were filed in the 3rd quarter - a new record for California, surpassing the 1st quarter of 1996 with 61,541 filings. Nowhere do they say that since that time, California has built 2 million more homes and condos. By the way, those filings were on 68,746 properties.

Source: Mortgage Bankers Association and DataQuick Information Systems

The Sub-Prime and Prime Loan Market (continued)

Foreclosures – 3rd Quarter Findings:

Foreclosures occur when the buyer has been unsuccessful in curing the debt, and either a lender or an investor has acquired the property.

	<u>Sub-prime:</u>	<u>Prime</u>	<u>Combined</u>	vs. <u>2006</u>
1. U.S.	3.12%	0.79%	1.45%	1.09%
2. CA	n/a	n/a	2.08%	1.17% (2Q)

Sub-prime adjustable loans represent only 6.8% of the market, yet they create 43% of all foreclosures. Over the past 20 years, the average foreclosure rate in the U.S. has been 1.09%. The lowest foreclosure rate ever was 0.86%. In California, 54.6% of homeowners emerge from the foreclosure process by bringing their payments current, refinancing, restructuring their loan or successfully selling their home and paying off what they owe.

Last year, 43 states had fewer foreclosures in 2007 than in 2006. Only 7 states have a foreclosure problem. One third of all foreclosures come from just two states - California and Florida. The other two thirds come from Nevada, Arizona, Indiana, Michigan, and Ohio.

Reasons for Foreclosure:

The #1 reason: Fraud and/or Speculation! As of Dec.1, 2007, the FBI reported 46,717 cases of mortgage fraud. As of Aug 30th, California investors (those not living in the home) represented 21% of the loans in default. In Nevada, the number is 33%, Arizona is showing 26%, and Florida has 25%.

The # 2 reason: Unethical Lending! The government has enacted new standards for lenders including more education and licensing. New *truth in lending* guidelines are being put in place and so far 21 states have enacted new rules and regulations, including California.

The #3 reason: Loss of a Job, Medical Problems or a Change in Marital Status

Financial Support for Housing:

Since housing is so important to the overall economy, it will always receive help when things go wrong. Today, lenders are modifying existing loans to prevent foreclosure. Other lenders are not adjusting the interest rates upwards when the rollover period comes due. Congress has passed legislation allowing Freddie Mac and Fannie Mae to buy more sub-prime loans. FHA may raise their loan limits and cut in half, the down payment. The Federal Reserve has reduced the discount rate, and is pumping money into the credit markets. The European banks put \$400 billion dollars into the credit markets in December. Investment firms, private equity companies, giant bond companies, and hedge funds are all planning on buying up delinquent mortgages. The big money houses have pretty much written off their bad loans, getting ready to institute new underwriting standards, and will once again enter the home lending business.

Source: Mortgage Bankers Association, Federal Reserve, FBI, Inside Mortgage Finance, U.S. Congress

Housing Markets

The U.S. Housing Market:

In November, existing home sales volume declined 20% and the median price dropped 3.3% from a year ago. Even with that drop in home prices, the Federal Reserve reported that by the summer of 2007, U.S. homeowners held a net equity position in their homes in the amount of \$10.7 trillion dollars. In an \$11 trillion dollar market, a \$6 billion dollar give-back (in a cyclical correction) is not a cause for panic. This correction is due to the fact that from 2001 to 2006, inflation-adjusted home prices had the 2nd fastest cumulative growth in the past 110 years. We often hear how the prices in Phoenix have dropped 8% in the past 12 months, but Phoenix still has a net gain of 80.2% since 2002!

Through November, existing home sales were moving at a yearly rate of 5.5 million units. Prior to 2004, that would have been a very good year. In November, a survey of the 150 largest metro areas in the U.S. showed 93 areas had price gains. The supply of homes on the market stood at 10.7 months.

Why hasn't housing taken a bigger hit? U.S. homeowners are really in terrific shape with their homes: 35% have no loan and 50% have fixed-rate financing, so that leaves only 15% of homeowners holding adjustable rate loans. Of the 15%, half are high-income earners, so that leaves only 7% subject to rate increases.

California Housing Market:

Home sales in November totaled 25,578, representing a decrease of 38.8% from a year ago. The median price was \$414,000, down 11.9% from a year ago.

As mentioned earlier, California leads the nation in foreclosures. It also leads the nation in the number of homes, number of mortgages, and number of people living here. An analysis of the sales shows sales from \$500,000 to \$750,000 were down 28%, while properties above \$750,000 had a decrease in sales of only 7%.

California's foreclosure problem exists primarily in only 293 (20%) of the 1,465 zip codes in the state. Of the foreclosures occurring in these 293 zip codes, almost all are located in the Inland Empire, the Central Valley and the Sacramento area. Of the loans on the properties entering the foreclosure process, most were originated from July 2005 to September 2006, an average of 18 months.

Southern California Housing Market:

November sales were the slowest in 20 years. Sales totaled only 13,173, which was a 42.7% decrease from a year ago. The median sales price dropped to \$435,000, the same price it was in March of 2005. This represented a decrease of 10.3% from last November, for the 6 county areas.

Conforming sales, loans under \$417,000, fell 31.2%, while sales requiring a jumbo loan dropped a staggering 69.3%! This was largely due to the impact of the financial mess and the spill-over into the jumbo market.

<u>County</u>	<u>Sales</u>	<u>% Change</u>	<u>Median '06</u>	<u>Median '07</u>	<u>% Drop</u>	<u>% Gain Since '02</u>
LA	8,274	-46.0%	\$517,000	\$499,000	-3.5%	77.5%
OR	2,867	-45.3%	\$623,000	\$582,750	-6.5%	52.1%
RS	4,406	-43.2%	\$427,000	\$356,500	-16.5%	56.4%
SB	3,309	-48.1%	\$380,000	\$330,000	-13.2%	88.6%
SD	3,248	-26.1%	\$487,000	\$440,000	- 9.7%	52.0%

Source: DataQuick Information Systems, California Association of Realtors

Incomes and Wealth

Income:

Never before in the history of the world has a generation accumulated so much wealth as the baby boomers. The Internal Revenue Service will tell you that from 1945 to 1979, incomes increased at the same rate for all tax brackets. By 1979, the early *baby boomers* had been in the workplace for over 10 years. They were the most educated generation to ever enter the work force, and they had the skills for our changing world. Their income from 1980 to 2004 exploded!

- ◆ The top 20% of incomes grew by 59%, while the bottom 20% of incomes grew by a measly 7%!
- ◆ The top 1% of incomes grew by 200% - earning more than the entire bottom 50% of wage earners!

In 2005 the IRS reports, the rise in income represented a 5-year high. If you rank the states by income, California had the 8th highest income wage earners in the nation! What is amazing about this statistic is that individuals in California receive only 68% of their income from wages and salary. The other 32% comes from capital gains and interest income. This means the income averages are really much higher!

- ◆ The number of taxpayers making more than \$100,000 in 2006 grew by 3.4 million and accounted for more than two-thirds of the growth since 2000!
- ◆ The top 1% earned at least \$364,657, and accounted for 21.2% of all earned income.
- ◆ Those making more than \$1 million grew by 26%, and numbered 303,817 in 2006!
- ◆ Half of American wage earners brought in 87.17% of the nation's income – an all time high!
- ◆ The top 85% of the nation's wealth resides with the richest 15% of Americans; the bottom 50% of Americans holds only 2.5% of the nation's wealth.

Over the next decade, there will be a 25% increase in the population over 50 years of age. They have more money than any preceding generation, due to having dual incomes, equity growth, and record inheritances (60% goes to the top 40%)! This age group is spending \$2 trillion dollars annually! Last year, 2.1 million boomers turned 60, with 25% planning on not retiring. They found a way to mix leisure with work and are not ready to fully retire – they have *money and income* and they are still investing in real estate.

They are one of 3 major home-buying waves, as 75% plan on moving to either the west or the south for warmth. Eighty percent own their own home, with 25% of those owning additional property.

Wealth:

There are 390 billionaires in the U.S., holding \$1.54 trillion in assets. California is home to 88 of them! The rich and super-rich around the world saw their assets surge 11.2% last year, to \$37.2 trillion dollars!

The Federal Reserve reports that consumers have \$5 trillion dollars in liquid cash sitting in banks and savings and loans! In 2006, households' net worth rose 7.4% and now exceeds \$56.2 trillion dollars! Homeowners real estate equity is \$10.7 trillion dollars – representing a 59% equity position! The value of individual stocks and mutual funds held by individuals grew to \$10.4 trillion dollars!

Other assets held by individuals include: \$3.2 trillion in bonds and credit instruments; \$1.1 trillion in insurance reserves; \$ 6.7 trillion of equity in non-corporate businesses; \$11.1 trillion in pension funds; \$2.5 trillion in 401K's – plus \$10 billion in loose change in homes and cars!

Source: 2004/2006 Census, Bureau of Labor Statistics, IRS, Federal Reserve, Forbes, World Wealth Report

Pent-Up Demand

Cyclical housing downturns have always occurred. The good news is these situations do not last forever. The cycles tend to run approximately 27 to 36 months, so this cyclical downturn should run its course by summer.

You cannot keep buyers out of the housing market indefinitely. Unknown to most observers, pent-up demand occurs at each of these ending cycles. As the financial institutions re-enter the lending market in a big way, this new money will help to put downward pressure on interest rates. Great home values and lower interest rates, may be the *push* needed to start the flow of buyers back into the housing market.

Where Will Demand Come From?

First, the United States is unique among developing countries – we are still growing! Last year our population surpassed the 300 million mark as we added another 2.9 million people. This makes us the 3rd most populous nation in the world, behind China and India. Since 2000, we have added 20 million individuals and by 2030, there will be 80 million more people living in America!

Second, California is home to 37.7 million residents. Even though 89,000 left California last year, our population still had a net gain of over 400,000. However, by 2050, our population is expected to explode (nearly doubling) to 60 million people. With our large, diversified economy, location on the Pacific Rim, and great climate, California will continue to prosper.

Third, immigrants are growing into a powerful buying force, and today they represent 14% of buyers. From 1980 to 2000, 6.2 million minority households joined the ranks of the middle-income earners and purchased homes. Immigrants represent 35% of the first-time home-buying market.

Fourth, foreigners are very interested in U.S. real estate. The falling dollar makes our real estate a great buy for foreigners. The British Pound is up 10% this past year, and the Euro has risen 47% since 2002. The British make up 12% of the foreign buyers. Canadians are becoming big buyers, especially out West. California, Texas, and Florida are the preferred locations for 52% of all purchases made by foreigners – with California being the most desired state. The median price of homes purchased by foreigners is \$70,000 higher than domestic buyers. Foreigners buy for investment purposes 22% of the time, and 47% acquire homes for just plain fun and frolic.

Fifth, over the next decade, Asians will become the fastest growing segment of the U.S. housing market, concentrating on the West Coast. By 2015, China's middle-class will be larger than the entire U.S. population. By 2025, India's middle-class will reach those numbers! Today, Indians hold 39% of the world's wealth compared to 34% by Americans.

Sixth, domestic buyers will re-enter the market. First-time buyers, move-up buyers and retiring boomers will continue to create a strong demand for housing. The transfer of wealth, either through record inheritances or gifts to children and grandchildren, will affect the housing market. Demographics of people getting divorced and/or staying single longer, will create a need for more housing. Single women now represent 20% of buyers (up 50% in the past 8 years) and 83% chose single family residences – not condos!

During the past 20 years, global prosperity has created millions upon millions of wealthy individuals, as well as a billion or so new members of the middle class. This global development is lifting living standards around the world. Underpinning this expansion is the integration of half of the world's population into the global market economy! These expanding economies and populations will profoundly affect our economy in a most positive way and once again, we will grow our way out of this downturn!

Source: 2005/2005 Census, State of California, California EDD, World Wealth Report, National Association of Realtors

Dynamic Orange County

Sales and Prices:

The strength of the OC housing market is evidenced by the numbers. Although the sale of existing single family homes fell 49.1% from November of 2006, the median sales price for November was still positive at 0.4%. The condo market saw sales volume decline 44.7% from last November, and the median price dropped only 2.1%.

Defaults and Foreclosures:

The media is great at announcing record foreclosures but, as the year came to an end, the average monthly defaults were at 1,075; lenders only foreclosed on 320 of those homes. Homeowners in default emerge successfully 71% of the time by either refinancing their home or successfully selling it. Approximately 60% of the foreclosures were under \$500,000 and almost 90% are under \$750,000. The numbers may seem large but, when you realize that Orange County has 800,000 homeowners, the percentages become very, very small.

Incomes and Wealth:

Orange County has a median income of approximately \$75,000, which is the 6th highest in the State. This is amazing when you consider how many workers earned less than \$36,000 last year. The median income is really much higher, because more than 12% comes from investments, interest and capital gains - not wages and salary!

Merrill Lynch has 6 offices in Orange County with \$24.2 billion under management. There are 42,120 families with \$1 million to invest (excluding primary residences), and 11% of households have a net worth exceeding \$1 million dollars. Orange County is home to 8 billionaires; ranks #3 in the U.S. with 113,299 millionaires; 67,729 earn more than \$200,000; and 30% of households earn in excess of \$100,000. In Orange County, 14% of our market is 2nd homes or income properties, and 22% of our properties have no loans!

Population and Employment:

Orange County's population only grew by 23,000 in the past 12 months, but still ranks 2nd in the state with a total population of 3,098,000. This county is a net in-migration county; 16% of immigrants are Asian and 33% are Hispanic. The California Department of Finance predicts our population will grow to 4 million by 2050.

The county's work force has 1.56 million workers and ranks 5th in the nation in the total number of jobs. The county's unemployment rate is 4.2%, ranking it the 3rd lowest in the State. Income growth for '07 was 4.5%.

Housing and Rents:

Orange County is one of the most densely populated counties in the United States. Builders are phasing out the single family detached home, with very few being built after 2010. Planners are developing more clustered housing and vertical unit developments. This dynamic county ranks 3rd in the U.S. for apartments (due to the high median price of homes) and retail growth (solid economic prospects). OC ranks 4th in the U.S. in rental rate increases at 6.4%, due to strong demand verified by the high occupancy rate of 95.5%.

Source: U.S. Bureau of Labor, California Employment Development Department, U.S. 2006 Census, DataQuick, Realfacts, California Department of Finance, Southern California Governments, Forbes