

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-four 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, PIMCO's outlook for the housing market and how the Housing Project is influencing the firm's investment strategy.

Q: The goal of PIMCO's "Housing Project" is to track changes in the U.S. housing market. How successful has the team been at forecasting changes in the housing market so far?

Simon: We've been very fortunate so far in terms of forecasting. Last year, we forecast 5% growth in housing prices for 2006, and price growth 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 October were down 11.5%, and new home sales were down about 25%. The next few months are not going to be very positive for volumes.

Q: Have those forecasts influenced PIMCO's investment strategy?

Simon: Yes. For example, our forecast that sales volumes were going to begin dropping around mid-year was a big reason we decided to extend duration [the price sensitivity of a bond to interest rates] pretty significantly in June. And in fact, since June, many housing indicators have turned lower and the bond market has rallied. Longer-term, we believe the housing market is ultimately going to be the major drag on the economy that causes the Fed to ease in 2007. That view is central to our global investment strategy, where we are favoring the short-end of the U.S. yield curve based on expectations that the Fed will eventually need to cut rates while other central banks continue to look at raising rates.

Q: When you talk about housing being a drag on the economy, does PIMCO expect an outright decline in housing prices or just slower growth?

Simon: We anticipate a much harder landing in volumes than in prices. The volume of home sales has gone down a lot and is going to go down considerably more. In terms

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of prices, new housing will likely be down the most. During the run-up in prices, new housing became extremely expensive versus existing housing, so there is a lot of room for new home prices to contract. Homebuilders are also trying to reduce inventories. Between incentives and absolute price cuts, homebuilders have really leaned on the prices of new homes. This will affect different home price indexes in different ways. The National Association of Realtors index, which tracks median home prices, will probably be down a few percent for 2007. The OFHEO [Office of Federal Housing Enterprise Oversight] index will probably be slightly negative because that index tracks repeat sales and is less affected by new home sales.

Q: Are homeowners likely to cut prices given that the inventory of existing homes for sale is even larger than the inventory of new homes on the market?

Simon: Existing homes on the market outnumber new homes for sale by about six to one. But, if you look at the incredible run-up in inventories of existing homes, we would argue that a lot of those homes really aren't for sale. In many cases, homeowners have put their house up for sale at above-market prices and will simply take that house off the market if it doesn't sell.

The inventory of new homes is real. Builders need to sell these homes. That will be an interesting dynamic to watch. Homebuilders are under more pressure today to control inventories than they were in the past because more builders are public companies. 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. They want buyers to purchase new homes, not existing homes. We think homebuilders are going to push on price, so that they make the sale rather than the existing homeowner.

Q: What is happening in local housing markets around the country?

Simon: The easiest way to characterize the local markets is that the markets that went up the most are the ones that are now softening the most. California, for example, could easily be down 10%.

One of the things we've realized from this study is that real price gains increase turnover considerably. The flip side is that if you go from insanely high appreciation to nothing, you get a really big drop-off in volumes. So, the markets that were the hottest look the softest, and I think that's just a natural reversal. But, it is important to recognize that those markets are still up significantly over the last five years. A huge amount of wealth has been created and is still there. It's just that people don't feel as good going forward.

Q: What will be the net effect on the U.S. economy from a slowdown in housing?

Simon: Some of the effects on the economy are isolatable and relatively simple to analyze. For example, the relationship between housing permits and residential investment has been amazingly robust for the last 45 years, and the decline in permits would imply about a 0.6% drop-off in residential investment as a percentage of GDP.

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There are also second-order effects. When homebuilding slows down, homebuilders employ fewer people. When the mortgage business slows down, the mortgage industry employs less people. When there are 2.5 million less existing homes trading, that's 2.5 million less people going to Home Depot and buying barbecues and new plasma TVs and paying someone to paint the house, build a deck, or any of the other things people do when they purchase a home.

Overall, we think the drag from housing on GDP is a minimum of 1% for the next 3 to 4 quarters. When you consider the multiplier effect that a housing slowdown could have on consumption, the impact on the economy could be even larger. Because of that multiplier effect, we think we are much more likely to have underestimated the impact on the economy than to have overestimated the effect.

Q: How would Fed rate cuts in response to slower economic growth affect the housing market and refinancings?

Simon: The Fed had a difficult time getting the housing market to slow—the record quarter for housing price appreciation came 18 months after the Fed started tightening—and we think that will be the case on the flip-side as well. Fed rate cuts are probably not going to provide a lot of relief for the housing market in the short term.

We also don't expect a big refinancing wave unless the Fed really cuts rates a lot. As the economy slows, and the Fed shifts toward rate cuts, short-term rates should fall more than long-term rates. Right now, you can get a 30-year mortgage for about 6.3% while an adjustable-rate mortgage is about 7.5%. So, if 30-year rates don't really drop, it will take a lot of Fed rate cuts to get short-term adjustable rates down to levels that would prompt refinancing.

Q: PIMCO has traditionally overweighted mortgage-backed securities in its portfolios. How has the firm's view on housing influenced that strategy?

Simon: The bulk of our mortgage-backed assets are really fairly unexposed to price changes in the housing market. Fannie Mae and Freddie Mac securities represent about \$150 billion, or about three-quarters of what we own. So, the average loan has a very high-credit borrower. The average loan-to-value is also very low, somewhere in the low 50% range. These are really high quality loans.

Q: Has PIMCO changed strategy in other housing-related sectors of the bond market like asset-backed securities or sub-prime loans?

Simon: In the asset-backed sector, we've clearly changed the way that we invest because of our concerns about the housing market. For example, on negative amortizing ARMs (adjustable rate mortgages), S&P and Moody's require 10% credit support¹ for AAA-rated, standard structures. We build in 45% credit support.

In sub-prime loans, we tend not to buy the AAA-rated piece of the loan. We carve the AAA-rated piece up and take the first cash flows off the AAA piece, which are self-

¹ Credit support is the par amount of subordinated bonds required to support the senior bonds in any security. For example, if 10% subordination is required to create senior bonds, then AAA bonds will equal 90% of the par amount of the deal, and subordinated bonds (AA down to equity) will equal 10%.

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liquidating if the deal performs normally for about four months. The biggest complaint you could make about our approach to those kinds of loans is that we've been too conservative. But given our view, that's a criticism that we will gladly bear.

Q: You mentioned that the majority of PIMCO's mortgage holdings are in Fannie Mae and Freddie Mac securities. How is PIMCO attempting to add value in agency mortgages?

Simon: We believe identifying relative value opportunities between agency mortgage backed-security coupons is the single highest information ratio way to earn alpha². Coupon trades are the most mean-reverting, liquid, robust relationships in the market that we've seen, and we take advantage of them regularly.

Over time, many investors don't invest from a total return point of view; instead they are accounting or politically driven. They are central banks, commercial banks, or all sorts of other types of accounts—mortgage servicers, for example—who do non-total return trades. As you go down in coupon, you get more duration. Many of these investors trade MBS for duration reasons, not for valuations. We believe that duration should not dictate what mortgages you buy. So, we take a duration-neutral approach to coupons and move up and down in coupon depending on valuation.

Agency MBS are incredibly homogenous, and the only real difference between them is the degree to which the homeowner's option to refinance is in or out of the money. For example, if mortgage rates are 6%, homeowners with a 7% mortgage have an in-the-money option to refinance into a 6% loan. Since agency MBS are so similar from a fundamental standpoint, there should be a natural relationship between various coupons that is based on the value of the prepayment option for the homeowner.

When premiums get cheap because people are afraid of prepayments or people are bullish or people are just doing trades for accounting reasons, we sell lower coupons and go up in coupon while holding our overall duration exposure neutral.

At PIMCO, we have a long history of understanding the underlying mortgage collateral and the relationship between coupons. We'd argue that to the degree we can sell expensive coupons and buy cheap ones, we can enhance expected return and reduce risk.

Q: Thank you, Scott.

² Alpha is the excess return active managers attempt to add relative to a benchmark. The information ratio is a measure of alpha relative to risk designed by William Sharpe to measure the effectiveness of active management strategies on a risk-adjusted basis.

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Past performance is no guarantee of future results. Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Mortgage-backed securities are subject to prepayment risk. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Diversification does not ensure against loss. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Freddie Mac: Federal Home Loan Mortgage Corporation (FHLMC) is a congressionally chartered institution that provides a secondary Market for conventional residential mortgages. Fannie Mae: Federal National Mortgage Association (FNMA) is a privately owned, publicly traded corporation, which provides a secondary market for federally guaranteed or insured mortgages as well as conventional mortgages. FNMA and FHLMC issue a number of different mortgage-backed securities.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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