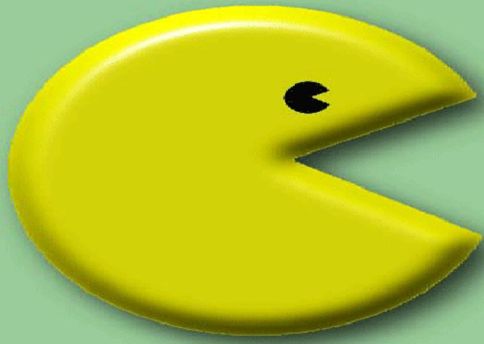


Newsletter - Vol. 6 Issue 8

August 2009

mortgagestraightTalk.com

Tel: 760-726-4600 Cel: 760-717-8584

Fax: 760-639-0785

Rod@MortgageStraightTalk.com

THE MONTH IN REVIEW

7/1-7/3: A report issued Wednesday by the Office of the Comptroller of the Currency and the Office of Thrift Supervision stated that home delinquencies doubled on prime loans which are the least risky and account for two-thirds of all U.S. mortgages. In the same report, foreclosure filings topped 300,000 for the 3rd straight month. The Dow dropped 200 points, Thursday. Investors were rattled by unemployment hitting 9.5%, marking a new 26-year high and the 9th straight month of increases. The markets were closed on 7/3 because of the 4th of July holiday.

7-6-7/10: Oil fell below $65 a barrel, a five-week low, as rising unemployment challenged prospects for a recovery and energy demand in the global economy. Stocks stumbled Tuesday as jittery investors dumped shares and oil declined to below $63/bbl. Oil fell to $60, an 18% slide in the past week, as domestic demand waned in the face of high unemployment. Retail sales recorded a 4.9% decline for June in contrast to a 1.9% percent increase a year ago. First-time jobless claims fell by 52,000 due to seasonal layoffs in the automotive industry, but continuing claims rose to another record high. U.S. consumer sentiment wilted in early July to the weakest since March, when confidence in the financial sector and economy were at its low ebb.

7-13-7/17: After four down weeks, the Dow rallied strongly (up 185 points) Monday, ahead of the first big wave of quarterly financial results. The Treasury reported that the Federal deficit exceeded $1 trillion in the first 9 months of fiscal 2009. The Labor Department said U.S. producer prices which measures rates received by farms, factories and refineries, increased by 1.8%, twice as much as was expected due to a big rise in energy prices. It was the steepest gain since November 2007. Stocks surged mid-week after Goldman Sachs and Intel reported larger-than-expected quarterly profits, fueling optimism that the economy is starting to stabilize. A record 1.53 million homeowners entered the foreclosure process in the first six months of 2009. The national unemployment rate rose for the ninth straight month in June, climbing to 9.5% from 9.4%, and hitting another 26-year high. Michigan was hardest hit at 15.2% and California came in 6th at 11.6%.

7/20-7/24: As the stock market spurted up another 104 points, the price of a barrel of oil closed above $64, a 9% increase from its $59 dollar lows two weeks ago. Tuesday, Fed chairman Ben Bernanke said the economy is showing signs of stabilization, but added that the housing and labor markets are still not recovering. The Dow rallied Thursday surpassing 9,000 for the first time since the start of the year as several major companies reported results that surpassed expectations. June home sales rose, but the average home price fell 15.4% from last June. The Reuters/University of Michigan Surveys of Consumers confidence dipped for July, an indication that consumers are wary about the slow pace of recovery.

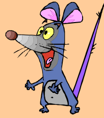
7/27-7/31: New home sales spiked 11% in June as the median price fell 3% to $206,200; the mean price was $276,900. Wednesday, the Commerce Department said June durable goods orders tumbled 2.5%, marking the sharpest monthly decline since January. Stocks surged on the 30th, hitting their highest levels in nearly 9 months, as continuing jobless claims dipped and investors saw a slew of better-than-expected corporate profits. The Dow closed out the month with a gain of nearly 8.4%, its best July in 20 years.

RATE SUMMARY: Despite an 8.4% gain in equities, mortgage rates were surprisingly unaffected over the past 4 weeks. Instead of increases, we saw modest decreases among conforming programs mostly an 1/8th percent better in rate. While the Jumbos saw increases, they were modest, being limited to a 1/10 of a percent or less. The governments, FHAs & VAs, followed the conformings trends of an 1/8th to a ¼ percent improvement.

FOR CURRENT INTEREST RATES FOR THE 16 MOST POPULAR PROGRAMS GO TO: www.mortgagestraighttalk.com click on the menu tab labeled "RATES". The rate sheets are updated every Friday.

Five more lenders fell by the wayside this month. This brings the running total to 352 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:



THE INFLATION vs. DEFLATION DEBATE

The economist John Kenneth Galbraith once said, "The only function of economic forecasting is to make astrology look respectable." Even so, it has not kept a great many pundits from engaging in the inflation vs. deflation debate. Economists are worried about prices—but they disagree about whether prices are going up or down. They ruminate over whether the Federal Reserve will be more worried about the threat of inflation in the long-term horizon, or deflation in the short-term? The reason that this is of more than academic concern to homebuyers and borrowers is because inflationary expectations in the form of rising bond yields often results in higher mortgage rates and deflationary expectations (decreasing yields), lower ones. The trend toward higher interest rates has already begun. Since March, the yield on the 10-year Treasury has jumped from 2.5% to 3.8%, sending prices which move in the opposite direction–down an astonishng 34%. As the yields march upwards, mortgage rates usually follow and a major justification for the government's massive deficits, the cheap cost of borrowing, will disappear.

The bond market is very savvy about predicting where interest rates are headed. But, let me caution the reader about a common misunderstanding. As I said in the paragraph above inflationary expectations (rising bond yields) OFTEN result in higher mortgage rates, but the one is not tied to the other. Many people assume an implicit relationship between the bond markets and mortgage rates. The financial press has been complicit in linking mortgage rates to the U.S. 10-year Treasury Note. This happens because though financial reporters may understand the bond markets they do not understand how mortgage rates are determined. Mortgage interest rates and the intra-day re-pricing that occur are based on the performance of mortgage-backed securities, not U.S. 10-year Treasury Notes.

POINT

Inflation hawks argue that the recent rise in oil prices (from $35 to $70 over the same 6 month period), the dollar's loss of value and the recent rise in yields on U.S. Treasuries are all signs that higher interest rates are just around the corner. These economists claim that inflation in every instance is always a monetary phenomenon—that is, too much money chasing too few goods. They say the seeds for inflation have been sown by the Fed's dramatic expansion of the money supply over the past year in its extraordinary efforts to keep the economy afloat.

While they allow that borrowing remains relatively cheap by historical standards, government deficits and inflation will change that picture over the next few years. They point out that the trend towards far higher rates has already begun. As evidence, they cite the near doubling of the yield on the 10-year Treasury Note in the past 6 months. Another possible cause for boosting treasury yields is that China—a key buyer of U.S. Treasuries might close its wallet because of concern over the U.S.'s credit quality. They reason that as yields march upwards, mortgage rates will follow, and the cheap cost of borrowing, will disappear. For these reasons they see inflation as inevitable.

To avert disaster they believe the Fed needs to throttle back quickly on the various programs it has created to pump cash into the economy, even if the U.S. economy is still struggling. If the Fed doesn't act, it could risk even worse problems down the road—especially if long-term bond yields and the lending rates tied to them continue to rise.

COUNTERPOINT

But the opposition argues the economy is still so weak that deflation, or a drop in prices, is the more serious threat. A Labor Department report said that American wages fell 1.2% as unemployment rose to 9.5%. They aver that unemployment and debt will make rising prices a non-issue and cite the recent decline in the Consumer Price Index (CPI), the government's

key inflation measure which posted its largest 12-month drop since May, 1950. As further proof of an emerging trend they point to the fact that the so-called core CPI which strips out food and energy prices, was negative for three consecutive months (March - May). Moreover, they say that prices are a lagging indicator in deflationary contractions and point to borrowers' lines of credit being frozen, credit limits being cut, and LTVs being lowered on mortgages are precursors of falling prices. A similar contraction is occurring among state and municipal governments. Many have budget shortfalls in the millions and billions which will necessitate their having to slash spending to the bone. History has shown that weak economies drag down inflation. Businesses unable to make a profit in an environment of declining prices inevitably cut production and lay off more workers which intensify the deflationary spiral. The Great

Depression and Japan's so-called Lost Decade of economic stagnation are both well-documented examples of the damage that deflation can cause.

But what about all the money the government is pumping into the system? Proponents claim that by itself it is not inflationary. They claim that Gross Domestic Product

(GDP) is equal to money times its turnover, or velocity, which is basically, the speed with which people spend it. In the last two quarters, the money supply has grown at 14% but the velocity has declined by about 17%, so nominal (non inflation-adjusted) GDP fell 4.5%. Deflation proponents believe that excessive debt controls all, or nearly all, other economic variables. The reason that velocity is down, they say, is that in financially perilous times, people are more interested in trying to get out of debt rather than increasing it, which means the economy cannot grow, and if there's no increase in demand, there can be no increase in prices.

The deflationists envision that high unemployment, low factory utilization, and real estate vacancies (in both commercial and residential sectors) are underlying reasons

that the economy will be weak for years. And, they argue even if inflation and interest rates were to rise, this would be short-lived since the economy would quickly stall because with widespread unemployment, wages would seriously lag inflation. Thus, real household income would decline and truncate any potential gain in consumer spending. As a consequence, they forecast that with core inflation at zero, a deflation is a real possibility for 2010 or 2011.

SYNTHESIS

As for China liquidating its sizable bond holdings, it would severely decrease the value of its $1 trillion investment. Another reason that I believe fears about inflation are overwrought, is that the Fed knows how to fight it—with higher interest rates and tightening the money supply. But if a nation goes into a deflationary spiral, it's very difficult for it to extricate itself. Ben Bernanke, the Fed Chairman, is a longtime student of the Great Depression and well-versed as to its causation. It is why, last December, the Fed cut the Fed Funds rate to virtually zero and has since engaged in a policy known as "quantitative easing" to restore the flow of credit.

The central bank has, also, created a mountain of bank reserves to fight the financial crisis. These very reserves have filled the inflation-spooked economists with apprehension. But their concerns are misplaced. In normal times, banks don't want excess reserves, which yield them no profit. So they quickly lend out any idle funds they receive. Under such conditions, Fed expansions of bank reserves lead to expansions of credit and the money supply and, if there is too much of that, to higher inflation. In abnormal times such as these, providing banks with the reserves they demand, fuels neither money nor credit growth—and is therefore not inflationary. Rather, it's tantamount to what the Fed does every Christmas season, only on a grander scale. It puts additional currency into circulation during this prime shopping period because people demand it, and then withdraws the "excess" currency in January.

Inflationists and deflationists are concerned about this last step because the timing has to be spot on: if the Fed withdraws the reserves too late, you get inflation; if it does so too soon, we remain mired in a recession. While the Fed is not infallible, there are a couple of important points to note:

1. It is not incompetent: it does have an exit strategy—it has committed itself to an inflation target of just under 2 percent. Naturally, there are no guarantees that the Fed will hit the mark. If it were to miss, the result might be inflation of 3 percent or 4 percent—but not 8 or 10 percent.

2. The Fed will begin the exit process when the economy is still below full employment and inflation is below target ("pulling away the punch bowl just as the party starts to get underway"). So, the Fed shouldn't have to raise rates or contract the money supply by much.

As we've seen, given the unusual nature of the current economic environment, economists are having a hard time figuring out if it's inflation or deflation that we need to be concerned about. In most cases life is not an either/or proposition and reality resides somewhere between the two extremes. I expect to see the economy struggle for many months to come and the housing market, longer still. But, the reasons cited by the inflationary camp do not strike me as credible in the near term for the very reasons cited by the deflationists. And, rising commodity prices have eased some worries, though not all, about a deflationary spiral.

Thus far, this year, ten-year bond yields and stock prices have marched in lock-step: When yields hit highs of almost 4%, stocks also soared, and when bonds began to drop, so, too, did equities. I believe that we are in the midst of what amounts to a two-tiered interest rate environment.

Barry Knapp, an equities strategist at Barclay's Bank discovered through regression analysis that there exists two distinct interest rate mileus that influence the economy—a higher and a lower. *"When the yield on the ten-year bond is [was] 5% or lower, the correlation between the yield and equities tends to be positive, but when it is above, then it becomes negative. As long as we are in a low rate environment, it appears stocks will rise in concert with bond yields. On the other hand, should rates climb past 5%, rising yields cut into companies' earnings and slow the overall economy. Right now, though, stocks are still undervalued compared to interest rates".*

So, I expect to see the economy occupying a middle ground—with prices moving largely sideways in the near term and moderate inflation 3-5 years down the road. Our economic recovery will no doubt be hampered by unemployment, predicted to reach 10% by 2010 and elevated for years afterward. And, the fact that families are saving more of their income in these uncertain times is another development thwarting consumer stimulus efforts. Our Gross Domestic Product is expected to shrink about 1.5% this year. Also, the recession that the U.S. is experiencing is a global phenomenon, not merely national in scope. Challenging as it is, what we're going through is not nearly as harsh as what much of the rest of the world is undergoing. As a consequence, I believe it will take years for economies to revert to normalcy and some markets (like housing) even longer. Because of weak demand and high unemployment a protracted, jobless recovery is expected, a U-shaped one with a relatively flat bottom. I believe that inflation will return but that it will be moderate in the nature of 2-4%. If I'm wrong, blame it on John Kenneth Galbraith--my astrological sign is Taurus—so despite some of my comments I'm bullish by nature.

THE MORTGAGE LENDERS' CONUNDRUM OF 'LESS IS MORE'

Who in their right mind would choose to receive substantially less on a debt owed rather than more? Confoundingly, this appears to be the particular province of a great many mortgage lenders, according to a recent study by the Office of the Comptroller of the Currency. But this is no mere miscalculation, but rather what appears to be grossly contrary to their best interests.

The numbers are truly staggering and rising. Last January, there were about 242,000 foreclosures in the pipeline, in May, 277,847, and in June, 281,560 were in process. A record 1.53 million properties entered the foreclosure process during the first six months of 2009. And, the loss severities, like foreclosures, have been steadily rising, too. In November, losses averaged 56.1 % of the original loan balance; in February, 63.3%; and based on almost 32,000 foreclosure sales in June, the average loan balance of $223,000 (when liquidated) fetched on average, $144,000 less—a 64.7% loss. Perhaps no other single figure shows how wildly the mortgage mania inflated home prices. It also bodes ill for the quality of the mortgage-related assets residing on banks' loan portfolios.

Given losses like these, it is perplexing that lenders have been resistant to approve short sales and reluctant to do loan modifications with principal reductions. The data shows how rare it is for lenders to reduce principal. In June, for example, 3,135 loans—just 17.2 percent of the total modified—involved write-downs of principal, interest or fees. The total loss from these write-downs was just $45 million in June. Yet, the losses incurred in foreclosure sales involving loans in the securitization trusts were a staggering $4.59 billion. A

hundred times more money was lost to foreclosures than would have occurred with principal reductions on loan modifications. This is stunningly irrational economic behavior!

The goal of Obama's Home Affordability Stability Plan (passed in February and enacted in March) was to encourage

banks to effect loan modifications, but the plan has gotten little traction because participation was not obligatory for those banks on the receiving end of Troubled Asset Relief Program (TARP) funds. Mortgage modifications peaked in February and have declined in all but one month since. While servicers modified 23,749 loans in these trusts in February, they changed only 19,041 in May and 18,179 in June. Ironically, this is precisely when servicers were supposed to be hitting their stride with increasing numbers.

Loan modifications occur when a lender agrees to change the terms of a troubled borrower's mortgage. Most modifications involved the capitalization of arrearages into the balance of the loan thus leading to increased payments or lengthening the term of the mortgage known as forbearance. A less frequent approach is to reduce the loan's interest rate. A very rare one is to cut the amount of principal owed—an option that could be of more help to a borrower—because it means homeowners pay less money back to the bank over time.

If banks were to write down the value of these loans to the 40 cents on the dollar, their true value for these homes (based on what they are fetching as foreclosures), then why not reduce the loan amount outstanding for the troubled borrowers? This type of modification would have a better chance of succeeding than larding a borrower who is hopelessly underwater with yet more arrearages.

The seemingly incomprehensible reasons for lenders reluctance may be explained by a research paper by the Federal Reserve Bank of Boston that revealed why fewer than three percent of home-owners that were 60+ days delinquent had received a payment reducing loan modification. Some banks claim they rather foreclose than offer loan modifications because they expect to

recover more losses from a foreclosure versus a modified loan.

Many delinquent home owners, for example, "self-cure," that is, start paying again without assistance. The Fed found that an estimated 30% of all borrowers who miss two payments start repaying on their own. If the lenders had modified these loans, they would have lost money unnecessarily.

A second reason, according to the report, is that so many modified loans re-default, with up to 50% of all modified mortgages succumbing. This costs the banks twice. They bear the expense of the initial workouts and they pay again to finish the foreclosures, including any additional missed payments. By postponing foreclosures, lenders say that they are forced to absorb subsequent losses in housing values. If the final repossessions are delayed a year , the lenders could be getting houses worth 10%, 20% or even 50% less than they were at the point of the original default. In which cases the banks would have been better off foreclosing. In addition, a borrower who faces a high likelihood of eventually losing the home will do little or nothing to maintain it, or may even contribute to its deterioration.

Given the above, there appears to be two sides to every story, but the anomalies remain unmitigated

OPTION ARMS WORSE THAN SUB-PRIME!

As of April, 36.9% of option ARM loans were at least 60 days past due, while 19% were in foreclosure, according to data from CoreLogic. (For an explanation of option ARM loans go to: **www.mortgagestraighttalk.com** Click on Talking Points and scroll down to Option ARMs). By contrast, 33.9% of sub-prime loans were delinquent, with 14.5% of those loans in foreclosure. It is surmised that 25% of these mortgage defaults are "strategic," that is, borrowers walking away from their homes because they've lost so much value they see it as a poor financial decision to keep paying on a declining asset.

Option ARM mortgages are heavily concentrated in the worst-hit regions in the housing market, including California and Florida, making borrowers inordinately vulnerable to declining property values. The deepening loan turmoil could mean higher-than-expected losses for Wells Fargo and J.P. Morgan Chase & Co. because of their recent acquisitions. These loans will be resetting through early 2011.

IF THIS IS YOUR STRATEGY? YOU MAY WANT TO RECONSIDER!

Perhaps you've heard of owners who say they can't currently sell their homes for what they think they're worth in this market and have opted for a strategy of renting their properties out until prices "come back" in a year (or two) at which time they'll sell. This "rent and see" strategy seems particularly prevalent in the mid- to high-end of the market. Though no one likes to hear that their reasoning is flawed, it is—for so many reasons.

First of all, the exotic loan programs and the liberal guidelines that fueled the stratospheric price increases that we saw from 2003 to 2007 no longer exist, e.g., the option ARMs, the No Doc, No Ratio, or NINAs (No Income, No Asset). Stated Income loans and 100% financing deals have also disappeared. The only vestiges of "times gone by" are the Interest Only loans, but those have more stringent guidelines, now.

Two years ago, a household income of $100k a year could legitimately buy an $800k home with almost nothing down and afford the payments using a Pay Option ARM. Now, to buy the same house, you need $160k down and an income of $200k a year. In the upper price tiers (just as in the lower ones) most people need to sell their old home for the down payment on the new one and carrying the mortgage payments on two properties simultaneously would render them ineligible for the new loan because of excessive debt-to-income ratios.

But in San Francisco, long thought to be safe-haven for housing prices, owners are resorting to renting out their properties. A real estate colleague I know sent me this note the other day that I thought bore repeating. He had been scouting relocation properties for an out-of-town associate.

"I walked through a beautiful home in Pacific Heights yesterday. It was listed at $6M about a month and a half ago. The price has been cut three times now and it currently listed at $4.95M. The amazing part is that the owner is now trying to rent it for one year (and I quote the agent) "and then sell it when the market comes back."

When I asked her what made her think the market would come back when rates were going higher, availability of credit was down, incomes were down, unemployment was up and willingness and availability of people to spend was down, she had no answer. Even more amazing was that we looked at four other properties in a similar price range and almost all of them had a similar strategy…"rent it out for a year and then sell when things get better"…

Because of the epidemic negative equity across the mid-to-high end, a large percentage of high-leverage exotic loans are still in place. In every case, the homeowner or Realtor managing the lease says "we want to wait a year or two until the market comes back". Why is there such feckless optimism that the prices of expensive homes will come roaring back or is it just wishful thinking? If not for interest only loans, Pay Option ARMs, stated income programs and 100% financing the mid-to-high end values would have never gotten there in the first place.

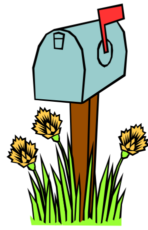
As was the case with the sub-prime market and the conforming tiers, the mid-to-high end housing strata are beginning to "have their day in the barrel". High-end communities are now experiencing the phenomenon of relative overnight re-prices.

Sales transactions have increased over the past couple of months, but largely because sellers are finally capitulating—or desperate. The properties being sold now are either by folks with lots of equity who can afford to sell now and are doing so whenever they see market blips or by those that are counting on being able to steal the new house that they buy and they view their sale asa wash. Lenders still appear to be tight-fisted about approving short sales. And, just as was the case in the lower price bands, foreclosures are beginning to grow.

The relative overnight home re-price phenomenon that we saw in the lower price tiers in 2008 is now playing out among the higher end properties with alt-A and A-paper loans. As values fall, more borrowers fall into an incurable negative equity position, which leads to more loan defaults, increased foreclosures, a supply exceeding demand and—ultimately lower prices. The cycle is repeated until supply and demand fundamentals neutralize. Eventually, prices will come down to a point where the market will clear. But we are still a long ways from that.

Bottom Line—there is a massive supply of quality single family residences for rent in California. So, rents are falling. Which begs the question why would anyone want to plunk down a $500,000 down payment with payments more costly than comparable rents in a falling market? Prices have much further to go on the downside. Homes in these price tiers (in California) are still 30% overvalued, on average.

MORTY'S MAILBAG



There were no letters in the mailbag this month.

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

Warning Signs that you Might Need a Different Lawyer....

He tells you that his last good case was a Budweiser.

When prosecutors see who your lawyer is, they high-five each other.

He picks the jury by playing "duck-duck-goose."

He tells you that he has never told a lie.

A big sign in his office says: "Don't ask me."

A prison guard is shaving your head.

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

NEXT ISSUE'S TOPIC:
TRUTH-IN-LENDING STATEMENTS (TILs)