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, 2008

U.S. housing prices could fall by 20% - 30%
If that happens, guess how many homeowners will have negative equity? Page 2

Is an economic recession a clear and present danger?
Find out what key indicator has a track record of 10 for 10 for predicting recessions. Page 3

There will be a dramatically shift in market psychology for 2008
What will this mean for housing prices? Find out – page 5.

What's ahead for SoCal housing prices?
Get the latest trend readings from the Real Estate Crash Index! Page 7

2008 Housing Forecast: More Blood in the Streets

From the start of 2007, roughly one year after the greatest housing bubble in history had peaked out, the forces of financial gravity were already in full force – exerting significant downward pressure on U.S. housing prices. It wasn't until August, however, that the true underlying weakness (and vulnerability) of the market was finally revealed.

It was then that the two Bear Stearns hedge funds blew up – exposing the fact that the trillions of dollars of ultra-creative mortgage loans that were originated from 2003 to 2007 should never have been made. These were Adjustable Rate Mortgage loans that were issued with little or no money down, "extreme balloon terms", the rates being largely irrelevant, where the low "post-teaser" monthly payments lead to almost certain and immediate default.

This marked the official Day of Reckoning for U.S. banks, Wall Street, and the entire investment community – where all parties owning these creative mortgage loans were essentially left holding Old Maid cards – namely, bad loans that would ultimately result in significant losses.

You see, as long as housing prices rise, all mortgage lending sins of the past are forgiven. Even if a borrower gets into trouble and can't make his monthly payments, the home can be sold for more than it was purchased for and the loans could be paid off. But when a real estate boom turns into a bust – as they all do – there is no price appreciation "safety net" for ill-made mortgage loans.

With the mid-summer 2007 blow ups, and with the U.S. housing market already in the bust mode of the housing cycle, it became abundantly clear that – absent the ultra-creative lending schemes that artificially supported a highly over-priced housing market during the boom years – the owners of those once easy-to-get $500,000 mortgages were now holding loans (Old Maid cards) that were secured by assets that were really worth only $300,000.

This turn of events sent shock waves throughout the U.S. banking system, rendering many banks insolvent and unable to function normally. This forced a rapid tightening of lending standards – known as a credit crunch – which sent the housing market plummeting into an even steeper decline. As hundreds of thousands of loans started going into default … as a growing number of "for "sale" signs failed to turn up a shrinking number of qualified buyers … foreclosures started spreading like an infectious disease by the end of 2007.

This brings me to the subject of this month's Timing Letter – what I see coming down the pike in 2008.

Lending Crisis Will Get Worse

In 2008, the lending crisis will continue to extend far beyond the creative sub-prime mortgages that precipitated the massive problems we're now experiencing. With falling housing prices and rising default rates, lenders are now becoming more afraid to make loans to even qualified borrowers – and are tightening their loan standards, even on "A" paper loans. Loans are getting approved, but in most cases, buyers have to come up with sizable down payments, have high credit scores, and, in most cases, fully document their income.

Take giant investors like Fannie Mae and Freddie Mac, for example, who buy and own trillions of dollars of mortgage loans. Starting March 1, they require an extra 5% down payment in declining markets. That's now all of California, Florida, Nevada, Arizona, and many other metro areas. And if first-time home buyers can't buy until they save up 5% or more down, it impacts the entire housing chain, and so practically no one can sell their home. At the end of the day, it's the first-time homebuyers that drive the real estate market.

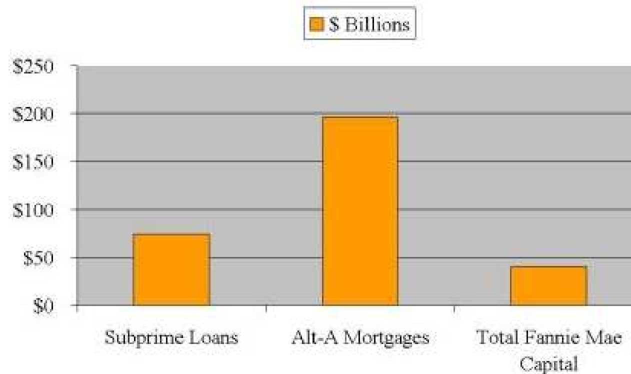
Once considered "prime" borrowers, significantly higher fees are also being charged to those people with FICO credit scores less than 680 and who have less than a 30% down payment – either in the form of higher loan costs or higher interest rates.

While it's true that sub-prime lending died off a year ago, these changes back to "normal" loans are only now starting to have a more and more serious impact on mortgage lending. In addition to the increased down payment requirements, Freddie and Fannie are often requiring a minimum of 6 months worth of "reserve" mortgage payments in the bank. As one mortgage broker said to me, "and who has that!"

The U.S. banking system is heading deeper into a crisis. Data from First American Core Logic estimates that if home prices fall 20 percent, there will be 13.7 million homeowners with negative equity. If prices fall 30 percent, that number would rise to more than 20 million.

Only time will tell how far housing prices will ultimately fall, but its safe to say there are going to be a massive amount of loan losses – maybe a trillion dollars or more by some estimates – and that explains why mortgage lending is tightening up.

To illustrate the amount of bad debt out there, and the huge problem that many if not most owners of mortgages face, take a look at the chart below.



As of September 30, 2007, Fannie Mae had $40 billion in capital. The company also owned $196 billion in Alt-A loans and $74 billion in sub-prime loans (loans with a FICO score under 620). Altogether, Fannie owns $2.7 trillion worth of mortgages. If a high percentage of the risky loans go bad – and there's no reason to think they won't – Fannie Mae could quickly lose all the capital they have, becoming insolvent, and they would not be able to purchase any more mortgages without capital infusions.

Freddie Mac – as well as Countrywide, CitiBank, Washington Mutual, Downey, and a host of other bagholders – are in essentially the same boat as Fannie Mae right now: they're insolvent, and their ability to generate and buy new loans is becoming more limited each month.

How will this credit crisis end? The lending markets won't start functioning normally again until all the bad debts have been purged from the system. And that probably won't happen until housing prices have stopped falling and all the bad loans have been written off. Only then can the lending system be successfully "rebooted" – and that will probably take years.

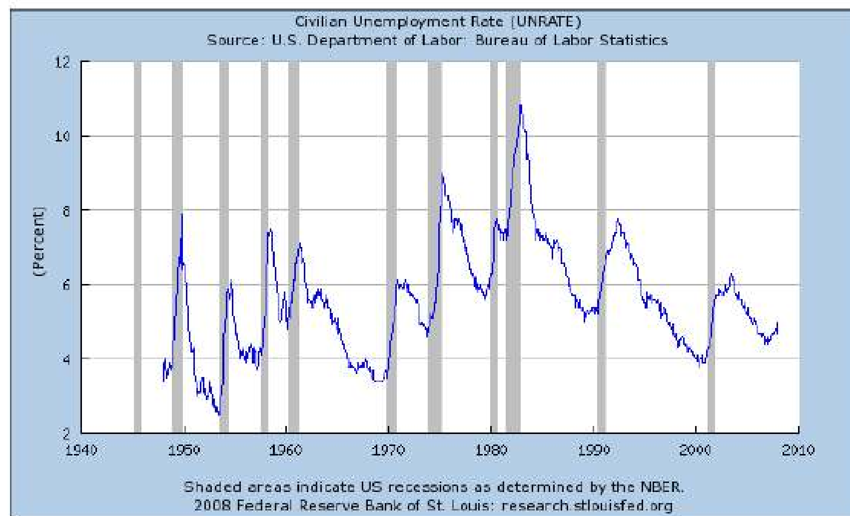
Meanwhile, anyone who expects the Fed or anyone else to come up with a magical plan in 2008 that makes this financial crisis go "poof" and disappear is wishing for a miracle. It's simply not going to happen. The Fed is now caught in a trap they set for themselves by allowing – or causing – a real estate bubble to occur. When an asset like real estate becomes overvalued, even if you drop interest rates to zero, you can't force consumers to borrower more, because they've already borrowed too much. Nor can you force lenders to lend, because they're already puking on "bad paper." It's called a liquidity trap.

The one way out is also likely to be most the painful: higher levels of housing affordability. This will require a long period of downward price adjustment until lower amounts of mortgage debt can once again be adequately serviced by household incomes and rents. Because the housing market and economy have been tightly connected since 2001, not only will this period of readjustment hit the housing market like a freight train, but the U.S. economy is going to get pounded as well.

Recession: A Clear and Present Danger

In the last 12 months of my Timing Letter, I have repeatedly shown you reliable recession warning indicators that were consistently flashing "recession dead ahead."

Well, based on the increase in the 2007 unemployment rate, here's another one that shows the U.S. economy may be on the verge – or is already in – a recession.



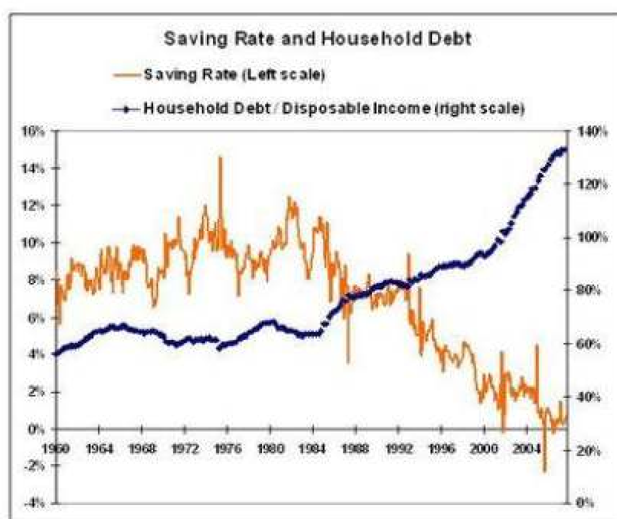
The civilian unemployment rate rose to 5.0% in December from 4.7% in November. The December reading is the highest reading since September 2005. The jobless figure was 0.6 percentage point higher than the March 2007 low of 4.4 percent, which was the lowest reading of the economic expansion that began at the end of 2001.

As the above chart shows, anytime the unemployment rate has risen 0.5% from the bottom, a recession always follows. We are already up 0.6%, and combined with all the past mentioned indicators that have been predicting recession, it is hard to imagine how it will not be so this time.

Even President Bush recently said "We can't take economic growth for granted." If that isn't a confirmation of a recession, I don't know what is.

How bad will the recession be? It could be severe – and surely far deeper than the shallow contraction we experienced in 2001. The dot-com led downturn in of the 1990's was set off by a collapse in business capital spending, which at it's peak in 2001 accounted for only 15 percent of the country's GDP. The current recession will be come from a spending collapse by the American consumer – whose spending now accounts for a record 70 percent of GDP.

As you can see from the chart below, American household debt has been soaring since 2001— rising from an already absurd debt-to-income ratio of 100% in 2001 to an even more absurd level of 35% in 2007. To make matters even worse, the savings rate fell from already an measly 2% to a near 0% during this same period of time – which leaves Americans with little or no cushion to withstand any kind of economic adversity.



The fact is, we live in a credit society and the use of credit has been huge. We have over-consumed in the last five years, gone deeply into debt, and now have a big hangover to work out. How big? With current spending at a record 135% of household income, Americans would need to <u>cut back</u> on their spending by a whopping 25% <u>just</u> to return to a household debt-to-income ratio of 100%. If this isn't a "come to Jesus" awakening for you – meaning we are likely facing difficult economic times ahead – then you can't say you weren't forewarned.

From 2001 to 2007, we have experienced a monstrous credit bubble. Americans didn't have to save money because rising housing prices filled that need for them. But now that housing prices are going into a clear period of what looks to be a lengthy and significant decline, Americans will come face-to-face with their misplaced saving strategies. Households will now have to start saving money from the incomes that they make – and that will reduce consumer spending and take the economy into a nasty recession.

Will the country survive? Yes, and a shift back to saving more and spending less – coupled with the fall in housing prices to bring them back into alignment with household incomes – will be good for the U.S. economy in the long-term. In the short-term, however, there's going to be a significant amount of pain as we go through the necessary process of financial deleverging, which will wipe out trillions of dollars debt that should never have been created and can no longer be sustained.

New Market Psychology for 2008: Fear

First and foremost, you have to realize that all markets are psychological. Greed drives the market higher, and fear takes it lower.

Thus, if fear and greed were numerically quantifiable – it could be used to calculate trends in the real estate market. But that's impossible to do, so what I do instead is track relevant market data – i.e, my Vital Sign data – that tends to reflect what these psychological forces are doing to trends in the marketplace.

In 2007, we moved past the denial phase of this current real estate downturn. Now, in 2008, anyone with two functioning brain cells is aware that the recent boom has ended and that housing prices are now falling. This fact is no longer breaking news and everyday you hear the media report about the real estate slowdown, widespread foreclosures, the mortgage crisis, rising builder inventories, stricter lending requirements, and bailout programs to save people from losing their homes.

To illustrate the point that fear will more and more become the dominant force in the marketplace, take a look at the December 18, 2007 headline from the *San Diego Union Tribune*.

Gulp. If a headline and chart like that doesn't scare the hell out of home buyers and home sellers, I don't know what will.

And here's the story: "Home prices in San Diego County tumbled nearly 10 percent last month from year-ago levels, taking the median down to $440,000, the lowest level in three years, DataQuick reported. The latest price represents a 15 percent fallback from the all-time record of $517,500 set in November 2005."

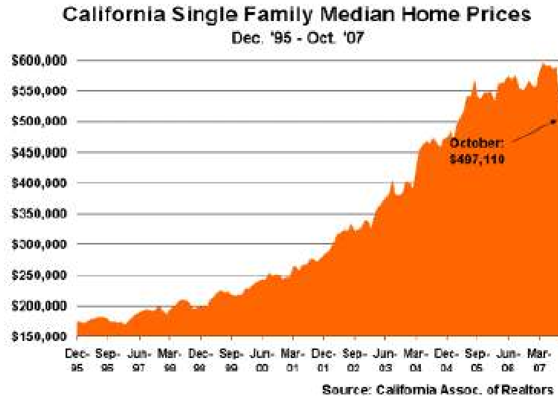
"Across Southern California, it was the slowest November for home sales in more than 20 years. The median price of a Southern California home was $435,000 in November, a 10.3% decrease from a year ago. That's the biggest year-over-year drop ever reported by DataQuick."

The fact is, the housing market has hit an iceberg and is now sinking. And people are worried. And until prices start rising again, there is absolutely nothing that can be done to turn this negative psychology around. Bottom line, a deflating real estate market is now an accepted reality. Each successive drop in prices will scare more and more buyers, until finally, hardly anyone wants to buy real estate. This, of course, is when the bottom will be reached but I expect that to be many years away.

Going forward, the news stories are only going to get worse. As millions of Adjustable Rate Mortgages reset in 2008, 2009, and 2010 – see the chart from the May 15, 2007 issue – there will be more defaults, more foreclosures and more price drops. This will only reinforce the growing belief that that real estate values are in full decline.

At least a year too late, even the head cheerleader from the U.S. Treasury Department, Henry Paulsen, could no longer ignore the cold hard facts and had to admit that housing affordability was a real problem. On January 9, Paulson said in a speech in New York that the current housing correction was "inevitable and necessary" following five years of unsustainable boom which saw sales and home prices hit record levels.

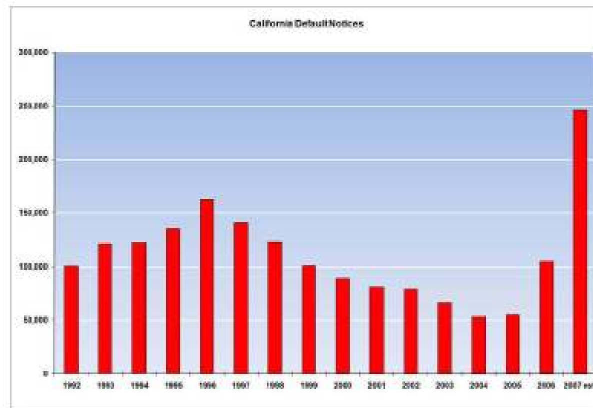
The graph from the San Diego Union Tribune article shows the median price home in San Diego has fallen back to early 2004 pricing. As you can see from the chart below, in a recent near vertical two month collapse of prices, the median price home for the entire state of California has retreated to similar levels.



According to the California Association of Realtors (C.A.R.), California's median price home (detached, not attached) fell $33,720 in October 2007 to $497,110 – putting the decline for the past two months at a remarkable $91,860. This price drop represented a 9.9% decline over the previous 12 months.

As compared with the same period a year ago, home sales decreased 40.2% in October. The month's supply of home inventories was 16.3 months – a huge rise from the year ago figure of 6.4 months.

What explains the fall of CA housing prices is the staggering rise in foreclosure activity.



According to DataQuick, and as seen in the above chart, lenders started foreclosure proceeding on a record number of California homeowners in 2007. A total of 72,571 Notice of Defaults were filed in the July-to-September period, up 34.5 percent from the previous quarter, and up 166.6 percent from the third-quarter of 2006.

With foreclosures rising and home prices falling like this – not only in California but throughout many if not most major U.S. cities – this fear-driven market psychology will become more pronounced in 2008. People will react predictably and strongly to the bad news. Does anyone here feel compelled to walk the plank when they know housing values are highly inflated and that lower prices lie dead ahead?

Real Estate Crash Index

The Real Estate Crash Index gave us a -82 reading as of November 30, 2007. This forward looking indicator tells us that Southern California housing prices are likely to fall for <u>at least</u> 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 only one indicator (interest rates) is in a friendly trend.

Vital Sign Readings

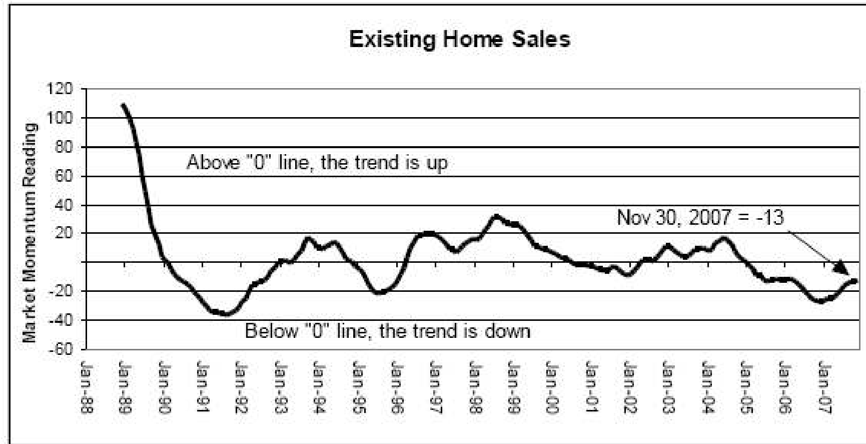
SAN DIEGO VITAL SIGNS

Vital Sign Indicator	Month-End			Market Momentum Reading
	Sept 07	Oct 07	Nov 07	Nov 30, 2007
Existing Home Sales	1,609	1,614	1,605	-13
New Home Building Permits	302	490	178	-35
Notice of Defaults	2,074	2,228	1,600	114
Foreclosure Sales	767	911	535	312
30-Yr Fixed Mortgage Rates	6.38%	6.38%	6.21%	-1

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

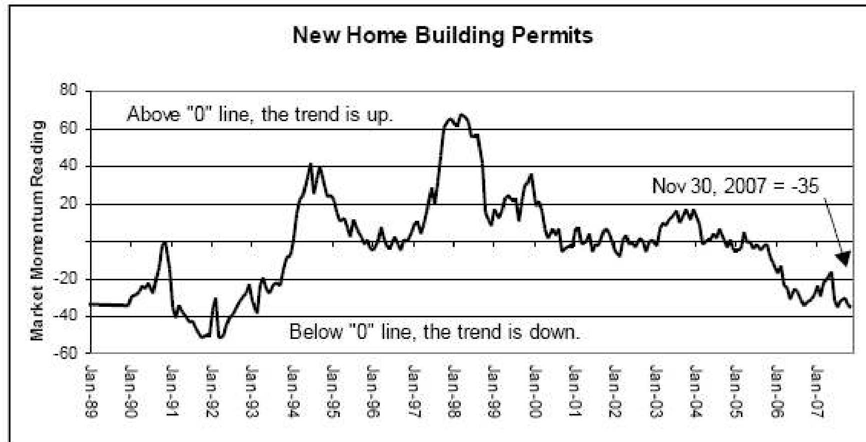
Editor's note: While my trend indicators are based solely on statistical data derived from the San Diego real estate market, the trend signals they send have historically worked with equally good accuracy for the Los Angeles, Orange County, and many/most other California real estate markets. Thus, I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

Vital Sign #1: Existing Home Sales



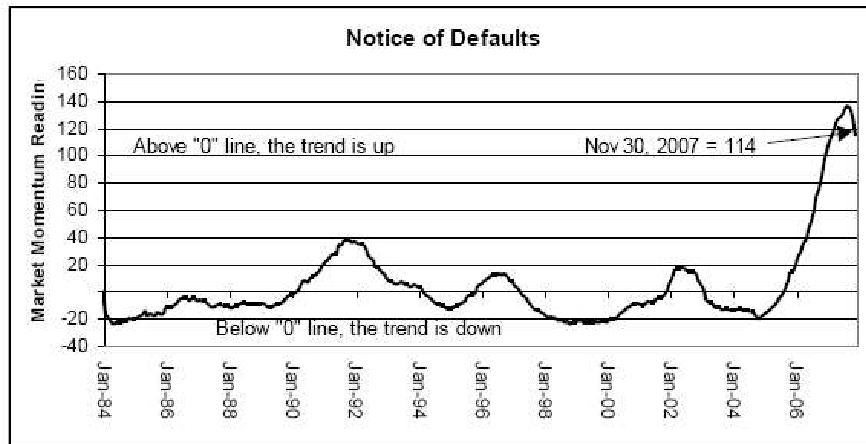
After hitting a five-year peak of +17 in June 04, the Market Momentum readings for Existing Home Sales dropped below the "0" line in February 2005 and have stayed there ever since. This is a signal that the trend is down. There were 1,605 homes sales in November 2007, giving us a trend reading of –13. The number of home sales in Southern California housing is decelerating. It has been statistically proven that Existing Home Sales are an excellent leading indicator for predicting the future direction of housing prices. The 12-month moving average (MA) was 2,254 in November 2007, the lowest reading since June 1996 (2,223) – which, according to the December 1996 "buy signal" generated by the Real Estate Crash Index, marked the bottom of the l990s real estate down cycle. 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



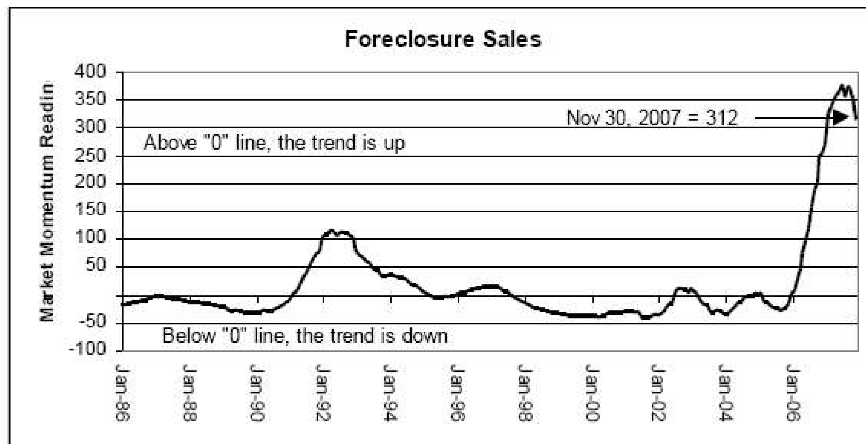
There were only 178 New Home Building Permits pulled in November 2007, the lowest monthly total ever since I started compiling the data in 1988. This produced a Market Momentum reading of –35. New home building activity is rapidly decelerating, a negative trend for housing prices and a good leading indicator as to what will be the future strength of the SoCal economy. The 12-month moving average (MA) was 589 in November 2007, the lowest reading since December 1996 (572). The November 2007 MA is currently 62% 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 1,600 Notice of Defaults in November 2007, producing a Market Momentum reading of +114. This tells us that mortgage defaults are in a strong uptrend, which is a negative sign for both the San Diego economy and its housing market. The 12-month moving average was 1,721 in November 2007. This is the highest 12-month moving average reading ever, surpassing the prior peak of November 1993 (1,044) – a point in time when the SoCal real estate market was only half way through the last down cycle that went on for 6 years.

Vital Sign #4: Foreclosure Sales



There were 535 foreclosure sales in November 2007, producing a Market Momentum reading of +312. The 12-month moving average for foreclosure sales was 621 in November 2007, and has been moving steadily higher since hitting a 23-year record low set in August 2005 (37). The November 2007 12-month moving average was the highest reading ever. The previous high was 503, recorded in February 1997. The fact that the current trend is rapidly rising is a negative sign for the Southern California housing market and its economy.

Vital Sign #5: Interest Rates

The chart on the right shows 30-year fixed rate mortgage rates going back to the year 1970. The shaded areas represent U.S. economic recessions.

As you can see, rates tend to fall when the economy goes into recession, which has already happened – or is likely to happen – in 2008. Therefore, if historical patterns hold true in the future as they have in the past, you can expect mortgage rates to fall in 2008.

Final Words

I think that 2008 is going to make 2007 look like a good year. This is not a good time to seek profits, but to protect what you have … and wait for the market to hit bottom before you buy back in.

The housing market may melt down gradually, or it could turn into a more sudden event. Only time will tell, but I do believe that there is more danger in present circumstances than most people imagine. I say this because a huge percentage of the $5 trillion dollars of mortgage debt that has been created in the last five years has little or no chance of ever being paid back.

In other words, most of the housing "wealth" created during the 2002 to 2007 real estate boom was fake. It wasn't driven by income growth and rising rents – which put solid legs under higher housing prices. It was fueled by creative Ponzi financing schemes – which requires new debt to pay off the old – that only creates the illusion of real wealth.

With the illusion now gone, now it's payback time and I expect much of this fictitious real estate wealth to be destroyed.

To all my valued readers, best wishes until next issue.

Robert M. Campbell
(858) 481-3235

PS: If you didn't attend my October 20, 2007 seminar – "**The California Real Estate Crash – How to Make Money Now …and Make a Killing Later**" – you can order the 4-hour audio CD for $60.00. The CD is free if you re-subscribe for another year.

The Campbell Real Estate Timing Letter is published bi-monthly by Robert Campbell. All subscription inquiries should be directed to: 3525 Del Mar Heights Road, #634, San Diego, CA 92130. Telephone number is (858) 481-3235.
Website: www. SanDiegoRealEstateReport.com
Subscription rates: $120.00 per year (6 issues). Individual issues are $25.00 each. Copyright 2007 Robert M. Campbell. All rights reserved. This information may not be quoted or reproduced in whole or part without written permission from the publisher. Information contained herein has been carefully gathered from sources believed to be reliable but cannot be guaranteed as to its accuracy or completeness. No guarantee is made that any recommendations will be profitable or that past performance is a guarantee of future results. Those using this information are responsible for their own actions.
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.