

Still Renting

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One question my friends and colleagues have asked me repeatedly over the past six months is: Are you still renting? Yes! I sold my house over a year ago and continue to rent. Back in late 2005, I became anxious about my investment in the “American Dream,” after spending a considerable amount of time and effort researching several factors that I felt would influence housing prices. At the time, I was nervous about housing and ended up selling my house in early 2006 after owning for eight years, and then, upon closing, published *For Sale*, our U.S. Credit Perspectives, June 2006 publication. A year ago, I suspected housing prices were set to take a sharp turn for the worse and more “For Sale” signs were coming.

Based on the current outlook for housing, I will likely be renting for one to two more years. While many factors that influence housing prices have turned negative, I suspect we have not yet hit bottom. In fact, housing prices should head lower throughout the rest of this year and next year as well. Why? Housing inventories remain high, delinquencies and foreclosures are set to rise as homes purchased over the past few years by speculators and individuals with teaser-rate and adjustable-rate mortgages come back on to the market, affordability is low, and sentiment and risk appetite has shifted negatively. Most importantly, the availability of credit is set to take a turn for the worse as lenders tighten credit standards.

This is all great news for renters and buyers who are patient. Over time, housing prices and interest rates should decline, resulting in improved affordability. This adjustment, however, will take time and occur over a period of years, not months. Housing is illiquid and prices are sticky. As a result, potential buyers should exercise patience and not jump back into the housing market too early. A year ago, I described the state of the U.S. housing market as “the next NASDAQ bubble.” The NASDAQ took over 2 ½ years to go from peak to trough. I suspect that housing prices could display a similar pattern, and we are still over a year away from the bottom. Given these risks, I prefer renting versus owning, and an investment strategy which favors defense versus offense.

Unwinding the Housing Bubble

Housing was an asset bubble influenced by bullish sentiment, robust risk appetite and speculation, lack of fundamental analysis, cheap money, inflated appraisals and easy lending standards. These factors helped to drive housing prices up to new levels and the unwinding of these conditions is expected to drive housing prices down. Never before have we witnessed so many people lever-up real estate with so little money down or “skin in the game.” This growth in mortgage debt and risk appetite helped fuel

consumer spending and corporate profits. As such, the unwinding of this bubble will have broad consequences for the overall economy.

As the housing bubble unwinds, what are the implications for the overall economy and credit spreads? The U.S. economy will likely experience sub-par economic growth for the next year as declining housing prices lead to weaker consumer spending, slower corporate profit growth, a decline in business investment and less job creation. This environment favors reducing credit risk, especially to cyclical industries and lower-quality sectors of the market. As lending standards tighten and risk appetite turns more conservative, housing prices are likely to face a further leg down.

What's the big picture? Declining housing prices will lead to a pullback in job creation and a sharp slowdown in corporate profit growth, causing the Fed to lower short-term interest rates by the end of this year. Despite lower short-term rates, mortgage rates may not follow downward, because more cautious lenders will charge higher spreads relative to Treasuries. In addition, credit spreads should widen as consumers rein in their risk appetite for housing and investors turn more cautious on the outlook for the U.S. economy. We will now turn to an analysis of the supply and demand factors influencing housing. These factors should help to illuminate the future path of housing prices over the next year.

Inventory

On the supply side, the inventory of new and existing homes available for sale remains near all-time highs (Chart 1). The homebuilder industry helped contribute to today's record inventories through its bullish sentiment and aggressive land purchases over the past several years. Unfortunately, homebuilders have little incentive to stop building once they have purchased land for development. In hindsight, homebuilders bought too many lots over

the past few years, expecting that the run-up in land prices would continue for several more years. Given that undeveloped land is less valuable than developed land, homebuilders went through the process of getting zoning approvals on their land and started the build-out process in order to monetize their investments.

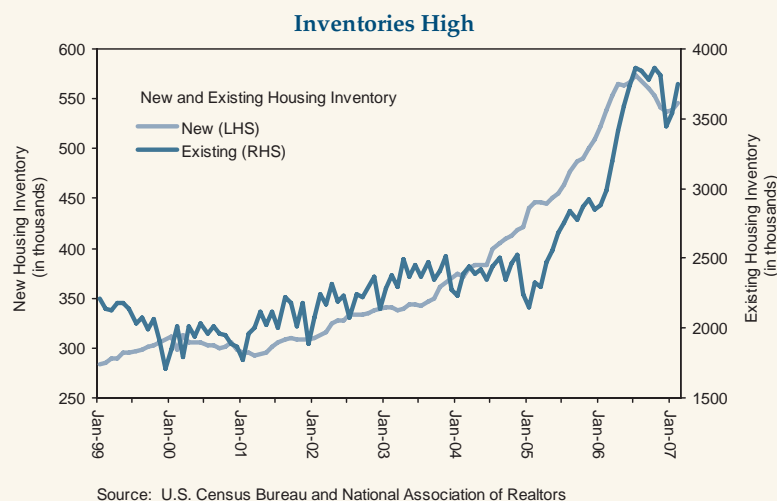
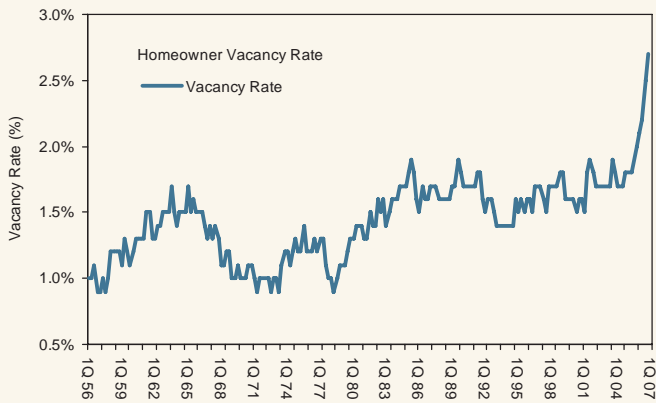


Chart 1

Even when prices appeared to have peaked over a year ago, homebuilders continued to commit to new developments and communities. Meanwhile, even in the face of large discounts and concessions, housing order rates have fallen more precipitously than most expected, resulting in inventories remaining stubbornly high. Undeveloped land cannot be monetized without a completed home. The cost of carry, including completion guarantees, provides strong incentives for builders to keep building. Unfortunately, housing is like a supertanker, which takes time to slow down. In addition, homebuilders have little incentive to stop building when a home is incomplete, even if economic conditions soften. All of these factors help to ensure that once projects are started, they are completed, and also help to explain why homebuilders' inventories have remained elevated despite aggressive incentives such as -10% to -15% price discounts.

The housing market faces potential new supply from other sources as well. First, a large portion of incremental housing demand over the past several years has come from speculators and investors. With housing prices now falling in most of the markets where speculative activity was strongest, yesterday's marginal buyer is becoming today's marginal seller. Not surprisingly, the inventories in highly speculative regions such as Florida, California, Phoenix and Las Vegas, have risen sharply. In some of these over-heated markets, supply represents several years of demand. Not surprisingly, homeowner vacancies are soaring (Chart 2). This trend may even accelerate as recent speculators with low initial equity, and negative future equity, choose to walk away from paying monthly mortgage payments on a losing investment, especially factoring in the cost of 4-5% real estate commissions.

Vacancies Soar



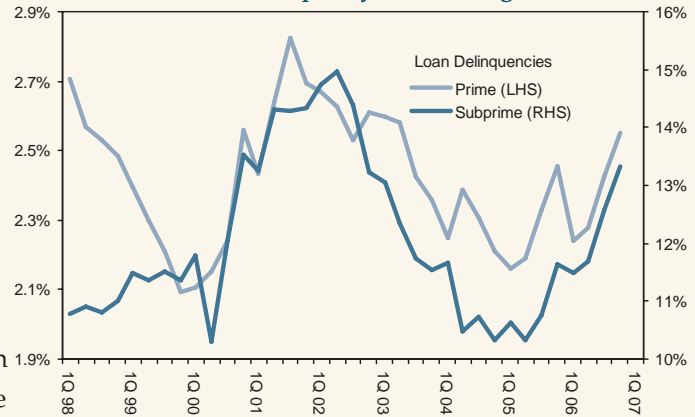
Source: U.S. Census Bureau

Chart 2

Another source of new supply will likely come from rising delinquencies which will eventually turn into more foreclosures. A growing segment of recent homebuyers have bought homes using teaser-rate, adjustable-rate, and no-money-down or low-money-down mortgages. As adjustable-rate mortgages reset upward, the housing market will likely see increased foreclosures involving individuals who can't afford the new reset rate on their mortgage. The total inventory of homes in foreclosure has risen to 437,041 homes, a

+39% increase over the past year.¹ The problem is not only in the subprime category, as delinquencies for both prime and subprime loans are rising (Chart 3).

Loan Delinquency Rates Rising



Source: Mortgage Bankers Association (MBA)
Delinquencies are for loans 60 days overdue

Chart 3

In fact, the market's primary focus on subprime ignores a major issue, which is that Alt-A and prime borrowers will also face "sticker shock" when adjustable-rate mortgages reset upward. Lehman Brothers estimates \$421 billion of ARMs will reset in 2007 (\$308 billion subprime and \$113 billion prime) and \$542 billion of ARMs will reset in 2008 (\$349 billion subprime and \$193 billion prime).² Clearly, this is not just a subprime issue, but rather an ARM reset issue as both subprime and prime borrowers potentially are forced to put homes back on the market with almost \$1 trillion of ARMs resetting over the next two years. What impact will this have on housing? According to a study published last month by First American CoreLogic, a total of 1.1 million foreclosures with losses of about \$112 billion will occur over a period of six years or more with roughly 500,000 homes going into foreclosure over the next two years.³

Rising foreclosures will result in homes coming back on the market not only at a time when current inventories are near record levels, but also when pent-up demand for housing is low. Easy lending standards and innovations in the mortgage market over the past several years brought forward future

housing demand. People who would have qualified for a mortgage in the future were given a mortgage today. Why? Lenders, hungry for yield, relaxed their underwriting standards and provided cheap money. Naturally, consumers took the bait, and levered-up with record low down payments. In fact, 46% of homes purchased in the U.S. last year had less than a 5% down payment.⁴ Over time, homeowners with little capital at risk and negative home equity will likely walk away from homes under water. For all these reasons, housing inventories are likely to remain high over the next few years.

Affordability and Risk Appetite

On the demand side, housing affordability remains near 20-year lows due to a sharp run-up in housing prices (Chart 4). While mortgage rates have come down slightly over the past few quarters, housing remains unaffordable for a large group of new potential buyers. This buyers' strike will continue until prices fall and/or mortgage rates decline. Given that homebuilders can't control the absolute level of mortgage rates, we should expect buying incentives to remain elevated over the next several quarters. Given the strong incentives for buying a new home, owners of existing homes who are forced to sell will likely be forced to lower their asking prices.



Chart 4

We know from the NASDAQ bubble that once risk appetite changes, prices can shift violently in the other direction. Housing is different from equities because it is much less liquid; therefore price adjustments take more time. In a down housing market, the gap between buyers and sellers widens, and volumes fall. Buyers pull back and sellers take time to realize their listing prices are too high.

Eventually, housing prices in entire neighborhoods will get reset downward by the weakest hand. Just as prices went up and everyone in the neighborhood applauded the newest neighbor who bought at the top, prices will likely start to fall as financially-stretched home owners and speculators sell, and are forced out of the market. As this process unfolds, risk appetite for housing should take a sharp turn for the worse. This year's weak start to the traditionally strong spring selling season suggests we have indeed entered the "buyer's strike" phase of the cycle.

Credit Availability, Lending Standards and Appraisals

A major headwind for housing in the near future will be more restrictive credit availability. Lenders are already increasingly asking for income verification and higher down payments. Countrywide changed their no down-payment lending policy last month, and is now requiring homeowners to have at least a 5% stake in their homes.⁵ Other lenders are following Countrywide's lead, which will result in a smaller pool of potential homebuyers. The threat of increased government regulation and restrictive legislation is likely to cause lenders to reduce offerings of no-documentation loans, and to ensure that adjustable-rate borrowers can qualify at the higher reset rate. This trend will tighten credit availability for potential homebuyers.

As delinquencies and foreclosures rise, lenders will also suffer losses. This should reduce their willingness to take risk and cause credit spreads to widen,

particularly for riskier borrowers. As lending standards tighten, less credit will be granted. And, credit that is granted will likely be offered at higher interest rates. In the long run, this will be a positive for the housing market, as only buyers who can afford to buy a house will buy one. However, in the short run, tighter lending standards will cause a reduction in demand for housing, and could cause the home ownership rate to fall. Given the significant increase in projected foreclosures mentioned above, an extended period of credit tightening could materialize.

As we discussed in *Credit Innovation and Opportunity*, our December 2006 U.S. Credit Perspectives, the mortgage industry's ability to develop new products that kept initial monthly payments low enabled consumers to buy homes they could not otherwise afford, and was a major factor in driving the home ownership rate up 5% in the last 10 years to today's level of 69%. With rising delinquencies and foreclosures, the downside of credit innovation will surface and may be met face-to-face with increased regulation. Innovation in the mortgage market, which has provided a huge lift to consumers and housing prices through growth in non-traditional products (Chart 5), is clearly at risk. Consumers will likely shift away from exotic mortgages, resulting in less overall stimulus for the

housing market, particularly given the lack of pent-up demand for housing.

Lenders are not the only players in the real estate market who are turning more cautious. Real estate appraisers will also become more conservative in their evaluations of property. Some appraisers, who in hindsight probably inflated appraisals over the past several years, helped contribute to the housing bubble on the way up by helping to get marginal buyers and mortgages approved in order to "make the deal work." Given heightened regulatory oversight, appraisers will turn more realistic.

As lending standards tighten (Chart 6) and appraisals become more conservative, the pool of potential homebuyers will shrink. Why? A major problem in today's housing market is not only sales to new home owners. The "move up" market, or existing owners who want to sell their current house to buy another house, is basically frozen. Outside of speculators exiting the market, this is a major reason why cancellation rates have risen. It isn't only the speculators and investors backing away. Potential new homebuyers can't sell their existing home to another buyer. As a result, they cannot move up. Changing buyer sentiment, more restrictive credit and less aggressive appraisals are all helping to restrict marginal buyers.

Housing Has Benefited From Credit Innovation

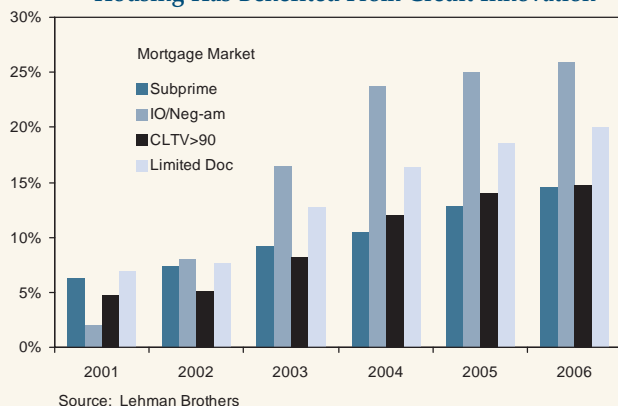


Chart 5

Credit Tightening

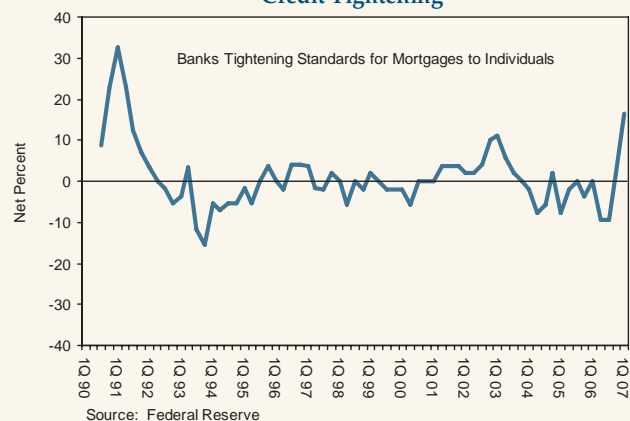


Chart 6

Where's The ATM ?

Over the past several years, consumers leveraged rising housing prices and easy credit availability using their home as an ATM. Mortgage equity withdrawal (MEW) soared, allowing consumer spending to grow faster than income growth over the past several years. This process was facilitated by rising home prices and loose lending standards. As long as housing prices were rising, lenders were willing to lend, and consumers were willing to spend, as rising housing prices gave them the confidence to draw down on savings.

Today, mortgage equity withdrawal appears tapped. Consumers have been accessing their homes as bank accounts, but housing prices are now falling in many areas, and credit is becoming more difficult to obtain. The slowdown in MEW has been remarkably swift. Over the past year, consumers tapped over \$400 billion less equity out of their homes than the previous year. And, in looking at the four-quarter moving average of MEW divided by nominal GDP, the change in MEW as a percent of nominal GDP is now -1.8% (Chart 7). Slower housing price appreciation is causing mortgage equity withdrawal to fall sharply, and is set to detract from U.S. economic growth.

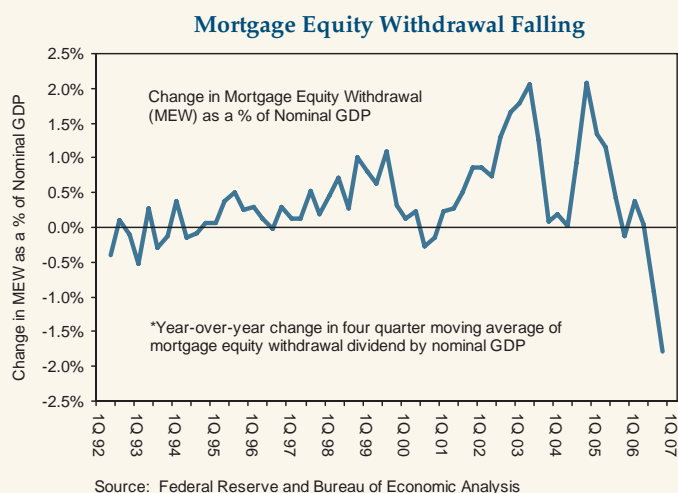


Chart 7

To understand why corporate profits may be at risk as a result of the slowdown in MEW, let's turn our attention to consumer spending. Companies make money when consumers spend. And, consumers have been spending in part due to rising housing prices, which have allowed consumers to grow debt faster than nominal GDP. Why are corporate profits as a percent of nominal GDP at new highs? Some would argue the reasons are: (a) healthy productivity gains, (b) cost cutting, (c) strong global growth, and (d) low long-term interest rates due to robust global savings. Instead, I suggest turning the focus back to the consumer and housing. Thanks to rising housing prices, consumers have been able to grow spending significantly faster than income growth, through unprecedented increases in mortgage equity withdrawal. In fact, the growth in mortgage debt parallels the growth in corporate profits (Chart 8). As a result, corporate profits, and thus economic growth, are highly dependent on housing prices. As housing prices turn negative, corporate profit growth will eventually follow.

Robust Mortgage Debt Growth Has Helped Support Corporate Profits

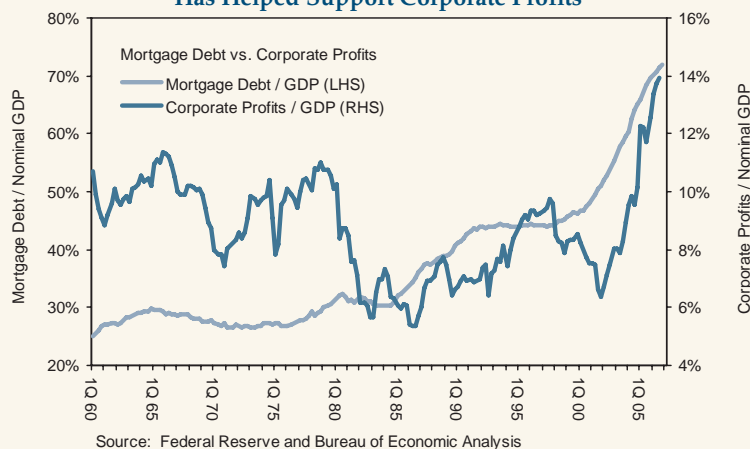


Chart 8

Housing Is Today's Leading Indicator

Housing is today's leading economic indicator. To quote our forecast from one year ago in *For Sale*, "with a softening housing market, we should expect tighter lending standards, a moderation in the

willingness to take risk, a slowdown in the pace of asset price appreciation, less liquid markets, and rising volatility in financial markets.” On the economic front, I believe declining housing prices and tighter credit are set to unleash a sharp downturn in housing turnover and job creation. As housing prices fall, corporate profits are expected to be at risk as consumers pull back their spending.

Housing is a momentum market. Turnover rises when real housing prices, as defined as housing price appreciation (HPA) minus mortgage rates, are rising. Turnover slows when real housing prices are falling (Chart 9). Today, the growth in real housing prices is falling. We believe real housing prices will turn further negative in 2007, causing new and existing home sales to decline towards 5 million units per year, down from a peak of over 7.5 million units per year in 2005.

approximately 200,000 new construction jobs last year. It would not surprise me if we lost 400,000 construction jobs this year, as homebuilders complete their existing projects and then lay off workers. As corporate profit growth deteriorates with a slowdown in housing, business investment and consumer spending, layoff announcements across all sectors of the labor market will likely pick-up.

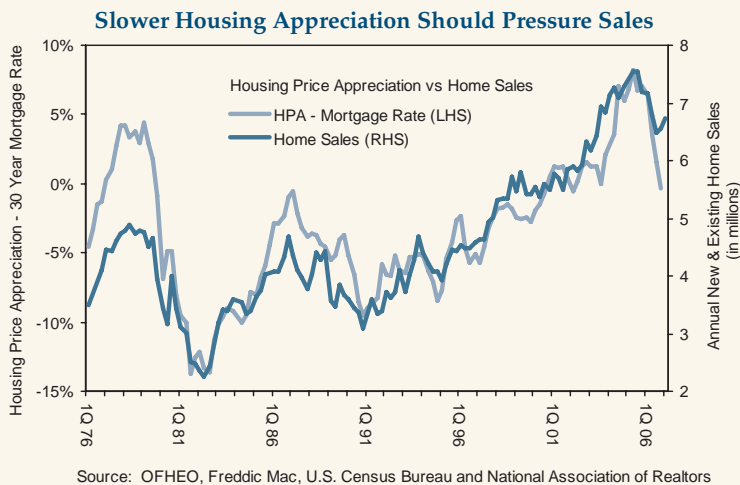


Chart 9

Housing starts and permits tend to be a good leading indicator of job growth. Through February 2007, housing starts are down -28% year-over-year. This type of decline in housing starts typically leads to a sharp slowdown in job growth, within roughly one year (Chart 10). As a result, I believe that job creation is set to slow, possibly materially. The U.S. economy created

Weaker Housing Should Lead To Less Jobs

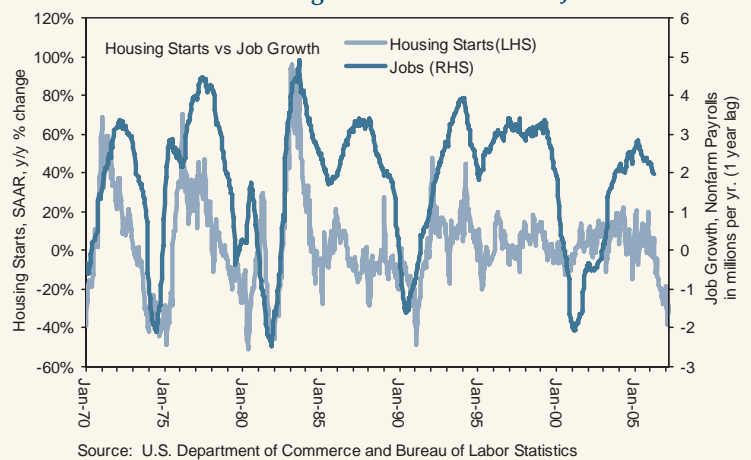


Chart 10

Investment Strategy

At PIMCO, we have anticipated the warning signs in housing and positioned our portfolios accordingly. Our duration is above index with an emphasis on the front-end of the U.S. yield curve given our view that short-term interest rates should trend lower. Our overall credit exposure is under-weight with a cautious stance on cyclical industries such as home builders, paper, building products, home appliances and retailers. Industries we favor include energy, refining, pipelines, utilities, rails, cable, metals and mining, healthcare and telecom. Given today’s environment of tight credit spreads, poor covenant protection and heightened event risk and economic uncertainty, we believe our conservative investment strategy makes sense, especially given our more negative views on housing.

Housing is today's leading indicator of economic growth and risk appetite. An extended downturn in housing will likely lead to slower job creation, softer corporate profit growth, tighter lending standards and weaker consumer and business confidence. The Fed should lower the Fed Funds rate as soon as we have confirmation that the employment situation is deteriorating. By that time, credit spreads will have already anticipated the fact that risk appetite is set to turn for the worse.

For renters and potential homebuyers, my advice is to still rent. The housing market has turned for the worse but the unwinding of this bubble will take more time. Unfortunately, this is not good news for the U.S. economy, job creation or corporate profits. Nevertheless, investors who are patient and adopt a conservative investment strategy should prosper over the next few years.

Mark Kiesel
April 12, 2007

¹ Mortgage Bankers Association, through 4Q 2006

² "Will Subprime Woes Spill Over to the Broad Markets?," Lehman Brothers, March 8, 2007

³ "Mortgage Payment Reset: The Issue and the Impact," Christopher L. Cagan, Ph.D., Director of Research and Analytics, First American CoreLogic, March 19, 2007

⁴ "Mortgages du Jour: Underestimated No More," CSFB, March 2007

⁵ Reuters.com, Countrywide ends no down-payment lending, 3/12/07

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