

For Sale

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Three weeks ago my wife, Amy, and I sold our house and moved into a rental apartment. I believe the U.S. housing market is set to cool given the current level of prices and fundamental trends. Recent price gains have likely come primarily from rising speculation and “creative financing” because affordability is declining and inventories are rising. When asset prices diverge from fundamentals, I favor taking the other side of the trade – even if it involves moving. Amy wasn’t thrilled about moving, but my sense is she will look back on our sale and view it as a good one. In the end, the fundamentals should win out.

The U.S. housing market is turning for the worse and housing price gains are set to moderate. What does housing have to do with corporate bonds? Plenty. Rising home prices have been a key driver of U.S. economic growth, which in turn has played a major role in the tightening of corporate bond spreads. In other words, housing will foreshadow not only the direction of the economy, but also the direction of credit spreads. As the housing market turns, consumers will pull back their spending and the U.S. economy should slow. 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. And at that point, “for sale” will not just be a sign you see in front of your neighbor’s yard – investors may also put a “for sale” sign on risk assets as well. Investors in the credit market should therefore remain cautious given the tight overall level of corporate bond spreads and focus on developments in the housing market.

The Outlook for Housing

The outlook for housing has turned less positive over the past few quarters. Rising housing prices and interest rates have squeezed affordability, pushing new buyers out of the market (chart 1). Federal Reserve rate hikes and rising U.S. Treasury yields have helped propel mortgage rates higher. The 30-year fixed-rate mortgage is now 6.58%, which is +120 basis points higher from levels two years ago. One-year adjustable-rate mortgages (ARMs) are now 5.62%, which is +226 basis points higher from levels two years ago. These developments have resulted in increased monthly mortgage payments. A homeowner is now able to afford a less valuable house than they were able to afford only a couple of years ago.

An example will help to illustrate this concept. Assume two years ago you bought a \$250,000 house by making a 20%, or \$50,000 down payment, and entered into a one-year interest-only (IO) adjustable-rate mortgage (ARM) at 3.36%. At this rate, your monthly mortgage payment two years ago would have started out at \$560/month. At today's one-year IO ARM rate of 5.62%, your monthly mortgage payment borrowing the same \$200,000 would start out \$937/month, or +67% higher. Had you borrowed \$200,000 by getting a 30-year fixed-rate mortgage two years ago your rate would have been 5.38%,

for a payment of \$1,121/month. At today's 30-year fixed-rate mortgage of 6.58%, your monthly mortgage payment borrowing the same \$200,000 is \$1,275/month, or +14% higher.

What if you can only afford the same payment as two years ago? Assuming you put 20% down and need a payment of \$1,121/month (using a 30-year fixed-rate mortgage), a homeowner can only "afford" to buy a \$219,775 house. Two years ago, they could afford to buy a \$250,000 house using a 30-year fixed-rate mortgage. To summarize, the +120 basis point rise in 30-year fixed mortgage rates over the past two years has caused homeowners seeking a constant monthly payment to be able to afford 12% less house.

In addition to affordability, investors should also be concerned about speculation, which

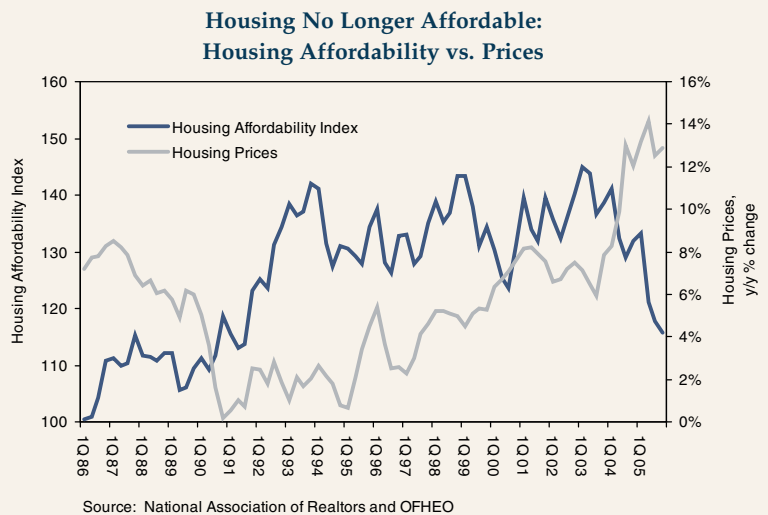


Chart 1

has increased the number of buyers on the margin. The percent of home buyers purchasing homes for investment purposes has risen from 3.8% in 2000 to 10.5% in the first half of 2005¹. We believe that rising speculation has significantly supported housing prices in the face of declining affordability.

Developments in the mortgage market have also increased the presence of marginal buyers in the housing market. This industry has transformed its product offerings in an effort to keep the initial monthly payments on new mortgages as low as possible. The growth in interest only (IO), negative-amortizing (Neg-Am), limited documentation and forty-year fixed rate mortgages attests to the industry's use of "creative financing" to keep the game going. For example, IO and Neg-Am loans represented 1% of total mortgage organizations five years ago but have climbed to 22% as of 2005². Banks have been able to maintain easy lending standards, despite higher short-term interest rates, by securitizing mortgage loans and transferring the risk to foreign buyers.

The incredible growth in both new players and new products has transformed the housing market. I believe this is the main reason housing prices have risen so much faster than income

growth over the past few years (chart 2). In fact, the secular change in lending practices helps to explain why the U.S. economy has remained resilient in the face of consistent Fed Funds rate hikes.

However, history reminds us that over the long-run housing price gains should roughly match income gains. With current +13% annual housing price gains exceeding the +4% growth in personal disposable income by a record margin, today's environment appears unsustainable. The current +9% gap is unprecedented in looking back over the past 30 years. This trend should reverse course. While Fed tightening has so far done little to change lending standards, delinquency rates are picking up and foreclosure rates are rising. In addition, banking regulators are beginning to crack down on risky loans and

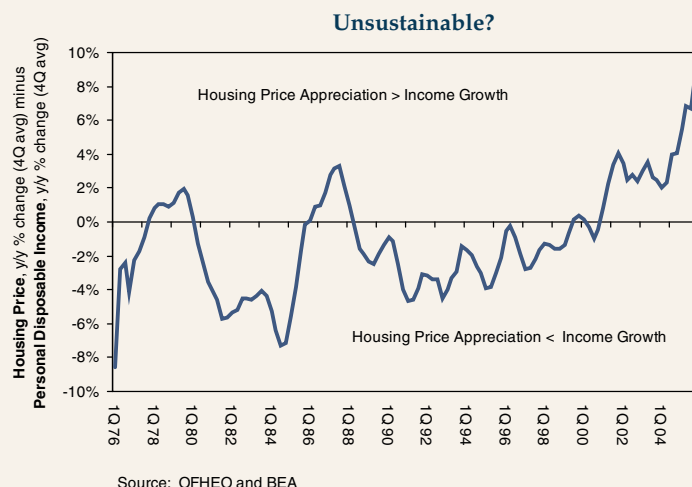


Chart 2

lending practices. These are clear signals that lending standards are set to tighten.

Demographics are another factor to keep in mind. While demographic trends are more secular in nature, there is no doubt that aging baby boomers have been supporting the housing market, particularly in warmer regions of the country, through a pick-up in second home purchases. The overall home ownership rate has risen by a sharp 5% over the past ten years to an all-time high of 69%.³ While part of this increase has likely been driven by wealthy baby boomers, the rise in homeownership has clearly been influenced by cyclical tailwinds and the proliferation of “creative financing.” As these winds change direction, the home ownership rate should level off and housing is likely to provide less support to the economy.

Investor preferences should also be considered. The bursting of the Nasdaq bubble was likely the catalyst for a substitution trend, causing individuals to move out of equities and into homes. Individuals, no longer wanting the volatility of the stock market, sold stocks and moved into what they considered to be the safer choice – real estate. A year later, tragedy struck on 9/11/01. This event

further dampened consumer confidence, causing people to travel less and invest more time and money into their homes. The corporate scandals of 2002 reinforced the belief that real estate was more secure than the stock market. Meanwhile, the Fed, in an effort to reflate the economy, supported the transition into housing by lowering short-term interest rates all the way to 1% in June of 2003. Finally, once mortgage rates started to move higher, lenders became more creative with financing in order to attract new buyers. Any mortgage that kept monthly payments low was marketed. Homebuyers took the bait. The use of interest-only (IO) mortgages soared. Documentation for new loans became less stringent. Down payments fell. These forces all combined to create a wave of asset reflation and housing was the direct beneficiary. However, past momentum is unlikely to continue.

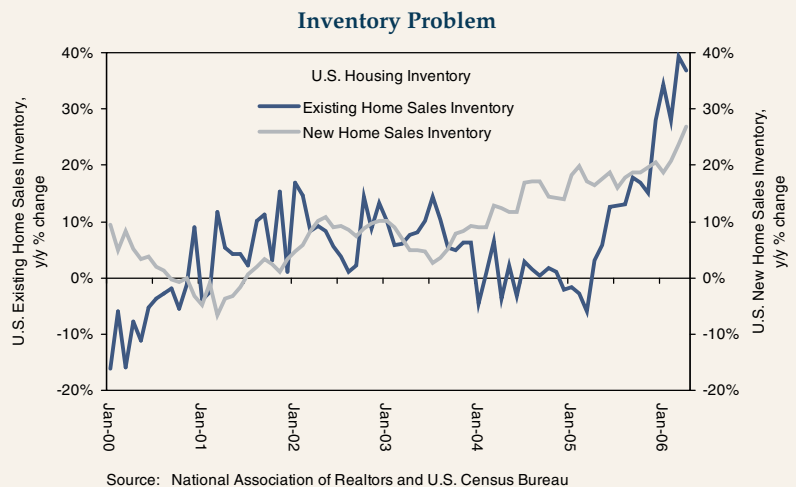


Chart 3

Housing inventories are becoming a problem. Presently there are almost 4 million homes available for sale nationwide, including 3.383 million existing and 565,000 new homes. Current inventories are at record levels, having risen 27% and 37% year-over-year for new and existing homes, respectively (chart 3). Given declining affordability and rising inventories, we expect to see homes for sale remain on the market longer and asking prices come down. The housing market should quickly transition from a sellers' market to a buyers' market.

In summary, the main forces driving housing price appreciation in the past are now softening. Declining affordability, resulting from rising prices and interest rates, has become a significant headwind facing new buyers. Despite the persistence of creative mortgage financing, prices have now risen to a point where demand is slowing. Federal regulators are beginning to crack down on risky lending practices. Speculators are shifting from buyers to sellers. Mortgage application growth is slowing. Finally, and most importantly, the supply and demand imbalance in the housing market is turning sharply for the worse as inventories soar.

Homebuilders

The current state of the homebuilding industry also foreshadows a cautious

outlook for the housing market. Homebuilders are reporting a decline in buyer traffic and rising cancellation rates. Some homebuilders have seen 30-35% decreases in new orders on a year-over-year basis⁴. Not surprisingly, new home purchase incentives, including subsidized financing, free landscaping and rebates, are sharply on the rise. However, offering these perks does not change the fact that homebuilders hoping to sell new residences are facing an already crowded market. The inventory of existing homes has reached record levels, as speculators attempt to realize gains and some new homeowners choose to sell given the impact of rising monthly payments due to increases in rates on their ARMs. Oversupply is dampening the sales of both new and existing homes. Land acquisitions made by homebuilders over the past few years (chart 4) will not help the current situation. Such purchases are made with the intent of development after a time lag. Therefore, over the next

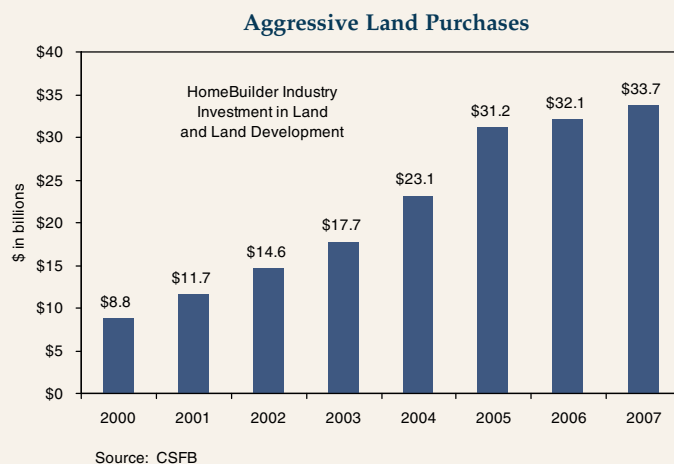


Chart 4

few years, homebuilders will either flood the market with additional inventory or be forced to write-down the value of their undeveloped land on their balance sheets. If homebuilders continue to build, new home prices are likely to fall. While good news for potential buyers, it is an unwelcome transformation for would-be sellers, who are probably approaching the point where it is too late to sell.

Investors in homebuilder companies should pay close attention to liquidity. Real estate is about to become less liquid as turnover volumes soften. Sellers needing cash will likely be hitting bids below the market as buyers turn more cautious. In addition, financing for both homebuilders and homebuyers will become tighter. The period of “cheap money” is over. As these developments unfold, creditors will demand both higher interest rates, larger down payments and more security or collateral. Homebuilder margins should come under pressure from both weaker overall demand, rising construction costs and higher interest rates. Profit growth and cash balances will both come under pressure. In this environment, bondholders should be demanding covenant protection as well as higher spreads on homebuilder bonds. Lenders to homebuyers should also protect themselves from less liquid markets by charging higher rates.

Housing and the Economy

So what do the leading indicators of housing market trends signal for the outlook for U.S. real GDP and consumer spending? To answer this question, we turn to the University of Michigan and National Association of Home Builder (NAHB) surveys.

The University of Michigan regularly surveys consumers on whether or not it is a “good time” to purchase a home. This survey attempts to gauge whether or not consumers feel (a) housing is a good investment, (b) housing prices are low and there are good deals available, (c) interest rates are low, and (d) times are good. The index has ranged from 53 (low) to 87 (high) over the past eighteen years and is currently at 57 indicating that consumers do not feel it is a “good time” to buy a house. This is likely due to high home prices and rising inter-

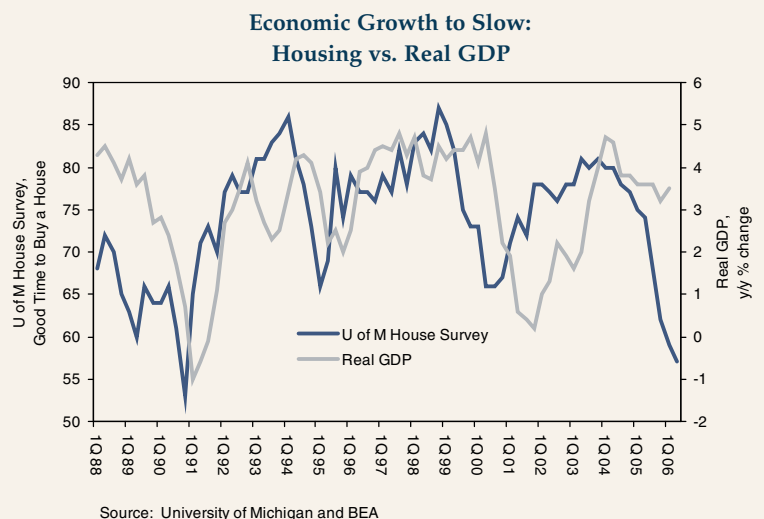


Chart 5

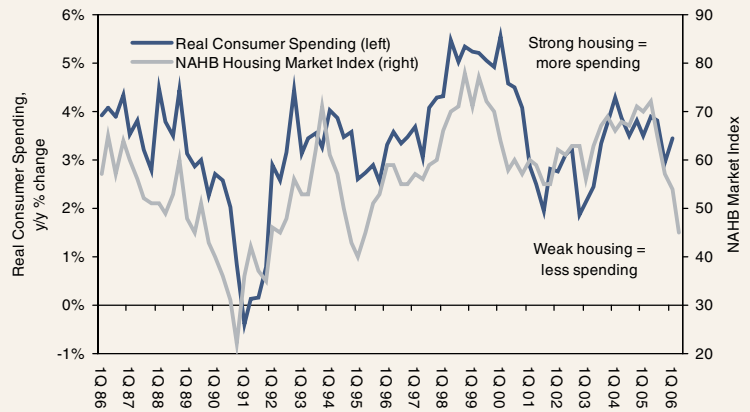
est rates as well as a growing belief that housing is unlikely to be a good investment going forward. Interestingly, the University of Michigan survey on housing tends to lead U.S. economic growth by a few quarters (chart 5). The sharp deterioration in this survey from 75 early last year to 57 now suggests the U.S. economy should start to slow soon.

The National Association of Home Builders (NAHB) takes a monthly survey of its members and calculates a housing market index based on (a) single family detached home sales, (b) single family detached home starts, and (c) traffic of prospective home buyers. The index ranges from 0 (least favorable) to 100 (most favorable), with 50 representing an equal number of members who believe conditions are unfavorable vs. favorable. The index has ranged from 22 (low) to 79 (high) over the past twenty years and is currently at 45, having declined more than 25 points in just over one year. Conditions have deteriorated for the overall housing market. This is important as a slowdown in housing tends to lead rather quickly to a slowdown in consumer spending (chart 6).

Time to Move?

I am not suggesting that everyone should sell their house and move into an apartment. However, for the reasons discussed above,

**Weaker Spending Ahead:
Housing vs. Consumer Spending**

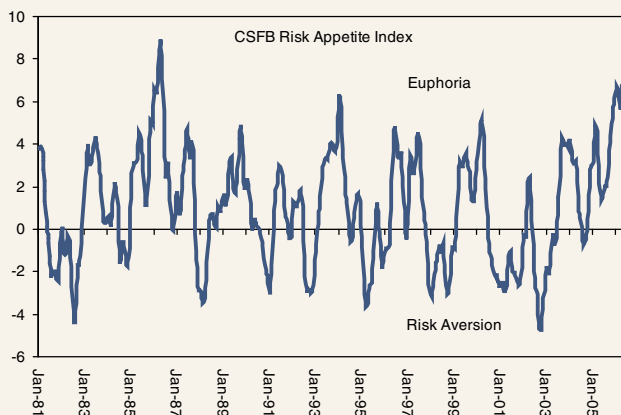


Source: National Association of Home Builders (NAHB) and BEA

Chart 6

housing should not be a source of economic stimulus going forward. While an increasing number of homeowners will likely choose to take profits on their homes, corporate bondholders should consider “moving” as well. Risk appetite (chart 7) has been abundant in financial markets; however, we should expect investors’ euphoria to change going forward given a more cautious outlook for housing.

Risk Seeking at a Peak?



Source: CSFB

Chart 7

Housing is a leading indicator of the overall direction of the economy. As housing slows, economic growth will surely follow. As such, we should expect to see tighter terms on credit extension, less liquid markets and a pick-up in the overall corporate default rate over time with a slowdown in the pace of economic growth. An eventual rise in the default rate, combined with higher near-term volatility, should lead to a more challenging

market environment for credit. Watch the “for sale” signs – in both the housing and corporate bond market – my sense is more of both are coming as the market transitions from a mode of risk taking to that of risk aversion.

Mark Kiesel

May 26, 2006

¹ Credit Suisse, February 2006 Homebuilder Monthly, page 35, exhibit 44.

² Credit Suisse, February 2006 Homebuilder Monthly, page 18, exhibit 21.

³ U.S. Census Bureau, 4Q 05.

⁴ Toll Brothers Inc., 2nd qtr earnings release, 05/23/06. Ryland Homes, 2006 outlook update, 05/25/06.

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Each sector of the bond market entails risk. Mortgage-backed securities are subject to prepayment risk. With corporate bonds there is no assurance that issuers will meet their obligations. In an environment where interest rates may trend upward, rising rates will negatively impact fixed income securities. Bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

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