

Housing and the economy: From bad to worse



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Thornberg**
Principal



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The half full cup...

Good news

- Bay in strong recovery
- Tech sector doing well
- Export market booming
- Inflation fears down

Bad News

- Housing getting worse
- Financial problems still coming to light
- Overall economy slowing, chance of recession at 75%



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Macro-Economic Forecasting

Rule 1: Forecasts are Always Wrong
Good Forecasters are *Less Wrong*

Rule 2: Forecasting is all about...



*Trends
and
Bends*

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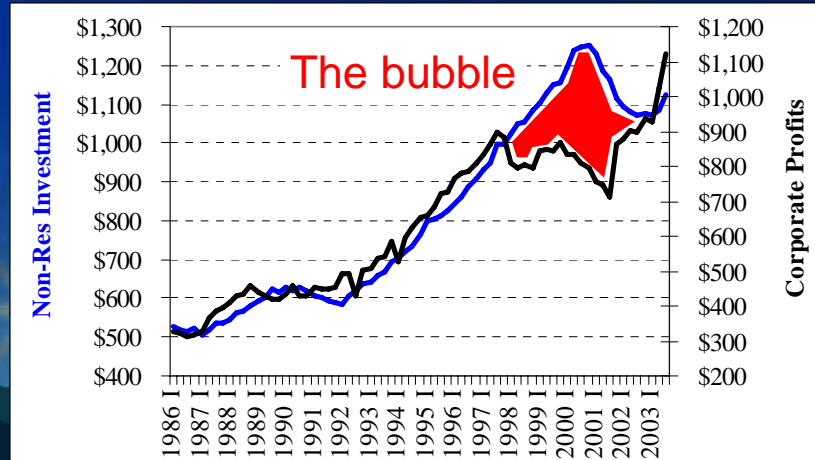
The Bends!

- Bends are caused by shocks to the economy that cause turbulence
 - Sustained, rapid, large
- This causes higher than normal rates of unused resources
 - Fed policy can reduce pain
 - Still- the economy will typically heal, although length depends on severity

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Bends are caused by imbalances

The 2001 Downturn



Local MSA Employment Performance

Payroll Job Growth Q2 00 – Q2 03

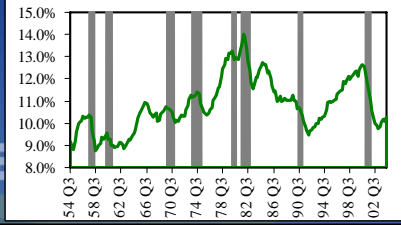
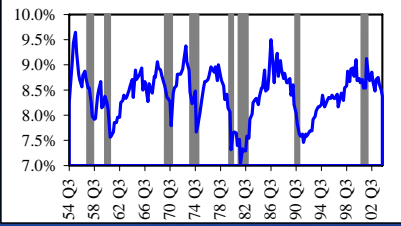
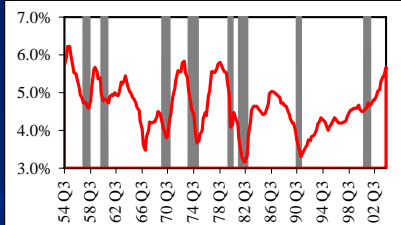
Riverside-San Bernardino	10.2%	4
Stockton-Lodi	7.2%	10
Bakersfield	6.9%	11
Fresno	6.6%	12
Vallejo-Fairfield-Napa	6.4%	13
Sacramento	6.4%	14
Modesto	5.7%	15
San Diego	4.1%	21
Ventura	3.8%	24
Orange County	2.9%	30
Salinas	1.3%	43
Santa Barbara-Santa Maria-Lompoc	0.6%	54
Oakland	-1.5%	106
Los Angeles-Long Beach	-1.9%	113
Santa Rosa	-2.1%	116
San Francisco	-11.3%	182
San Jose	-15.9%	184

But it was mild...

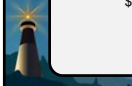
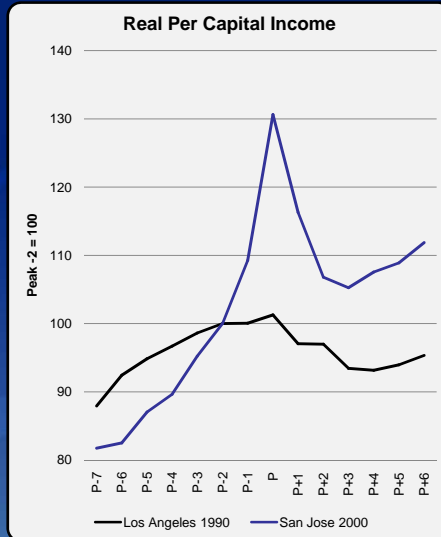
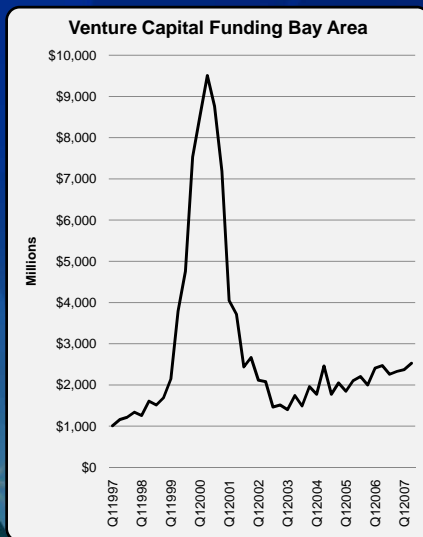
No Housing Cycle

No Consumer Cycle

Just one big investment cycle

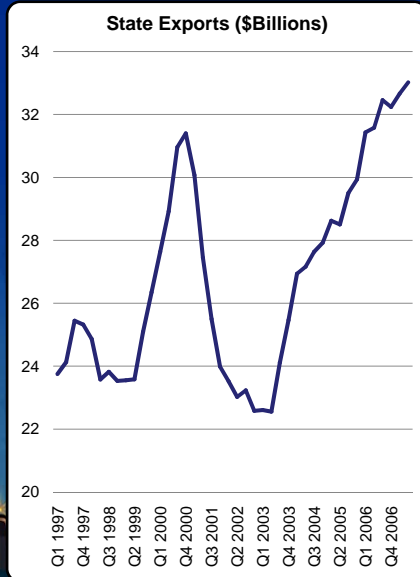


2000 was unusual, not today



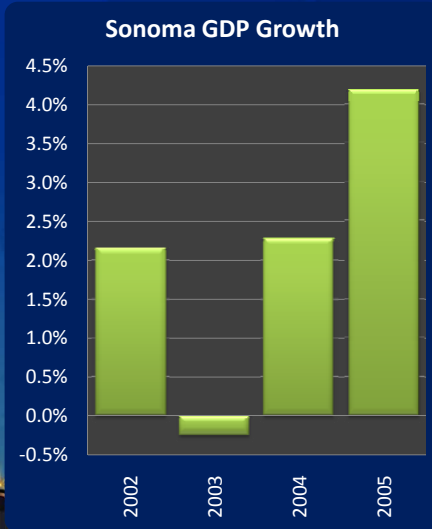
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Outsourcing: Not an issue



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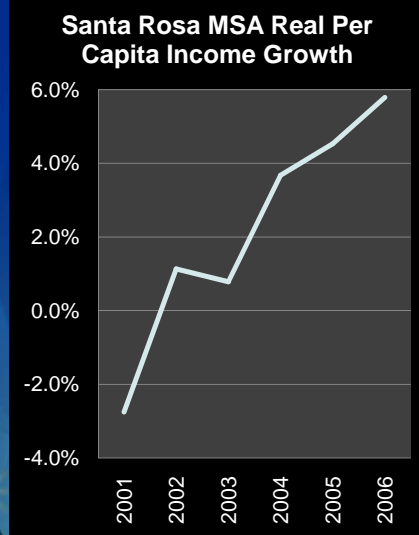
Sonoma Growth: Solid



Industry	2005 Share
Total Gross Domestic Product	3.2%
Professional and technical services	7.6%
Wholesale trade	5.3%
Real estate and rental and leasing	17.3%
Retail trade	9.1%
Health care and social assistance	8.0%
Durable goods	8.6%
Construction	6.6%
Agriculture\	1.9%
Nondurable goods	5.6%
Information	3.6%
Accommodation and food services	3.0%
Arts, entertainment	0.8%
Transportation and warehousing	1.4%
Educational services	0.4%
Other services, except government	2.6%
Management of companies	0.6%
Government	8.8%
Administrative and waste services	2.8%
Finance and insurance	5.0%

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Local Income Growth: Great!



Income by Industry, Contribution to Growth 03-06

Industry	Share	Cont.
Professional and technical services	8.4%	24.6%
Health care and social assistance	11.2%	15.4%
Wholesale trade	5.4%	13.6%
Construction	8.9%	13.4%
Government	16.5%	12.6%
Nondurable goods manufacturing	6.8%	8.1%
Retail trade	8.6%	5.8%
Accommodation and food services	3.6%	3.2%
Finance and insurance	5.4%	2.7%
Real estate and rental and leasing	1.3%	1.6%
Farm compensation	1.3%	1.6%
Forestry, fishing, related activities	0.5%	1.3%
Other services	3.0%	1.3%
Arts, entertainment, and recreation	0.9%	1.3%
Administrative and waste services	3.5%	0.4%
Educational services	0.7%	0.2%
Mining	0.2%	-0.4%
Management of companies	1.0%	-1.3%
Information	2.5%	-2.1%
Durable goods manufacturing	10.2%	-3.3%

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Where are we today?

The 'Bear-come-latelys' briefly came out in August

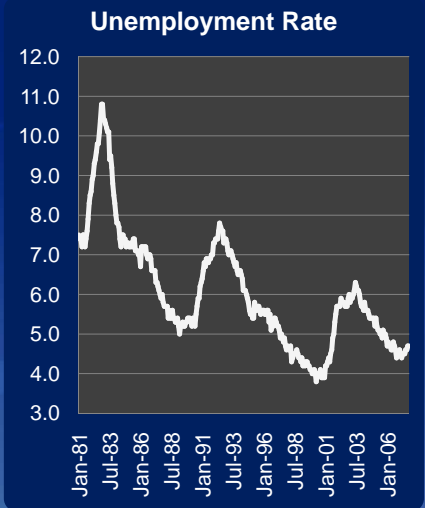
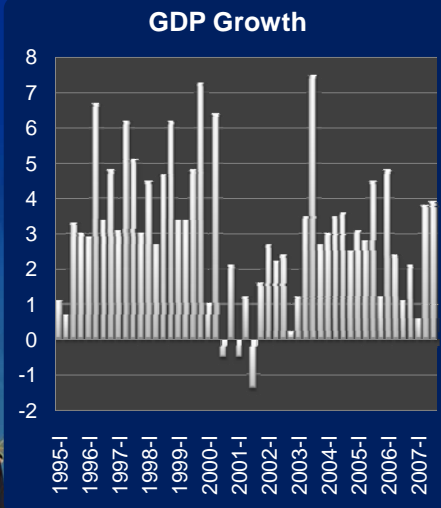
Growth Outlook Worst in 5 Years
 By JEANINE AVERSA - 1 hour ago
 WASHINGTON (AP) — Strained by a ailing housing market and credit woes, the economy in 2007 is expected to log its worst growth in five years and should be somewhat sluggish next year.
 The No. 1 risk, though recession, forecasters
 A forecast released M
 growth of gross domes
 group's previous surve
 If the latest prediction

Wall Street Journal
Dow, S&P 500 hit new records after
Credit crunch may not lead to recession
 Wed Oct 10, 2007 9:26 PM BST
 Email This Article | Print This Article | RSS

By Ellen Freulich
 NEW YORK (Reuters) - The credit crunch that has troubled financial markets in recent months will restrain the U.S. and global economies, but odds of a recession are less than 50 percent, monetary experts said on Wednesday.
S&P sees
 Leaked reports of the International Monetary Fund's upcoming growth forecasts onthly d
 showed the IMF has revised down 2008 projections for the United States economy, ional
 forecasts had expected a gain of 110,000 jobs. The unemployment rate remained at 4.6%.
 AFP, NEW YORK Saturday, Oct 06, 2007, Page 11
 Standard & Poor's analysts see signs of stability returning
 The S&P analysts said the credit markets appeared to have
 also slumped after it cut its outlook for shipments and sales for the remainder of the
 Group agreed to pay \$12m to various states in order to settle complaints about the ins

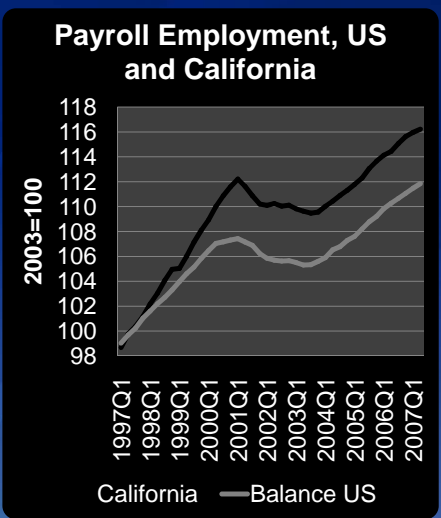
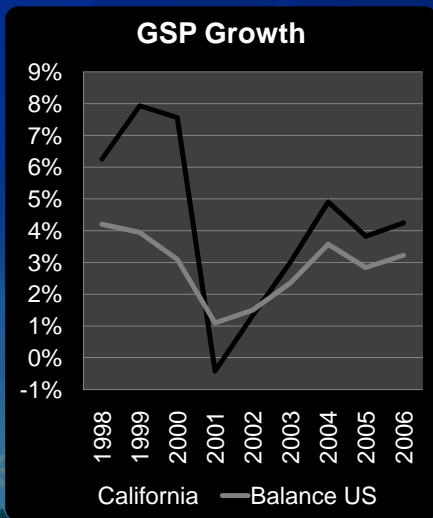
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GDP Growth Rebound, Labor Markets Still Tight



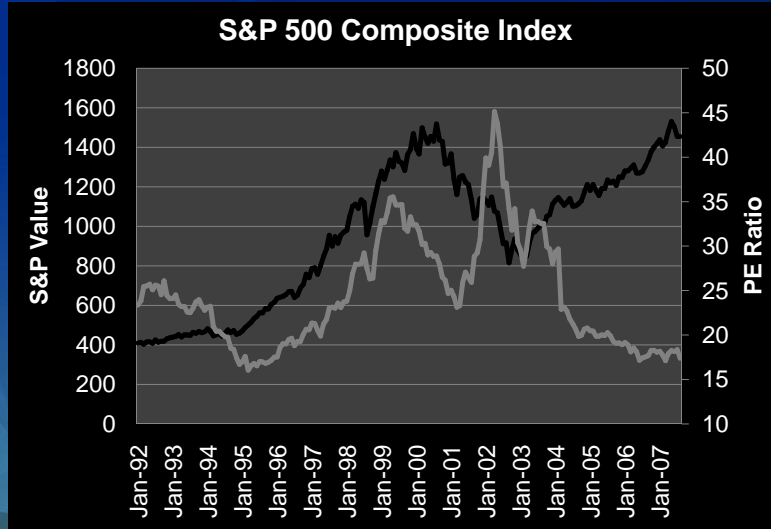
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State: Ahead of the Game

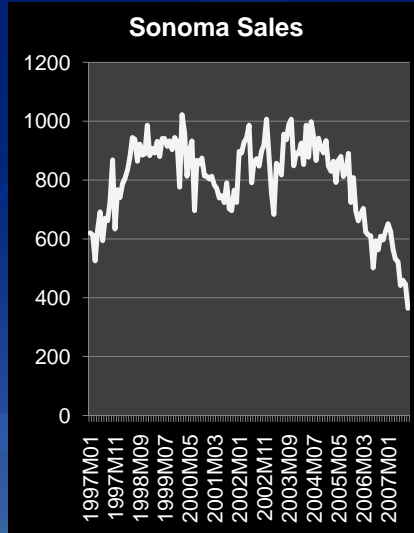
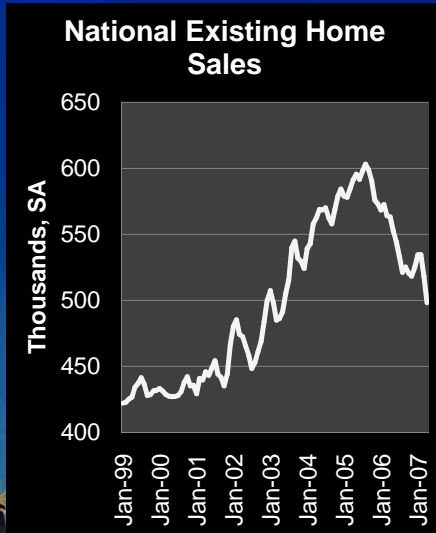


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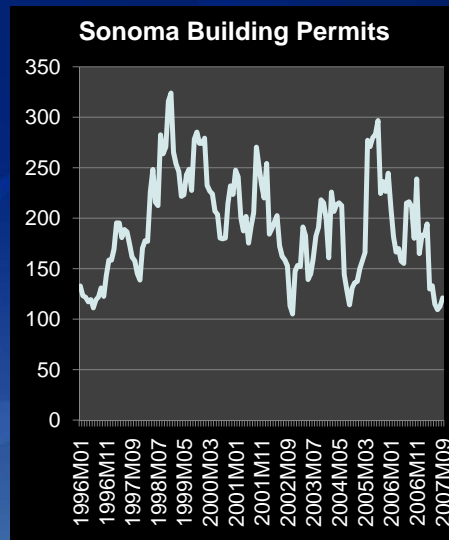
Equity Markets: *Turbulent but Solid Fundamentals*



Housing Bubble: Popped in late 05



State and Local Effects



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Four reasons why the housing market is still on its way down.

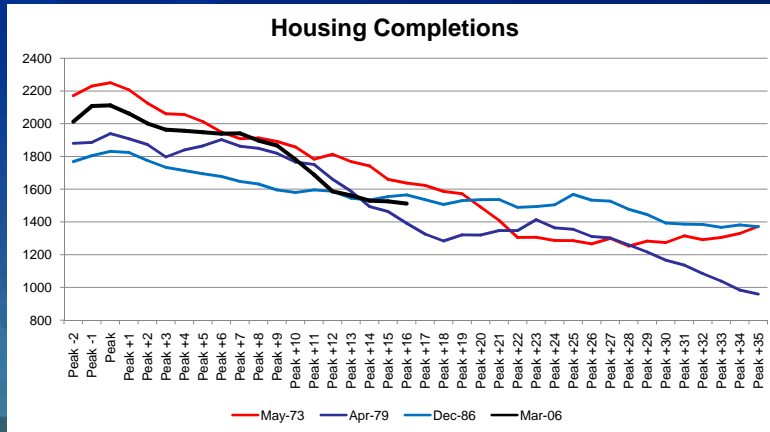


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Reason # 4

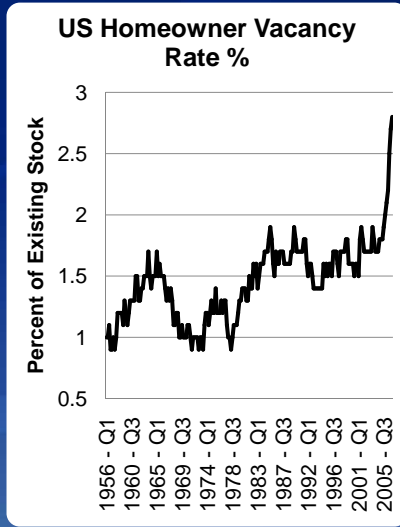
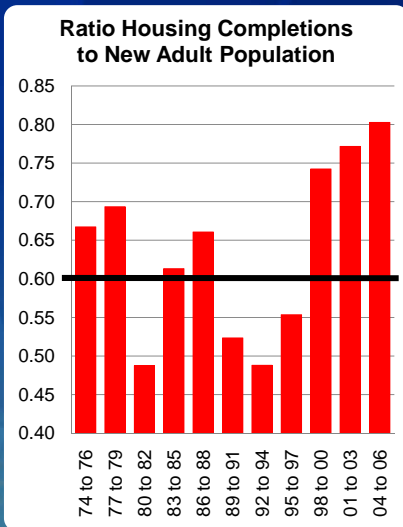


Housing Markets Don't Bounce



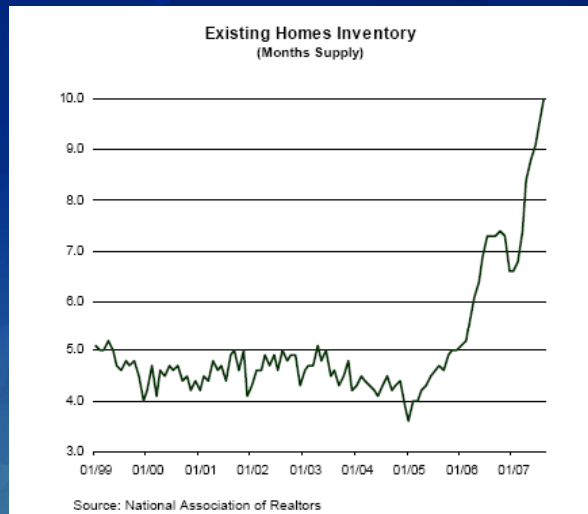
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Excess Inventories



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Supply

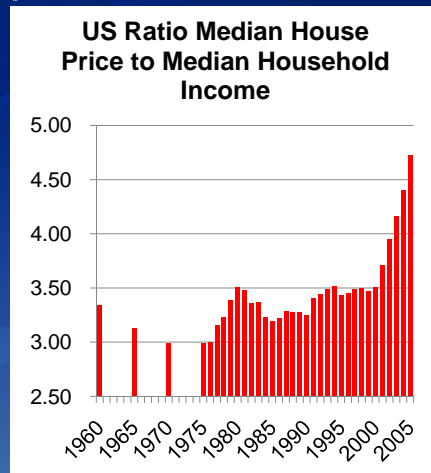
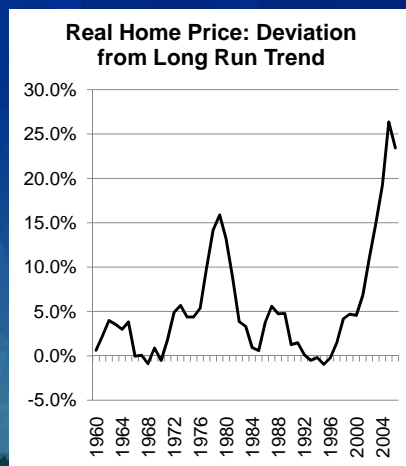


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Reason # 3



Massive Appreciation



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Housing Costs...

Affordability based on FHA definition

	Median Prices			Owner Affordability		
	Q1 89	Q1 99	Q1 07	1989	1999	2007
Alameda	\$179,750	\$228,333	\$618,167	83%	138%	66%
Contra Costa	\$163,583	\$209,167	\$584,833	100%	153%	72%
Los Angeles	\$185,333	\$177,500	\$553,333	79%	147%	61%
Orange	\$223,333	\$246,417	\$681,667	77%	125%	59%
Riverside	\$106,000	\$117,167	\$409,667	112%	187%	76%
San Bernardino	\$93,167	\$98,367	\$368,333	131%	223%	81%
San Diego	\$160,167	\$200,333	\$546,667	86%	131%	67%
San Francisco	\$268,167	\$327,167	\$799,000	55%	100%	50%
Santa Clara	\$231,333	\$334,333	\$738,000	78%	114%	66%
Ventura	\$233,333	\$215,167	\$610,667	71%	139%	64%

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Reason # 2



The Mortgage Markets

Greenspan June 2005:

“Although a “bubble” in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.

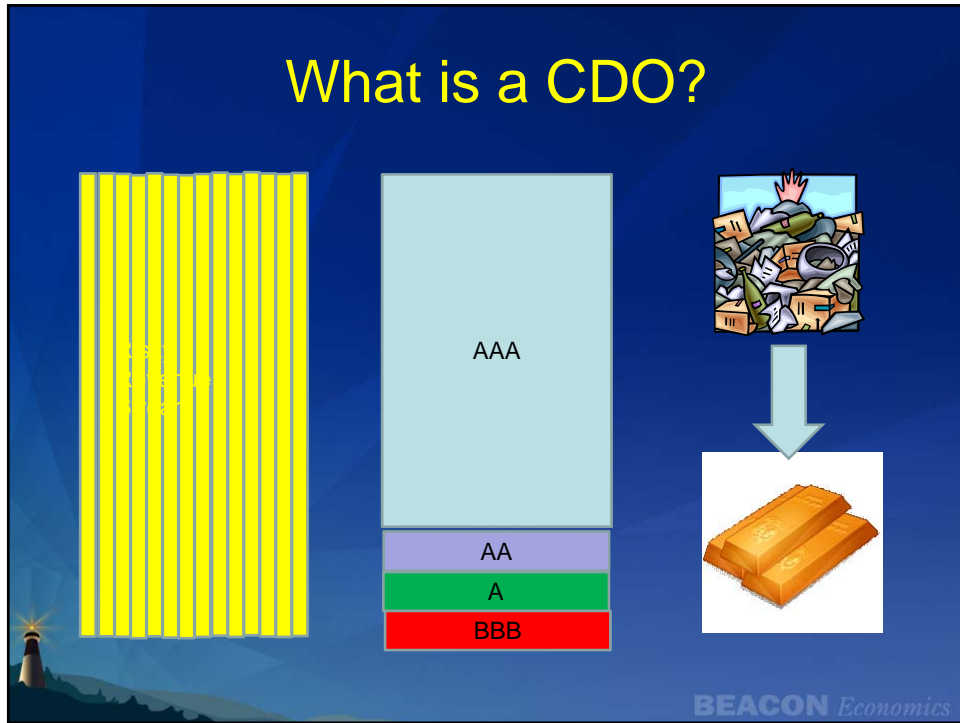
“[Home price declines] were they to occur, likely would not have substantial macroeconomic implications. Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections.”

Bernanke May 2007:

“About 7-1/2 million first-lien subprime mortgages are now outstanding, accounting for about 14 percent of all first-lien mortgages.¹ So-called near-prime loans--loans to borrowers who typically have higher credit scores than subprime borrowers but whose applications may have other higher-risk aspects--account for an additional 8 to 10 percent of mortgages.”

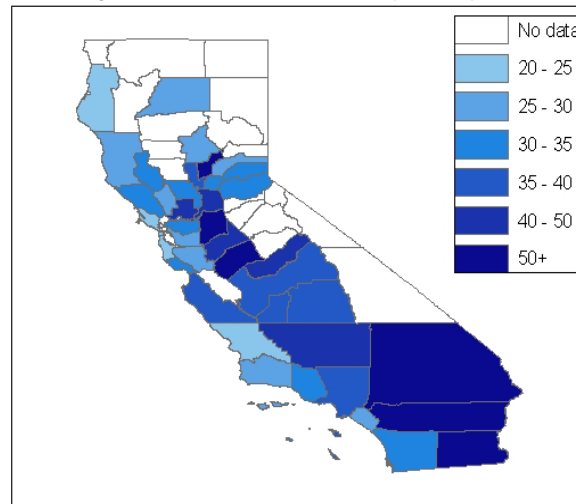
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What is a CDO?



Alternative financing around the state

Share of Mtg loans that are subprime, by county



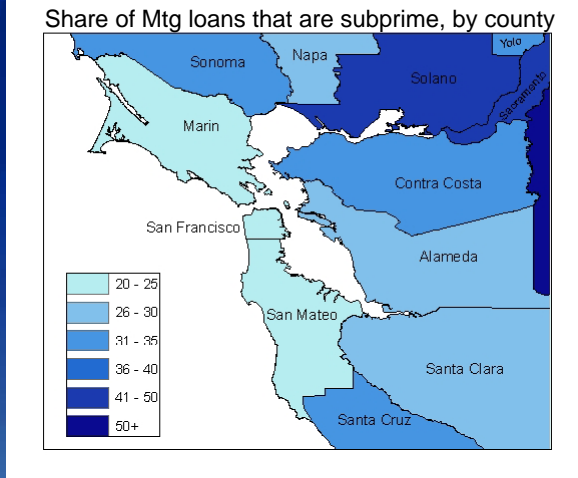
What about the Bay Area?

Less common
In N. California....

But not rare:

Santa Clara: 25.7%
San Mateo: 22.2%
San Francisco: 21.4%

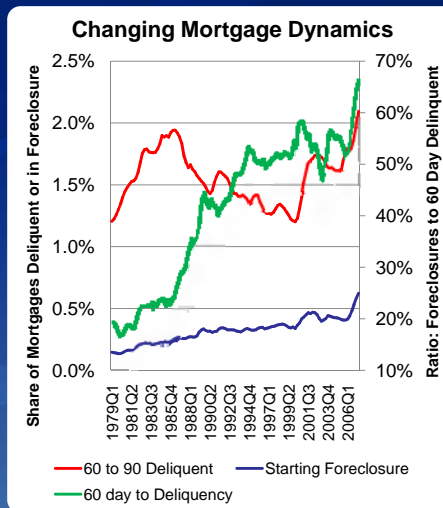
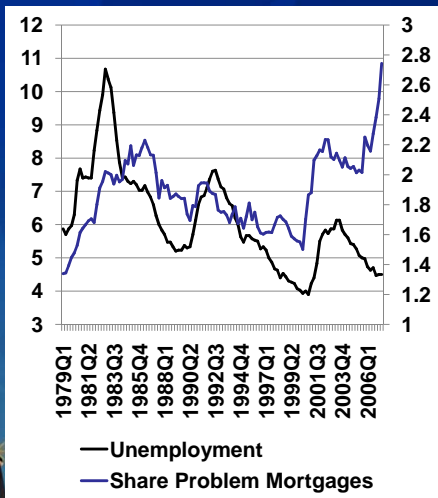
Contra Costa: 34%
Solano: 43%



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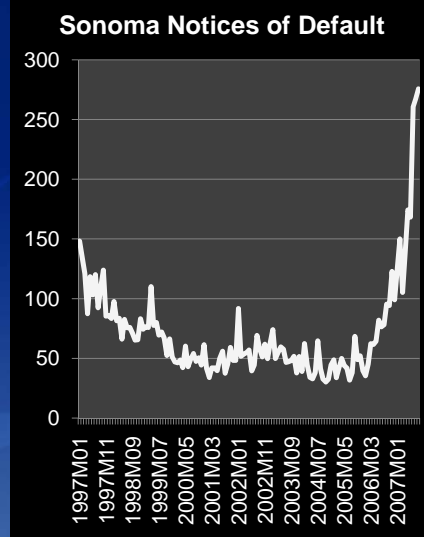
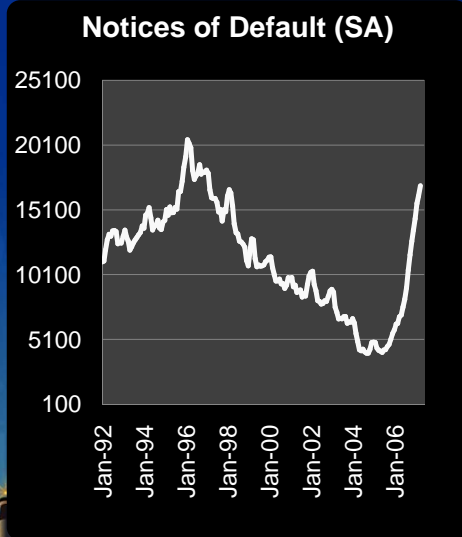
The inevitable...

The Mortgage Meltdown



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Notices of Default

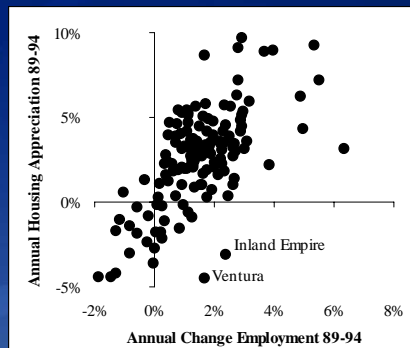


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How could they be so wrong?

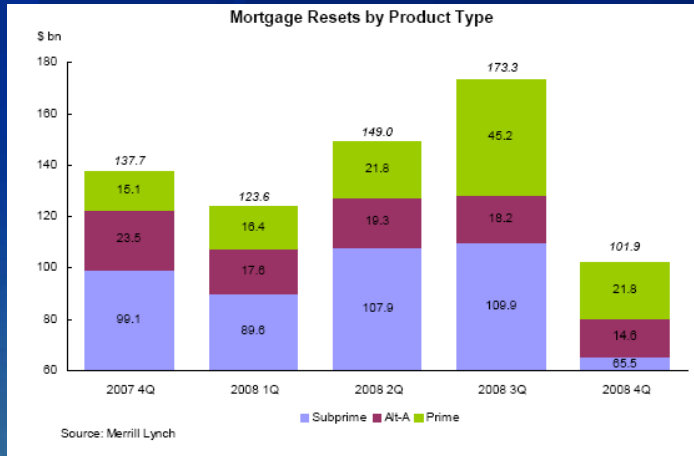
- Tyranny of models
 - FICO score most important in past
 - Prices don't fall unless massive long-term loss of jobs
 - Ignored the fundamentals
- Tyranny of commissions
 - Why listen to reason when the income is flowing
 - Long term investments made by those with only a short run stake in the game

Employment and Prices by MSA 1989 to 1994



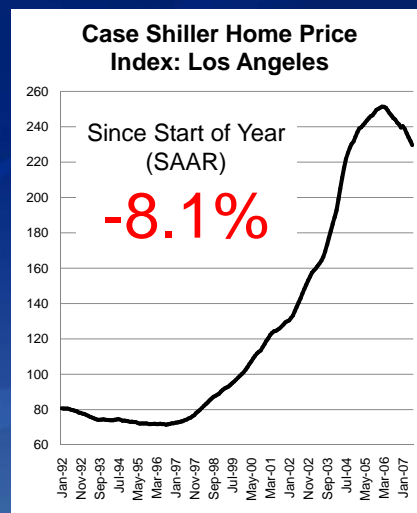
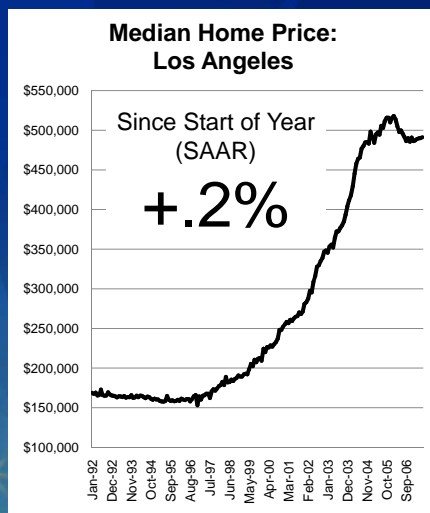
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Worst is to come...



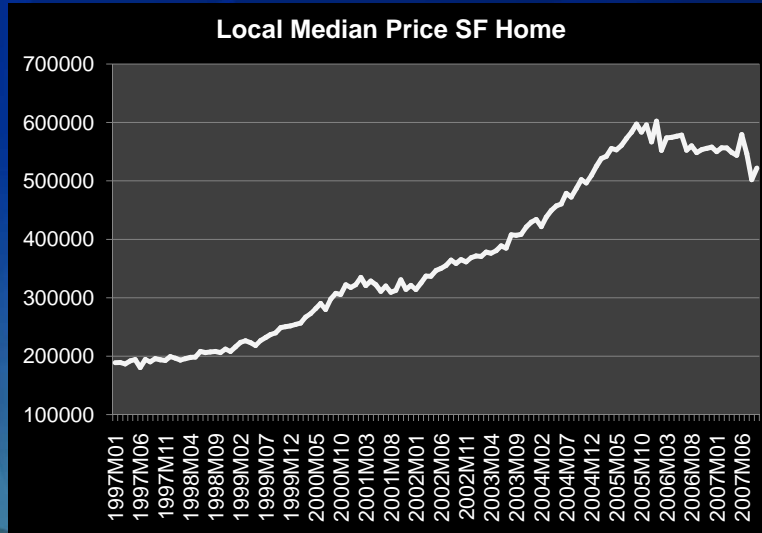
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But, prices are stable, right?



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Local Prices?

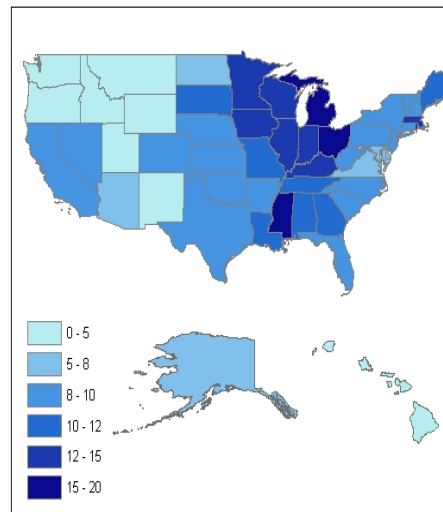
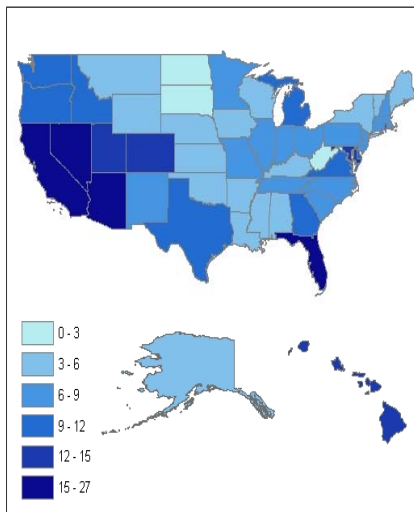


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The meltdown: a closer look

Share of owned homes with subprime

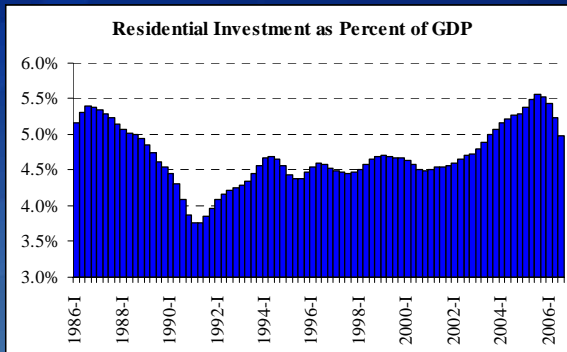
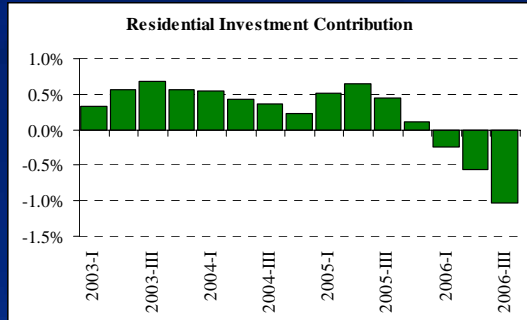
Share of subprime 60 day+



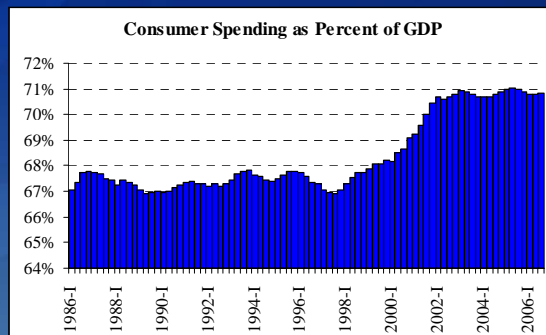
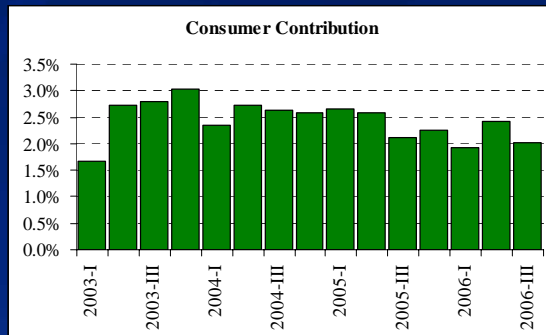
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What does residential construction mean to the economy?

Not Much



But Consumer Spending Does...

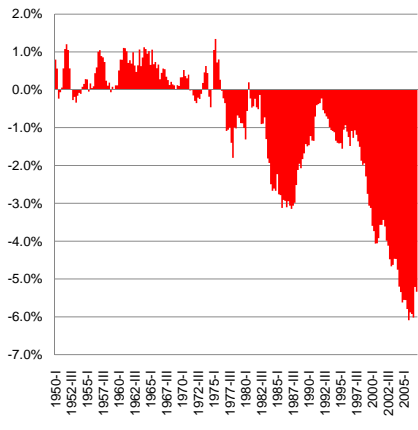


Reason # 1

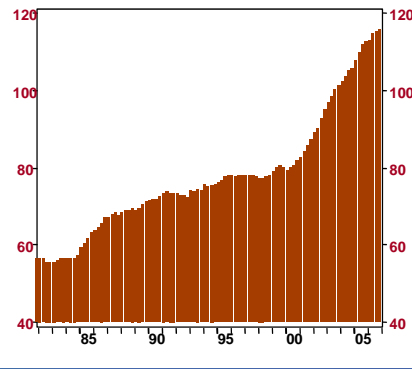


The rest of the economy...

Trade Deficit as % of US GDP



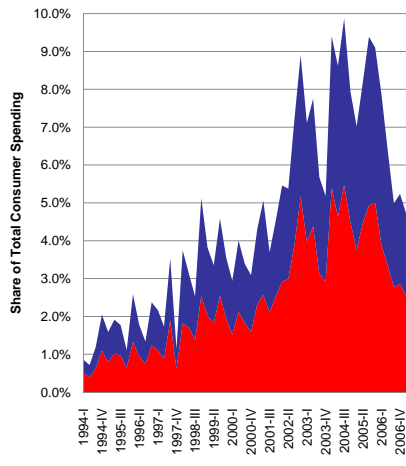
Household Debt as % of Income



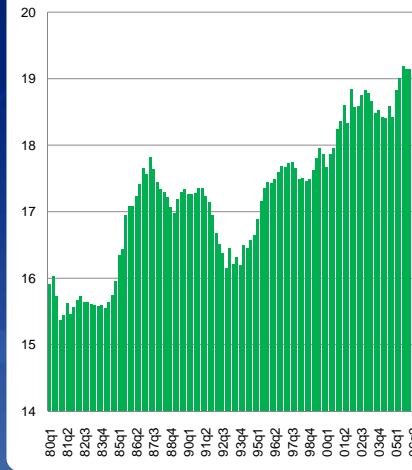
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The Home ATM

Net Mortgage Equity Withdrawal (Fed Estimate)

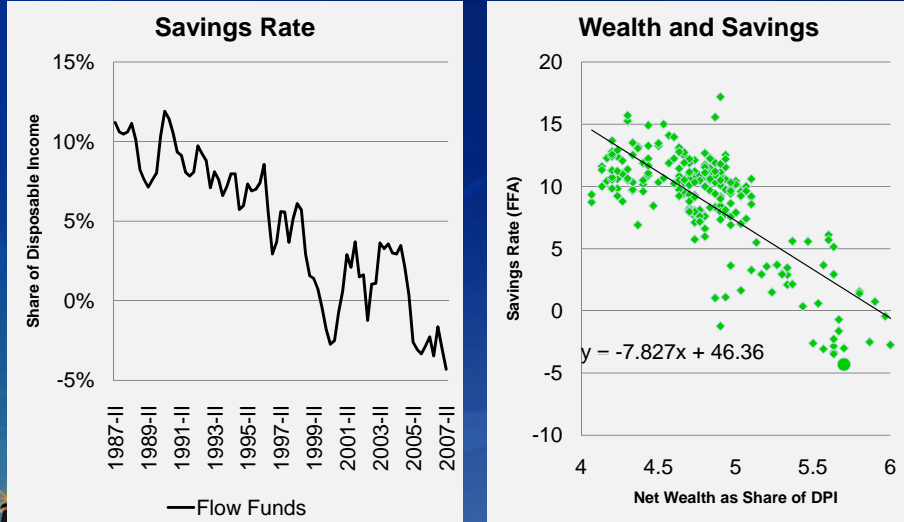


Consumer Debt Obligation
% of Disp. Income



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Consumer Savings



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What do these two guys have in common?

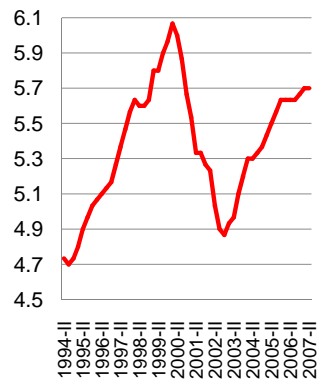


Both will have their records marked with an “*”

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Sources of new wealth

Net Wealth as Share of Disposable Income



	1994	2007	Ch	07 Est
Assets	5.66	7.04	1.39	6.40
Tangible assets	2.07	2.70	0.64	2.25
Real Estate	1.61	2.29	0.68	1.83
Other	0.45	0.41	-0.04	0.41
Total financial assets	3.59	4.34	0.75	4.16
Deposits	0.62	0.66	0.04	0.66
Total Credit Assets	0.39	0.32	-0.07	0.31
Corporate equities	0.64	0.61	-0.03	0.58
Mutual fund shares	0.22	0.49	0.27	0.47
Pension fund	0.91	1.23	0.32	1.17
Other	0.81	1.03	0.22	0.98
Total liabilities	0.88	1.36	0.47	1.36
Mortgages	0.61	1.00	0.39	1.00
Consumer credit	0.18	0.24	0.06	0.24
Other	0.10	0.12	0.02	0.12
Net Wealth	4.8	5.7	0.9	5.0

Estimate for 2007 based on 20% decline in home prices, 5% of non-deposit financial asset values

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Some New Vocabulary...

- Intoxication!

Euphoria at getting a tax refund, which lasts until you realize it was your money to start with.

- Dopeler effect:

The tendency of stupid ideas to seem smarter when they come at you rapidly.

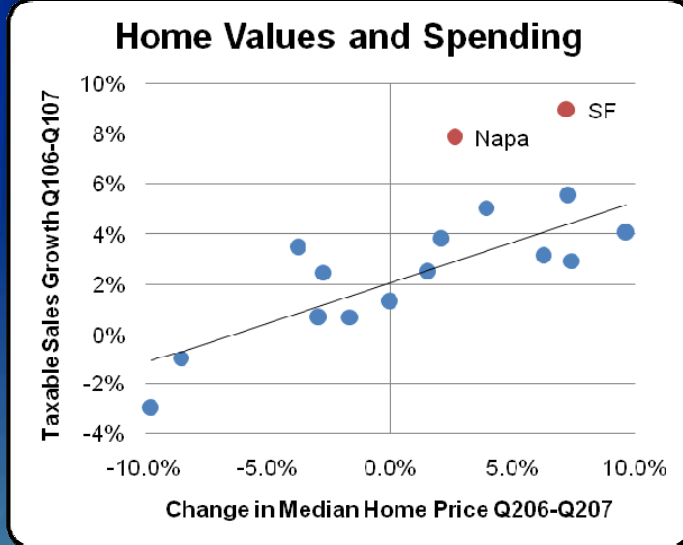
- Cashtration:

The act of buying a house, which renders the subject financially impotent for an indefinite period of time.

Source: Washington Post's Mensa Invitational

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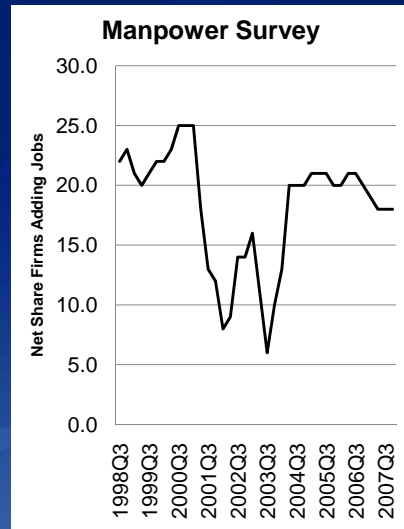
California wealth effects



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Labor Market Slowing

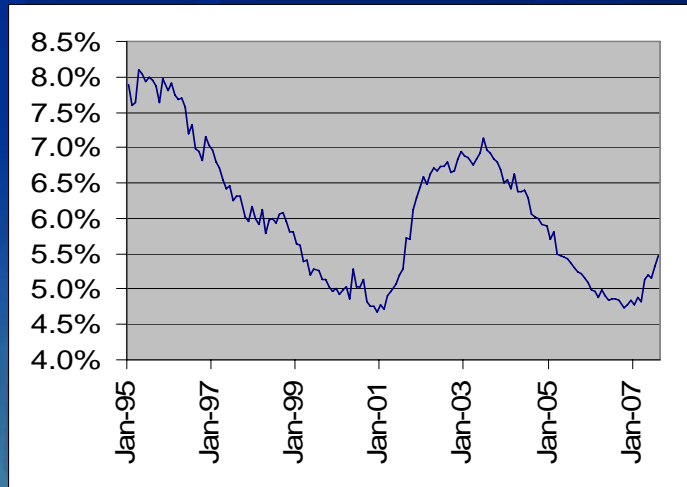
Sector	04 to 06	07	Diff
Total nonfarm	2305.7	1404.0	-901.7
Construction	290.3	-157.5	-447.8
Manufacturing	-52.0	-220.5	-168.5
Wholesale trade	108.5	119.3	10.8
Retail trade	133.6	53.7	-79.9
Transportation and Utilities	101.5	39.1	-62.4
Information	-24.3	42.0	66.3
Finance and insurance	107.5	10.1	-97.4
Real estate and leasing	45.4	0.9	-44.5
Professional and technical	280.5	312.0	31.5
Management of enterprises	41.2	35.9	-5.3
Administrative	228.5	-128.1	-356.6
Services	441.3	643.5	202.2
Leisure / Hospitality	345.3	324.0	-21.3
Other Services	12.7	49.5	36.8
Government	202.7	246.0	43.3



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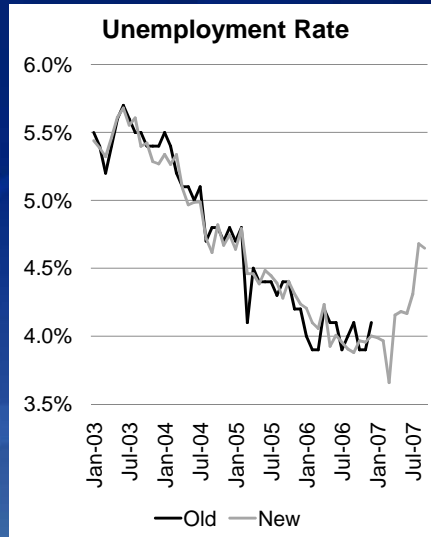
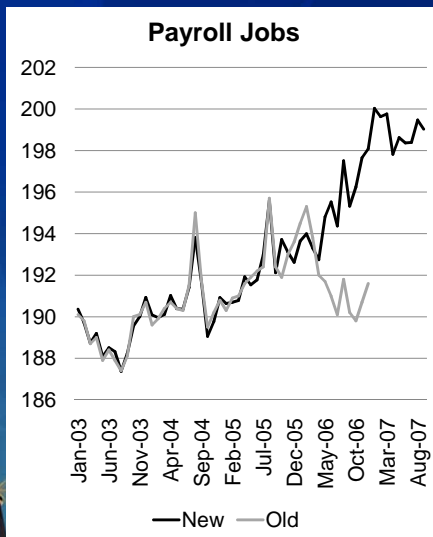
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State Unemployment



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Local Labor Markets: Softening



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Recent Job Growth

	04 to 06	07	Diff
Total	4.14	0.28	-4.42
Construction	0.80	0.53	-1.33
Pro and Tech	0.98	0.35	-1.33
Retail	0.16	0.77	-0.93
Admin	0.53	0.25	-0.79
Gov	0.47	0.26	-0.73
Non-Dur	0.52	-0.15	-0.37
Edu and HC	0.41	-0.19	-0.22
Fin and Ins	0.16	0.01	-0.17
Transport	0.20	-0.04	-0.16
Wholesale	0.35	-0.21	-0.14
Real Estate	0.01	0.08	-0.09
Farm	0.09	-0.09	0.00
Mgmt of Ent	-0.02	-0.02	0.05
Other	-0.08	-0.13	0.21
Information	-0.35	-0.04	0.39
Leisure	0.51	-0.95	0.45
Dur Manu	-0.60	-0.13	0.74

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Outlook for Real Estate

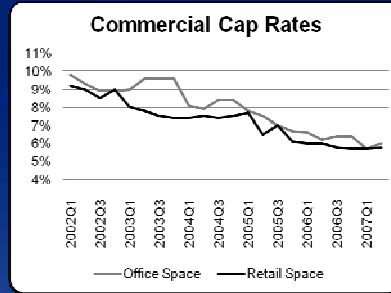


- New vocabulary Part II...
 - Homallucination: the ability to convince oneself that while the price of everyone else's home will fall, your neighborhood is clearly different.
- Prices will continue a slow decline for 07 and 08
 - Speed depends on rest of economy
 - Total downward adjustment: 20% to 25% locally
- Sales markets, new and existing, will get colder and stay cold for some time
 - No recovery in liquidity until 2008, some builder will be crushed
- Mortgage markets will get much worse
 - The Reset Peak Hits in mid 2008!

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Is residential the only sector I should worry about?

- Retail
 - Driven by consumer spending
- Office Space
 - Driven by Employment and stock
- Investment side
 - Low cap rates an issue

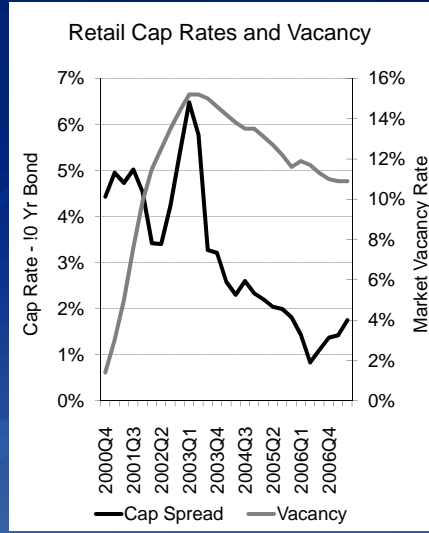
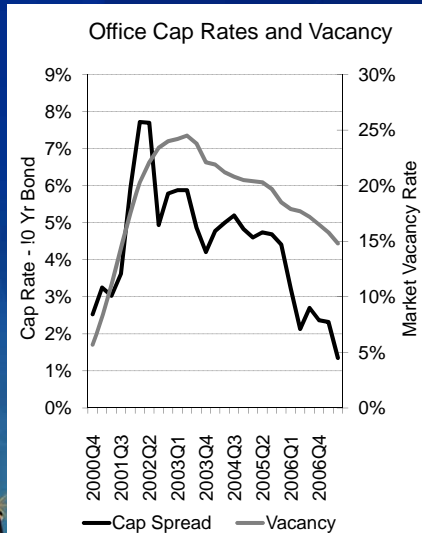


	U.S. Assets	Non-U.S. Assets	Total Issuance
2001	67,149.9	22,713.8	89,863.7
2002	52,073.3	28,705.9	80,779.1
2003	77,848.1	20,802.9	98,651.0
2004	93,838.2	33,746.0	127,584.2
2005	169,169.5	69,376.1	238,545.6
2006	185,700.0	81,100.0	266,800.0
2007	136,991.2	54,990.7	191,981.9

Source: Commercial Mortgage Alert.

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Commercial Cap Rates: Bay Area



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Big Picture Summary



- Positives
 - Manufacturing / Inventory Cycle shifted out
 - Productivity still good, fundamentals
 - Exports and the World Economy
- Negatives
 - Housing has not hit bottom, will be a drag for some time to come
 - Consumers will slow spending / financial mess
 - The external accounts / financial markets can have a severe impact
- **2008 Overall Forecast: bad**
 - Recession Almost Certain
 - #1 indicator: Consumer spending
 - #2 indicator: The US Exchange Rate



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Primary Risks to the Local Economy

- Consumer spending falling
 - Pressure on retailers and local government
- Commercial real estate
 - The unwinding of historically low cap rates
- Financial sector is vulnerable
 - Lots of “froth” in financial sector
- Business spending
 - Profits and the World Economy



BEACON Economics

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*Jon Haveman and
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