



# Real Estate and Mortgage Trends

June 29<sup>th</sup> 2007

## Residential Sector: is the adjustment going to be long or short?

Regarding the different evolution of household growth and housing started in the last four years, adjustment in the residential sector was obvious. The question is whether it is going to be long or short. The answer depends on the side of the coin: short from the supply side but longer from the demand side.

New mortgage lending policy will help to prevent high delinquency rates for 2007 mortgage vintage

Tighter mortgage underwriting standards and a higher percentage of fixed interest rate loans are the basis for new lending policy.

### 1 Households and Housing.

In the long term, production of housing is strongly linked to demographic factors, household formation in particular; from 1959, the first year that the data are available to the present, net household formation averaged 1.33 million of units a year while housing started averaged 1.55 million of units. New housing is used not only to house families but also to replace obsolete stock.

Looking at the trends from the early seventies to the late nineties, housing starts and household formation followed similar paths; housing starts increased when the number of household enlarged and vice versa. But in the last six years trends have followed opposite paths; while household formation diminished, housing starts increased dramatically, figure 1. In this context, questions like the unavoidable adjustment process, the severity of it, and the time needed to equilibrate supply and demand rise among the economic agents.

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Figure 1

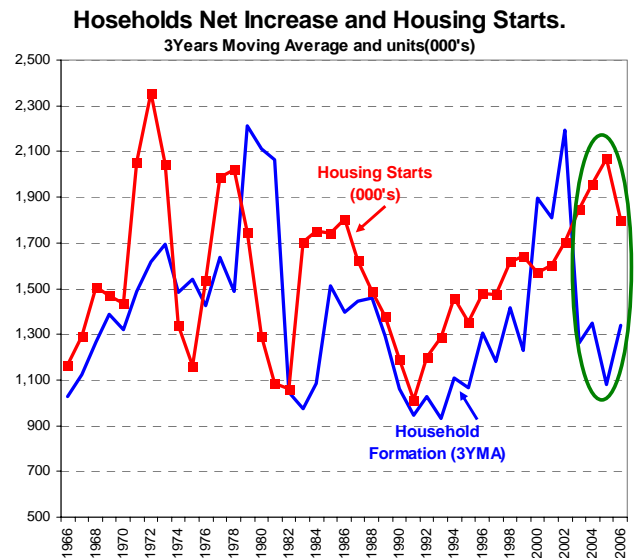
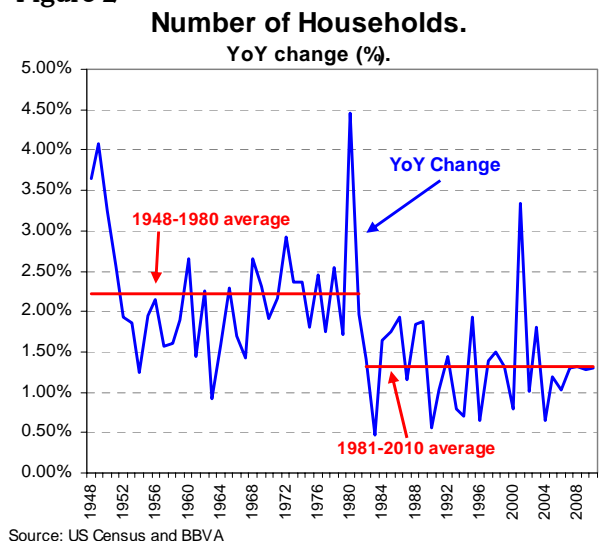


Figure 2



By the end of 2006, the US Census projected population over 300 million living in 114.5 million of households. Using a simple model based on actual population and 2005 householder rates, it can be foreseen that, from the structural point of view, net household formation will continue to grow at an average of 1.4 millions units a year up to 2010, reaching a total of 120 million of households by then. From 2006 to 2010 net households will increase at an annual rate of 1.25%, 25 basis points below the past 25 year's average, figure 2.

Not only the natural aging of today's population but also immigration would be another factor behind household growth in the next years, not to mention smaller family sizes. Regarding the young people living at home, in 2005 they were more than 18 million of children aged from 18-34 years old living with their parents. This figure is very similar to the ones observed in the nineties, which suggest an analogous pace of household formation. In that sense, only 5.5% of young people aged 15 to 19 year old form a household. This percentage rises to 28.5% in the segment of the young from 20 to 24 years old and to 47.1% in the 25-29 years old segment, to stabilize around 51% for people 30 or more years old. According to the model, the natural aging of population could add a net average increase of 1.1 millions of households a year from 2006 to 2010.

Immigrants average more than 630,000 a year in the eighties and more than 975,000 in the nineties but slowed down slightly to an average of almost 960,000 in the present decade. Foreign born population present higher concentration in the segment from 18 to 44 years old than natives and have higher percentage of married people, which make them to need more housing in relative terms. In the next years, if present trend continues, immigration would add an estimated of 0.3 million households every year.

In the past 45 years, the number of persons per household has decreased to 2.57 members from 3.35 persons observed in 1960. A further decline in this rate would enlarge the number of households. In the short term it would remain unchanged but trend is to diminish in the long term. In that sense, by 2010 the US households would have an average of 2.55 members.

Summing up, in the coming years, there would be demographic elements, as household formation and immigration, driving the positive household formation in the US and increasing the need for further housing construction.

Figure 3

Children Living at Home. 1960-2005  
18-24 Years old and 25-34 Years old (000's)

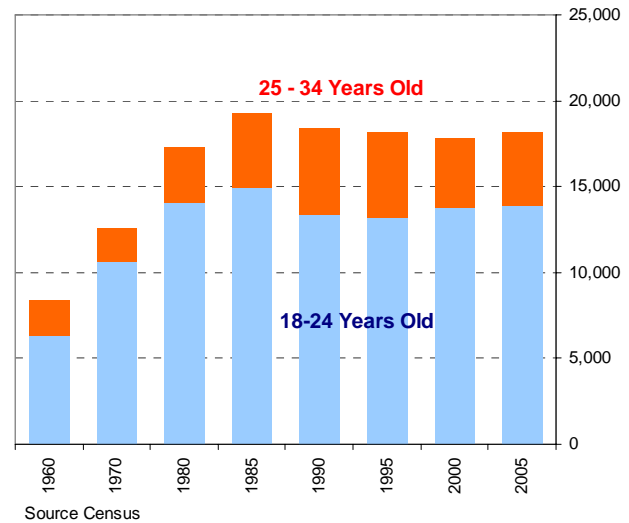
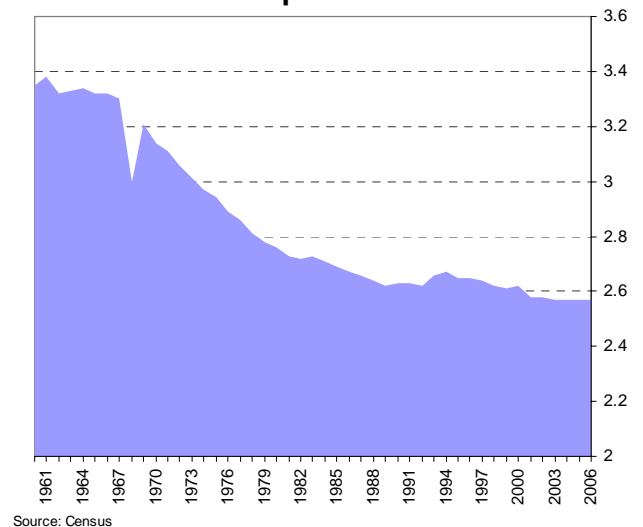


Figure 4

Persons per Household



## 2. Supply of housing.

Housing investment, which depends not only on demographics but also on economic factors, is clearly linked with housing starts, as it can be seen in figure 5. After 10 years of uninterrupted activity expansion, with an average growth rate of 4.7% a year, residential investment dropped by 4.2% in 2006, subtracting 0.2 points from total economic growth. Trend will follow in 2007 with further activity decrease, reflecting building permits and housing starts strong reduction. So, in the first semester of 2007, housing investment dropped 16% compared to 2006 data.

Housing starts are closely associated with housing demand, and descending sales from the end of 2005 has led to a lower number of houses started. In that sense, home builders have a great capability to adapt relatively fast to a changing demand environment. In the first two quarters of 2007, in spite of lower housing transaction, the sales trend has moderated as well as housing started, figure 6.

In May 2007, the twelve months accumulated housing starts was 1.47 million of units, one of the lowest levels of the present decade. Despite this low production, supply of houses is at its highest level with more than 4.6 millions of units on sale: 4.43 million of existing houses and 0.18 million of new houses already finished. This total supply almost doubles the average supply available from 1999 to 2005, which was 2.3 million of units.

Table 1: Housing supply indicators

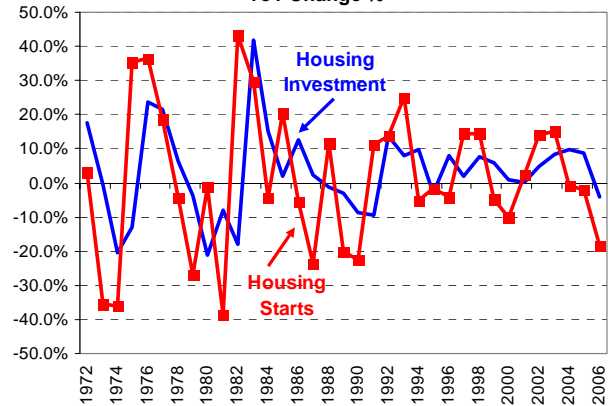
Housing Supply Indicators. Thousands						
	May	Apr	March	1Q07	4Q06	1Q06
<i>Building Permits</i>	1,501.0	1,457.0	1,569.0	1,558.7	1,571.7	2,150.0
<i>Housing Starts</i>	1,474.0	1,506.0	1,491.0	1,460.3	1,554.7	2,127.3
<i>Houses Completed</i>	2,332.0	2,285.0	2,234.0	2,181.7	2,003.0	1,628.7
<i>Houses for sale</i>	4,608.0	4,399.0	3,987.0	3,896.0	3,877.3	3,146.7
<i>Existing</i>	4,431.0	4,220.0	3,806.0	3,716.7	3,706.7	3,022.0
<i>New</i>	177.0	179.0	181.0	179.3	170.7	124.7

Source: NAHB \$ NAR

Regarding the existing elevated housing supply and the growing number of houses to be completed, in the next months it is expected a further reduction in the number of building permits and houses started. The latest ones could reach a minimum of 1.4 million of units (twelve months accumulated) as the average for the second part of the present year, as BBVAUSA forecast points out, figure 7.

By the end of 2007, the level of housing construction would be inferior to the expected net household formation and the housing reposition needs, which could indicate the end of the

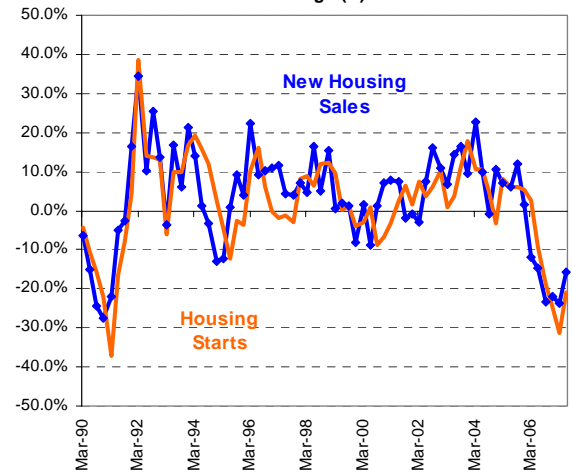
Housing Starts and Housing Investment. YoY Change %



Source: Census

Figure 6

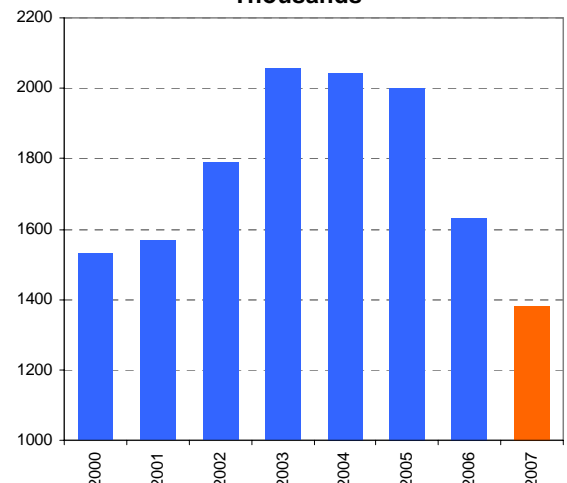
Housing Starts and Sales. MM3 Average YoY Change (%)



Source: NAHB, NAR & BBVAUSA

Figure 7

Housing Starts. Units. Thousands



Source: NAHB & BBVA USA

housing production adjustment. It would help to reduce the existing supply to its historical average, around 2.5 million of units.

### 3. Housing Demand

The increase in the mortgage interest rate in 2004 preceded the change in the housing sales trend that occurs in 2005, by making housing affordability harder. Historically, housing affordability changes have led to changes in the housing demand, figure 8. Decreasing housing price, slightly lower interest rates, stable maturity loan terms and households income increases are all factors which are helping to improve affordability conditions since last September. So, in the first quarter of 2007, affordability index rose to 114.7 points, 12 point above the values of the second quarter of 2006, when the index went down to the lowest level in the last twenty years. A 3% year-over-year increase in the household real disposable income, a drop of 50 basic points of the mortgage effective interest rates and lower housing prices were the main drives that improved affordability indexes. In spite of latter improvements, affordability level is still low compared to its historical average.

Indeed, sales confidence indexes for the second quarter of the year show certain deterioration. After increasing around 5 points in the first quarter of 2007, market index and present and future sales indexes have had a negative evolution since March 2007 to reach, in June, the lowest levels since 1991.

Table 2: Housing demand indicators

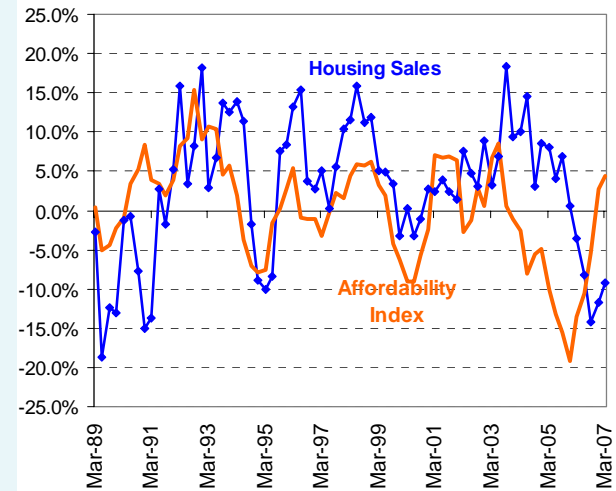
Housing Demand Indicators							
	Jun	May	Apr	March	1Q07	4Q06	1Q06
<b>Affordability Index</b>					114.7	109.4	109.8
<b>Houses Sold (000's)</b>		6,115.0	6,170.0	6,177.0	6,485.7	6,489.3	7,155.0
Existing		5,200.0	5,240.0	5,350.0	5,633.3	5,503.3	6,023.3
New		915.0	930.0	827.0	852.3	986.0	1,131.7
<b>NAHB Indexes</b>							
Market Index	28.0	30.0	33.0	36.0	36.7	32.3	55.7
Present Sales	29.0	31.0	33.0	36.0	37.3	32.7	60.7
Future Sales	39.0	41.0	44.0	50.0	50.3	45.3	64.0

Source: NAHB \$ NAR

Despite descending housing prices, demand adjustment will continue in the next months, especially from the investors' side. Lower housing prices will be a disincentive for investors to demand housing and would encourage them to put their existing stock into the market, pressing prices further down.

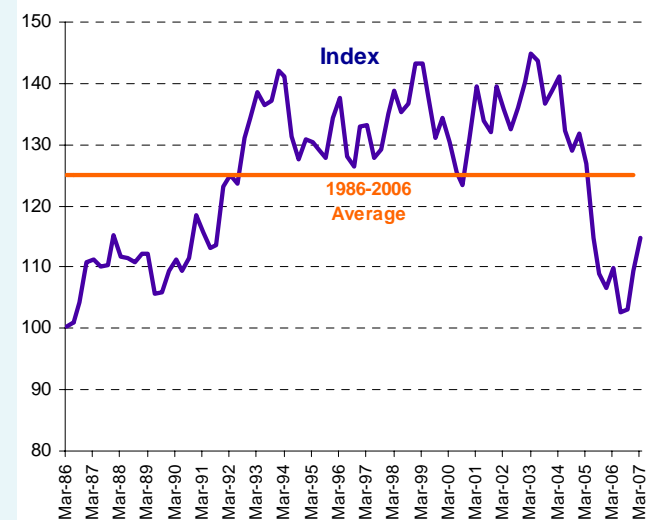
In the mid term, the household streamlined total wealth, with real estate assets twice the mortgage outstanding debt, the low level of mortgage interest rates, the estimated positive

Figure 8  
Housing Affordability and Sales.  
YoY change (%)



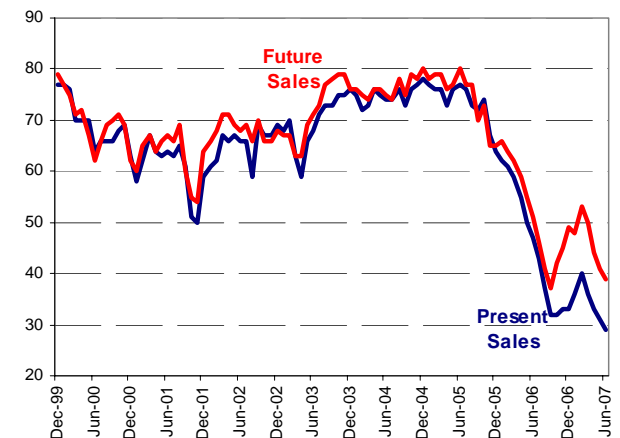
Source: NAR and BBVA USA

Figure 9  
Housing Affordability Index.



Source: NAR

Figure 10  
NAHB Sales Indexes.  
Present and Futures Sales.



Source: NAHB

employment evolution and the growth of household income will support housing demand.

#### 4. Mortgage Markets

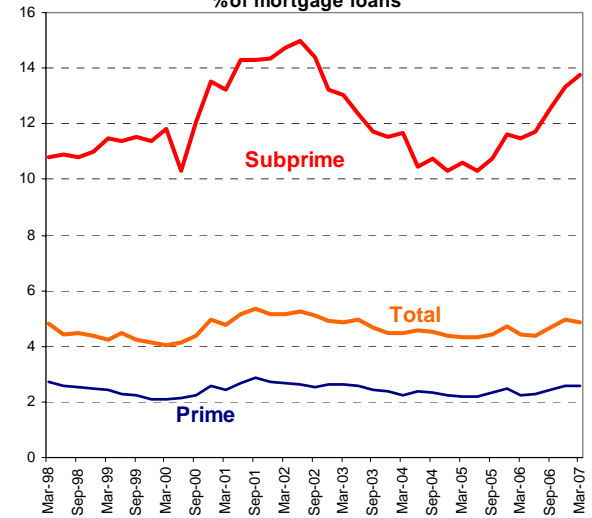
In the first quarter of 2007, mortgage delinquency increased not only in the subprime but also in the prime segment. In the subprime market, delinquency rate rose to 13.77% of total outstanding, 44 basis points above the 4Q06 figure. In the prime mortgage market, delinquency rate reached the 2.58% of total outstanding, 1 basis point higher than the rate from the last quarter of 2006, figure 11. Overall, delinquency rate dropped 9 basis points in the first quarter of the year to 4.84% of the loans due to the lower weight of the subprime segment in the total mortgage loan outstanding. The mortgage delinquency rate has increased mainly in the segments related with the adjustable interest rate, not only in the subprime but also in the prime market.

In May 2007, foreclosures raised 19.2%, compare to the figures of a month earlier, to a total of 176,100 fillings, according to Realtytrack Inc. Accumulated home foreclosures reached a total of 761,300 units in the first five months of the year, 50% above the figure for the same period of 2006.

Mortgage subprime turmoil is not causing a broader restriction to credit prime borrowers. Indeed, tighter lending standards in the subprime mortgage are not dissuading eligible borrowers from the prime market, where mortgage applications for home purchase are growing since the end of last summer, figure 12. Slightly lower effective and contract interest rates are backing this evolution. New lending policy, focusing mainly on fixed interest rates and tighter underwriting standards, are gradually implemented by mortgage financial institutions; it would help to prevent high delinquency rates in 2007 mortgage vintage.

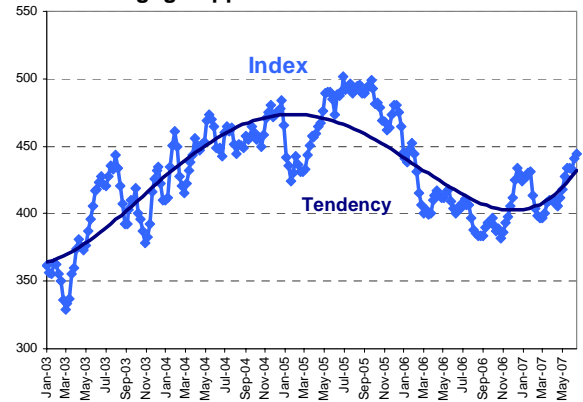
At the end of the first quarter of 2007, the mortgage outstanding debt reached a total of 9.85 trillion of dollars, according to the Federal Reserve data. This amount was 1.5% above the level reported at the end of 2006, showing the lowest quarterly increase since 4Q97. Despite rising mortgage+ applications, the mortgage debt shows a moderating trend and the mortgage outstanding portfolio could increase by 5% year-over-year rate at the end of 2007, four percent points below the first quarter rate. In May 2007, average conventional mortgage interest rate was 6.26%, 3 basis points above the average interest rate of 1Q07. According to our forecast, in 2007 US official interest rates will remain stable at today's level and mortgages rates will have no further reductions.

Figure 11 Mortgage Delinquency. % of mortgage loans



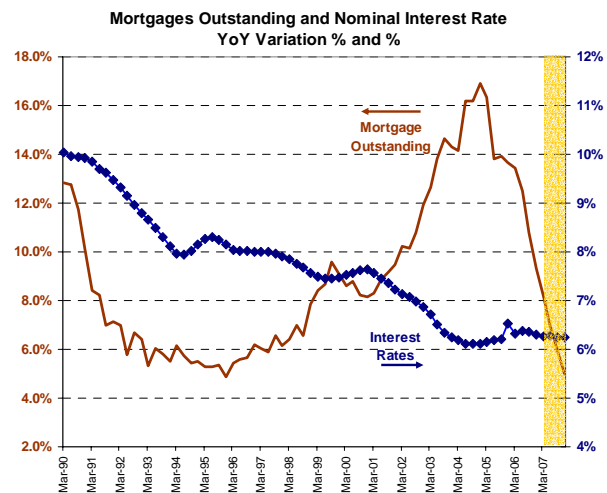
Source: MBA

Figure 12 Mortgage Applications. Purchase Index



Source: Mortgage Bankers Association and BBVA USA

Figure 13



Source: Federal Reserve, Bureau of Economic Analysis & BBVA