

THE BUTTONWOOD



Second Quarter 2007



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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Houses, houses everywhere, nor any place to live

By Gail Gardner, CFP, ChFC

According to HUD guidelines, the cost of a home - including principal, interest, taxes and insurance (PITI) - should not exceed 28% of total household income. The median household income in the United States, as of 2005, was \$46,326.

28% of the 2005 median household income is \$12,971, or \$1,081 per month. Subtract an estimated \$45 for homeowner's insurance and \$250 for real estate taxes and that leaves \$786 for principal and interest (P&I). That will buy a mortgage of \$127,656 at 6.25%. Assuming a 20% downpayment, probably a stretch for a first time homebuyer at the median income level, that translates into a home worth \$159,570, according to HUD guidelines. Since most first time homebuyers do not have 20% to put down, let's add mortgage insurance of \$75 per month and assume a downpayment of 5%. Taking the earlier calculation of \$786 for P&I, less \$75 for mortgage insurance, that equates to P&I of \$711. That will buy a mortgage of \$115,475. Add the 5% downpayment and you

can assume that most first time homebuyers can purchase a home worth \$121,553.

In the fourth quarter of 2005 the median home price in the United States was \$213,900. While the median climbed to a peak of \$230,200 in July of 2006, in March of 2007 it had fallen back to \$217,000. It's easy to see that the average home is out of the reach of the average household. Based on the principal of supply and demand, it would seem that the median home value should remain in line with the median household's home purchasing power. Granted, this is a gross oversimplification, but this analysis does provide some significant insight into the current situation. The price of an average home today indicates that HUD lending standards have not been followed by a number of lending institutions. No surprise there. In order to keep the bubble from bursting, creative financing had to come into play. But at some point the party had to end, as evidenced by the recent rash of foreclosures, the subprime lending crisis and leveling, if not declining, home values.

Houses, houses everywhere, nor any place to live (cont)

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Have you been in recently to review your portfolio? If not, please contact us to schedule a meeting.

Housing is a demand driven industry. In order for demand, and consequently prices, to rise, there have to be buyers. Since most homeowners don't pay cash for their homes, buyers need income to qualify and a lender to fund the purchase. It stands to reason, then, that loose credit and creative financing – such as interest only, negative amortization, and adjustable rate mortgages - helped drive up home prices. No doubt so did investors looking for above market returns who were willing to take on excess risk. Subprime-mortgage backed investments are to 2007 what internet stocks and junk bonds were to 2000. The current situation is a correction in the most literal sense of the word. As with any market correction, the pain will be felt until the market becomes fairly valued. Since there is a lot of excess capacity out there – empty homes without qualified buyers – that could take awhile.

The recent downgrades in credit quality of many subprime-mortgage backed securities is at least a sign of acknowledgement that loose lending is not good for the housing market in the long

run. With any luck, the lending spree is at an end and more prudent practices are on the horizon. There isn't much agreement on just how much of an impact all the fallout will have on the economy. Many forecasts are still showing the impact being moderated by low inflation, consistent growth, and favorable earnings, but financial and housing-related stocks have already taken a hit, and recently Bear Stearns shut down two hedge funds that were largely invested in subprime mortgages. Only time will tell the full impact of this correction.