

# Can the U.S. Economy Recover without a Stabilized Housing Market?

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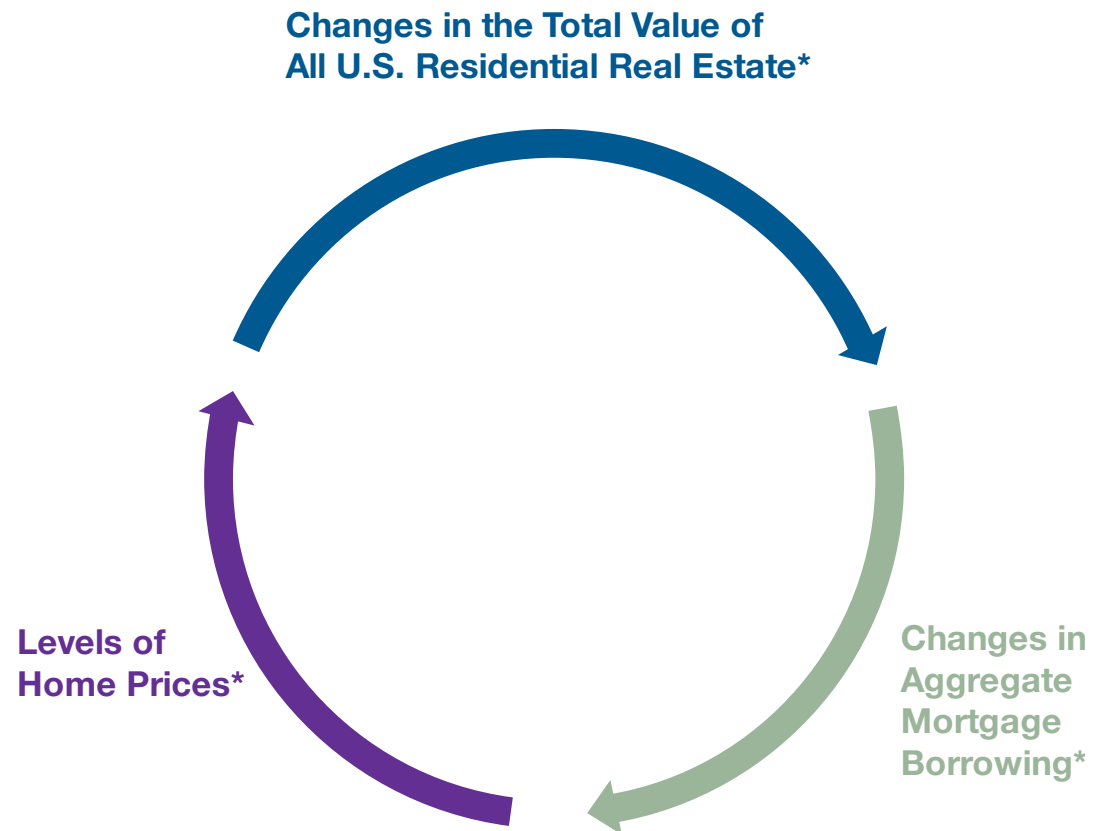


# Agenda

- Updated house price outlook
- Potential policy solutions
- Implication for the economy and investing

# A Positive Feedback Loop

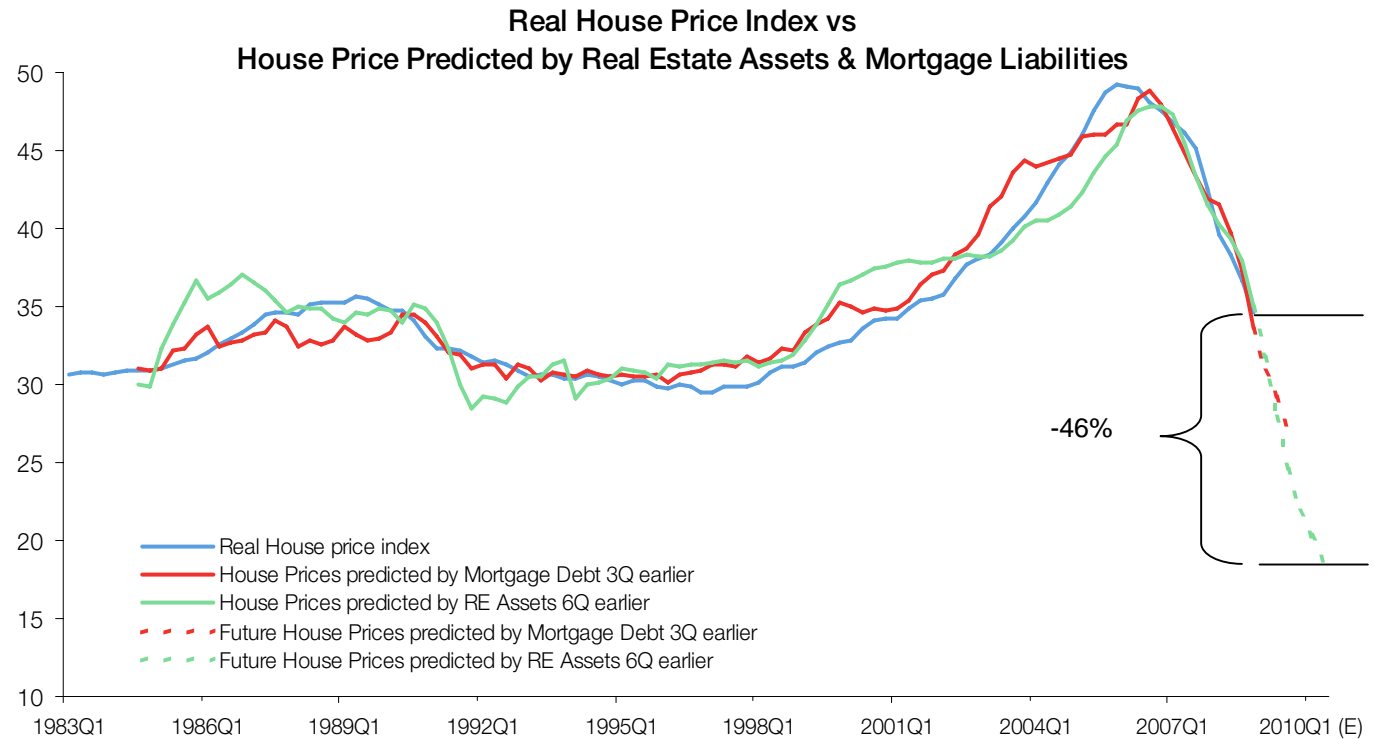
- This loop describes the linkage between changes in the total value of all U.S. residential real estate, changes in aggregate mortgage borrowing, and levels of home prices (all inflation-adjusted)



\* Inflation adjusted

# Our House Price Outlook Is Negative...

- In spite of a number of initiatives, home prices continue to tumble
- Our model indicates 46% downside from the prices observed at the end of 2008



As of 31 December 2008

Source: Board of Governors of the U.S. Federal Reserve System, Flow of Funds Accounts of the United States, Section B.100 Balance Sheet of Households and Nonprofit Organizations, OFHEO, Standard & Poor's/Case-Shiller Home Price Indices, Bureau of Labor Statistics, Bloomberg

Seasonal adjustments were made using a linear moving average.

Predicted changes in mortgage debt based on a single-factor linear regression model developed by Dr. Emma Rasiel, Assistant Professor of the Practice of Economics, Duke University. For more information, refer to the Lazard Investment Research paper "The Crumbling Foundation of U.S. House Prices: May 2009 Update," available at [http://www.lazardnet.com/lam/us/literature\\_research.shtml](http://www.lazardnet.com/lam/us/literature_research.shtml).

There is no guarantee that the stated forecast will be realized.

## ... but Still Likely Overstates the Downside

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- We recognize that our forecast for home prices is primarily based on time periods of increasing prices
  - As we gain more data points when prices are declining, we are able to refine the forecast
  - Additionally, the model does not explicitly include the impact of lower mortgage borrowing costs
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• Duke/Lazard Forecast	-46% (from end of 2008)
• Observed YTD*	<u>-7%</u>
Subtotal	-39%
• Offset from interest rate reductions	<u>+16% to +22%</u>
• Remaining potential decline	-17% to -23%

As of 31 December 2008

Source: Board of Governors of the U.S. Federal Reserve System, Flow of Funds Accounts of the United States, Section B.100 Balance Sheet of Households and Nonprofit Organizations, OFHEO, Standard & Poor's/Case-Shiller Home Price Indices, Bureau of Labor Statistics, Bloomberg

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\*As of 31 March 2009. Source: Standard & Poor's/Case-Shiller Home Price Indices

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# Mortgage Borrowing Rates

- A key assumption in our forecast is that rates stay low and stable
- Recent rate increases, if sustained, could lead to a price decline greater than 17% to 23%

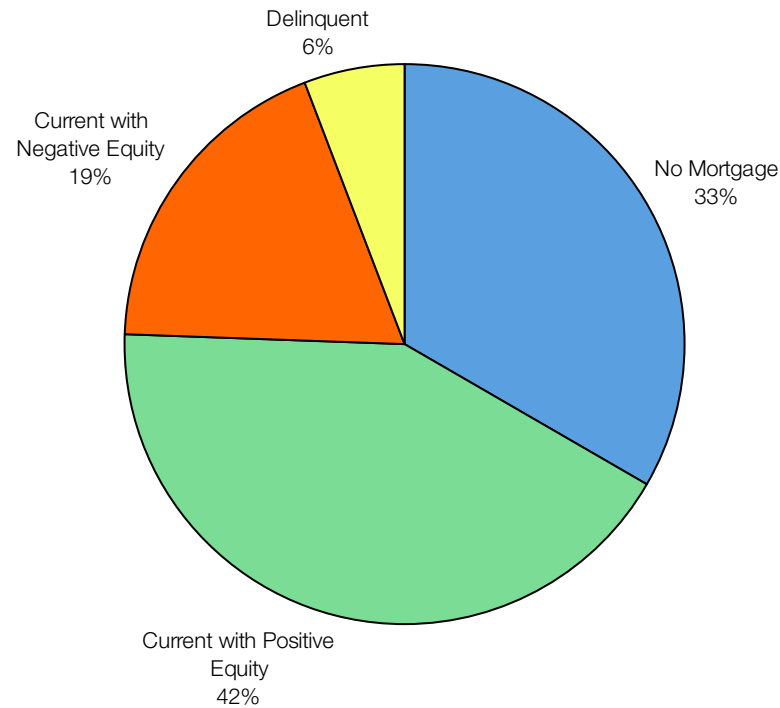


As of 5 June 2009  
 Source: Fannie Mae, BanxQuote, Bloomberg

# Mortgage Borrowers Have Little Home Equity

- The average equity for U.S. homes with a mortgage was approximately 8% at the end of March 2009
- If our home price forecasts\* are realized, over 30 million borrowers could have negative equity

Total U.S. owner-occupied homes: 74.9 M



As of 31 March 2009

Source: U.S. Census Bureau, Inside Mortgage Finance, U.S. Federal Reserve, S&P Case-Shiller, Lazard Asset Management

\*There is no guarantee that the stated forecast will be realized.

# What Policies Have and Have Not Worked?

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- Broad, not narrowly targeted, policies worked
  - Policies that address one borrower at a time have not worked
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## What has worked

- Fed and Treasury mortgage purchases to reduce borrowing rates
- Tax benefits for home purchases

## What has not worked

- Mortgage modifications plans
- Cram-down proposals

# What Am I Proposing?

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- The goal is to pull forward demand for house purchases to meet excess supply from foreclosures
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- Expand tax credit
  - No income restrictions
  - All buyers
  - Previously occupied homes
  
- Broaden MBS purchase plan
  - All AAA-rated RMBS
  - Primary benefit to jumbo mortgages

# Implications for the Economy

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- Predicting recovery based on historical observations may prove inaccurate
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- We are in a period of economic normalization
- Housing is currently the single biggest risk to recovery
- This recovery will be unlike any we have previously experienced
  - Not be led by the consumer
  - Not be led by a return of cheap, widely available leverage
- This recovery will be characterized by
  - Increased government involvement
  - Reallocation of capital across industries
  - Gradual recalibration of capacity and sustainable demand

# Implications for Investing

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- As the economy transitions, we will likely see a wide range of outcomes including winners, mere survivors, and outright losers
  - Winners will continue to compound their market share lead and competitive advantage, while competitors disappear or recover slowly
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- Panic and freefall have ended
- We are in the early phases of a multi-year period of differentiation
- We believe investors should actively engage risk
- There will be significant divergence in performance between winners and losers
- Winners will be characterized by:
  - Strong organic cash flow
  - Balance sheet strength
  - Operational flexibility

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