



First Republic
Mortgage Corporation

ECONOMIC UPDATE

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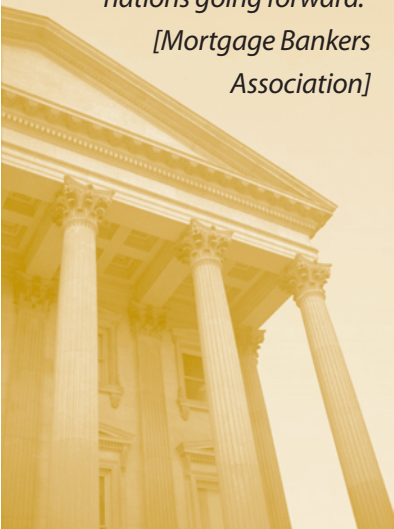
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INTEREST RATE MARKET ANALYSIS

*"We expect that the recovery
in home sales will occur in
fourth quarter of next year.*

*We continue to expect restrict-
ed credit in the subprime and
nontraditional segments of
the mortgage market, signifi-
cantly curtailing the volume
of subprime mortgage origi-
nations going forward."*

*[Mortgage Bankers
Association]*



If ever a real estate market brought to mind the ironic ancient Asian curse ("May you live in interesting times!"), it is now. The same may be said of the overall economy. The stock market indices, for example, have recently taken roller coaster rides, up high and fast one day, down like a rolling stone the next. Employment is apparently declining, according to weekly unemployment insurance claims; consumer confidence is falling, according to the Consumer Confidence Index, as well as other measures of our feelings about the economy.

In this environment, it is nearly impossible to read the tea leaves for either the overall economy or the real estate market. Let's look, nonetheless, at what we should be watching for. And let's also take note of the simple fact that the national data for sales—and, indeed, the data for sales in our state—don't necessarily predict what our experience will be in selling a home and, even more, in buying a property.

► Is Recession On The Way?

Not long ago, several superb economists let the "R" word out of the economic Pandora's Box. The editors of *The Economist* noted: "Our latest assessment...suggests that the United States may well be heading for a recession." Mark Zandi, chief economist at *Moody's Economy.com*, and Paul

THREE THINGS TO WATCH FOR IN 2008

Krugman, Princeton economist and columnist for *The New York Times*, said essentially the same thing. Zandi even asserted that current numbers suggest several states, California among them, have already slipped into recession.

The Economist, however, offers the following sober reminder: "In 1929, days after the stock-market crash, the Harvard Economic Society reassured its subscribers: 'A severe depression is outside the range of probability.' In a survey in March 2001, 95% of American economists said there would not be a recession, even though one had already started. Today most economists do not forecast a recession in America, but the profession's pitiful forecasting record offers little comfort."

The Economist and others point to further problems from existing subprime mortgages. "The coming months are likely to see a sharp jump in the supply of homes for sale under distressed conditions. More than 2 [million] subprime borrowers face markedly higher mortgage payments over the next 18 months as their interest rates are adjusted to new levels." Economists predict that real estate values will fall further, that we'll see a worsening credit crunch (as banks, financial

brokerages and lenders show reluctance to finance mortgages), and that oil prices will start to put a restraining order on consumer purchases.

It is an unusual set of ingredients. In the past, recessions have generally resulted from tightened monetary policy to ward off inflation—and a slowdown in real estate, generally, has followed. This recession, if indeed there will be one, will result primarily from trouble in the real estate financial sector—and a subsequent slowing in the rest of the economy. As Mark Zandi notes, “In general, those [businesses] outside the subprime shock zone are financially healthy, and surely loath to cut their investment and hiring.... It would be unprecedented to experience a recession with the majority of U.S. businesses doing so well.”

This is reason enough to be less than certain about a forecasted recession. But we need, in this uncertain economic climate, to keep our eye on interest rates—to which we now turn:

2 ▶ What Will Happen To Interest Rates?

It is nearly certain that, should the economy continue to deteriorate, the Fed—and financial markets in general—will push interest rates lower. Having taken the fed funds rate from the fairly recent low of 1% to a high above 5%, the Fed still has maneuvering room to take that rate lower. Will it do so? Most economists expect it will, indeed—if the economy does continue to slow.

What signs are we looking for? Slowing employment growth, as mentioned above, is a key problem

that would worry the Fed. A continuing decline among stock market indices would be important as well. But surely nothing would be more important than a retrenching American consumer, as well as a growing reluctance among businesses to invest and spend. That’s why the recent holiday season was watched with tremendous concern.

Now, lower interest rates would, of course, enable many homeowners to do needed refinancing to get out from under onerous existing mortgages. Further, they would help many potential homebuyers put together transactions that work for them.

We are likely to remain in something of a credit crunch, even if rates come down further, because there is far less money available for the funding of mortgages—especially those at the subprime level. But lower rates can have another



“On September 18, 2007, the U.S. House of Representatives passed H.R. 1852, the ‘Expanding American Homeownership Act of 2007.’ [If also passed by the Senate, it] ‘will reform the FHA mortgage insurance program in an effort to allow it to compete in today’s housing market. Additionally, it can provide homeowners with a strong option for refinancing or avoiding altogether subprime loans and loans that include teaser rates or negative amortization.’ [California Real Estate]

effect. Investors become hungry for a better yield. That, frankly, was one of the main reasons that the subprime problem arose in the first place. It is extremely doubtful that such a problem could develop again anytime soon. Instead, it is more likely that the mortgage industry would accelerate its development of new mortgage programs that could make lower interest rates even more attractive than they would otherwise be.

3 ▶ What Will Happen In The Lending Community?

While it is true that the level of lending taking place when over \$2 trillion in subprime loans were written required the aggressive backing of huge investment institutions, those institutions have rarely been at the forefront of new mortgage program development. Sometimes, innovations come from the Federal Housing Authority (which—recall—was the first to develop the 30-year mortgage). Some come from municipal organizations designed to develop more affordable housing and to help first-time buyers. Sometimes, it is a small, local savings-and-loan, whose clientele is made up primarily of local businesses and individuals, that develops innovative and appropriately conservative lending programs. Such institutions were responsible for some of the most viable early ARMs, for example.

What we need to acknowledge is that, when Americans begin to clearly define a need, our creativity goes to work, and the results are usually outstanding. So let’s go out on a limb and predict that we will look back in the near future and call this the time of revolutionary change in real estate financing. Indeed, let’s suggest that we’re not



"Most post-war construction busts have been followed by recession, but only because they were triggered by tighter monetary policy to head off inflation. The housing busts were a symptom of a forthcoming recession rather than the cause. This time, the source of trouble lies with the bursting of the housing bubble itself." [The Economist]

waiting glumly for the market to take a few deep breaths and start to revive itself...that instead, we're taking part in experiments that will substantially change the way houses are financed and result in a real estate market that we would find it hard to recognize if we could have transported ourselves a few years into the future. (To validate this idea, consider having been dropped into the 2005 real estate market if we were living in 1990...1995...2000. And think of the differences that took place between, say, 1975 and 2005—from the development of alternative mortgages to new ways of buying and selling homes. Then notice how everything seems to be changing at an ever-faster pace.)

Most likely, we simply can't predict the loan instruments and technology and business practices that will benefit this market, its participants, and sellers and buyers within even one year. But we CAN reasonably predict, with some assurance, that change will indeed occur, bringing great advances.

Further, we can't know how and why the real estate market will bounce back in a somewhat altered form—but we can reliably guess that it will...and that it may do so much more quickly than is being woefully predicted by those who are looking in vain for a recovery that will take us back to the real estate market of 2005.

If All Of This Is True, What Should We Be Doing?

Probably, we should no more be predicting the future course of the real estate market based on the data from the past several months than we should try to predict who will win the next World Series based on team statistics for the past season. New chemistries develop in unexpected teams; new superstars come from astonishing backgrounds; team composition, management, locations, and other circumstances can and will change. We need to keep our eyes on the ball, so to speak—and not on the past.

Further, we need to look at me-

"To negotiate effectively, you need to know up-to-the-minute sale prices—not just what your neighbor's house sold for last year—and the deal-making behind them. ...Your agent should be knowledgeable about the details of sales in your area and be nimble enough to revise the marketing plan for your home to reflect changing conditions."
[Consumer Reports Money Advisor]



dia reports on real estate conditions with a degree of skepticism. For one thing, it is impossible to generalize in today's market. A severe slowing in certain areas of South San Diego County doesn't mean that real estate has slowed that much in North San Diego County, for example. And, as always, California does not equate to Michigan. Perhaps most important, your own transaction most likely bears little relationship to others reported across the country, and even to others in your own county or city.

And for signs of change, look at fast-developing real estate markets, quietly building themselves up in the current slowdown. Some of them will surprise you. In and around St. George, Utah, for example, more homes (particularly for the retired) continue to be built than anyone sitting in a Wall Street office can imagine. And take a look at Las Cruces, New Mexico. And at areas that aren't as dependent on immigrating retirees but have simply used the past two decades as a time to build for the future. Spokane, Washington, for example—with its several colleges, its new facilities for the arts and entertainment, its riverfront parks and updated retail areas—is a great example of today's choices for relocation that are just beginning to assert themselves.

This is exciting stuff. Let's explore it together. Let's look at your own goals and dreams and study the new opportunities that are showing up in both the world of real estate and the world of real estate financing. It is indeed a time when you will profit by having your own "real estate and real estate finance insider," earning your trust, exploring your future, and uncovering opportunities for you. Let's talk soon!



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It is said that the Indians who lived where Columbus and his crew first landed couldn't even see the ships because they were so completely outside their experience and expectations. What we would like to posit in this issue is the overlooked fact that, when things are changing dramatically, we rarely recognize the changes for what they are. And thus, tremendous opportunities are missed as we judge all that is happening based on assumptions and ideas that are rapidly becoming outmoded.

We notice that most economists and, indeed, most people in the real estate industry are watching for a real estate

recovery that will look like the beginnings of a market like that of, say, 2005. Such a market is nowhere to be seen. Further, though we wait for them to do so, the major financial brokerages and huge banks aren't leading the real estate market out of the wilderness. Their attention seems to be diverted to the healing of their own wounds.

It is time to open ourselves to possibilities that are growing all around us. Let's talk about what you would like to accomplish in the coming years, and begin to engineer a place in your plans and dreams for all that real estate can offer. Please call.

Jerry Anderson