

A Requiem for a Housing Bubble

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We've written about the housing bubble on quite a few occasions this year – and for good reason. The difference between the US housing market this summer and last is like night and day. Last year at this time homebuyers were falling over themselves outbidding each other in a sizzling housing market – one that had all the earmarks of a market consumed by greed and mania. This frenzied activity often resulted in bidding wars, which led to homes selling for well above asking price merely days after being listed. What a difference a year makes! Today the situation on the ground (or the lawn, if you will) is completely the opposite. The unsold inventory of new and existing homes is blowing out at an alarming rate. Buyers seem to have packed their bags and left. Bids are getting increasingly difficult to come by, forcing asking prices to drop precipitously. Rather than days, it can now take several months (even a year or more) to sell a home. Median existing home prices are now down year-over-year in three-quarters of the US. Homeowners are levered to the gills, with imminent interest rate resets threatening to substantially increase their monthly payments. Refinancing options are becoming increasingly scarce due to rising interest rates and the end of price appreciation. Just like a balloon that has inflated to the breaking point, the pop in the US housing bubble has been quick and decisive. Every week seems to bring more bad news from the housing market.

The speed of the reversal has been stunning, but such is the nature of bursting bubbles. There can now be no denying that the first half of this decade witnessed a housing bubble of unprecedented proportions. According to the federal housing index, average home prices have increased almost 60% – far greater than people's incomes and far greater than supposedly tame core inflation. Like all bubbles, it burst under its own weight and is now in freefall. As students of the psychology of market manias, we aren't reticent to boast that we saw this coming. Just like the NASDAQ of the late 1990's, the housing market of the 2000's had all the makings of a mania. A chart of the homebuilders index is eerily reminiscent of the NASDAQ six years ago, with much further to fall (see www.investech.com for such a chart). Recall that, seven years ago, we were one of the few on the street to warn of a pending stock market crash whilst the vast majority were claiming that "things are different this time." We've been making the same foreboding claims about the housing market, and the dangers of the financial schemes being used to fuel it, in these articles. For alas, things are never different. All manias play out the same way. They are dynamics of *greed* and *fear*. The greed of making easy money. The *fear* of missing the boat. Manias are designed to draw people in and, once *everybody* is in, to pull the rug out from under them leaving them high and dry. The housing market was a textbook bubble. It was *déjà vu* all over again.

The trigger for the housing bubble was falling interest rates thanks to the Fed's ultra-aggressive easy monetary policies that began in 2001. But this was by no means sufficient to sustain the bubble for as long as it has. When a bubble begins to gather steam, the immutable human characteristic of greed transforms the financial system itself to facilitate the bubble's expansion so that the bubble gets inflated to well beyond reasonable levels. Financial institutions, among others, aided and abetted the housing bubble, as did anyone who had a

vested stake in its existence. Even the protestations of regulators, who saw the financial risks mounting, proved meek and ineffective – as is the case in any bubble. Why spoil the party? Even the revelation of questionable accounting at Fannie Mae failed to stem its book of business from doubling in the past five years. Abuses of the system run rampant whenever a bubble is in progress. Regulatory overhaul tends to occur only in the aftermath of a bubble, never during. There is too much at stake and too much money to be made.

The housing bubble, like any bubble, spawned abuses of the system. As we've mentioned in the past, real estate appraisals were being inflated as appraisers were being asked to "hit the number" on mortgage applications, or else risk losing business. The real kicker for the bubble, however, was when banks and mortgage lenders came up with a slew of creative (some would say reckless) financing options, or "hybrid" mortgages, which (pre-bubble) were considered too risky to be deemed prudent lending practice. To the extent that such mortgages existed before the housing bubble, they comprised a very small percentage of a mortgage lender's business. Furthermore, they were only extended to people with the best credit ratings. Today, these types of mortgages have become the norm, not the exception. Furthermore, they were being extended to people with poor credit ratings, also known as sub-prime. This is recklessness that can only occur in a bubble. (As an aside, we are now seeing "sub-prime" referred to as "near-prime" – yet more evidence of the bubble.)

New fangled mortgage schemes included: Interest-only loans that required payment of only interest and no principal in the early years of a mortgage. Teaser mortgage rates that offered mortgage rates as low as 1% in the first year of an adjustable rate mortgage. 2/28 mortgages that offered low rates in the first two years of a fixed-rate mortgage, followed by a substantial step up in the remaining 28 years. (If the step up proved too onerous for the borrower after the second year, they were allowed to refinance into another 2/28 mortgage!) Option-ARM's that gave borrowers the option of negative amortization whereby the principal outstanding was allowed to increase over time by making minimal mortgage payments in the first five years that weren't even enough to cover interest. Piggyback loans that allowed homebuyers to borrow money for the downpayment through a home equity loan. Downpayments in low-income neighbourhoods being paid for by charities funded by homebuilders. Even mortgages that didn't require any downpayment whatsoever were being offered in quantity. (We've seen estimates that 43% of first-time homebuyers made no downpayment in 2005.) These financing schemes were the tip off that we were in a housing/mortgage-finance bubble of massive proportions. There were endless television ads enticing people to take out mortgages or withdraw equity from their homes in one form or other. All these schemes were designed to facilitate getting everybody into the mania, using as much leverage as possible, and into homes and/or mortgages that they could not otherwise afford. But the question is: **When everybody has already been drawn in, where will the incremental source of demand come from to sustain the bubble?** There's nobody left. It's a classic bubble-ending scenario.

This is the situation the US housing market faces today. Everybody is in, and it's getting increasingly difficult to get out. The number of listings is exploding. In some markets it is double, even quadruple, what it was last year. The inventory of unsold homes now averages 7.3 months nationally and rising, versus 4.6 months last year at this time. In some markets there is one, two, even **four years** of inventory waiting to be sold. Buyers are getting increasingly scarce. There are many anecdotal stories in the Wall Street Journal of late. In today's paper, a woman put her 5-bedroom house up for sale for \$1.1 million last September. In March she dropped the price to below \$900,000 and still no takers. Now, in desperation, she's putting the house up for auction. In another recent WSJ article, there's the story of a Detroit woman who couldn't get out of an option-ARM. She put her house up for sale last summer, asking nearly \$400,000. No takers. Now she's willing to accept as little as \$270,000, even though her mortgage has \$324,000 outstanding. In Florida, homes in a new housing development had a contract price of \$490,000 but some buyers/speculators walked. One of these homes was recently sold by the builder for \$315,000. The evidence is everywhere. There is a hard landing taking place in

the US housing market as we speak. To make matters worse, apartments rents are increasing across the US after a 5-year lull in rental prices. This does not bode well for inflation, even with housing prices coming down. (Even though housing is 30% of CPI, it's not housing prices that get counted – rather implied/owner-equivalent rents.)

The troubles aren't just in the housing market, but in the financial world as well. Creative financing schemes cease working when interest rates go up and housing prices stop rising. Now the plethora of aggressive lending is threatening to derail the entire US financial system. 10% of homeowners now have zero or negative equity in their homes. 30% of homeowners who took out mortgages last year now have zero or negative equity. There is over \$9 trillion of mortgage debt outstanding in the United States. Needless to say, a substantial amount of that debt is now at risk.

The main danger is with adjustable-rate mortgages, or ARM's. It is estimated that over \$2 trillion of these mortgages are due for an interest rate reset in the next two years. The ARM rate has risen substantially in the past year or so. Now the 1-year rate is 6%, whereas last June it was just over 4%. Many borrowers will be imminently faced with substantially higher mortgage payments. But this is not the worst of it. Two of the most popular hybrid mortgages in the past couple years have been interest-only and option-ARM mortgages. As we've mentioned above, these loans promised low mortgage payments in the initial years by delaying principal repayment. We've seen estimates that a third of new mortgages issued last year were of this variety. It is these borrowers that are due for the biggest shock. Not only are they facing higher interest rates, but also the repayment of principal which, in the case of an option-ARM, could be higher than the initial loan outstanding thanks to negative amortization. At least half a trillion dollars of these loans are due for a reset within a year.

Countrywide Financial, the largest mortgage lender in the US, is sufficiently concerned to have sent thousands of letters to its customers warning them of a pending payment reset. Those with interest-only loans can face a payment increase of 50% or more. Those who have been making the minimum payment on an option-ARM (more than 7 out of 10 borrowers have chosen to do so) can face a mortgage payment that doubles or more! How's that for sticker shock? Mortgage insurers are now pleading with regulators to place restrictions on these types of hybrids... but to no avail. It's what invariably happens in a bubble – people are lured in only to have the rug pulled out from under them. We believe interest rate resets and the end of teaser financing periods not only threaten lending and insurance markets, but also threaten to flood the housing market with even more inventory for sale. This can only lead to a crash in housing prices.

Rising interest rates were bound to lead to the housing bubble's demise, made all the worse by the financial recklessness that has pervaded the mortgage finance industry these past few years. Robert Toll, the CEO of homebuilder Toll Brothers, claims to have never seen a downturn like this one in the 40 years he's been in business. He claims that each of the prior slumps he's witnessed were preceded by a downturn in employment or some other macroeconomic variable. "This time, you've got low unemployment, you've got job creation, you've got a stable stock market and relatively low interest rates." For how much longer, we would ask? Bruce Karatz, the CEO of KB Homes, recently called the housing market "very, very bumpy" with "tremendous hesitation" among buyers. Angelo Mozilo, the CEO of Countrywide, recently said "I've never seen a soft landing [in housing] in 53 years, so we have a ways to go before this levels out." Ameriquest Mortgage, the biggest US subprime mortgage lender, plans to cut a third of its 11,000 workforce. Washington Mutual has also announced mortgage-related job cuts. Will these laid off workers be able to pay their mortgages?

They won't be alone. The fact of the matter is the housing bubble was a boon for the US economy. It is estimated that 50% of job growth in the US over the past five years has been housing bubble related, i.e., homebuilding, renovation, construction, real estate brokerage, mortgage finance, etc. The spin-off effects of

this newfound wealth pervaded all aspects of the economy, consumer spending included. Now that the mania has come to an end, is it any wonder that the US economy is starting to show signs of sickness? Employment is slowing. Consumer confidence is weakening. People have leveraged themselves to the hilt, having used rising home prices to extract equity from their homes. Given the extent of the rise in housing prices, many average Joes were able to extract, say, \$50,000 in cash. Think of how difficult it is for the average American to save \$50,000 *through normal means*, namely, employment income. Very few are able to do it, even those with six-figure salaries. Now imagine this windfall gone, and the effect that is bound to have on the economy.

With no equity, people are already starting to feel poorer. Wealth creation via a housing bubble will ultimately prove to be a sham. In our view, it's a tautology that a hard landing in housing will mean a hard landing in the economy... and with it, a rough ride for the stock market as well.

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