

The Campbell Real Estate Timing Letter

Separating likely probabilities from whims and pure hope

The only real estate timing advisory for Southern California investors

January 15, 2009

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Housing Forecast for 2009: More Deflation Ahead

The extreme of any position will ultimately become its opposite.
– Epicurus (500 BC)

Throughout history, there are some universal truths that never change. Just as high tides are always followed by low tides, every market move is always followed by a reaction. That's why a boom is always followed by a bust. It's simply the nature of mankind. And when the booms go to extremes, it's only logical that so do the busts.

The bust, however, always catches most people by complete surprise, as it strikes from what appears to be the height of apparent prosperity. Yet what is often not seen is as important as what is seen – or wants to be seen – namely that the boom was only the result of speculative excess.

In the U.S. we have lived believing in a number of myths about real estate. One of those myths was that home prices will go up forever. The past couple of years should be known as “myth busting time”. The hard lesson learned – which keeps repeating itself time and time again – is that in a free market economy if there is a good idea that seems to create wealth quickly, it will be identified, copied and mass created until it creates failure.

Like it or not, the most general principle of economics is that all actions have consequences. When people say that the way to real estate wealth is to increase credit, this is essentially another way of saying that the way to real estate wealth is to increase debt. This doesn't sound nearly as appealing, does it? But like a coin, all economic actions do have a reverse side – namely, that inevitable consequences follow every action.

Can easy money lending practices inflate real estate prices in the short-run – and create apparent wealth? Sure, they can – and it allows everyone to “shop until they drop” and live the good life on borrowed money for awhile. But you also have to consider the long-run – which is the other side of the coin – that follows: that the debt has to be paid back.

And as I've stated in previous Timing Letters, this is where the problem arose: borrowers took on far more mortgage debt than they could ever pay back and that's why real estate prices are crashing and we are witnessing the destruction of the biggest credit bubble in history. And in absence of dramatic increases in household incomes that are needed to service this massive amount of mortgage debt, all the bailouts in the

world are unlikely to stop housing prices from eventually reverting back to the 2001 pre-bubble years – or close to it.

The root cause of the real estate crash is that housing prices became highly-inflated and severely overvalued. To try to stop (or reverse) this crash, the government's desperate attempt to lower short-term interest rates to zero, stimulate the economy with historically unsuccessful Keynesian borrow and spend policies, and to recapitalize the banks to keep them afloat doesn't change the mathematics of housing's unaffordability.

Furthermore, these policies didn't work in Japan from 1990 to 2008 – where housing prices in most cities today are still roughly 40% lower than their 1990 highly-inflated peak values – and I doubt that they are going to work in the United States.

The good news is that this housing crash is not destroying any real value. We are only giving back what we didn't deserve in the first place.

Let's now take a look at where we are in the housing cycle and what I expect to happen in 2009.

The Aftermath of a Financial Crisis

After the credit bubble burst in 2007, it has been a steep downhill journey for real estate. Since then, the Federal Reserve Board has been hyper-active in pumping over a \$trillion of liquidity into the financial and lending system in order to try to stimulate home lending and arrest the fall.

Fannie Mae and Freddie Mac were given \$600 billion of taxpayer money in 2008 to keep interest rates down. So far, these efforts have been successful as 30-year fixed rate mortgage fell to 5.19% in December, a 50 year low. The Fed is also considering a program – sponsored by Fannie and Freddie, and again at the taxpayer's expense – that would provide 4.5% 30-year conventional loans (under \$417K) to new home buyers. In other words, the Fed is pulling out all stops in an attempt to prevent further deflation in housing prices – and hopefully start forcing prices to rise higher again.

The key question we have to ask ourselves as real estate decision-makers is whether government programs can (or will) work. After the implosion of the biggest debt and real estate bubble in U.S. history – which has brought us the greatest financial crises since the Great Depression of the 1930s – can the Fed and the U.S. government now come to the rescue and magically engineer programs that will keep the crises from getting worse and bring about a 2009 housing and economic recovery?

If you study history, the answer is “no.”

I say this because Professors Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard have researched this for us in a December 2008 paper titled “The Aftermath of Financial Crises.”

In studying 21 different episodes dating back to 1899, they found that financial (banking) crises are “protracted affairs” that create economic downturns that are much more severe than your normal business-cycle recession. While my Timing Letter focuses on residential real estate trends, you should know that residential real estate has always been a cornerstone and a key leading macro-indicator to a country's economic health. Thus, odds are high that as real estate goes, so goes the economy.

Feinhart and Rogoff found that the aftermath of severe financial crises share three real estate and economic characteristics:

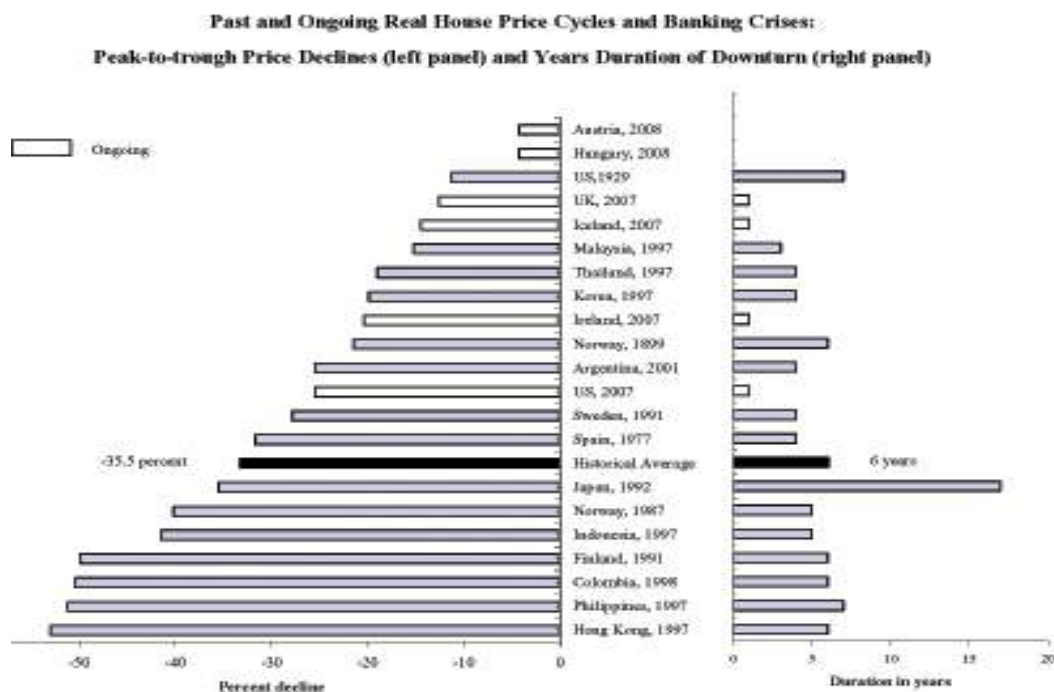
1. Asset market collapses are deep and prolonged. Real declines in housing prices average 35% and last an average of six years. Stock market prices fall by an average of 55% over a downturn of about three and a half years.
2. Economic output (GDP) and employment suffer steep declines. The unemployment rate rises by an average of 7 percentage points above the low point in the cycle, and lasts an average of roughly five years. Economic output falls (from peak to trough) an average of over 9%, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment.

- The national debt tends to explode, rising an average of 86% in major post World War II episodes. Interestingly, the main cause of debt explosions is not widely cited costs of bailing out and recapitalizing the banking system. Instead, it is caused by an inevitable collapse in tax revenues that governments suffer because of deep economic contractions, as well as the often ambitious Keynesian borrow and spend counter-cyclical fiscal policies that are aimed at fighting the downturn to bring the economy back to a more acceptable level of employment.

Housing Downturns after a Financial Crisis

The graph below is from the Reinhart and Rogoff study. It looks at how far housing prices fall and how the downturns last after a financial crisis, and it includes the current episode in the United States as well as other six other countries also experiencing financial crises: Austria, Hungary, Iceland, Ireland, Spain, and the United Kingdom. The six ongoing crises are shown by the unshaded bars while the 15 past crises are shown by the shaded bars.

Figure 1



Not including the six ongoing crises, the historical average for the past 15 crises resulted in a 35.5% peak to trough decline in real housing prices. This is shown by the solid black bar on the graph.

The four worst housing crashes occurred in Finland, the Philippines, Columbia and Hong Kong, where prices fell from over 50%, measured peak to trough. As measured by the 20-city Case-Shiller Housing Price Index, prices in the United States have fallen 30% from their peak values during the current episode.

The length of housing price declines averaged roughly six years. And even if we exclude the astonishingly long 17 year price decline for Japan housing prices, the average still remained over five years.

What Do the Post Financial Crises Averages Foretell for the U.S. Economy and Its Asset Markets?

Assuming the current U.S. financial crisis turns out to be the same as the historical averages stated above, let's calculate how this is going to play out. Note: The historical averages are measured from peak-to trough, starting in the year of the crisis – which I submit to you was the year 2007 for the U.S.

To calculate how far U.S. housing prices would fall, I will use the Case-Shiller 20-City Index. In January 2007, the 20-City Index was at 221 but it fell to 201 at the end of the year. If we take an average of the two, we get 211. Because housing prices fall by an average of 35% after a financial crisis, the 20-City Index would have to fall to 146 to be “average” – which represents an 8% decline from the current reading of 158. If we exclude the 1992 Japanese episode and use five years as the average length of housing downturns, we can expect the U.S. housing market to trough in the year 2012.

To figure out how far and how long the U.S. stock market would fall, the S&P 500 peaked at about 1570 in late 2007, right after the start of the financial crisis. If the S&P falls by the average of 55% from that peak high, it would fall to roughly 700 at the trough. If the downturn lasts the average of three and a half years, this low point in the S&P 500 would occur between late 2010 to early 2011.

How much would the U.S. economy contract? The Gross Domestic Product (GDP) for the U.S. was \$13.8 trillion in 2007 (Bureau of Economic Analysis). If GDP were to fall by the historical average of 9%, it would fall to \$12.6 trillion at the trough – which would likely occur in 2009 because economic downturns tend to only last for two years.

The U.S. unemployment rate would rise to 11.4%, seven percentage points above the 2007 cyclical low of 4.4%. This would become the highest rate of unemployment since the 1930s – taking out the old post WW II high of 10.8% which occurred in 1982, right after the end of the severe 1981 recession. This would mean at least another 6 million to 7 million jobs could be lost from current levels. The December 2008 unemployment rate jumped to 7.2%, the highest since 1993. There are currently 11 million unemployed workers in America. Because rises in unemployment last for an average of five years after a financial crisis, the peak year for joblessness would be 2012 – three years after the averages say the U.S. economy would be expected to hit bottom.

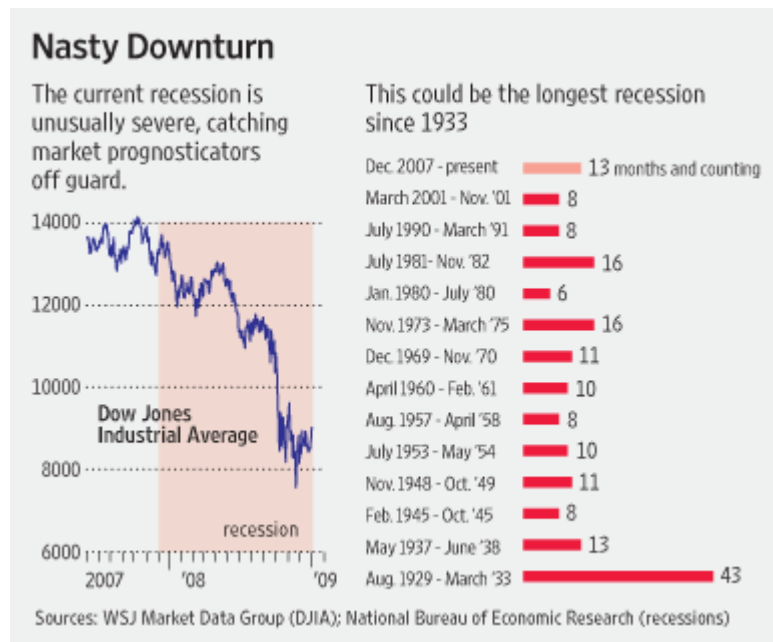
In 2007, the U.S. national debt was about \$9 trillion. As calculated by the Feinhart and Rogoff research, if it were to increase by the post WW II average of 86%, the national debt would rise to a staggering \$16.7 trillion in the aftermath of the current U.S. financial crisis. Impossible you say? Hardly. President-elect Barack Obama said on January 5, 2009 that the nation probably faces huge deficits – record deficits, likely in the range of \$1 trillion or more – for years to come. Do you wonder how we will ever be able to pay all this money back? Because of the inexorable laws of compounding interest – I do, and I seriously doubt that we will ever be able to pay it back. Nevertheless, in order to create 3 million “make-work” jobs to temporarily spur the economy and break the momentum of the recession, the government is frantically engaging in a “short-term gain vs. long-term pain” economic recovery program. To me, it’s simply another version of a Ponzi financial scheme: borrow and spend now, and worry about the future and the adverse consequences later.

That future will arrive – and maybe sooner than you think. I hope you are aware that the government has nothing to give you without taking it away from someone else – or from you. The current stimulus programs of borrowing from yourself to pay yourself may work for awhile in the short-run but it doesn’t work in the long-run. Like it or not, there is no free lunch.

But back to today’s reality – and what we have to deal with right now: This financial crisis is not likely to result in an ordinary U.S. “garden variety” recession that bounces back quickly.

Not hardly. The study of similar patterns from the past show that this financial crisis is likely to be a long extended affair, leading to deep and lasting effects on asset prices (real estate, stocks, and commodities), economic output, and employment.

Furthermore, this dismal forecast of a long and severe recession is already supported by current data. According to a Jan 5, 2009 Wall Street Journal article – and looking at the chart on the left - “Since the Great Depression, only two recessions have run longer than this one, the first ending in 1975 and the other in 1982. Each lasted 16 months, according to the National Bureau of Economic Research, the government-designated recession tracker.”



Where We Are in the Housing Cycle

Before we see a bottom in the housing market, I feel the two most fundamental issues that need to be resolved are high prices and too much inventory (supply).

Even though housing prices have already gone through a significant correction, they are still too high. To give you some historical perspective on this, look at the chart to the right, courtesy of [ContraryInvestor.com](#). Going back to 1963, the chart plots the ratio of median family home prices vs. median family incomes in the U.S. The horizontal dotted line shows that the average of this ratio has been 325% for the past 45 years. To get back to 3.25 times family incomes, the median priced U.S. home would have to fall another 12% from current levels to return to the historical average.

This additional 12% fall correlates rather closely with the estimate made earlier in this Timing Letter, namely that the Case-Shiller 20 City Index would have to fall another 8% from current levels in order to reach the average 35% fall that occurs after a financial crisis.

Here's another formula for predicting how far prices could fall. As I said earlier, I think U.S. housing prices will eventually fall to at least 2001 prices, which was the year when the housing bubble started. According to the National Association of Realtors (NAR), the median priced home was \$150,000 at that time and then proceeded to soar to a peak price of \$240,000 in late 2006. (The median value is \$180,000 today - the same as it was in 2004.) If prices retreat back to \$150,000, we'd be looking at a 38% correction from the peak and prices that are 16% lower than they are today.

As you can see, all three estimates fall within a reasonably close range – and tell us that U.S. housing prices are likely to fall another 8% to 17% before they hit bottom.

Let's now look at inventories – the supply of houses being offered for sale. Again, I use a chart from [ContraryInvestor.com](#). Because the population is ever growing, the chart compares the number of houses for sale to the total U.S. population. From 1965 to 2008, the horizontal dotted line shows that the average number of homes for sale was .49% of the total U.S. population. With the current level at .95%, this means we currently have almost twice as many houses for sale as the historical average.

Because of the laws of supply and demand, most if not all of this huge overhanging inventory has to clear the marketplace before U.S. housing prices stop falling.

Even at today's already depressed housing prices, we have a 10.6 months supply of unsold single-family home for sale, 16.7 months supply of unsold condos on the market, and 11.5 months supply of new home inventory.

Although housing prices have already come down a lot, most people are taking a "watch and wait" approach to buying because prices are still too high – and they would require too much mortgage debt to finance. As I explained in my November 2008 Timing Letter, the average American is already buried with too much debt – debt they are struggling to make payments on – so why would they want to take on anymore? In spite of the fact that the government is trying to restart the flow credit to get consumers spending again, Americans think otherwise: they don't want any more debt. And a recent Fed survey confirms this – the demand for mortgages and consumer credit has never been as low as it is today.



Current Housing Trends for 14 Major U.S. Cities

The table below shows data through October 2008. Here's how to read the data and determine what it is telling you. If housing prices in one of the 14 cities is likely to rise, the October 2008 Market Momentum reading will be a positive number – and if it is likely to fall, the Market Momentum reading will be a negative number. This tells you what the primary trend of the market is – up or down – and whether you should be positioned in the market for potential capital gains, or out of the market for capital preservation.

It is also valuable to know whether a housing market is getting stronger or weaker relative to the primary trend. This can be determined by comparing the latest Market Momentum reading (October 2008) to the Market Momentum reading from three months ago (July 2008). If the reading has become more positive in the last three months, it tells you the market is improving. If it has become more negative, it tells you the market is getting worse.

City	Sell Signal	Price Change in Last 12 Months	Price Change from Peak Values	Market Momentum Reading: July 2008	Market Momentum Reading: October 2008	Primary Trend
Phoenix	Jan 07	- 32.6%	-40.6%	- 29.3	- 32.7	Down
Denver	Jan 07	- 5.1%	- 8.0%	- 4.7	- 5.2	Down
Washington DC	Oct 06	- 18.7%	- 26.3%	- 15.8	- 18.7	Down
Miami	Apr 07	- 22.7%	- 38.3%	- 28.2	- 29.0	Down
Tampa	Feb 07	- 19.9%	- 30.5%	- 19.4	- 19.8	Down
Atlanta	Oct 07	- 10.5%	- 12.2%	- 8.3	- 10.5	Down
Chicago	May 07	- 10.8%	- 13.7%	- 10.0	- 10.8	Down
Boston	Apr 06	- 6.0%	- 12.8%	- 5.4	- 6.0	Down
Detroit	May 06	- 20.4%	- 32.2%	- 16.7	- 20.4	Down
Las Vegas	Mar 07	- 31.7%	- 39.3%	- 29.9	- 31.7	Down
New York	Feb 07	- 7.6%	- 11.9%	- 7.2	- 7.5	Down
Cleveland	Sept 06	- 6.1%	- 11.9%	- 7.8	- 6.2	Down
Dallas	Oct 07	- 3.1%	- 4.6%	- 2.5	- 3.0	Down
Seattle	Jan 08	- 10.2%	- 11.4%	- 8.2	- 10.2	Down

As you can see, the October 2008 Market Momentum (MM) readings for the 14 cities tracked are all negative. This means housing prices in each of those cities are likely to fall during the next 3 to 6 months. With the exception of Cleveland, the MM reading for each of the 14 cities has gotten weaker in the last 3 months – telling us the downtrends are accelerating.

Dallas is the city closest to a buy signal, with an October 2008 MM reading of – 3.0. The next strongest cities are Denver and Cleveland.

Phoenix is the city farthest away from a buy signal, with an MM reading of – 32.7. The next weakest cities are Las Vegas and Miami.

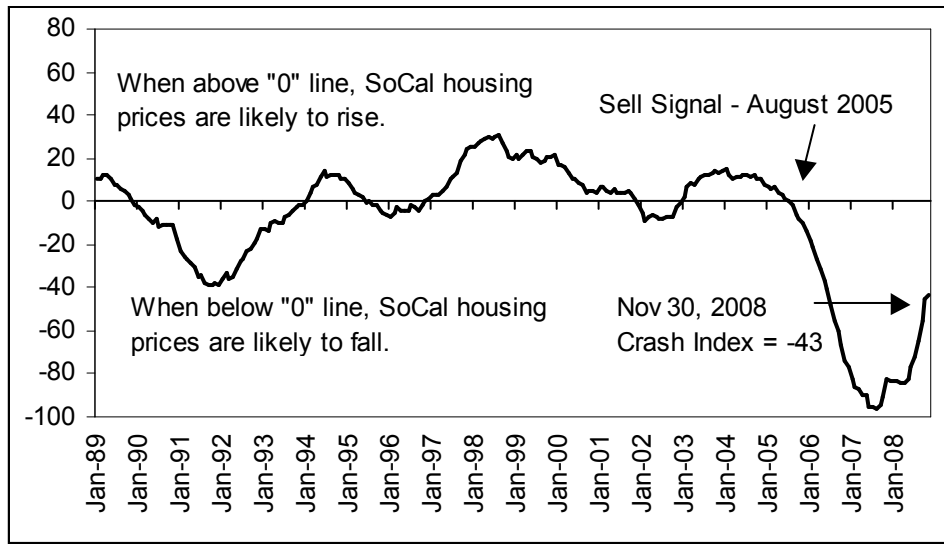
If you look at the difference between the MM readings in the last 3 months (Oct 2008 vs. July 2008), you'll see that the cities that are getting weaker at the fastest rate are Detroit, Phoenix, and Washington DC, in that order.

Detroit, a non-bubble market during the 2001 to 2006 real estate boom, is really getting slammed right now because unemployment is rapidly rising in the automotive industry. According to the Tribble Ad Agency (December 2008), the average price of a home is now \$18,513 and unemployment has reached 21%. This is statistically on par with the Great Depression. And if the auto industry collapses, unemployment could double. In some parts of Detroit, I'm told that you can find entire neighborhoods where many (or most) of the houses can almost be acquired for free. I continue to feel that buying cheap houses in selected Detroit neighborhoods – at the market cycle bottom, or course – will turn out to be great investments.

Real Estate Crash Index

The Real Estate Crash Index gave us a -63 reading as of November 30, 2008. This forward looking indicator is telling us that Southern California housing prices are likely to fall for the next 3 to 6 months. A "sell signal" was flashed in August 2005, when the "0" line was crossed to the downside.

Currently, four Vital Sign indicators are in trends that are unfriendly to price appreciation, and one is in a trend that is friendly to price appreciation.



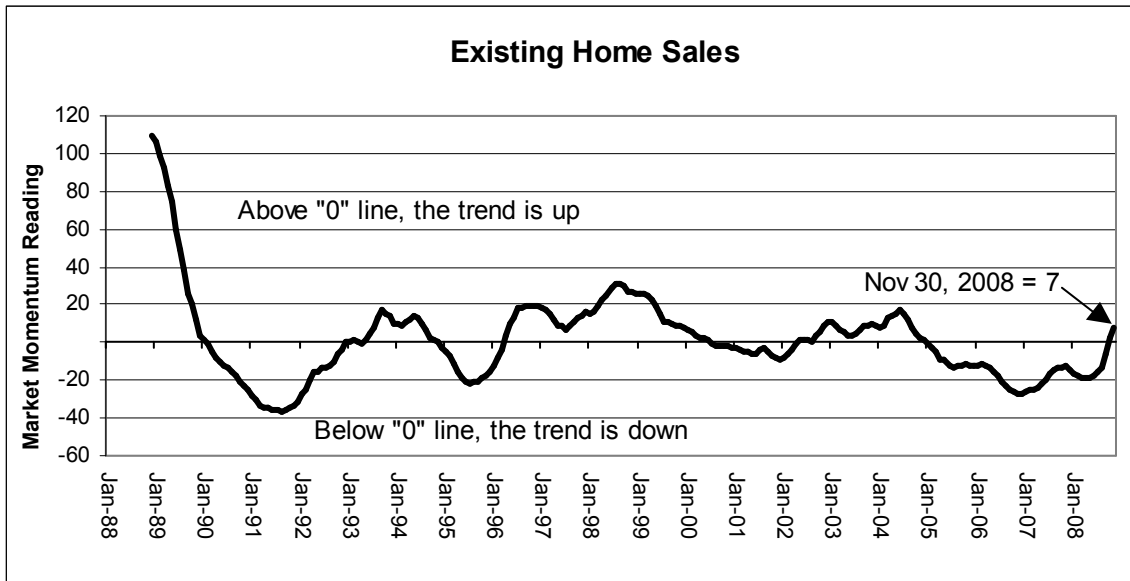
Vital Sign Readings

SAN DIEGO VITAL SIGNS				
Vital Sign Indicator	Month-End			Market Momentum Reading
	<u>Sept 08</u>	<u>Oct 08</u>	<u>Nov 08</u>	<u>Nov 30, 2008</u>
Existing Home Sales	3,095	3,282	2,411	7
New Home Building Permits	295	232	237	-24
Notice of Defaults	1,360	1,269	1,495	63
Foreclosure Sales	1,981	1,293	1,144	161
30-Yr Fixed Mortgage Rates	6.04%	6.20%	6.09%	-4

Sources: DataQuick Information Svcs, C.I.R.B., S.D. Recorder's Office, Federal Reserve Board

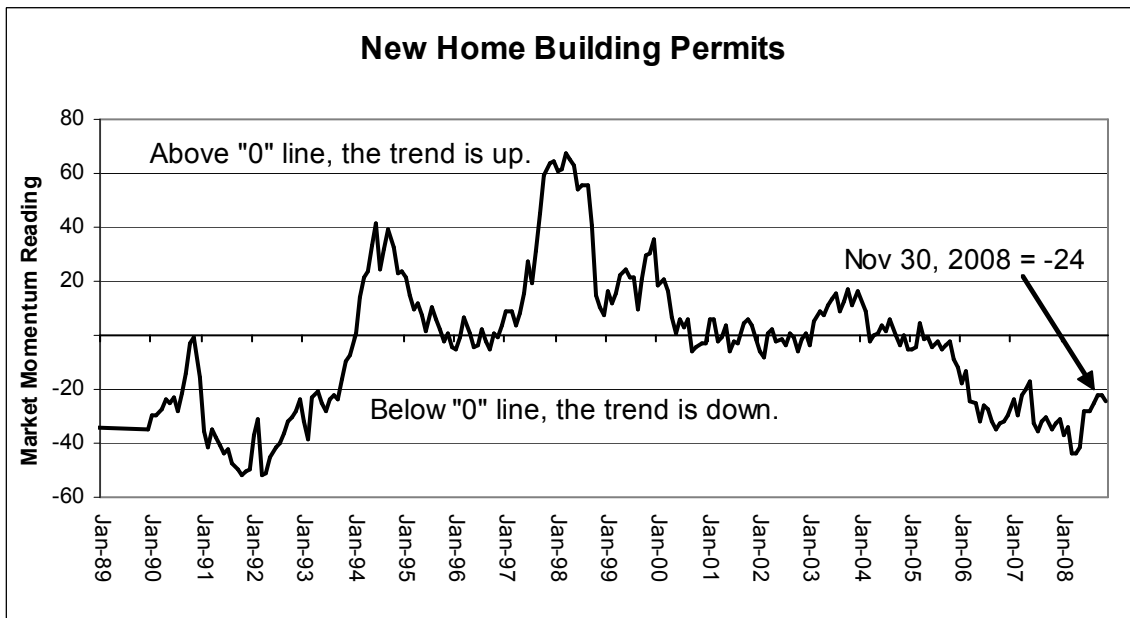
Editor's note: While my trend indicators are based solely on statistical data derived from the San Diego real estate market, the trend signals they send have historically worked with equally good accuracy for the Los Angeles, Orange County, and many other California real estate markets. Thus, I often use the words "Southern California" and "California real estate markets" interchangeably.

Vital Sign #1: Existing Home Sales



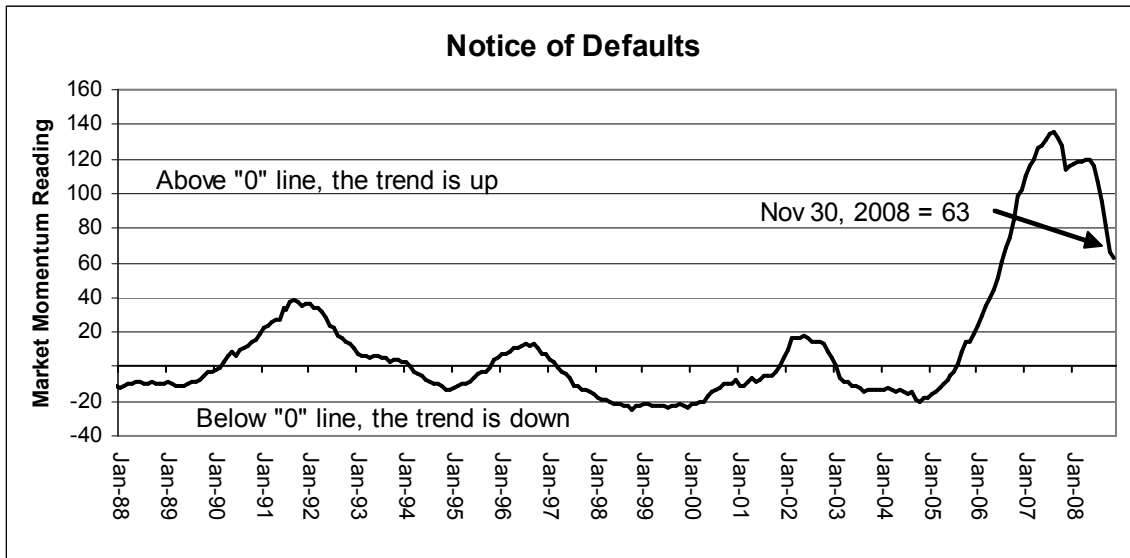
There were 2,044 homes sales in Nov 2008, giving us a trend reading of + 7. This means that the trend is up. It has been statistically proven that Existing Home Sales are a good leading indicator for predicting the future direction of housing prices. The 12-month moving average (MA) was 2,422 in Nov 2008, which represents a 16 month high. During the last upcycle, the peak reading for the 12-month MA was 4,221 in June 2004.

Vital Sign #2: New Home Building Permits



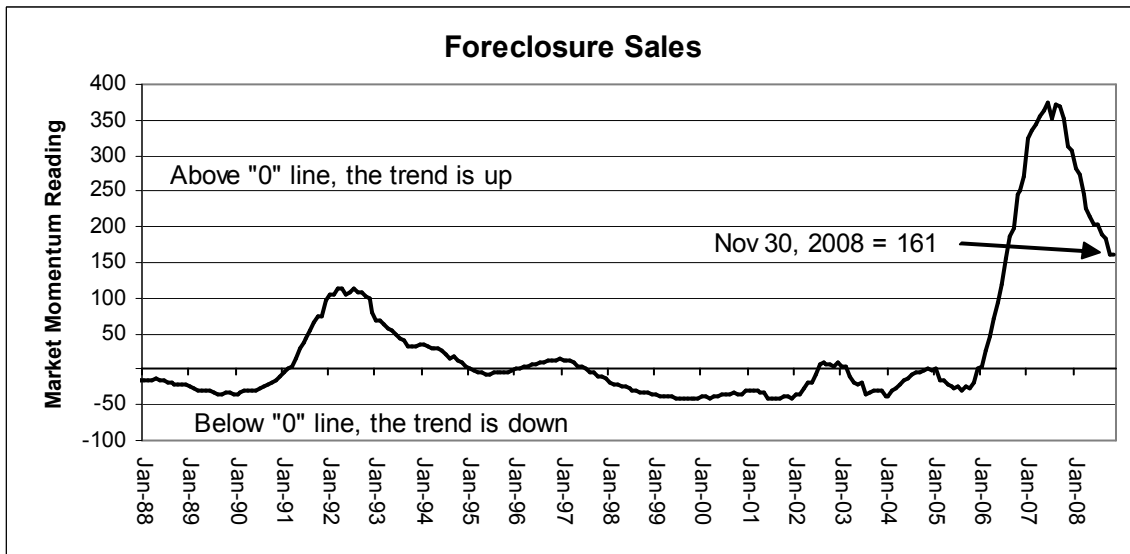
There were only 237 New Home Building Permits pulled in Nov 2008. This produced a Market Momentum reading of -24. New home building activity is still decelerating, a negative trend for housing prices and a good leading indicator as to what will be the future strength of the SoCal economy. The 12-month moving average (MA) was 461 in Nov 2008, the lowest reading since Nov 1993 (450). The May 2008 MA is currently 70% lower than its most recent peak reading of January 2004 (1,556) – which was when the SoCal real estate market was booming.

Vital Sign #3: Notices of Default



There were 1,495 Notice of Defaults in Nov 2008, producing a Market Momentum reading of + 63. This tells us that mortgage defaults continue to be in an uptrend, which is a negative sign for both the San Diego economy and its housing market. The 12-month moving average was 2,803 in Nov 2008. This is the fifth highest 12-month moving average reading ever, surpassing the prior peak of November 1993 (1,044) by 162% – which marked a point in time when the SoCal real estate market was only half way through the last down cycle that lasted for 6 years.

Vital Sign #4: Foreclosure Sales



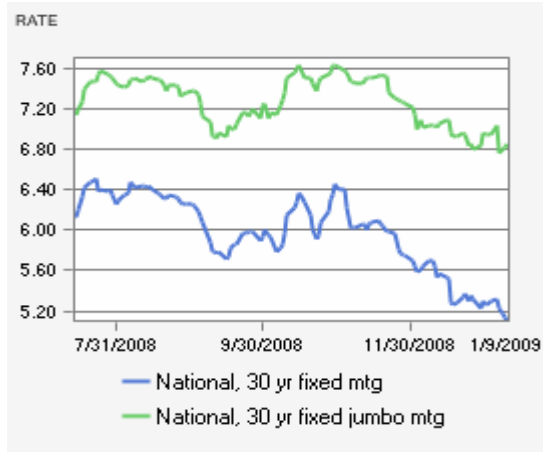
There were 1,144 foreclosure sales in Nov 2008, producing a Market Momentum reading of + 161. The 12-month moving average for foreclosure sales was 1,662 in Nov 2008, and has been moving steadily higher since hitting a 23-year record low set in August 2005 (37). The Nov 2008 12-month moving average was the highest reading ever – surpassing the previous high by 278%. The previous high was 503, recorded in February 1997, which was near the bottom of the last down cycle that, according to the Real Estate Crash Index, ended in December 1996.

NOTE: Notice of Defaults in San Diego fell sharply from September 2008 forward because a new California law came into effect. The law, passed July 8, 2008, now requires lenders to contact CA homeowners and explore options to avoid foreclosure before starting the foreclosure process. Because of this, the Real Estate Crash Index will now have to be modified to account for this key piece of market timing data that no longer accurately reflects what is really happening in the marketplace. No problem – I can make adjustments that will accurately reflect the true strength or weakness of the SoCal real estate market. This new law will also reflect foreclosure data as well.

Vital Sign #5: Interest Rates

As seen on the chart to the right – courtesy of BankRate.com, mortgage rates have been on a steep downswing since October 2008. The average 30-year fixed rate mortgage has fallen from 6.40% to 5.15%. Most of this decline has come since the Fed's October announcement that they would be pumping \$500 billion into mortgage back securities beginning in February 2009.

Rates for 30-year fixed jumbo loans (>\$417,000) have only fallen from 7.60% to 6.80% since October, creating a record spread (1.60%) vs. conforming 30-year fixed rates (<\$417,000).



Final Words

Find the premise that is false and bet against it.

– George Soros

From 2001 to 2006, almost everyone thought that real estate would go up forever. Those who bet against that false premise – by selling and going to cash near the peak – have been happy with the results.

I say this because housing prices are now in a full-crash mode – even worse than the Great Depression. For each of the last three months, the Case-Shiller home price data shows that the year-over-year price declines have hit new record lows for both the 10-City and 20-City indexes, as well as for most of the major cities they follow.

In California, the California Association of Realtors (C.A.R.) reports that the median priced single-family home fell to \$286,000 in November 2008, an incredible 52.2% drop from its 2007 peak value of \$598,000.

In 2009, I expect more price deflation. I believe one of the big stories of 2009 will be that the hordes of foreclosure buyers who bought “bargains” in 2008 are going to learn that they bought too early. I know of a Sarasota, Florida buyer who thought he bought a steal in mid-2008 for \$176,000 – which was over 50% less than its peak value. Six months later, an identical house right down the street went up for sale at \$148,000.

Be careful, folks. Cheap does not always mean it's a good time to buy.

At the end of this housing bust, however, there will be a new false premise to bet against. It will be that real estate will be a bad investment forever. Those who bet against that premise will profit handsomely. But I doubt you'll be placing that bet in 2009 – so until that time arrives, my advice is to stay in cash.

To all my valued readers, have a great year in 2009 and best wishes until next issue.

Robert M. Campbell
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PS: If you didn't attend my June 21, 2008 seminar – “Will You Be Ready for the Next Great Buying Opportunity” – you can order the 4-hour audio CD for \$65.00. The CD is free if you re-subscribe for another year. Please note that the new subscription price is \$130.00 per year.

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How to read the Vital Sign charts: All charts use the statistical tool called “momentum analysis” to determine trend changes in the marketplace. Trend changes are signaled when the “0” line is crossed. When the market momentum reading is above the “0” line, it means the trend is upward. When the market momentum reading is below the “0” line, it means the trend is downward. Consult the book *Timing the Real Estate Market* for a complete understanding of these charts, how to construct them, and how to interpret them.