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Inflation and Mortgage Rates Remain Low

A wide range of major economic data released during the week and comments from the Fed reinforced the consensus outlook for the economy. Economic growth appears to be on track for gradual improvement, while inflation is not a concern in the short-term. With few surprises this week, mortgage rates ended the week nearly unchanged.

The economy is currently experiencing moderate economic growth with low inflation. In a speech on Tuesday, Fed Chief Bernanke indicated that the recession is "very likely over". Retail Sales and Industrial Production showed nice increases this week. Housing Starts, Building Permits, and Homebuilder Sentiment also moved higher. Meanwhile, there have been few signs of inflation in the short-term. For example, Core CPI rose at a modest 1.4% annual rate, the lowest annual rate since February 2004. Tame inflation readings have helped mortgage rates stay at low levels.

Recently, the Fed has been purchasing about \$25 billion of mortgage-backed securities (MBS) each week, which represents a very high percentage of the average new issues. At this pace, the Fed will purchase the entire \$1.25 trillion authorized for the program by the end of the year, when it's currently scheduled to discontinue its MBS purchases. On Wednesday, at the conclusion of next week's Fed meeting, investors will be hoping to receive an update on the MBS purchase program. The majority outlook is that the Fed will purchase the full \$1.25 trillion and end the program, possibly by gradually reducing the level of weekly purchases and extending them into next year. Still, a significant number of investors expect the Fed to increase the limit, while others think the Fed will end the program early. Since mortgage rates are largely determined by MBS prices, changes in the level of demand from the Fed could have a large impact.

FHA In The Red – Big Changes Coming

To first clarify matters, the Federal Housing Administration does not fund loans, they insure them against lender (note holder) losses. FHA announced today that due to increased defaults on loans, and subsequent pay-outs by FHA, they are running out of money. Congress has mandated the minimum amount of money FHA must keep on hand in order to pay current and future losses, and today's announcement is that they have now fallen below the 2% reserve threshold.

Since the collapse of the housing market FHA backed loans have soared from 3% of all mortgages issued to nearly 25% today. The default rate on those FHA loans has nearly doubled from 5.4% to 8% in the latest figures available from the Mortgage Bankers Association.

To stop the flow of loans defaulting, the FHA has announced changes for both the borrower and the lenders that offer FHA financing. For lenders, they will now be required to provide annual audited financial statements and show their company's net worth is a minimum \$1,000,000. That is up for the old level of \$250,000. FHA will also adopt appraisal policies based on Fannie Mae & Freddie Mac's HVCC (*review history of HVCC in prior newsletters*). For borrowers, the FHA will now require income documentation of all types of loans, doing away with streamlined reduced documentation refinances. They will also require higher minimum credit scores, reduce the maximum Loan-to-Value on refinances, and increase the minimum down payment on purchase transactions. If these changes fail to stop the flow of red ink, FHA will have to request a bail-out from us, the US taxpayers.

Events This Week:

Inflation Low

Retail Sales Higher

Housing Starts Up

Manufacturing Rose

Events Next Week:

Tues 9/22
2-yr Auction

Wed 9/23
Fed Meeting
5-yr Auction

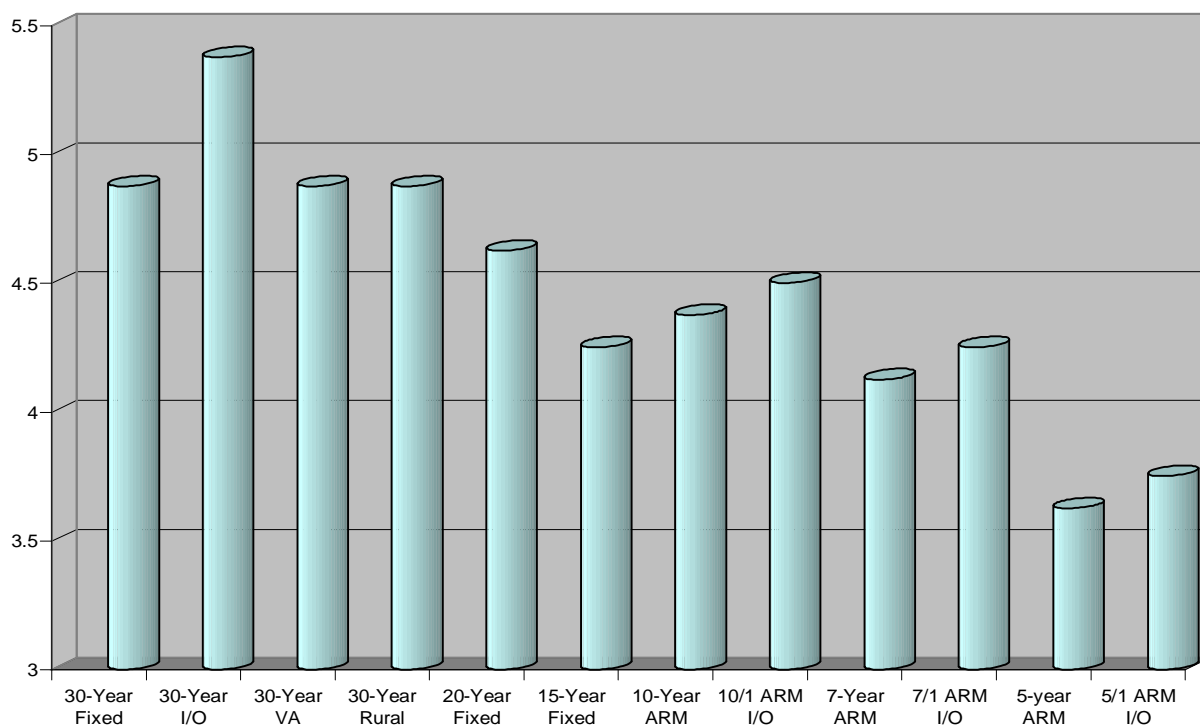
Thur 9/24
Existing Sales
7-yr Auction

Fri 9/25
Durable Orders
New Home Sales

Also Notable:

- August Housing Starts rose 2% to the highest level since November
- The Treasury will auction a record \$112 billion in 2-yr, 5-yr, and 7-yr Treasuries next week
- The FHA announced that reserves will fall below required levels and it's planning policy changes
- The Fed purchased \$26 billion in agency MBS during the week ending 9/16

Conforming Rates as of 9/18/09



Average 30 yr fixed rate:	
Last week:	-0.10%
This week:	-0.02%

Stocks (weekly):	
Dow:	9,800 +200
NASDAQ:	2,125 +50

Week Ahead

The biggest economic news next week will be Wednesday's FOMC meeting. No change in rates is expected, but the Fed's announcement may contain important information on the timing of future rate hikes and the status of the MBS purchase program. Data from the housing sector will come out on Thursday and Friday with Existing Home Sales and New Home Sales. Durable Orders, an indicator of economic activity, and Consumer Sentiment will be released on Friday. In addition, the Treasury will auction a record \$112 billion in 2-yr, 5-yr, and 7-yr Treasuries on Tuesday, Wednesday, and Thursday.

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