

In Focus

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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-one 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, let's get right to your team's latest findings. What are the most recent data on the housing market showing?

Simon: Our forecast 13 months ago of a gradual slowdown in the housing market for 2006 is coming true. About a year ago, we forecast double-digit increases in home prices and a really robust housing market through the end of 2005, followed by a gradual slowdown in 2006 to about five percent price appreciation. And that is the path that the housing market has taken.

Home prices are increasing more slowly, the volume of sales is down at least 10 percent, the number of homes on the market is starting to really skyrocket, the number of days homes are on the market is increasing, affordability has gotten much worse, and interest rates are up. When you add all of these things up, overall conditions in the housing market are fairly negative, so we just think the market is slowing under its own weight.

Q: Considering the negative conditions in the housing market, why does PIMCO expect a gradual slowdown in house price appreciation this year rather than a rapid slowdown or an outright decline?

Simon: When we look at the housing market, the analogy we use is a supertanker, in that when you go to full throttle, it takes a really long time to speed up. In fact, the two biggest quarterly increases in house prices occurred last summer and last fall, which were a year and a quarter after the Federal Reserve started raising rates. In other words, the housing market was still accelerating after the Fed had shifted into reverse. And even when you throw it into full reverse, the housing market takes a while to slow down, just like a supertanker that takes 23 miles to stop if you throw it in reverse from cruising speed.

We've looked at housing bubbles over the last couple of hundred years and one thing that was very consistent and I think was really clear is that bubbles only burst when there is a lot of unemployment. If you just look at the last 25 years, there are two examples of housing bubbles that burst. One was in California in the early 1990s, when virtually the entire defense industry got laid off and there were 20 for-sale signs on a block. The other big case was the

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Texas-Louisiana oil patch problems of the 1980s where you had 35% unemployment regionally.

In both cases, the banks ended up owning property that they wanted to get out of and ended up selling at any bid. That's how housing prices go down. Otherwise, people just live in their houses and the number of home sales really goes down a lot, but prices don't have to collapse because people have to live somewhere.

Many people are impatient when it comes to the housing market, but the reality is that the housing is not a speedboat, it's a supertanker that just doesn't speed up or slowdown that fast—unless it hits an iceberg like a big jump in unemployment.

Q: With U.S. unemployment at its lowest level in years, why would the housing market have to slow at all? Are rising interest rates the biggest factor?

Simon: The biggest factor behind the slowdown in the housing market is probably prices. If houses double in price, monthly mortgage payments become more expensive even if mortgage rates don't move at all. And the fact is that most people don't buy a \$300,000 house; they buy a \$2,000/month mortgage.

When mortgage rates went from 9% to 5% and houses went up 25%, we were arguing that housing was actually cheap because suddenly you could buy a much bigger house with a \$2,000 monthly payment, or you could buy the same house with a lower monthly mortgage payment. For example, with 30-year mortgage rates at nine percent, a monthly mortgage payment of \$2,000 gets you a \$249,000 mortgage. At five percent on a 30-year mortgage, that same monthly payment gets you a \$373,000 mortgage.

What happened was that house prices went up 50%, and then 75% and then 100%, and suddenly people really started to have problems because a \$2,000 monthly payment could no longer buy the house they wanted. At that point, people started to use interest-only loans, which at five percent and monthly payments of \$2,000 gets you a \$480,000 mortgage.

Interest-only loans temporarily closed the gap, but then, home prices went up 125%. So what do you do now? Many people decided they didn't even want to pay the interest on a mortgage anymore and took out a negatively amortizing loan. With a negatively amortizing loan, the interest is added to the mortgage, the mortgage gets bigger every month, and you hope that the price of your house goes up.

So the mortgage market got to a point where the magic ran out. If borrowers aren't paying principal, or not paying interest, there is nothing left to *not* pay. People just won't lend you any more money. And at that point, affordability in the housing market started to get really stressed by prices.

At the same time, 30-year mortgage rates are now at the highest level in three years and the rate on adjustable-rate mortgages, which are much more dependent on the Fed, have gone up significantly. So the housing market has been squeezed on the affordability side and has lost fuel in its tank from the mortgage side, and the two add up to a gradual decline in activity.

Q: As part of the Housing Project, PIMCO sent people to a number of cities to establish contacts in regional housing markets and collect data on an ongoing basis. What are the data from regional markets showing?

Simon: We've sent people to 20 markets around the country—hot markets and cold markets—and we check back every month for an update on all areas in terms of activity, price trends, volume trends, anything they are concerned about, anything odd they are seeing in finance or

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supply shocks in either direction. The local data has largely confirmed the gradual slowdown we are seeing at the national level.

Regional markets have seen a gradual erosion of the velocity of price increases, a gradual erosion of sales volumes, and a gradual increase in the volume of supply. That's pretty consistent. Some regions are slowing moderately and some are slowing a lot, but overall, the numbers suggest a gradual slowdown.

Q: Thank you, Scott. We'll be checking back with you regularly for updates on the latest findings from PIMCO's Housing Project.

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