WEEKLY MARKET PERSPECTIVE

AUGUST 2, 2010

ECONOMY

‘The Story in Housing’

BY SCOTT MINERD

Chief Investment Officer,
Guggenheim Partners, LLC

Two weeks before Abraham Lincoln became the sixteenth President of the United States, seven Confederate states elected Jefferson Davis as their own Commander in Chief and declared secession from the Union. In his 1861 inaugural address, Lincoln sidestepped the inherent moral conflict of slavery, choosing instead to plead for the peaceable reconciliation of the Union.

Four years later, against the backdrop of a bloody Civil War drawing to a close, Lincoln’s second inaugural address was devoid of any pretense as to the cause of the conflict. In a speech known for its power and concision, Lincoln basically admitted (and I’ll paraphrase), “When this the war started we said it was over saving the Union, but in our heart of hearts we all know it was about one thing… slavery.”

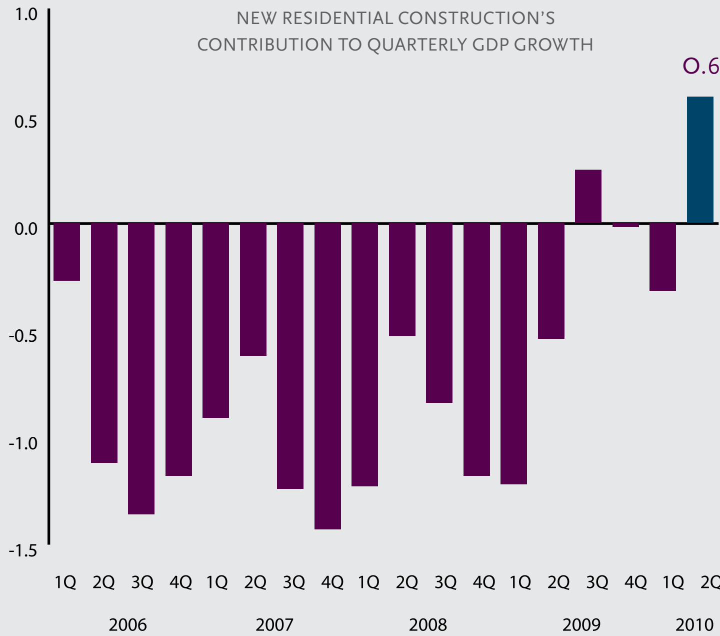
I often lead with this story when I present my thoughts on the economy to clients. Sure it’s grim and overly powerful, but there is an analogy to be made. When we think about what triggered the worst recession since the Great Depression, in our heart of hearts we all know it was really about one thing… our nation’s over-leveraged, over-valued position in housing.

Regardless of the public policy solution – be it TARP, TALF, quantitative easing, stimulus spending, etc. – housing always seems to find its way back to the forefront. From the latest GDP numbers to the U.S. Treasury’s announcement of housing finance reform, focus is returning to our fundamental problem in housing.

CONTINUED ON NEXT PAGE

AN UNLIKELY CONTRIBUTION

New home construction contributed 0.6 percentage points to the second quarter's 2.4 percent GDP growth. This abnormally high quarter-over-quarter surge should not be counted on to provide similar boosts to future GDP figures.



Source: Bureau of Economic Analysis; Bloomberg

While it will require years of concerted effort to work through the nebulous inventory of homes for sale or in distress, the main take-away for investors today is that the morass in housing is the main reason interest rates will remain low for an extended period of time.

'New Construction's Last Surge'

When the second quarter GDP numbers were released last week, most of the focus was on the decline in headline economic growth — annualized GDP fell from 5.0 to 3.7 to 2.4 percent over the past three quarters. Although the latest GDP number disappointed to the downside, it would have been a lot worse if not for a 28 percent surge in second quarter residential real estate investment that contributed 0.6 percentage points to the 2.4 percent headline GDP growth.

While the spike in residential construction bolstered second quarter GDP, it was essentially a "dead cat bounce" off of historic lows for new construction. Forward-looking data show that residential real estate investment is not likely

CONTINUED ON NEXT PAGE

to be a positive contributor to GDP in the near future, as second quarter new home starts and building permits were down 13.4 and 14.5 percent, respectively, from the prior period. In addition, June residential construction data, released by the U.S. Census Bureau on August 2, fell for the second consecutive month after a 6.0 percent surge in April ahead of the expiration of the home buyer tax credit.

But any problems in the new construction market are miniscule compared to the colossal issues facing the rest of the housing market. In fact, the recent positive news may be the last time we can celebrate housing data for some time.

> "Inventory of existing homes for sale is estimated to be 3.99 million (and is growing at an annualized rate of 48 percent over the past six months). Including the estimates for shadow inventory, this would result in 9.5 to 11 million homes waiting to be sold."

'The Answer is Lurking in the Shadows'

The biggest problem in housing today is the glut of inventory of existing homes either currently for sale or in distress and awaiting sale. The time it will take to clear this inventory is dependent on both the rate at which homes are selling and the number of homes on the market. Unfortunately, the rate at which existing homes are selling is decreasing steadily, especially following the expiration of the home buyer tax credit. In June, existing home sales declined for the second straight month. In addition, the supply of homes for sale continues to increase. As a result, there is approximately 8.9 months worth of existing home inventory currently on the market. This is the largest supply (as measured by months) the market has seen in nearly a year, well above the 6.15 month historic average and the 3- to 4-month level generally associated with price appreciation.

Yet, this is only the tip of the housing iceberg. The real problem with the current inventory numbers is that they do not reflect the number of distressed properties, better known as the "shadow inventory." Homes with delinquent mortgages that have yet to move through the foreclosure process are being held on the balance sheets of financial institutions waiting to be sold, but not currently on the market.

The number of homes that lurk in the "shadows" is nebulous. Recently, Standard & Poor's estimated the principal balance of properties 90 days or more delinquent, in foreclosure, or in REO status, but not yet on the market, to be $480 billion, or the equivalent of 30 percent of the entire non-agency market. Estimates for the number of homes that could potentially emerge from the shadows are as high as 5.5 to 7 million.

CONTINUED ON NEXT PAGE

TIME HEALS ALL WOUNDS – 8.9 MONTHS WORTH OF INVENTORY AWAITS

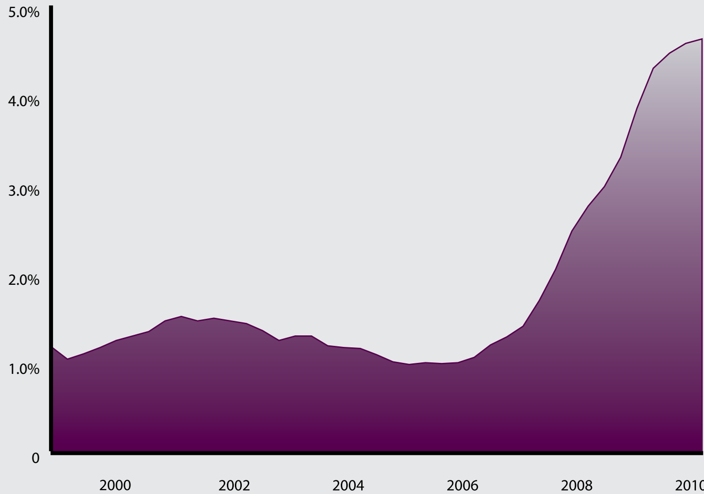
On June 30, 2010, the supply of existing single-family homes, town homes, condominiums, and co-ops for sale reached the equivalent of 8.9 months worth of inventory at current sales rates. This is the highest level since August 2009.

Currently, inventory of existing homes for sale is estimated to be 3.99 million (and is growing at an annualized rate of 48 percent over the past six months). Including the estimates for shadow inventory, this would result in 9.5 to 11 million homes waiting to be sold. At the current sales rate of 5.37 million homes per year, this would result in approximately 21 to 25 months to get through just the existing inventory of homes for sale. When you add in the number of homes that would normally come on the market over the course of the year, it's easy to imagine the process taking much longer. Not only will the market need to sell more houses than are becoming available each year, it will need to somehow gobble up an existing inventory that would take at least two years to digest by itself. This is a pretty bleak picture, something that could take five to ten years to clean up, especially in light of all the other problems the economy faces.

CONTINUED ON NEXT PAGE

RAMPING UP – FORECLOSURES AS A PERCENT OF TOTAL LOANS

Foreclosures (excluding REOs) as a percent of total loans reached 4.63 percent in the first quarter of 2010, the highest level on record. By comparison, the average since 1979 is just 1.21 percent.



Source: Mortgage Bankers Association; Bloomberg.

'Housing Finance Regulation Cometh'

Further hindering the healing of the housing market is the restricted flow of credit. In order to work through the inventory in housing, the availability of financing is critical. By historical standards, homes are currently more affordable than they have ever been, and rates on 30-year mortgages are also at absolute lows. Nonetheless, new loan applications plummeted 29 percent in the second quarter and 36 percent since the beginning of the year, according to the Mortgage Bankers Association.

Part of the problem is the uncertainty around regulation. Recently, the G20 proclaimed that banks will need to raise capital standards. In addition, the U.S. Treasury has announced plans to implement housing finance reform sometime in 2011. Ironically, political focus on housing has returned just in time for policymakers to appear ahead of what is sure to be a significant slowdown in the housing market following the expiration of the home buyer tax credits. From the perspective of financial institutions, however, there is little incentive to make new loans in the near term when regulation won't be settled until the first quarter of 2011, at best. Reduced liquidity in the mortgage market will only

CONTINUED ON NEXT PAGE

serve to slow the pace of home sales for the rest of the year, which in turn will only extend the time it will take to work through the backlog of inventory in the market.

'Who Can Qualify?'

The constricted message to prospective borrowers only continues when it comes to the former heroes of liquidity, Fannie Mae and Freddie Mac. Dubbed by Chairman Bernanke as "half fowl, half horse" due to their dual mission to maximize profits and achieve the government's objective of promoting home ownership, Fannie and Freddie are currently foreclosing on a home every 90 seconds, according to The Wall Street Journal. Currently, the two government sponsored entities own over 163,000 residences, or more homes than there are in Seattle. In addition, the U.S. Treasury has spent more on the bailout of Fannie and Freddie than it has on AIG, giving them the dubious title of the single most expensive bailout effort of the financial crisis.

As a result of this dubious track record, qualification standards for Fannie and Freddie's conforming mortgages are under intense scrutiny. Last week, Fannie Mae CEO Michael Williams gave a speech in Washington heralding what he calls a "new realism" in the U.S. housing market. Under this new paradigm it will take longer to get approved for a mortgage and a smaller percent of the population will be able to become homeowners. According to Fannie's top executive, the average FICO score for a conforming mortgage has climbed to 760 and average loan-to-values are down to 70 percent. Based on FICO score alone, over 60 percent of the population falls below the average qualification standards for a conforming mortgage. One can only imagine the miniscule percent of the remaining population that also has access to sufficient capital to muster a 30 percent down payment.

"Under this new paradigm it will take longer to get approved for a mortgage and a smaller percent of the population will be able to become homeowners. According to Fannie's top executive, the average FICO score for a conforming mortgage has climbed to 760 and average loan-to-values are down to 70 percent."

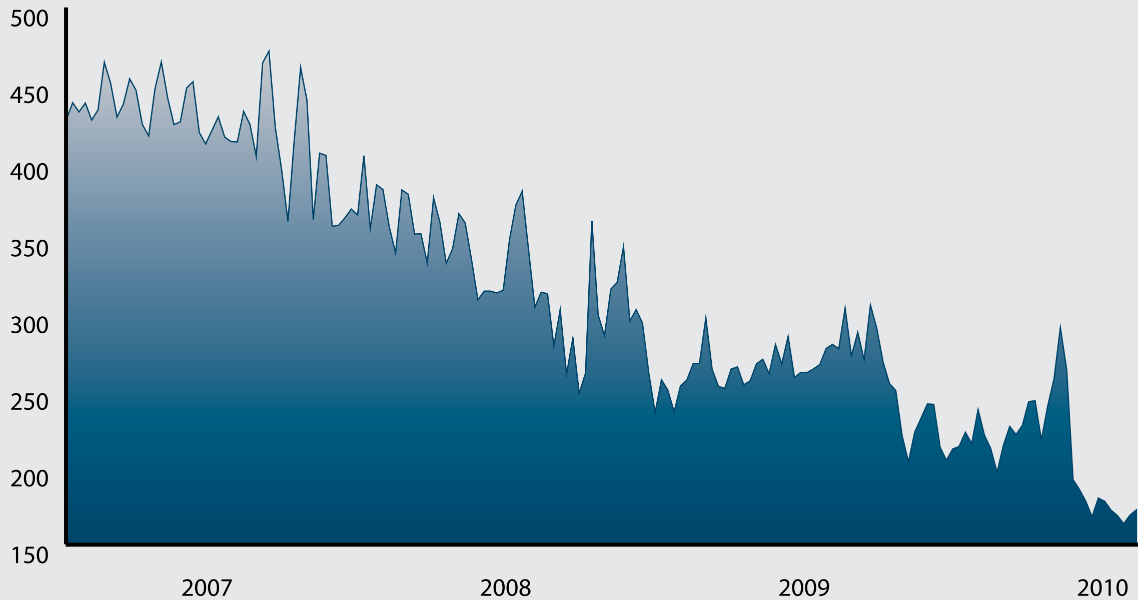
The final twist to the finance side of the housing equation is rather Sarbanes Oxley-esque. The Dodd-Frank Wall Street Reform Act contains provisions restricting mortgage originator compensation as well as the creation of personal liability for originators who violate the Truth in Lending Act. This will make it much more difficult for prospective buyers to get a mortgage if they lack a paper trail of W-2s. The self-employed for example, will certainly find it more difficult to get access to credit in order to buy a house.

In June, mortgage applications for the purchase of single-family homes fell to

CONTINUED ON NEXT PAGE

THE FUTURE IN DECLINE – NEW MORTGAGE APPLICATIONS FALL

The Mortgage Bankers Association Purchase Index measures applications for single family homes across the entire market. The purchase index has proven to be a reliable leading indicator of impending home sales.



Source: Mortgage Bankers Association; Bloomberg

their lowest level since late 1990, according to data from the Mortgage Bankers Association. In light of the aforementioned challenges to housing finance, it's hard to imagine a scenario where the rate of existing home sales would do anything but continue to decline in the third and fourth quarters.

'Greenspan's View'

The supply and demand imbalances in the housing market have profound ramifications for the economy in the near future. Former Fed Chairman Alan Greenspan made poignant comments to this effect over the weekend. In an interview on "Meet the Press," Greenspan was asked if he thought the proverbial "double-dip" was a possibility. His response was: "It is possible… if home prices go down."

Greenspan went on to add that while home prices have stabilized for the most part, they could easily trend downward, which runs the risk of triggering another layer of foreclosures and, with it, a host of related challenges to the economy. In his discussion on housing, the former chairman of the central bank concluded,

CONTINUED ON NEXT PAGE

"If home prices stay stable, then I think we will skirt the worst of the housing problem. But right under this current price level, mainly 5, 7, or 8 percent below, is a very large block of mortgages which are under water or could be under water. And that would induce a major increase in foreclosures. Foreclosures would feed on weakness in prices, and it would create a problem."

Already, in the second quarter, a record 270,000 U.S. homes went into foreclosure, according to data from RealtyTrac Inc. Registered foreclosures for the year are estimated to reach the one million mark. If Greenspan's concerns about prices were to come true (on top of these projected foreclosures), the housing market could be headed for a downward spiral. Needless to say, this would be a huge detriment to an economy already flying at minimum speed.

"Right under this current price level...is a very large block of mortgages which are under water or could be under water. And [a decline in prices] would induce a major increase in foreclosures. Foreclosures would feed on weakness in prices, and it would create a problem." - Alan Greenspan

'Conclusion: Another Case for Low Rates'

The good news in housing is that homes are at record affordability levels. The ratio of monthly payment versus median family income is at the lowest level on record. It is now technically cheaper to buy a house in certain parts of America today than it is to rent. If affordability stays low and liquidity re-enters the housing market it's only a matter of time before excess inventory gets slowly absorbed.

The bad news is that in addition to the issues we've discussed, recovery in the housing market is also being hamstrung by a problem outside of its domain, namely, unemployment. Until the economy can get people employed and earning higher levels of income, the process of working through the inventory of existing homes is going to be very, very slow.

How slow could it be? Research on real estate cycles from the Foundation for Cycle Studies supports a theory of a protracted period before we witness true recovery in housing. According to their research, residential real estate follows a consistent 18-year cycle in terms of its price behavior. If you think of a cycle as being half the period of time down and half the period of time up and you consider that the real estate market maybe topped around 2006 or 2007, with nine years being the average down cycle, we wouldn't expect the real estate problem in the United States to bottom out much sooner than 2015 or 2016. That would also correspond with some of the larger estimates for the time required to work through the shadow inventory given the other headwinds in the economy.

CONTINUED ON NEXT PAGE

I hate to sound like a broken record, but the mess in housing, and the years of work that lie ahead to clean it up, boil down to another case for an extended period of low interest rates. The economy cannot afford to have interest rates rise if we hope to work through the backlog in the housing market. Last week the 10-year Treasury fell to 2.905; it is down a remarkable 21 percent in the past three months. How much lower can rates go? Well, the answer is probably 2.25 percent on the 10-year Treasury before all is said and done.

Historically, there is a negative correlation between interest rates and home sales. Generally, when the 10-Year yield starts to rise, the volume of home sales declines. Conversely, as the 10-Year yield goes down, the volume of home sales goes up. This has interesting policy impact. You can draw the conclusion that the Federal Reserve, if they want to clean up the financial system, which I think they are committed to seeing happen, has to find a way to keep interest rates low for an extended period of time.

There is another element to the low rate story. If interest rates don't stay low there will be downward pressure on prices. In turn, this would adversely affect the capital position of not only the major financial institutions, but also Fannie Mae and Freddie Mac, in addition to the possibility of inducing another layer of foreclosures, as Greenspan mentioned. These are all outcomes that the Federal Reserve would choose to avert.

In the end, the moral of the housing story points to the same themes we have been discussing for the past several weeks: quantitative easing, increased volatility, and ultimately higher prices for equities, commodities, and non-financial assets, excluding residential real estate.

Past performance is not indicative of future results. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information.

This article is distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. This article contains opinions of the author but not necessarily those of Guggenheim Partners or its subsidiaries. The author's opinions are subject to change without notice. Forward looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed as to accuracy. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Guggenheim Partners, LLC. ©2010,Guggenheim Partners.

Claymore Securities, Inc.
is a wholly-owned subsidiary
of Guggenheim Partners, LLC.

2455 Corporate West Drive
Lisle, IL 60532
800-345-7999
Member FINRA/SIPC 8/2010