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Fires out, California housing still burns: James Saft

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By James Saft

LONDON (Reuters) - The fires that scorched California may be out, but a bigger man-made disaster, the housing market, burns away, threatening the U.S. economy and holders of billions of dollars of debt backed by homes.

The housing conflagration is fed by its own 100 mile-an-hour winds; impossibly high housing prices - the legacy of a binge of irresponsible borrowing - a credit crunch and rising repossessions.

And with some analysts predicting top to bottom falls in prices of as much as 40 percent, California looks headed for a recession. Don't be surprised too, if in six months the question angry bond holders ask is not "Is it subprime?" but "Is it Californian?"

Make no mistake: California matters. It's the world's 10th biggest economy, it generates 13 percent of U.S. GDP and its homes are collateral for billions of bonds held by investors around the world.

The recent flow of news has been poor, to put it kindly. Foreclosures rose 34.5 percent in the third quarter to a record 72,571, tracker DataQuick said last week, while median prices fell 7.5 percent in September from the month before. Sales too, are falling off a cliff, falling 26.8 percent from August to September.

The situation has worsened dramatically since a freeze in global capital markets in August made it much tougher and more expensive to get a subprime or large loan.

And with unemployment rising in the state, in part because of job losses in construction, finance

and real estate, things could get a lot worse.

"We are heading into a state recession and that will take an already horrendous mortgage problem and take it over the top," said Christopher Thornberg, of Beacon Economics in Los Angeles.

"Prime loans will be in trouble too. We've got a giant mess on our hands."

Prime loans, those made to borrowers with good credit histories, constitute a huge majority of lending and are so far performing well in California, though delinquencies are creeping upwards.

CREDIT CRUNCH DETONATES HOUSE QUAKE

Essentially, the same factors that drove housing prices upward in California are now conspiring to take them back down again.

Prices in the state have tripled in the last decade, but most of the gains have come since 2003, when subprime and adjustable-rate lending took off. That allowed people to buy homes with debt they really were not able to repay. As long as prices went up, no problem: borrowers were able to refinance when the introductory rate rose or even sell for a new higher price that more than paid off the debt.

But when prices begin to fall - by 6-9 percent in the major metropolitan areas so far - that logic no longer held. What's worse, the investors who had been buying the debt got wise and cut off the tap. Market rates have gone up, lending criteria have gotten tighter and a bunch of borrowers have handed the keys back to the lenders, who then try and sell into a plunging market.

In Sacramento County in September, 27 percent of all sales were by lenders who had repossessed homes, according to DataQuick.

Alex Barron, an analyst who follows housing and construction for Agency Trading in Wayzata, Minnesota, says if you really want to see how far prices will fall, look at auctions of bank-owned real estate and at some of the fire sales now being held by developers.

"The builders are already pricing their homes 30-40 percent lower than they were at peak," he said.

"(Bank-owned) prices have come down 30 percent or so from where those loans used to trade at, as well. If the last clearing price is that much lower, everything is going to get there sooner or later."

A report released by Goldman Sachs analyst James Fotheringham last week called Californian house prices 35-40 percent over-valued in a note to clients.

Gains up through 2003 were largely driven by good fundamentals, rising disposable income and falling interest rates, according to the note. But in 2004, as "affordability" loans such as subprime took off, so did house prices. As of the last quarter of 2006, 41 percent of all loans in California were subprime.

CALIFORNIA THE NEXT SUBPRIME

Barron sees top-to-bottom falls of 50 percent, while Thornberg is looking something on the order of 25 percent.

While these are far worse than consensus, falls of those magnitudes in California house prices would have far-reaching effects.

California would tumble into recession, raising the risks of a national recession. The rate of default by prime borrowers would also spike upwards, putting further pressure on bank balance sheets and deepening and hardening the credit crunch.

Those types of house price falls are almost certainly a lot higher than the assumptions used by the ratings agencies, so expect to see another round of shock and losses by holders of so-called safe bonds.

If the bailout fund for bank-affiliated structured investment vehicles (SIVs) is going to be \$80 billion, how big a fund will we need for California?

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

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