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WEEK OF JULY 31, 2006—WHOSE DEFAULT IS IT?

Californians were just notified by Data Quick, the real estate statistical service, that mortgage defaults have risen 67 percent in a year this last quarter, a 3-year high. Though not yet alarming, the rising number of defaults signals an end to the double-digit price rises of recent years.

In fact, San Diego and Sacramento County residents, two of the fastest growing regions with 20 percent annual appreciation rates in recent years, saw median prices for existing homes fall 1 percent over the past year, according to Data Quick. Defaults have risen 99 percent in San Diego and 109 percent in Sacramento over that time as a result.

Of course a Notice of Default is just the first step in the foreclosure process. It means the borrower is at least 2 months behind in payments. Lenders do not like defaults turning into foreclosures so will usually wait another 2 months before beginning formal foreclosure proceedings. Since the foreclosure process itself takes at least 4 months, delinquent borrowers can have the better part of a year to work something out with their mortgage lender before the home is sold out from under them.

The national default rate has averaged slightly more than 4 percent for conventional loans. VA/FHA and subprime programs, which cater to lower-income borrowers, average 11-12 percent default rates, hence the higher interest and costs for those programs. Approximately 1 percent of all loans are actually sold in foreclosure, so the spike in defaults doesn't necessarily mean a spike in foreclosures.

Why the increase in defaults? Certainly the uptick in short-term interest rates (that affect adjustable rate mortgages) of approximately 2 percent per year—which can increase loan payments as much as 33 percent—is the main culprit. This is while household incomes have been rising 4 percent per year since 2000, not even ahead of inflation. Yet as long as home values continued to rise, borrowers could take cash out of their homes to pay other bills. In fact, home equity loans have jumped from 4.5 to 11.5 percent of all outstanding loans between 2000-2006.

In the overall economy, inflation is still a problem for both the manufacturing and service sectors of our economy, according to the July Institute for Supply Management (ISM) surveys. The activity index declined slightly in both sectors, with material and energy costs still rising. But employment was also up. So both materials and labor seem to be in shorter supply, a sure sign that the economy is operating at or near full capacity.

Freddie Mac also reported stronger than expected refinance activity in Q2. And borrowers were still taking cash out of their homes, to the tune of $81 billion in Q2, versus $74.1 billion in the first quarter. Borrowers kept their loans an average of 3.2 years, and their homes had a median-price appreciation of 33 percent since the prior loan was taken out.

Why is this of interest? Because Freddie Mac estimates a total of $500 billion in first mortgages will adjust upward this year and $650 billion in second mortgages adjust upward at least once. There will be many more borrowers scrambling to refinance before the year is over, in other words.

Why are defaults increasing in California where values have been rising the fastest? Because it has become one of the most overvalued real estate markets in the U.S., according to a study by Global Insight and National City Bank. And prices in overvalued markets tend to fall by about half of the overvaluation in subsequent downturns, said National City's chief economist Richard DeKaser.

The study found that 11 of the top 20 most overvalued markets were in California. Salinas, Merced, Santa Barbara, Stockton and Madera metropolitan areas through Q1 2006 were more than 70 percent overvalued, using household incomes, interest rates and "any historical premiums or discounts metro areas have exhibited over time" to measure statistical "normal" values.

What would keep real estate healthy is a healthy job market that allows wage and salary earners—who make up 80 percent of the work force—to earn more than the rate of inflation. This may seem self-evident, and corporations with record profits and a $1 trillion cash hoard can certainly afford to increase their employees' paychecks (and pensions), foreign competition notwithstanding. Our over indebted consumers and federal government are the most in need of a stronger cash flow, not private corporations.