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ECONOMIC OUTLOOK

"A House Of Cards"

Since the stock market crash (2000 - 2002) real estate has become the major driver of economic growth. Three main factors combined to influence real estate investment in the past five years, 1) low interest rates, 2) tax law changes and 3) creative financing.

With the "Fed Funds Rate" at 1% mortgage rates fell to their lowest levels since 1960. The tax code has always encouraged home ownership through deductions for mortgage interest and property taxes. More recently the tax code was amended to eliminate capital gains on personal residences up to $500,000, (if held for at least 2 years). This change gives real estate a tax advantage over other investments such as stocks and bonds. Additionally, exotic mortgage products and reduced lending standards have made it easier to speculate in real estate. And finally, foreign investors eager to purchase mortgage securities created by the financial institutions added more liquidity to the system.

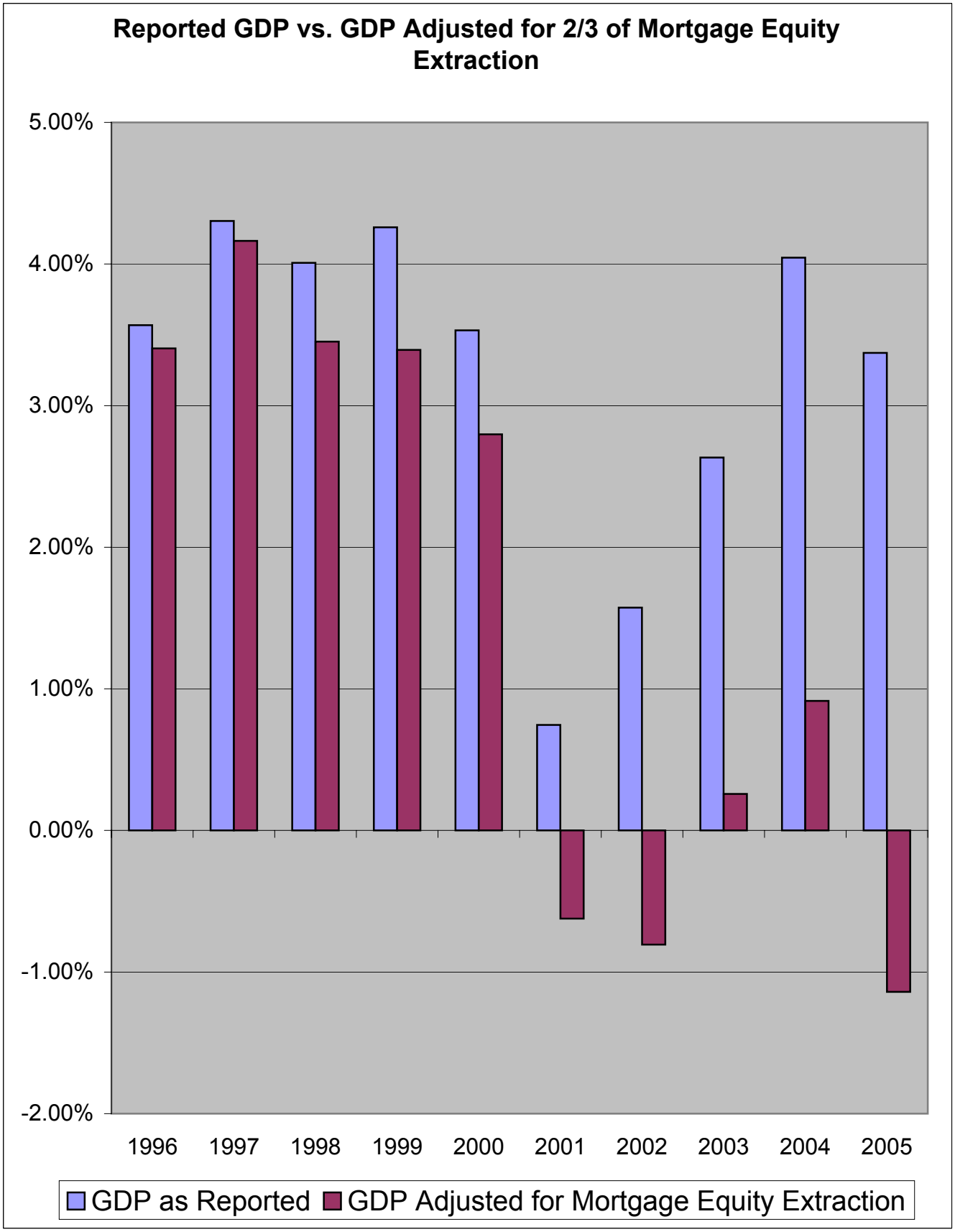
In one way or another real estate has accounted for all of our economic growth the past five years. First, more than 1 million jobs or 40% of all the new jobs created since 2001 are directly related to real estate. This includes jobs in construction, mortgage financing, appraisers, real estate sales and management. The new jobs created extends to retail, transportation, equipment manufacturing, legal services and other ancillary businesses. Secondly, as a result of low interest rates and creative financing, real estate prices across the country have appreciated roughly 50%. The recent rate of appreciation is five times faster than historical averages which generally trend with the rate of inflation. This rapid appreciation has allowed home owners to withdraw equity from their homes. In fact homeowners have withdrawn a staggering $2.2 trillion in equity since 2001 (see MEW graph) and $747 billion last year alone. Using the governments "Flow Of Funds" report we calculate that of the $2.2 trillion extracted approximately $1.5 trillion was used for consumption. The $1.5 trillion is more than the total increase in GDP for the past five years. Consumers have been using the appreciation in their homes to supplement their life styles which in turn has supported the economy. The average age of mortgages refinanced in 2005 was less than 3 years old. With interest rates virtually flat from 2003 - 2005 the only reason to refinance was to cash out equity.

Economic growth is benefiting from a credit cycle of historic proportions, not a traditional business cycle. Job and wage growth are the worst of any economic recovery in history. Since 2001, wage growth adjusted for inflation is near zero and job growth is half the growth rate of the civilian labor force. Further proof of the weak wage and jobs numbers is the steadily declining savings rate. The savings rate in 2005 was negative for the first time since 1933 when the country was in a depression. Fortunately for consumers and the economy real estate has provided a stimulus to jobs, wages and consumption. If not for the rapid appreciation in real estate and mortgage equity withdrawal (MEW) annual GDP in the US would be negative.

> "The greater fool theory has been the bedrock of our economic prosperity since the mid-1990's"

With the economy heavily dependent on real estate three conditions are converging to create *"The Perfect Storm."* As a result of rising interest rates and high real estate values, the inventory of unsold new homes has increased dramatically. At the same time many national homebuilders continue to add inventory even as cancellation rates increase. The slowing real estate market is bad news for those who need to refinance because many counted on appreciation to refinance to a conventional fixed rate mortgage. Roughly 25% of all mortgages (about $2.5 trillion) will reset to higher interest rates in the next 24 months. Many of these adjustable rate mortgages were 100% financing with low front end teaser rates or interest only for the first few years. Some homeowners are beginning to see payment increases as high as 300 - 400% and can no longer afford their homes.

The real estate market doesn't need a severe correction to spell trouble for the economy. When real estate returns to it's normal growth rate, jobs, the consumer and the economy will face difficult times.


Reported GDP vs. GDP Adjusted for 2/3 of Mortgage Equity Extraction
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
-1.00%
-2.00%
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
GDP as Reported
GDP Adjusted for Mortgage Equity Extraction