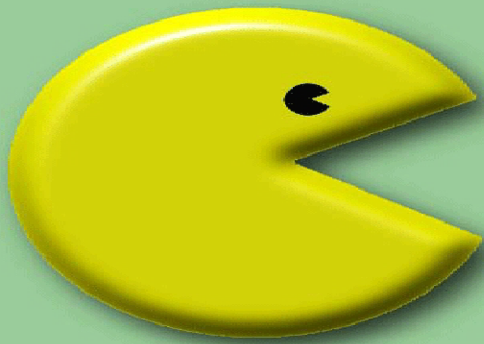

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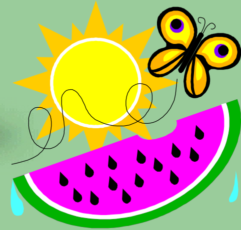


A PARADIGM SHIFT IN SPENDING

I offer the following preamble to provide essential context for the topic that follows—and one more likely to resonate with homeowners—namely, where are mortgage rates headed.

President Obama has tackled an staggering number of problems during his first five months in office—a recessionary economy, the housing crisis, health care reform, alternative energy sources, a moribund automotive industry, wars in Iraq and Afghanistan, and foreign policy issues with Israel, Iran and North Korea. Previous leaders squandered precious time by neglecting many of these issues for so long that we are at the nexus of several tipping points. The President and his advisers believe that unless they begin to fix long-term problems now, short-term efforts to save jobs and revive credit flow will be useless. "Yes, we can," is no longer a campaign slogan, but a requisite call to action.

No longer can we pick and choose on which to focus on and on which to wait because these problems are all interrelated and adversely impact our economy. Obama has famously said that "we cannot successfully address any of our problems without addressing them all." He was referring to the intertwined nature of the economic crisis—the connections among the housing crisis, the credit crunch, and the decline in jobs. The nation's economic engine is also greatly impacted by the rapid increase in healthcare costs and the costs of energy and education. If left unchecked, they will only worsen over time and their solutions grow ever more costly. The President's plans are expansive and expensive. The deficit is expected to reach $1.8 trillion this year and rise to 65% of the Gross Domestic Product at the end of 2010, up from 41% at the end of 2008.

Yet, we must address the immediate problems of a crippling recession that has erased trillions of dollars in household wealth, hobbled investment portfolios, and raised unemployment to its highest levels in a generation. Thus, even as the government incurs huge budget deficits as it tries to spend its way out of the worst economic crisis since the Great Depression, we must fix the banking system, stem rising health care costs, reduce budget deficits, improve education, and achieve energy independence to attain financial stability and healthy economic growth.

America has been on a consumption binge for the past several years. In the 60's, consumer spending as a share of Gross Domestic Product stood at around 62%, and rose to about 73% by 2008. Meanwhile the Chinese, Japanese and European economies became reliant on the overextended U.S. consumer. Much of this American indebtedness and over-consumption was enabled by foreign governments who purchased Treasury Bonds. This additional demand for Treasuries was one big reason (though not the only reason) that interest rates fell so low in recent years. So, we kept borrowing and consuming. It all worked very nicely, until it didn't and we found out too late that this paradigm was not sustainable.

Facing the possibility of systemic collapse, the government stepped in and replaced private borrowing with public borrowing. Obama got a $787 billion stimulus bill passed earlier this year and introduced a budget that looks ahead ten years and contains ambitious plans for, energy and education. **Domestically, the President's economic agenda is organized around economic growth that is less reliant on consumer spending and more dependent on spending by government to rebuild our crumbling infrastructure and improve our educational system and on business to invest in research and invention. Americans will need to save more and borrow less. The American economy will have to transition from an economy based on consumption and imports to an economy with a greater balance of business investment and production.**

Political leaders will need to be largely on the same page. First, they will have to appeal to the country to postpone gratification for the sake of rebuilding the country. In this regard, they will also be walking through a political mine field in trying to satisfy the electorate. If they stimulate the economy too much, ruinous inflation may result. If they preserve failing companies, the country may wind up with stagnation similar to what afflicted Japan for a decade.

Second, political leaders will have to raise taxes and cut spending to get the federal fiscal house in order, and they will have to do it at a time when voters are already scaling back their lifestyles.

Third, they will have to refrain from doing anything that might further damage America's fiscal position, which is extremely fragile. That means not passing a health care reform package unless it is really and truly paid for. It also means tackling the entitlement problem or Social Security, the "third rail" of politics.

Fourth, the U.S. is going to have to discourage spending and encourage savings. There's also a crying need for tax reform. The tax code is rife with provisions that encourage leverage and discourage investment. The government will have to spend less on transfer payments and more on investments in science and infrastructure.

Thus, a paradigm shift in spending is essential to restructure the economy and put the nation on a more sustainable path.

WHITHER MORTGAGE RATES GOEST AND WHENCE THEY CAME

I know the title has a biblical ring to it, but clients always want to know where I (like some latter-day prophet) think rates are headed. The funny thing is that if my opinion doesn't coincide with theirs, guess whose opinion is immediately discounted?

Last month in my opening remarks I surmised that the window of opportunity for homeowners looking to refinance was closing due to the combination of home values (appraisals) continuing to slide while at the very same time mortgage rates were being pushed upward. As many of you know, mortgage rates are closely tied to Treasury rates (bond yields) and higher bond yields have rippled through to the mortgage markets such that rates are now three-quarters of a percent higher than they were just six weeks ago. The reason for this is that investors in the bond markets, where the Treasury Department goes to raise money to keep the government running, are growing increasingly skeptical about the scale of Washington's spending. They are worried about the glut of new Treasury notes and bonds hitting the market in recent months to help finance the economic stimulus package and various other Federal lending programs.

Since mid-December, the yield on the benchmark 10-yr.Treasury note has shot up, rising from a low of 2.04% to 4.00 %, their highest level in 8 months and the sharpest upward spike in 15 years. Mortgage rates did not experience a corresponding increase, largely due to Fed's program to purchase up to $300 billion of mortgage-backed securities to help drive down borrowing costs. Its actions lowered rates for a while, with 30 yr. fixed mortgage rates clipping 4.50% as late as April and mid-May.

But, as the saying goes, "that was then, and this is now." Since mid-March the stock market has gained 30% which has contributed to investors dumping their bond holdings to obtain higher returns in the equities markets. (Remember, there is an inverse relationship between bonds and their yields: as bond prices drop their yields increase because their interest rates are pegged). Even though the Fed has continued buying Treasuries and mortgage backed securities which would ordinarily drive mortgage rates down, its actions, alone, are now insufficient to offset the overall market's increased inflationary expectations. While rates are still low by historical standards, the recent spike in rates comes at a critical juncture, threatening to negate the positive effects of the stimulus package.

As a consequence, the Fed finds itself in a box. Policymakers may be forced to increase the purchases of mortgage-backed securities, if refinance applications and purchases of new and existing homes fade. But, if it steps up its purchases of mortgage-backed securities, it's not clear that will bring yields down because the purchases would be counteracted by added inflationary expectations. If mortgage rates do rise, however, this stands to imperil the "recovery" since home prices will have to fall further to keep monthly payments affordable. Moreover, as home prices fall, more foreclosures result, particularly in instances where homeowners no longer have any equity left in their property.

While the economy is no longer in free-fall, it's still declining—just not going down as fast. If it stabilizes in the third quarter, it may start to grow modestly in the first quarter of 2010. As for rates, they will likely "self-correct" and eventually head lower again (but probably not below 5%), once it becomes clearer to investors that the economic recovery will be a protracted one, especially if oil prices continue their upward climb. This all adds up to a scenario where rates probably won't trend much higher and in some respects that's a good thing. But while rates have rebounded because of a belief that the economy is getting better, if they keep surging, this could put the recovery at risk. Yet at the same time, a pullback in rates would signal what people might not want to readily admit: that the climb out of this recession is neither going to be quick nor easy.

THE MONTH IN REVIEW

6/1-6/5 Stocks rallied Monday, sending the Dow soaring more than 221 points as better-than-expected readings on manufacturing activity raised hopes that an economic recovery is brewing. Pending home sales jumped 6.7% in April, and posted year-over-year increases in every region but the West, according to a National Association of Realtors report. Amid mixed economic readings and some cautious notes from Fed Chairman Ben Bernanke,

equities experienced a modest decline. Even though job losses for May slowed dramatically, the Bureau of Labor Statistics reported the unemployment rate rose to 9.4%, a 26-year high, Oil prices touched $70 a barrel Friday, the highest level in six months.

6/8-6/12 General Motors filed for bankruptcy. The U.S. government said Tuesday that 10 banks that received

TARP loans last fall can repay a total of $68 billion to the government. Also, the U.S. Supreme Court on Tuesday cleared the way for the sale of Chrysler to a consortium led by Italian automaker Fiat. Spiking Treasury bond yields ramped up worries, that inflation could hamstring the recovery effort. Oil hit $72/barrel. On Friday, Treasury bonds rallied, lowering their yields and improving mortgage rates, slightly. The yield on the benchmark 10-year note fell to 3.77% from 3.85% Thursday. The yield touched 4% during Wednesday's session for the first time since last October.

6/15-6/19 Stocks dropped 187 points as weaker oil prices and more geopolitical unrest raised worries that the recession may not be waning as soon as some had hoped. The Census Bureau reported that May housing starts were up 17% over the previous month. Building permits, a measure of builder confidence, also rose 4% in May. The Consumer Price Index, a key measure of inflation, fell 1.3% over the past 12 months, its largest decline in 59 years. The Dow gained Thursday after reports showed a drop in the number of Americans receiving unemployment benefits. Stocks were mixed in sluggish trading despite Friday's quadruple options expirations, a quarterly event in which stock index futures and options and individual stock futures and options all expire at the same time.

6/22-6/26 The World Bank said the global recession has worsened and cut its global growth forecast. In reaction, oil prices slumped, stocks did a triple-digit header (down 200 points) and bond prices rallied. Wall Street churned, amid a strong bond auction and weaker-than-expected existing home sales report as investors geared up in anticipation of what the Federal Reserve has to say about the economy. Mid-week, the Federal Reserve kept Fed Funds, its key interest rate, near zero and stated that although the U.S. economy remains weak, there are signs of a recovery. After several down sessions, stocks rallied (up 172 points) as investors set aside worries about a surprise rise in jobless claims. The Dow struggled, Friday, amid sliding oil prices, a weaker dollar and a government report that showed while personal income surged so did savings, indicating that consumers were sitting out the recession rather than spending.

6/29-6/30 Oil climbed to $71 a barrel on reports of attacks on oil installations in Nigeria, Africa's largest oil producer. Consumer confidence fell unexpectedly in June after two straight months of gains as more Americans say jobs are hard to find. Stocks slumped in response.

RATE SUMMARY: In the past 4 weeks, Conforming loans (under $417,000) and High Balance Conformings ($417,001 to $697,500) worsened in the range of 0.125% to 0.25%. The Jumbos were worse in the range of 0.1% - 0.5%, with the 5/1 jumping from 4.5% to 5.05%. FHAs increased between an 1/8th to 3/8ths. VAs saw both the biggest increase (1/2 percent under $417,000 for a 30 yr. fixed) and the most improvement, (1/4 percent drop for a conforming 15 yr. fixed).

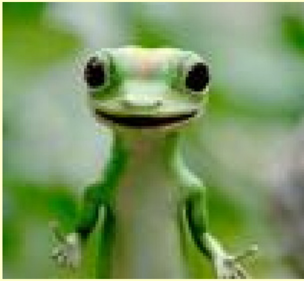
FOR CURRENT INTEREST RATES FOR 10-15 OF THE MOST POPULAR PROGRAMS GO TO: **www.mortgagestraighttalk.com** then click on the menu tab labeled "RATES". The rate sheets are updated every Friday.

A FIRST IN 30 MONTHS

It appears that one aspect of the economy is on the mend as **this past month was the first month since January 2007 with**

no lenders imploding. The number currently stands at 347 mortgage lenders that have "imploded" since the beginning of 2007, meaning that they have halted major operations, filed for bankruptcy or become a "fire sale" acquisition of another lender.

THIS ISSUE'S TOPIC: INSURANCE



Homeowners' insurance is one of those areas about which there is considerable misinformation, not just among the lay homeowner, but the realtors and mortgage brokers, alike. The purpose of hazard insurance as required by lenders is to protect their collateral or interest in the subject property. Only the structure(s) on the property are insured against fire, destruction or other damage, since the land is indestructible. Most borrowers will obtain a homeowners insurance policy which covers both the structure as required by the lender, and the contents, for their own protection. Yet, most lenders, brokers, and borrowers are misinformed about the extent of the coverage required. I have had any number of lenders steadfastly maintain that the required coverage had to, at the very least, be the amount of the loan on the property. **THIS IS NOT SO.** For example, on a $500,000 property with a $400,000 mortgage with the land value assessed at $200,000 and the home valued at $300,000 they (lenders) maintained that it was necessary for the homeowner to carry $400,000 of coverage even when full replacement value of the structure was only $300,000. As I mentioned a moment ago, such is not the case, in fact, there are laws against over-insuring properties. Many insurers have fallen victim to these laws in the past and have had to pay settlements because of their being in violation. The misinformation and half-truths that are disseminated in the area of real estate finance by well-meaning people is truly staggering and regrettable at times.

THE EXISTING RULE OF THUMB IS OFTEN MISLEADING

For years, many mortgage brokers approximated insurance premiums by multiplying the value of the subject property multiplied by a factor of .0035 and then dividing by 12. This equated to a cost of $3.50 per $1000 of insurance coverage or a factor of .35%. This amount was then divided by 12 (the number of months to arrive at the monthly premium). So, for a $500,000 loan X .0035 = $1750/12 = $145.83 per month in premium. In many instances it was a reasonably accurate approximation, but in others it could be wildly misleading. In California and other parts of the country, the land is valued at a premium. An 800 square foot shack on the beach might be priced at $3,000,000 but the replacement value of the structure might be as little at $100,000. Using the above formula would give a hugely inaccurate answer. Similarly, a lender who had provided a $2,400,000 loan to buyer to purchase said property and insisted on the buyer/borrower carrying $2,400,000 of insurance coverage (the amount of the existing loan) they would be guilty of requiring a borrower to massively over-insure their collateral.

PROPERTY MAY BE UNINSURABLE

When contemplating the purchase of a property, a necessary first step would be to have one's realtor request a CLUE report from an insurance agent. CLUE, by the way, stands for Comprehensive Loss Underwriting Exchange. It is essentially a data base that the insurance companies maintain on insured property. The data base is a record of all the claims that have been made and/or paid out by insurers on properties and the insured's names. The reason that potential buyers should obtain a CLUE report is because were they to purchase said property they might find it rather difficult, if not impossible to insure because of past claims on the property for say, water damage and its evil twin—mold. In fact, 85% of all homeowner claims are for water damage. In cases where there are repeated claims against the property, it is the property at that address that gets "dinged" or becomes uninsurable.

INSUREDS MAY BE UNINSURABLE

When there are repeated claims for liability or theft, the "dings" follow the insured in the belief that it is they who must have done something wrong as in attempting to perpetrate a fraud on the insurer. Accordingly, their premiums are increased or insurers decline to insure them.

UNDER-INSURANCE IS THE MOST COMMON MISTAKE WITH WATER DAMAGE THE MOST COMMON CLAIM

The most common mistake that homeowners make is that their property is under-insured. Most often this comes about because they do a room addition, often without being permitted, and they fail to notify their insurer of the add-on. If someone has spent $25-50,000 to add a room and then not get additional coverage to protect their investment it is a classic case of being penny-wise and pound-foolish. The cost of insurance coverage is relatively minimal. It is generally based on the square footage of the structure and its replacement cost. Discounts may be had for alarm systems, interior sprinkler systems and new roofs. Also, newer homes (10-years old and newer) typically have lower premiums.

VARIOUS TYPES OF COVERAGE

There are variations on a theme when it comes to insuring one's property. One of the most common is **umbrella coverage** where both home and auto are insured by one

company. Many people think that this type of coverage affords one discounts in terms of price, but it does not. It affords them greater coverage for the same price by raising the limits of one's coverage on both auto and home at no additional cost. Thus, umbrella coverage, for the same premium, might raise one's auto insurance coverage from a typical $300,000 to a million at the same time that it increased liability coverage for the property.

One cannot buy **earthquake coverage** without first buying a homeowner's policy. The cost of the coverage is dependent

upon the county in which the property is located. San Diego is fortunate in that its premiums are among the lowest for any county in the state. The amount of the premium is set by the state and it is usually about half the cost of homeowner's coverage and matches the limit on the dwelling.

Construction coverage is purchased when one is building a home. It is a term policy of sorts, normally a year in length that provides coverage during the course of construction. Its

purpose is largely two-fold: to insure against liability due to injury and to cover theft and damage to raw materials at the build site. It does not protect against shoddy construction, hence, the need for one to employ licensed contractors who are insured.

Most replacement policies cover replacing a damaged structure at the current cost of materials and labor. Built into the policy is what some term "shadow coverage" or extended replacement cost which provides for 25% beyond the normal cost of replacement. For a nominal sum one can purchase a policy with **increased replacement** cost up to 50%.

INSPECTIONS AND RATINGS

The **re-inspection process** is done annually by insurers. Something that may trigger a re-inspection sooner is one triggered by probable maximal loss. An example would be insufficient brush clearance around a property in a high fire risk area. It is also the biggest reason to re-inspect or deny coverage. The clearance norm may vary from as little as 200 feet to 200 yards, depending on the insurance company. In the past, this was done with a drive-by and a picture of the front (and back, if possible) of the property, but now things have gone high-tech with satellite photos.

Another type of inspection is the **pre-binding inspection.** This inspection is performed prior to insuring a property. It often takes a week or two. It is pretty much a given, provided the homeowner has not mislead the insurer by claiming the property to be larger than it actually is (insurers tend to go by square footage) or that the homeowner has not misrepresented material facts about the property, like claiming that the property had a tile roof instead a wood shake roof.

Insurance companies are rated by **AM Best and Standard & Poors.** The grading system runs from A to F, (A++ or A+ being best).

SPECIAL OF THE MONTH: The 5/1 Conforming (under $417,000) adjustable rate mortage (ARM) at 4.25% is the runaway best priced mortgage loan this month.

WHAT HAPPENED TO 'TOO BIG TO FAIL'?

One prescriptive missing from President Obama's Financial Regulatory Reform bill that was submitted to Congress this past month was the one addressing institutions growing too big to fail, like AIG, numerous banks, GM, Chrysler, et al. If anything it has gotten worse. The consolidation of large corporations becoming even larger corporations, to wit, Bank of America acquiring Countrywide and Merrill Lynch, Chase gobbling up Washington Mutual and Wells Fargo merging with Wachovia. This is an oversight that needs to be corrected.

MORTY'S MAILBAG

Q. Would you explain what a credit default swap is and why they're so toxic? It may seem like old news but I keep reading about them in the newspaper, but they never quite explain what they are and why they're so dangerous, least ways so that I can understand what they're talking about.

A. A credit default swap is an unregulated derivative, a form of insurance that guarantees payment to an investor in the event that a particular investment goes bad. They are not insurance in the usual sense because the issuer is not required to set aside reserves in the event of a claim.

But that's only part of the story. These products were designed to mitigate risk, but given their stupendous growth they have the potential to wreak havoc on the financial system. From 2001 they grew from $900 billion to more than $62 trillion, today. To put it in perspective, this is about equal to 70% of the total U.S. household wealth and about seven times the national debt. The market is totally unregulated and the firms are so interlinked with one another and with other market players that they do not know whether their counterparties, as they're called, have adequately protected themselves. If and when defaults occur, some of the counterparties are likely to prove unable to fulfill their obligations as was the case with AIG and the four attendant bailouts it required.

Credit default swaps took off as a way to bet on the likelihood of a default by a firm or an investment portfolio, without having to own any financial interest in the firm or portfolio.

So, as they are presently constituted, it's a form of gambling. The only reason they are not deemed gambling is that in 2000, congress specifically exempted credit default swaps from gaming laws. As a result, Eric Dinallo, the insurance superintendent for New York State, estimates 80 percent of the outstanding $62 trillion in credit default swaps were speculative.

Initially, they arose as a hedge against uncertainty. But, when the bubble for mortgage-backed securities burst and Lehman Brothers went under, the entire economic system was threatened. Later, as defaults rose, A.I.G. (a far bigger player than Lehman Bros.) was also unable to make good on its swaps, until the government stepped in. The payments by AIG went to about two dozen firms, including Goldman Sachs, Merrill Lynch, Bank of America and various European banks. Had AIG not been bailed out, it was feared that it would precipitate a domino effect of financial failures that would have been truly calamitous.

The size of the 'swaps' market and the lack of governmental oversight leaves on with the feeling being feeling that herein lies another instance of an accident waiting to happen. What is needed is transparency going forward. Banks have resisted the idea of requiring that all trading in credit default swaps be conducted on exchanges, in the open and subject to full regulatory scrutiny. But, it is an idea that is long overdue.

Recipients of the newsletter are invited to Ask Morty any real estate or financing questions. The answer to the question will be answered either by phone or email and posted in the next issue for the benefit of all. Questions may be forwarded via mail phone or fax. Due to the high incidence of spam, if you email me a question it needs to identified as "real estate question" on the subject line of the email. (See front of issue for phone and fax numbers). Morty's email address is **Morty@MortgageStraightTalk.com**

MORTGAGE MIRTH

In keeping with this month's topic, remember…

Insurance agents are premium lovers.

Insurance agents do it with third parties.

If you'd care to share one that you've heard, please email it to me at **Rod@mortgagestraightTalk.com**

NEXT ISSUE'S TOPIC: THE INFLATION vs. DEFLATION DEBATE