

**In Focus**

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**Scott Simon Discusses the Outlook for the US Housing and Mortgage Markets****Scott Simon**

*Managing Director, Head of PIMCO's Mortgage- and Asset-Backed Securities Portfolio Management Teams*

Mr. Simon is a managing director in the Newport Beach office, a senior member of PIMCO's portfolio management and strategy groups and head of the mortgage- and asset-backed securities teams. Prior to joining PIMCO in 2000, he was a senior managing director and co-head of MBS pass-through trading at Bear Stearns. He also authored The Daily MBS Commentary there. Mr. Simon has seven times been named to positions on the Institutional Investor All-America Fixed-Income Research Team, including first place in MBS pass-throughs and overall MBS strategies. He has 26 years of investment experience and holds both master's and undergraduate degrees in industrial engineering from Stanford University.

*The state of the US housing market continues to play a dominant role in the overall economic outlook. In the following interview, Scott Simon, managing director and head of mortgage- and asset-backed securities portfolio management at PIMCO, discusses the current situation in the housing and mortgage markets; the potential effects on the markets of the various government programmes and loan modifications; the outlook for mortgage rates, home prices, inventories and foreclosures; and the current value in Agency mortgage-backed securities compared to Treasuries.*

**Q: The US government has enacted a number of programmes to shore up the mortgage market and support housing, including the Troubled Assets Relief Program (TARP), the Homeowner Affordability and Stability Plan, the conservatorship of Fannie Mae and Freddie Mac, and the Federal Reserve and the Treasury Department's direct purchases of Agency MBS. Are they having the desired effect?**

**Simon:** These programmes are all helpful, especially in aggregate. Mortgage rates are about 1.5 percentage points lower than they were in November; it's hard not to view that as some degree of success.

That drop in mortgage rates increases the affordability of housing by about 15%. There are two ways you can look at that: for the same monthly payment you can buy a 15% bigger house, or you can buy the same house you wanted for 15% less. Ultimately that's the most important issue, because the purchase rate is more important than the refinancing rate.

For instance, if \$2 trillion of loans are refinanced at rates 100 basis points lower, that's only about \$20 billion in aggregate savings for consumers. Obviously it's important to each individual, but in the scope of the entire economy it's not a tremendous savings compared to gasoline, for example, which given the drop in prices from their peak is saving consumers about \$400 billion a year in aggregate.

The housing market and the economy really need rates to drop to a level where individuals believe houses are cheap enough, or payments low enough, that they have to

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own one. That's how to get housing prices to stop going down – by mopping up inventory. Foreclosures also need to be addressed, and truly preventable foreclosures avoided. In the end, though, we need to see housing prices stop going down, and the easiest way to accomplish that is to give people more buying power to purchase houses.

### **Q: What else needs to be done?**

**Simon:** There are two things I see that would be very important: 1) addressing the negative equity problem that homeowners have, and 2) targeting lower purchase mortgage rates.

The negative equity issue is huge. Almost 30% of mortgage holders are upside down on their homes – the mortgage is larger than the value of the home. This means that “willingness to pay” is becoming a bigger factor than “ability to pay” in many housing markets. Rational people will start walking away from their homes just to jettison the negative equity position.

The original Frank-Dodd proposal to Congress was on the right track: combine loan principal reductions with an immediate refinancing into a government-sponsored loan through Ginnie Mae (GNMA), Fannie Mae (FNMA) or Freddie Mac (FHLMC). This has a host of real benefits, including 1) it helps homeowners stay in their homes by reducing their underwater position, and 2) it helps the banks and investors, as it removes “toxic assets” from their balance sheets due to refinancing. It also solves the valuation issue on securities as it focuses only on the value of the home and mortgage, not the value of some arcane security. This will help the overall markets (both housing and mortgage markets), reduce foreclosures (and help real estate values), reduce uncertainty about securities valuations, reduce uncertainty about the value of bank assets and help remove toxic assets from bank balance sheets in a less controversial way.

The other simple programme would be for the government to subsidise purchase-only mortgages for homeowners. Inventory diminishes through purchases, not refinancings, so purchase loan subsidies have a much bigger bang than refi subsidies. I don't know the rate that makes everyone “need” to buy a home, but I believe 4% to 4.5% will attract a lot of new buyers.

### **Q: Are banks or other lenders more willing to lend, or are investors more willing to buy MBS?**

**Simon:** There is almost no appetite to buy MBS except those that are issued by government-sponsored enterprises (GSEs). The only real MBS demand is for Ginnie Mae, which is explicitly guaranteed by the government, or Fannie Mae and Freddie Mac, which are now explicitly supported by the government.

This means that homebuyers seeking jumbo loans – even prime borrowers with big down payments – are still getting rates that are a percentage point or two higher than conforming mortgages, which meet the Agency requirements. That spread between jumbo and conforming mortgages is exceptionally wide, in part because the market is

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afraid that programmes to modify loans in the non-Agency market could lead to violations of contract law and property rights.

The main reason lenders are willing to lend money to homebuyers at all is that the loan is collateralised by the house. The buyer puts some money down as well, and if there is a problem the lender gets the house. But at the point where the market questions whether that is truly the case, or whether modification programmes may interfere with contract law and property rights, the lender is going to require a premium for taking on that added risk.

From the investor standpoint, extending a home loan where there is a risk of not getting the collateral back is basically the same as investing in unsecured debt, such as credit card debt. There are not a lot of investors willing to lend \$500,000 at 5¼% on a credit card. So to the degree that the non-Agency mortgage market is perceived to be debased, and heading from a collateralised market to an uncollateralised market (cf. the credit card market), the availability of loans of that size goes down and the cost of that credit goes up.

**Q: Mortgage rates have come down from their peak and there are ongoing government programmes to support the mortgage market. Do you expect mortgage rates to keep falling?**

**Simon:** There are two elements that we have to consider: one is the really soft economy and another is the lack of inflation in the current environment.

While the Federal Reserve can try to stimulate housing, it can't repeal the business cycle. It can't change how savings rates are rising because people were overextended. It can ameliorate the economic weakness somewhat by keeping policy rates low for some time. With low policy rates and no imminent inflation threat, we don't expect mortgage rates to go meaningfully higher from here. They could periodically drift higher, but we don't expect them to go back to where they were before all of these programmes were implemented. That said, rates probably won't go significantly lower unless economic fundamentals get considerably worse than they already are and the Fed and the Treasury try more aggressively to lower mortgage rates.

**Q: Some policymakers have hinted at a 4½% target for mortgage rates. Is that a realistic target?**

**Simon:** A rate that low would be helpful in terms of increasing affordability. But if policymakers do that, they should target buyers instead of refinancers, especially at this time of year when home sales are seasonally pretty slow to begin with.

Currently about 90% of the mortgage volume is in refinancing and only 10% is for home purchases. Going back to my earlier point, given the limited amount of money available for these programmes, loans that are used to purchase a house are a much more efficient way to support the housing market. Unlike refinancing, purchases reduce inventories and support prices, which in turn stem the decline in value of the collateral for all outstanding mortgages.

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**Q: Looking at the trajectory of home prices, would you say the worst is behind us, or are housing prices likely to continue falling?**

**Simon:** Our view really has not changed very much since 2005, when we forecast that 2007 would not be a good year, 2008 and 2009 would be very bad, and that prices would eventually bottom late in 2010. We are about two-thirds of the way from peak to trough.

With the actions the government is taking, we are seeing probably the first glimmer of increased hope. Whether it is by making credit cheaper or more available or working on loan modifications, these programmes will mean the bottom in housing prices is likely to be higher in price, and likely to happen sooner than it otherwise would have.

So, depending on what comes out of Washington in the next few months, it's possible that housing could bottom out at the end of 2009. If they adopt the 4½% target we discussed, or if they implement responsible loan modification programmes, I think that this could happen. But housing is still going down, and even if it hits bottom by the end of 2009, it's not going to recover anytime soon. Prices will stay flat for a while after they bottom out, but the key is to make housing prices stop dropping.

**Q: Are inventories still at very high levels right now?**

**Simon:** Inventories are still very high. However, both existing and new home inventories have come down a lot; homebuilders have stopped building houses, and they have stopped applying for permits. In fact, permits are way through their lowest levels since the Commerce Department started tracking them about 50 years ago.

The number of permits as a percentage of households has sunk to 50% of the previous all-time low! From an inventory perspective, the halt in homebuilding will help. On the flip side, however, foreclosures continue, and this puts upward pressure on the number of homes for sale.

**Q: What is the trend in the foreclosure rate? Have foreclosures peaked yet?**

**Simon:** Foreclosures are continuing to rise. Foreclosures are also at levels we haven't seen since they started keeping statistics, but I expect them to continue to rise. This is why modifications are a big deal. Modifications are a huge political football, but they are a reality and very important for homeowners.

PIMCO's view is that whatever creates the most value is what ought to be done. That could mean forgiving principal or reducing the interest rate; it could also mean foreclosure. However, the most important thing is to modify loans for those homeowners who are willing and able to continue to pay their mortgages once they have been modified. More than half the modifications that have already occurred have ended up redefaulting within five months. That really doesn't help anyone. So the cornerstone of any loan modification programme should be to prevent *avoidable* foreclosures.

Unfortunately, there will be unavoidable foreclosures. So a responsible modification programme would need to look at foreclosures on a loan-by-loan and homeowner-by-

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homeowner basis, and should assess income, expenses, the house's value and the conditions of the old mortgage.

You need to be careful, because if you violate contract law and property rights, you are going to blow up the mortgage market. It is not a violation of contract law and property rights to give people loan modifications as long as they increase value and ultimately increase the recovery on the loan.

**Q: We are seeing massive increases in unemployment. Is the rising unemployment rate having a meaningful impact on the housing market? And is that already baked into the cake in your outlook?**

**Simon:** The weak economy and rising unemployment are completely counterproductive to a recovery in housing. We think the trends in the economy and jobs will continue. But now the government is on the other side rolling out programmes that are, by any historical standard, the most powerful and aggressive since the Depression.

Clearly Washington gets it. There will of course be disagreement over the implementation, but I don't think anybody on the Hill disagrees that this is a big problem that needs to be addressed by the government.

**Q: In the current environment, there are probably still a lot of unknowns. What are the risks to the outlook at this point, whether it's a recovery that's sooner than expected or a recovery that takes longer than expected? How are the risks distributed?**

**Simon:** I think there is more of a risk that a recovery will take longer than expected. It could be that the government pumps all of the stimulus into the economy, and we still end up in a situation like Japan in the 90s, where the economy just continues to flounder for a very long time. Ultimately, people need to come out of their shells and buy houses, and buy products; that's what's going to create jobs.

Many people have been emotionally scarred by all this. People believed they were wealthy, but their wealth was in their houses, and it went away. And unlike the NASDAQ bubble, which affected a relatively small number of people, there are 70 million households in the US, so this is being felt throughout the economy.

**Q: How are the trends in the housing market and the mortgage market driving your investment outlook? What are your views on MBS – are they still attractively priced? We've heard from Bill Gross that his purchases of MBS are plateauing.**

**Simon:** PIMCO's MBS purchases are plateauing at a very high level. We still like mortgages very much. We think that government-guaranteed or explicitly supported Agency MBS is still very inexpensive, particularly compared to Treasuries, which actually have a similar risk profile. We think Agency MBS represent excellent value relative to both Treasuries and swaps, and that they offer investors some of the highest risk-adjusted returns.

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Our investment in Agency MBS is not dependent on any of the outcomes in the economy or in the housing market. It is not a credit play. That is, we're not betting that housing will either turn around or collapse. As is the case with many of our current investment strategies, we are, essentially, investing alongside the government.

**Thank you, Scott.**

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