

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **Hashing Out a Bailout? The Bloodletting in Real Estate May Be Over.**

As we have said before, it is the moribund residential real estate market that is at the epicenter of the financial crises. Revive the housing sector and the banking industry will benefit as well. The problem, of course, is that real estate values won't improve unless homebuyers are able to get financing. But financing is not available because the balance sheets of lenders have been poisoned by securities that are tied to failed real estate assets. This is the trap the economy is caught in and one it can't escape from ---- unless the government intervenes. We've now had two days of stormy, laborious, and occasionally even enlightening Congressional hearings on the \$700 billion rescue plan. It's still unclear when Washington will complete work on the bailout, but there is a clock ticking here. US and foreign investors confidence is still shaky. Homeowners in default are anxiously hoping for a solution. Consumers are worried about job and income security. Bernanke and Paulson want to begin remediating the financial crises. And, last but not least, members of Congress want to return to their districts to campaign for the upcoming election.

Inaction, however, is not acceptable. Credit spreads continue to widen. It's never good news when rates on three months LIBOR are increasing, while those on 3-month treasuries are plummeting. The TED spread now stands at 2.73 percentage points, edging closer to its record high of 3.13 percentage points reached last week. Moreover, the dollar is under pressure and nervous foreigners continue to load up on gold.

In some respects it feels like classic western movie, High Noon. You know something has to happen soon, you're just not sure when and how the plan will take shape.

In the midst of this gloom and uncertainty, we are finding fresh evidence that the housing market is bottoming out. The National Association of Realtors (NAR) reported today that sales of existing homes fell 2.2% in August, after climbing a stronger 3.5% in July. The annual sales pace appears to have stabilized at about 4.9 million to 5 million homes during the last 10 months. The median price of homes has dropped to \$203,100, and while that is down 9.5% over the past year, the current price remains higher than what it was the first four months of this year. However, the most encouraging piece of news in the report is the inventory of unsold existing homes sitting on the market. It stands at 4.25 million, the smallest in four months, and that has brought the inventory sales ratio down to 10.4 months worth of supplies, the lowest since March. It is imperative that inventory levels continue to decline if there is any hope real estate prices will firm up in the future. Once prices do appreciate, the value of those now toxic mortgage-backed assets should increase as well.

For the time being, Americans will have to deal with a tough mortgage lending environment. Lenders have greatly tightened their standards and mortgage rates are on the rise. The result: The NAR has calculated that home affordability has fallen the last five months, with the index dropping to 118.5, from 135.4 last February; This, despite the sharp drop in home prices.

This is why a financial bailout is so crucial. This is not a plan to rescue Wall Street. It is a plan to remove an obstruction in the economy that cannot be corrected by the free markets. It is an obstruction with a weight too great for the invisible hand to remove. Thus, it is not an issue of saving one or two companies, but of thawing out an industry whose credit markets are frozen. Once lenders are able to toss these toxic assets into the treasury dumpster, it will increase liquidity levels and eventually make more loans available for homebuyers. We're far from that now. New mortgage applications to purchase a home fell for the second week in a row, according to the Mortgage Bankers Association.

Tomorrow, we'll get numbers on new home sales for August and we expect they, too, will show signs that the bloodletting is over, particularly in terms of sales and inventory levels. But an actual recovery may still be a year away.