# The Affordable Mortgage Depression

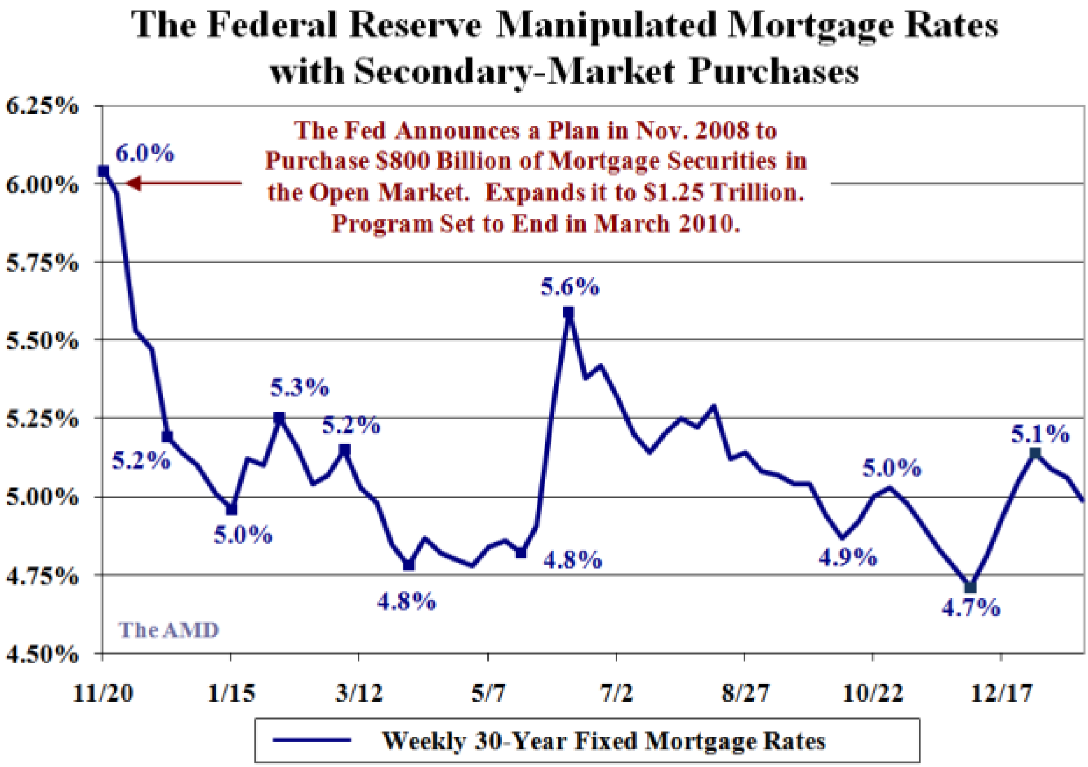
Government policies were designed to increase homeownership. Affordable Mortgages, created to realize this goal, were responsible for the Housing Bubble and distorted the economy. The unwinding of these distortions will result in a Global Depression.

## Why Housing Prices Will Resume Collapse in 2010

Home prices are falling again despite extraordinary Government intervention designed specifically to prop up values. Housing prices are destined to decline sharply during 2010 for a variety of reasons.

### Mortgage Rates Will Rise Dramatically

The Federal Reserve has spent approximately $1.25 trillion buying open market, mortgage securities issued by Fannie Mae and Freddie Mac. The purpose of this unprecedented activity was to lower mortgage rates and in doing so, prop up home values. The Fed succeeded in lowering interest rates, but failed to stop eroding housing prices.




In March (or thereabouts) the Fed is scheduled to end its mortgage rate subsidy. During 2009 Fannie and Freddie financed approximately 75% of new mortgage debt. The Federal Reserve purchased 73% of all securities issued by Fannie and Freddie. Borrowing rates for home purchase are about to rise materially.

Credible analysts believe that rates will rise to at least 6%, representing a roughly 20% increase in the cost of servicing a 30-year mortgage. While record low borrowing costs were not sufficient to prop up home values, a material increase in ownership expenses will certainly force prices lower.

### Buying Incentives to Fade

Many first-time home buyers were persuaded to purchase houses during 2009, enticed by the allure of an $8,000 tax credit. This Congressional effort to prop up prices succeeded in temporally increasing home sales, but has failed to stabilize home values. During 2010 the home buyer incentive will be reduced, then eliminated. Regardless, pent up demand amongst first-time homebuyers has already been largely exhausted.

First time home buyers will largely evaporate from the market when the tax credit vanishes. If remaining potential buyers are unwilling to purchase a home while being paid $8,000 to do so, why would they enter into such a transaction after the subsidy has expired? In the same way that car sales collapsed after Cash-for-Clunkers was exhausted, housing sales will decline forcing prices lower.

## Record Foreclosures Will Occur

According to RealtyTrac 2.3 million homes entered foreclosure during 2008, 3.0 million during 2009 and an estimated 4.0 million will enter foreclosure during 2010. This growing number is driven by ARM resets, unemployment trends and the failure of Government mitigation efforts which delayed inevitable foreclosures.

The presence of a material number of foreclosures within the marketplace is disastrous for housing prices. Banks liquidate the unwanted homes at below existing values causing the market price to fall. Given the proper environment, this cycle becomes self-perpetuating as falling prices trigger more inventories of foreclosures. At present we have all the necessities for such a phenomenon as housing has never been more leveraged, unemployment is high and rising, homes remain overvalued relative to market fundamentals and credit continues to be restrained. This has been my thesis for housing since 2005 and four and a half years later I continue to see no means by which we escape real price declines prior to 2013.

During 2010 the housing market will experience record foreclosures. Those foreclosures will inevitably drive prices lower.

## Supply and Demand

During the first half of 2009 monthly existing home sales averaged a run-rate of 4.5 million to 5.0 million transactions annually.

Homebuyer incentive programs increased that rate of transactions to in excess of 6.0 million a year. Given the waning influence of incentive programs, high unemployment and falling prices, it is unlikely that 2010 existing home sales will exceed 5.5 million.

This estimated rate of transactions is uncomfortably close to the 4.0 million estimated foreclosures which will occur during the year.

The percentage of existing home sales resulting from distressed transactions will remain high and increase during 2010. The higher the percentage of distressed sales, the greater the rate at which home prices will fall. There is a material risk that the supply of foreclosed properties may begin to overwhelm waning demand. At minimum this uncomfortable reality will force prices lower.

## Changing Perceptions and the Return of the Risk Premium

I have preached against buying houses that are “on sale”, but overvalued and falling in price, since early 2006.

As transaction volumes began to decline, homebuilders operating at the margin began offering incentive programs to attract buyers. During the first half of 2006 buyers were enticed with free kitchen counter-tops and upgrades. By the Summer of 2006 purchasers were being compensated with free pools and eventually cars. Finally, the homebuilding industry slashed prices and earlier “savvy” buyers found themselves increasingly underwater.

During 2007 foreign investors made equally “savvy” investments taking advantage of price discounts and a devalued dollar.

During 2008 distressed investors began to buy foreclosures enticed by large discounts relative to existing market prices.

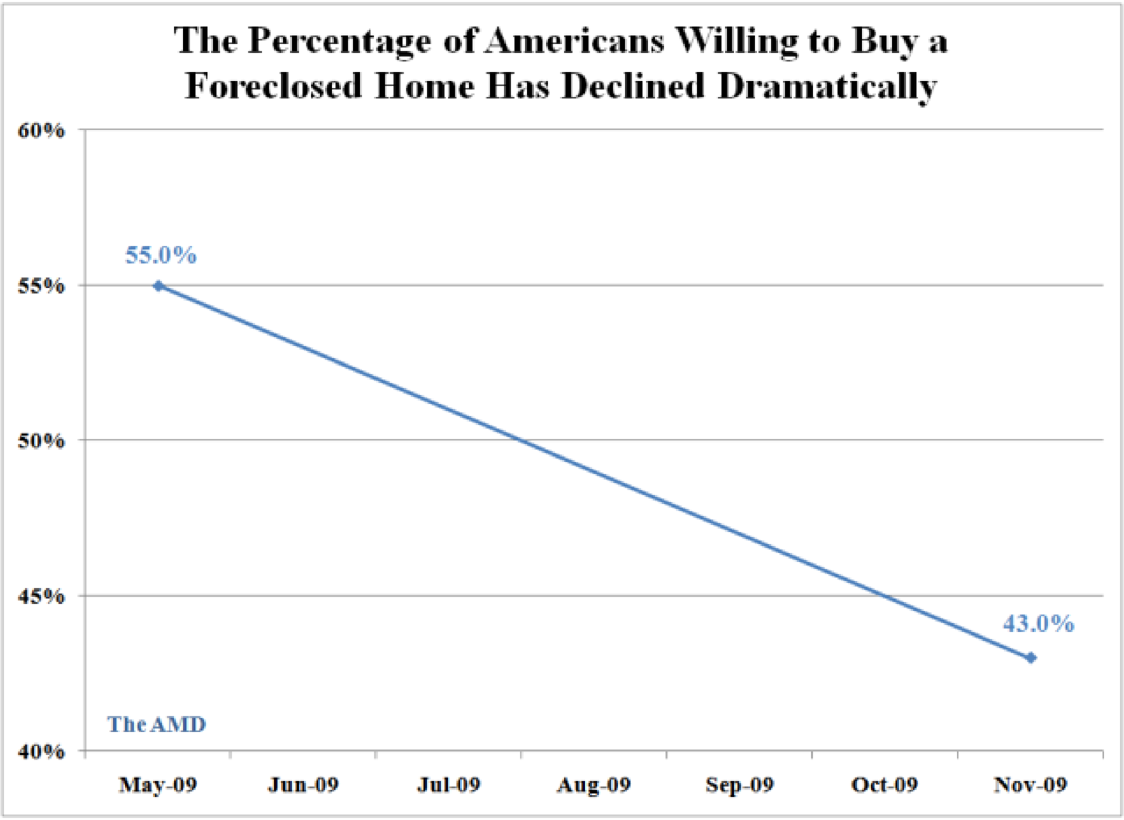
During 2009 the Government lowered mortgage rates and paid new buyers to buy homes.

These people, who convinced themselves a house on sale must be a good value, have all been disciplined by the market. Each has seen the value of their purchase continue to decline and a large number are now underwater on their mortgages. Many of these buyers who made purchases after the housing collapse began will contribute to record foreclosures during 2010 and beyond.

### Declining Demand for Foreclosures?

It is possible, as a result of sustained price declines, that the perception of "housing value" is beginning to change. There was recently performed a fascinating poll which bodes poorly for housing prices for years to come. The poll at present contains only two data points, and as such is not definitive, but it is intuitively appealing and centrally important.

The survey conducted by Harris Interactive determined that the percentage of Americans at least somewhat likely to consider buying a foreclosed home fell to 43% in November, down sharply from May's result of 55%.




It appears that four years of falling house prices and an eroding economy may have lessened interest in buying foreclosures. The implications of this trend are unsettling for house prices.

As established above there will be approximately 5.5 million existing homes purchased in 2010. An estimated 4 million foreclosures will occur during this period. Foreclosures will be the dominate force effecting the housing market and home prices in 2010 and beyond. If additionally the appeal of buying foreclosed properties begins to wane, as the supply rises, prices could fall at the most rapid pace we have seen since the Housing Bubble originally burst.

### Dismal Reality

There was never a housing recovery during the Summer of 2009; only a moment where the confluence of extraordinary Government intervention combined with the annual "buying season" to temporarily halt the decline.

This blog exists partly because I was and continue to be certain that Government efforts to prop up housing prices will fail and extend the economic downturn.

House prices are again falling, but the worst may be yet to come. Rising interest rates, falling subsidies, increasing unemployment, record foreclosures, restrained credit, and shrinking interest in homeownership will accelerate housing price declines in 2010.

Today houses are cheaper than they have been since 2003. Yet, based on a thorough understanding of the fundamentals which determine housing prices, there may never have been a worse time to purchase a home.

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