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THE MORTGAGE ARM SQUEEZE

As interest rates continue to rise, economists are beginning to conjecture on the fallout to holders of adjustable rate mortgages (ARMs). More than $2 trillion, or one quarter of all outstanding mortgage loans, will be readjusted in the next 2 years, according to Economy.com. And 1 in 8 of those households could default on those loans, per research done by First American Real Estate Solution's director of research, Dr. Christopher Cagan (a subsidiary of First American Title Co.).

Why? Because many ARM holders are ignorant of the terms of their negatively amortized loans with very low teaser rates. Dr. Cagan figures that 1.4 million of the 7.7 million outstanding ARMs could experience payment jumps of 50 percent or more, once the initial fixed or teaser rate adjusts. And a recent Federal Reserve study found that about 35 percent of ARM holders didn't know how much the rate could increase at one time, while 41 percent were not sure of the maximum interest rate cap!

This means borrowers need to be thinking about a solution now, rather than wait. The obvious solution is to refinance into a longer-term fixed rate mortgage with an interest only option, if necessary. (One can always make an additional principle payment without penalty.) And they should do it while property values are high. A book by a former Goldman Sachs investment banker John Talbott entitled, "Sell Now! The End of the Housing Bubble (St. Martin's Griffin, 2006, in paperback)," predicts that America's top 40 cities will face an average 47.2 percent decline in real estate values in the next 5 years.

Well-known economist Gary Shilling is another worrier. He states in a recent Forbes Magazine article, "The current housing weakness will develop into a full-scale rout…It's clearly a bubble and is nationwide…The house price collapse will induce a painful recession that will send U.S. stocks into a tailspin…China will suffer a hard landing…and weakness in the U.S. and China will spread worldwide."

This is extreme pessimism, of course, and dependent on a Federal Reserve policy that is oblivious to the effects rising interest rates, which would choke off continued job growth.

The jobs picture continues to improve with new 243,000 payroll jobs created in February, even though the unemployment rate rose to 4.8 percent. The higher jobless rate was mainly because 335,000 more job seekers entered the work force for the first time, a sign that workers are growing more optimistic about employment prospects.

It also means more of Katrina's victims are returning to work. The Labor Dept. calculated that approximately 1,000,000 people 16 and older were displaced by the hurricanes, yet our economy continues to chug along. Consumer spending also seems to be holding up. Though February retail sales fell 1.3 percent, January's rose 2.9 percent, and sales are up a very healthy 6.7 percent in 12 months.

Why so much alarm then? Adjustable rate mortgages origination have dropped to just 27 percent of all mortgages originated to date in 2006, when their share was as high

as 40 percent in 2004! This was at the end of the last real estate downturn, of course. As home values then began their climb to today's record values, homeowners were able to squeak through.

But we have a situation today where interest rates are rising at the same time that property values are due for a fall. The only question is how far the fall. An Economist Magazine article highlighted by columnist Paul Farrell (CBS Marketwatch) echoed such a warning: "Never before have real house prices risen so fast, for so long, in so many countries. Property markets have been frothing from America, Britain and Australia to France, Spain and China. Rising property prices helped to prop up the world economy after the stock market bubble burst in 2000…This is the biggest bubble in history."

It is always the low and middle-income homeowners that are most affected by any downturn. Only 13 percent with annual incomes of $150,000 or more did not know the maximum adjustment cap of their ARM, while 40 percent with earnings of $50,000 or less did not. And it was those in the low income brackets that went for most of the $675 billion in so-called subprime mortgages originated in 2005, up from $100 billion ten years ago. That is why the Mortgage Bankers Association supports greater consumer education with its Web site, www.homeloanlearningcenter.com. It is a good read.

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