

In Focus

August 2006

Scott Simon Discusses PIMCO's Views on the U.S. Housing Market



W. Scott Simon

Managing Director and Senior Member of PIMCO's Portfolio Management and Strategy Groups

Mr. Simon is the head of PIMCO's mortgage and asset-backed securities team. He joined the firm in 2000 from Bear Stearns & Co. in New York, where he was a senior managing director and co-head of MBS pass-through trading. He also authored *The Daily MBS Commentary*. Mr. Simon has seven times been named to positions on the *Institutional Investor* All-America Fixed-Income Research Team, including first place honors in MBS pass-throughs and overall MBS strategies. He has twenty-three years of investment experience, and holds bachelor's and master's degrees in industrial engineering from Stanford University.

The housing market has played an important role in U.S. economic growth over the last several years, and the outlook for housing holds significant implications for the economy and financial markets. Because of these implications, PIMCO began a special research project in 2005, known simply as the "Housing Project", to track changes in housing and forecast the future path of housing prices. In the interview below, Scott Simon, PIMCO Managing Director and head of the firm's mortgage-backed securities team, discusses the Housing Project's latest findings and PIMCO's outlook for the housing market.

Q: Scott, when we last spoke with you in May, you described the U.S. housing market as a supertanker that was slowing, but only gradually. Has there been any change in pace of the slowdown in housing?

Simon: The housing market continues to slow every day but it is not falling off a cliff. Home sales are declining, building permits are declining, price increases are slowing and inventories of homes for sale are increasing.

Last year, PIMCO forecast 5% growth in housing prices for 2006 and we haven't had to change that forecast. Price growth for this year will probably average about 5%, with stronger gains in the first half of the year and smaller gains through the second half.

We also forecasted a decline in sales volumes beginning around mid-2006 and that seems to be occurring as well. Compared to last year, existing home sales in June were down about 9% and new home sales were down about 11%. The next six months are not going to be very positive for volumes.

Q: In June, the number of new homes for sale was the highest on record. What are homebuilders doing to reduce this inventory?

Simon: The rising inventory of new homes for sale is due to a lack of buying. Homebuilders are actually building at a slower rate—canceling "phase three" of projects, for example—but their inventories are going up. That will be an interesting dynamic to watch because homebuilders are under more pressure today to control inventories than they were in the past because more builders are public companies.

In Focus

August 2006

For example, in the 1990 housing slowdown in California, only one of the top 10 builders was a public company. Today, nine of the top 10 builders are public companies. Equity analysts treat homebuilders like manufacturing companies and frown on excessive inventories.

So we believe builders will be much more aggressive than individual homeowners in cutting prices. Homeowners just do not cut prices in a meaningful way. People are stubborn and it's very emotional for them. For homebuilders, this is much more of a business decision. They want buyers to purchase new homes, not existing homes, and so we think they are going to push on price and soften prices so that they make the sale, not the existing homeowner.

Anecdotal evidence from our research suggests that is already occurring. Homebuilders are really pushing on prices to try to reduce this really large inventory overhang. They are making price concessions and offering options for free and taking other steps to increase sales

Q: Reduced affordability is one of the key reasons PIMCO expects housing to slow. What has been happening with housing affordability since we last spoke to you in April?

Simon: Affordability continues to get worse. Affordability has really been squeezed on both the interest rate side and the price side. That is a bad combination. For example, what was once a 5% 30-year mortgage is now a 6.5% 30-year mortgage, which means you have to pay 30% more to buy the same house. So how do you move? If you sell your existing home to buy a comparable house, it costs you 30% more today than it did when mortgage rates were at 5%. New buyers have it even worse. If the price of the house they want to buy has gone up 20%, and they have to pay 30% more because of the increase in mortgage rates, that means the price they have to pay has gone up 50%.

So affordability is one of the main reasons we expect price increases to slow. Home price increases have really dwarfed income increases over the last couple of years but we think home prices in 2007, nationwide, will be up slightly less than incomes for the first time in years.

Q: Homeowners have helped to sustain U.S. economic growth by withdrawing equity from their homes to fuel consumer spending. Has the rise in interest rates hurt homeowners' ability to extract equity from their homes?

Simon: In the first quarter of 2006, Freddie Mac data showed that 88% of refinancing was equity take-out refinancing, which is about the highest it's ever been. Even more interesting, and something we've never seen before, was the fact that in more than 50% of the equity take-out refinancings, the homeowner refinanced into a higher rate to take out equity. So people continue to literally use their houses as an ATM machine.

This can continue as long as there is equity in the homes and as long as lenders are willing to make the loans. Over the last six years, the boom in housing has created \$5

In Focus

August 2006

trillion more value in homes than mortgages have gone up, so there is plenty of equity in homes. And lenders continue to be willing and able to make these loans. At some point, people get too far in debt and bring too much consumption forward from savings and the market will stop making these loans. We think this is going to be a problem down the road but we don't think it is close to a problem yet. The market is still allowing homeowners to extract equity and we think you need to have real losses in credit before the market stops making these loans.

Q: Thank you for another update on the latest findings from PIMCO's Housing Project, Scott.

Past performance is no guarantee of future results. This article contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660. ©2006, PIMCO.