ECONOMY IN FOCUS BY ROBERT FREEDMAN

Beneath market punditry, underlying strength

WITH SOME 5 PERCENT OF SUBPRIME MORTgage borrowers facing trouble and global investors wondering if prime mortgages remain a smart investment, these are indeed challenging times for real estate.

In one of the most unsettling headlines of all, Robert Shiller of Yale University and one of the developers of the widely tracked S&P Case-Shiller Home Price Indices, has said mortgage troubles are only beginning and that some home prices could fall 50 percent in the next few years.

Dire predictions like that do more than grab the attention of the media; they can shake consumer confidence and help make such predictions self-fulfilling as home buyers stay on the sidelines, pressuring sellers to lower prices—in effect fueling a downward spiral.

But the prognosis is considerably different than the scare scenario forecasters would have us believe, says Lawrence Yun, NAR vice president of research. In this interview with REALTOR® Magazine, Yun puts the state of the economy into perspective, explaining just how contained the subprime problem is and why the trend lines are already contradicting many of the predictions of woe.

REALTOR® Magazine: No doubt the general media tend to play up negative market news like continuing soft home sales. Is there truth in these market concerns?

YUN: It's all a matter of perspective. Home sales do continue to be soft. We're predicting existing-home sales to be down 7 percent year-over-year at the end of 2007, but that's coming off a five-year boom. We're forecasting a sales level near what we had in 2002, a very good year, and a level that's far closer to normal than what we've been seeing over the past four years.

At the same time, price appreciation is holding up better than media reports would have us believe. In data we collected this fall, two-thirds of markets reported positive price growth in the third quarter, up from half of all markets in the second quarter. In markets where prices continue to be down, the declines are minimal, 1 percent to 2 percent. Only a very few markets are seeing declines higher than 5 percent.

RM: Why the dramatically different picture than what some analysts are seeing?

YUN: In some ways we're tracking different things. We use MLS data, so our figures are as timely as possible and are more representative of markets. Shiller

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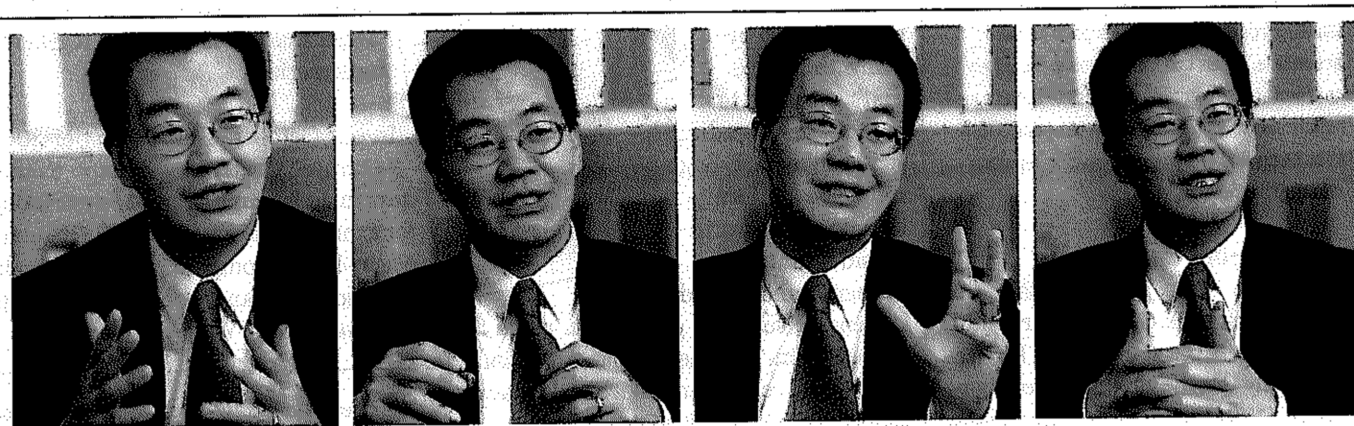

GIVING PERSPECTIVE Lawrence Yun looks beyond the headlines to find hidden strength in future housing demand.

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uses county records and mortgage data from the secondary market. These sources lag further than ours and they capture a disproportionate percentage of higher-priced homes.

RM: Aren't we facing a wave of defaults on option ARMs and other mortgages made in 2005 and 2006 with teaser rates about to reset to levels borrowers can't afford? These defaults will lead to more build-up in home-sale inventories, putting more downward pressure on prices.

YUN: Even with the Fed's rate cut in mid-September, foreclosures will rise in 2008. But these reset problems remain largely confined to subprime borrowers, who comprise only 9 percent of the market. Subprime borrowers with a mortgage in foreclosure account for only 5 percent of that. So the problem is confined to less than 1 percent of borrowers. We're expecting foreclosures to add some 200,000 homes to inventories. But when you add that to the 4 million homes already available for sale, you're talking about a relatively modest percentage increase.

RM: Yet it's an increase that comes during very challenging market conditions.

YUN: What's challenging isn't so much market conditions but the psychology behind those conditions. There continues to be huge pent-up demand, and that demand will grow. Our economy added 4.3 million net new jobs in the past two years.

For every two new jobs that are created we historically see one new home buyer. Right now we're not seeing those new home buyers because they're sitting on the fence. Once they look past the headlines, they'll see that this is actually a very good time to buy: Inventories are flush, so there are lots of homes to choose from; prices are moderating; and interest rates remain historically low. Once the psychology catches up to our real market conditions, that pent-up demand will be released.

RM: You're talking about consumer psychology, but what about investor psychology? We experienced a very real liquidity

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crunch in mortgage markets this summer because investors were skittish about holding any kind of mortgage-backed security. That crunch affected prime mortgages as much as subprime mortgages.

YUN: We did see a liquidity squeeze, and some home buyers lost their loans before they could close. But the Fed stepped in with a timely cut to its discount rate and there's plenty of funding today. If you're a good risk, credit will be there. Spreads between conforming and jumbo loans remain a little wide—up from about 20 basis points last year to about 1 percentage point today—but I expect the spread between conforming loans and jumbo loans to narrow in a few months.

RM: So the subprime conflagration isn't showing signs of spreading?

YUN: Lenders are quickly educating themselves about where the risks are. Not all borrowers pose the same risk, and lenders are starting to price accordingly.

RM: But what about all those subprime borrowers? Many of these are the first-time borrowers who helped fuel the growth we saw in home sales over the last few years. What are the options for them?

YUN: We certainly won't see the number of subprime borrowers that we saw during the boom. But borrowers who can't qualify for prime loans will still have options, particularly if we see enactment of reforms to the FHA that NAR has been championing. The FHA has historically been the safe and affordable financing option for these borrowers. Largely because it comes with a lot of red tape and lacks a big choice in products, lenders rushed to fill the void with their much-riskier subprime loans. So a reformed FHA can go a long way to returning moderate-income and first-time borrowers to the market.

Some additional flexibility to secondary mortgage market companies Fannie Mae and Freddie Mac, which NAR supports, will help too, because they'll be able to reach more moderate-income buyers. Mortgages with private mortgage insurance will also make a comeback for buyers with inadequate down payments.

RM: So, where will the home-sale market be in 2008?

YUN: Nationally, we're forecasting existing-home sales to make a comeback and rise to 6.1 million or 6.2 million units, up from about 6 million in 2006, and prices will also rise about 2 percent. Some local markets like Austin and Denver will do far better. On prices, we'll be helped by a significant drop in new-home starts. Media reports tend to portray that as a negative—further evidence of troubles. But it's actually very good for real estate, because it keeps inventories down and price pressure up—and that's what consumers really care about. The important economic trend lines for consumers are pointing in the right direction. RM

16%

If you listen to media reports, you might think foreclosures are on the rise in every corner of the country. But despite turmoil in the subprime market, foreclosures are actually down or unchanged in 16 percent of the states.

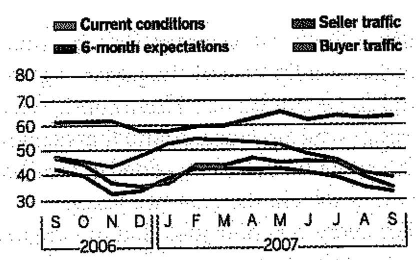
State	Foreclosure rates
Utah	-26%
New Mexico	-9%
South Carolina	-4%
Tennessee	-3%
Arkansas	-3%
North Carolina	-3%
Kansas	-1%
Pennsylvania	0%

*Percentage change in 2006 Q2 vs. 2007 Q2

Source: National Delinquency Survey, Mortgage Bankers Association

Business Confidence

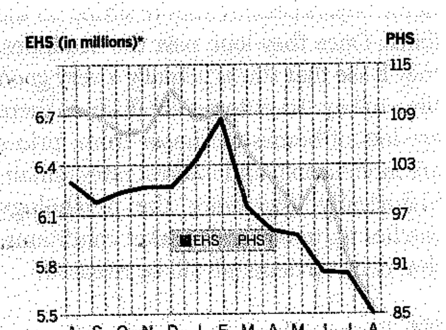
Seller traffic seen rising Practitioners expect buyer traffic to stay low in the months ahead while seller traffic rises, potentially adding to inventories. Practitioner confidence was surveyed in September and looks ahead six months.



Results are based on 369 responses to 3,000 surveys sent to large and small real estate offices. The survey asks practitioners to indicate whether conditions are strong (100 points), moderate (50), or weak (0). Responses are averaged to derive results.

Home Sales

Mortgage woes casting cloud Sales of existing homes continued to slow in August, and NAR's forward-looking pending home sales index points to additional slippage as mortgage woes stoke consumer uncertainty. Total existing-home sales—including single-family houses, townhomes, condominiums, and co-ops—were down 4.3 percent to an annual rate of 5.5 million units, from a level of 5.75 million in July. NAR's pending home sales index for August dropped to 85.5, down 6.5 percent from an upwardly revised 91.4† in July.



*Seasonally adjusted annual rate, which is the actual rate of sales for the month, multiplied by 12 and adjusted for seasonal sales differences.
†Adjusted from the figure published in the October 2007 issue.

Source: NAR Research