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**Economic Update
Lawrence Yun, NAR Vice President of Research, and Senior Economist**

Diana

Mark, what do you think is the number one topic on every realtor's mind today?

Mark

Well, now that *American Idol* is not on, it's easy. We read about it every day in the papers and on the Internet. It would have to be the housing market.

Diana

Well, our next presenter is just the person to tell us what is happening. NAR's Vice President of Research, and Senior Economist, Lawrence Yun, has the uncanny ability – you don't know how right on he is – to explain what is really happening on the national and local fronts.

Mark

He's also an expert at forecasting how the economy will impact real estate. Ladies and gentlemen, please welcome to the stage Lawrence Yun.

Lawrence Yun

Yes, we are getting a lot of news. In fact, I remember October 25, 2006 very well. That day, NAR was the lead news item on CBS Evening News. We were the lead news item on the ABC World News Tonight. We were the lead news item on the NBC Nightly News. So what happened?

Well, the prices – home prices – had declined for three straight months, for the first time ever in our data series. And it was bad news. And from the media's point of view, bad

news is newsworthy news. Good news is fluffy news for junior reporters. So they don't want to bother with good news, so they concentrate naturally on the bad news.

Wednesday, we released the data on our local price reports. Our local price report shows stabilizing price trends. We saw that two-thirds of the markets in the country saw a price increase, versus one-third of the markets that saw a price decrease. And we were trying to emphasize that point. And when I got a lot of media calls, that was the point that I was trying to emphasize.

Yet the headlines were on the negative – "Forty States Encounter Sales Decline." Well, for most homeowners, and I would say for most average persons, when they are looking at the stock market, the reason why they are looking at it is to see if their value is rising or declining. They don't care about the volume of the transaction that is occurring at the stock market. They are looking at the value rising or declining. However, the media focus was on the volume of the home sales transaction, as opposed to the price increases in many parts of the country.

Now having said that, I have forty slides, and I will go over [them] quickly. I have forty slides of statistics because one of the frequent questions that I get from the media is, "Well, you are an optimist. You work for an organization to be an optimist." And I cannot just say, "Well, my gut feelings is that things are going to pick up." So I have to support it with statistics. And as I was doing these slides, the most difficult slide to form was the title slide, because are we just entering into a storm? Are we in the midst of a storm? In my view, we are toward the end of the storm, and I have many statistics to support that.

First, clearly, there is negative news in the media, and it is concentrated in the sub-prime market. And it is guaranteed that the foreclosure rate will be rising due to the many [resets] that will be occurring in the sub-prime loans this year and next. That is guaranteed. However, I do not believe that the size of the sub-prime market is large enough to damage the overall housing market, or even the economy. It was clearly a mistake on the part of Wall Street in not pricing the risk correctly. They believed that "Well, let's invest our money. Where? U.S. Treasury? Well, you get [four] percent return. That's puny. We want something higher." So they said, "Well, what about mortgages – sub-prime mortgages? It gives you nine-percent, ten-percent return."

So global investors were dumping money into hedge funds and saying, "Buy mortgages. Buy mortgages." Well, they did. And during the housing market boom, they were getting the return. And they were very aggressive in providing the funding. Now, with the sub-prime market showing the delinquency rate rising, the foreclosure rate rising, now they are not getting their money back, and Wall Street is in a panic mode.

Let's look at the size of the sub-prime market. Of all of the homeowners in the U.S., people with sub-prime loans comprise nine percent – less than ten percent. Foreclosure rate – clear difference. If you have a sub-prime loan that has adjustable reset rates, foreclosure rates are very, very high. If you are a prime borrower, which is the largest

segment of homeowners, you can barely see the [bar] showing up. The foreclosure rate is very, very low.

So I mentioned that the sub-prime comprise less than ten percent of homeowners, yet in terms of foreclosures, the sub-prime market has more than half of all foreclosures. So it is clearly concentrated in the sub-prime. It is not spreading over to the prime borrowers.

This has the delinquency rate on two sets of borrowers. One, the green line, is the sub-prime borrowers. And you can see that the sub-prime delinquency rate rose during the short recession that we had, and the job losses. But during the housing market boom, as the home prices rose, the delinquency rate fell. Now that home prices are stagnating, delinquency rates are rising again.

The yellow bar, the prime borrowers – they are very boring people. No movement there. What Wall Street is not getting correct currently is the fact that they are saying, "We made a lot of money on mortgages during the boom. Now there is all this default, and we want to stay away from anything mortgage." And they are not distinguishing between prime and sub-prime. They are just saying – and this is global investors, so think about, say, Japanese investors or investors from Germany. They don't know all the complexity of mortgages, collateralized debt obligations, _____. Those are complex words. They are saying, "Mortgages – stay away." So they are pulling the money out of all mortgages currently, which is causing some liquidity problems.

Because of the rising sub-prime loans, we are seeing certain local markets experiencing rising foreclosures, California leading the way. And also, in all these markets that have rising foreclosure rates, one commonality is they are having stagnating home prices. Even though California's foreclosure rate is rising, it is not one of the top states in terms of the actual foreclosures.

So it is rising fast, because it started from a very small foreclosure rate. So it is rising fast, but it is still below the national average. In fact, if you are a homeowner in California who bought a home two or three years ago, you are not in trouble; you still have sizable housing equity to work with. The people who are in trouble in California are the recent buyers who don't have the housing equity, and the prices are not rising.

So this is the state differential on the high-foreclosure states, and the highest are in Ohio, Indiana and Michigan. And one commonality of these three high-foreclosure states is that the U.S. had very respectable job market growth, except it did not cover these three Midwestern states. And because of the job market situation, these states have continued to have high foreclosure rates.

I find this chart very, very interesting. And I'm going to be delivering to Jerry Giovaniello because I think he should be using this chart. What this says is that, assuming a person goes into delinquency, what is the probability that person will go into foreclosure? Or is there a system set up so that if there is a delinquency, they can work the loan out so that person does not go into delinquency? And an interesting thing is,

sub-prime, if you go into delinquency, there is a forty percent chance you will go into a foreclosure. For prime, it is about twenty percent.

Interestingly, for V.A. and F.H.A. loans, it is actually even lower than the prime. So there is some kind of infrastructure system already set up to minimize the losses. And one of the things that we are emphasizing in Washington is that F.H.A. is a far safer loan product, but people have been switched away from the F.H.A. – a traditional loan product for low- and moderate-income households – and just pushed into the sub-prime. Now we are saying it needs to be switched back, from sub-prime back to the more traditional loan products for low- and moderate-income households.

Bad news travels. Good news does not travel. There are some states that are currently experiencing declining delinquency and declining foreclosures. So it is not all parts of the country that are suffering. And I want to thank Pat Combs for emphasizing that, because she always said to me, "Just emphasize the local market, local market. All real estate is local. There are large local variations." And when I do a forecast, she gave an analogy of saying, "What is the national weather forecast? What does that mean? Well, that does not mean so much. It is the local weather forecast that really matters a lot."

And what this local data is showing is that in certain markets things are improving. Utah, Idaho... Yesterday, I was sitting with people from Wyoming, and they said, "You know, our market is doing great." And, yes, Wyoming shows up here. So all the local markets are different. And one commonality of these markets is that they have respectable job growth in combination with rising home prices. Those combinations are critical in minimizing foreclosures.

So the health of your future market will depend upon solid job growth. Jobs are needed in Michigan. Jobs are needed in Ohio to minimize those foreclosures. Jobs are needed in Utah to continue the declining path. We need a shift in mortgage product away from those teaser-rate, sub-prime, resetting mortgages, back to the traditional F.H.A. type of mortgages. And also, because of the disruption in the mortgage market against sub-prime lending, there will be some short-term pain in terms of reduced home sales. But I see that as positive in terms of cleansing away the risk. And by cleansing away all this risk, we are setting the stage for a long-term, healthy return to the market.

First the job market. How is the job market shaping? We have had two million net jobs created in the past twelve months, four million in the past twenty-four months. So the job market nationwide is very solid. Still, there are a couple of states in the Midwest that are not really participating. We have good job growth. At the same time, we have solid wage growth. Wage growth is now rising at about four percent per year.

Some people ask me, "Well, all this job growth – or even the wage growth – isn't that the Wal-Mart jobs, the McDonald's jobs?" Well, in reality, if one looks in the aggregate – how much wages are we paying to employees – in the aggregate, it is consistently rising. So it is not only those low-paying jobs, but it is also high-paying jobs. So it is job growth pretty much across the board.

Wages are rising. There is more payment on salaries. There is also very high corporate profits – not a record profit, but near-record profits currently. So profits are very solid. This is the S&P 500 Index. So we had a market crash back in the Internet bubble, the 2001 recession, post-9/11 era. They went down. Now they are slowly climbing back up. And now you reach the prior peak level. There are large market gyrations currently – one-day swings of 300 points up, 300 points down. In my view, the stock market is on fundamentally solid ground, for the simple reason that the stock market index should reflect corporate profits. And the only difference between the past peak and the current peak is that currently there is twice as much profit. So profit will support the stock market. I believe any current decline in the stock market will be temporary. I would say with near certainty that a new record will be set next year on the stock market indexes.

Economy? Respectable growth. Not a robust growth. There's a three-percent line. The three-percent line is the point where people would say, "Above three percent, very robust; below three percent, a little sub-par." So, we have been bouncing on the sub-par range. [Latest] show little increase, but that's likely to be temporary. We will most likely be something like two percent, two-and-a-half percent TVP growth rate.

One concern is decelerating consumer spending. Consumers have been spending, spending, spending – partly due to the accumulation in the housing wealth. They felt wealthy, and they went out and bought a car. Now that home prices are stagnating, there is a big concern that maybe consumers will hold back. And also we have these stubbornly high oil prices. However, even with consumer spending possibly weakening, there are other segments of the economy that are very solid and growing fast.

Business spending. Corporate profits are near record high. Companies are flush with cash. Countrywide is having liquidity problems, but many companies – ___ [Deere] tractor company, Boeing, even many financial banking companies, large banks – they are flush with cash. And because they are flush with cash, they can increase their business spending, not at a three-percent rate, but closer to a ten-percent rate.

If you come to the Washington, D.C. office, you can get a great view of the Capital - or you *used* to be able to see it. Now the view is blocked because two blocks away from us, there is a large crane. When I see cranes, I get excited, because that means jobs. And that is showing that companies are confident. They want to expand. They want to hire more employees, and business spending is very robust.

Another segment that is growing rapidly is exports. General Motors, Ford Motors squeaked out a profit in the latest quarter. And if you look at the individual items, they squeaked out a positive profit because of more cars selling abroad. Without the exports, they said the profit would have been negative. Goldman-Sachs – they get more than half of their revenue abroad. And one can go down the line – Boeing – selling a lot of airplanes overseas. So it is the export growth that is helping push up the economy despite the weakening consumer spending.

One nagging worry spot is the oil prices. I view oil prices as a tax on consumers, except the tax is not collected by the U.S. government. It is collected by Saudi Arabia, Venezuela, Iran. High oil prices – you pay more, that money goes straight out of the country. And this is a drag to the economy. I don't know how long it will stay up this high. Or maybe it will even go higher. But if it were to drop any measurable amount, then there will be additional push to the economy, and the economy can easily move into the robust growth path.

Also, I am not a political expert, but I believe that if oil prices somehow retreated back to what they had been in, say, 2000, I believe that the government of Venezuela, the government of Iran – they will be toppled. There is internal dissent, and there will be easy regime change without the U.S. doing anything. Russia – right now they are trying to play a super-power role because of high oil prices. And they can do that. But if oil prices were to retreat, they would have to go back to the fundamentals as to how to revive their economy.

Economic outlook. 2006 – respectable growth, 3.3 percent. Currently year – sub-par growth of two percent, but next year I see the growth rate picking up. Again, business spending, export growth.

Inflation. I can discuss a lot about inflation, but just to make it short – inflation appears to be decelerating. That is very positive news because the Federal Reserve, when they are thinking about interest rate policy changes... Right now, they are in the condition of, "We don't care about unemployment. If unemployment goes up, who cares? We don't care about GDP growth. If it slows down, who cares?" Right now, their principle focus is on inflation. If inflation retreats, then they will feel comfortable about cutting Fed funds rates. And my best guess is that they will cut the rates in early 2008.

Now, this morning, the Federal Reserve did cut something called a "discount rate" by ___ point. But that is not related to home equity loans or anything. It is just a discount rate [as with] the banks are having liquidity problems, they just go to the Federal Reserve and say, "Can I borrow the money temporarily because we are having a liquidity crisis?" And given the sub-prime market uncertainty, the Federal Reserve decided to cut the discount rate temporarily.

Now the housing market. So, the job market – I'm very optimistic that we can continue to create two million net new jobs per year. Very optimistic. Regarding home sales, home sales are in retreat – it's falling. New home sales are always more cyclical. So it's declining further. As a result, people are not buying homes. Inventories are piling up. So now we have a much higher inventory. And this is raising concern that prices need to decline. In fact, Moody's chief economist is predicting an eight-percent home price decline. S&P 500's chief economist is predicting eight-percent price decline. So there is a lot of discussion about measurable price decline.

And when there is this discussion of price decline, it spooks the potential homebuyer. They say, "Maybe I should wait." Home prices, in our best estimated guess through

statistical modeling, will decline about one-to-two percent. Now, when we first came out with it, there was a large discussion to say, "Well, NAR, they are always optimistic. Now they are saying price decline. It must be something serious." We tried to illustrate that this one-percent price decline is after better-than-fifty-percent [run up in] home prices. So one can view it as fifty steps forward, one step back – no big deal. But nonetheless, they are making a big deal out of it, and also it is very important for NAR to be part of the discussion. We don't want S&P and Moody's to dominate the discussion, to say eight-percent price decline. NAR needs to be having this discussion with others and giving our perspective.

Now, there is a professor at an Ivy League School. And he shows up in the media a lot. He [typically] writes frequently for the *Wall Street Journal*. He is forecasting a forty-percent price decline for the next decade. Imagine, you are a potential homebuyer, you have the money, but someone is saying forty-percent price decline. Will you go and buy a home? Especially coming from a professor from an Ivy League school?

The reason why he says that is because he uses this chart. The yellow is the home price line, the red is the income line, and he is saying that, traditionally, income and home prices have matched up nicely, but suddenly it has become out of whack. The only way for them to converge is either for income to rise quickly – thirty, forty percent, which we know cannot happen; salaries do not rise that fast in one year's time – or for prices to come down. And he is saying, because of this reason, prices have to come down.

However, we try to say the prior chart is irrelevant. What is important to a homebuyer at the end of the day is not the home prices, but whether or not they can make a manageable mortgage payment. Manageable. I am not talking about teaser-rate mortgages. Manageable mortgage rate payment. So using a prime mortgage rate average, because mortgage rates have trended down over the years – that even if home prices are high, because of a lower mortgage, their mortgage obligation has not really risen that much. And based upon this chart, we are near historic averages. Nothing is alarming. Everything is fine.

We have job creation. People are not buying homes. What are they doing? Renting. As a result, rental vacancy rates are declining, and rents are rising. And I believe the rising rents will begin to squeeze some of the households, and force them to think about buying a home. In places like Miami and Tampa, I hear the apartment rents are rising seven, eight percent – very, very strongly.

Federal Reserve, they control the Fed funds rate – that's the yellow line – and I believe they will cut in early 2008. It could be a little earlier, but definitely the next rate change will be a decline; it will not be up. But it's the global investors that control the mortgage rates – whether they buy U.S. mortgage-backed security and so forth. So it's no guarantee that even with a Federal Reserve rate cut, that mortgage rates would necessarily decline. But I believe in the current environment, that a rate cut would actually bring down the mortgage rate modestly, because that is hinting to the global market that the inflation is under control. And if you are a bond investor, you say, "Well,

low inflation, I need a smaller premium." And, hence, you can provide for lower mortgage rates.

One of the first things I do every day is, I come to the office, check the email to see if there's anything from Dale Stinton, and if there is nothing, I go to one of my favorite websites, which is a British news tabloid. It is just to wake me up, because British humor lightens me up. But I found this article very interesting. There was one article embedded there, and I went to the source and I discovered this: In Britain, they are saying there will be a forty percent price increase over the next five years. What is going on? Didn't British prices rise more strongly than the U.S.? So if there is a bubble – which I don't think there is – it would be Britain that first encountered some kind of price collapse. But what is going on there?

Well, the reason for the forty percent price increase, they are saying, is that there is a severe housing shortage – not enough building of new homes. Now, I am not saying that the U.S. has a housing shortage currently, but the market is moving away from oversupply. New construction is down. This is positive in helping the market return to normal conditions. In places like Florida, it is down seventy percent. Very positive in restricting new supply coming onto the market. There are many states with declining new home construction. All this is positive. Homebuilders are suffering. But we don't care about builders. But this is a positive for the return of healthier home prices.

And buyers are lining up. I'm just comparing 2005 – that's the peak housing year – versus 2007 currently, sales are down about 1.5 million. Assuming that the sub-prime mortgage disruption – so there will be 800,000 fewer loans – notice that home sales are down far more than the sub-prime disruptions. So in other words, there is a lack of buyer confidence. It is not due to the lack of loans. It is due to the lack of buyer confidence.

Jobs – 4.3 million more new jobs. Wage and salary – \$700 billion more. What is that? That's a large amount of money, but what does that mean? The [resettled] sub-prime, if one computes, you will have about fifteen- to twenty-billion-dollar negative impact. But compare that to the wage and salary increase – fifteen billion versus \$700 billion. So in the overall scheme of things, sub-prime will not knock off the economy.

Home prices are more affordable today than two years ago. The mortgage rate is about the same. So we have everything in better conditions, yet people are not buying, and that's due to the lack of confidence. And they don't have confidence because they hear so much negative news media – forty-percent price decline, eight-percent price decline, or they continue to see the headlines – "Housing Market Slump Continues, Continues, Continues."

F.H.A. [share] with sub-prime exiting, I believe [you] will come back and they will begin to move more buyers into the market. The national housing market outlook is for lower prices nationally – locally, I think Salt Lake City is doing fine; Raleigh, North Carolina will do fine – but nationally, it will be a slight decline. Next year, things will improve –

increased sales and increased prices. Not in a dramatic fashion, but at least it is an increase, the reversal from a decline.

Median home price, Los Angeles. I put this chart up, not because our incoming president is from that location, but because my wife is a realtor. And that is not necessarily a positive, because she claims that by paying her \$80 dues, that she can boss me around for the whole year.

But what this chart – this is the next-to-last slide – what this chart is saying... She has a recent client that came from Los Angeles, and the client said, her worst decision ever was when she sold her home in Los Angeles during a down market because she was scared. She had a job but she got scared. So she had a home – half a million dollars. It went to \$400,000, \$350,000 – she sold it.

After she sold it, it went back up \$400,000, \$500,000, \$600,000. Now it is listed at \$1.2 million. So people who are buying a home for the long term nearly always win. In fact, our latest data show that over the six-year time span – that's the average length of home ownership, staying in one home – over the six-year time span, along all the markets we covered, there were only two markets out of 150 that showed a decline. So [it is] saying that – almost guaranteed – if you live for six years, you will get an appreciation.

Final chart. I always include this final chart in every one of my slides. It is that home ownership inevitably provides huge benefits. This is information you should be sharing with your consumers. This is information not from NAR. It is information from the Federal Reserve. It shows that for homeowners, their net worth continually rises, and their net worth compared to the renters is staggering[ly] different. So over time, as people move into home ownership, they can realize a part of the American Dream.

Thank you very much.