HALF FULL OR HALF EMPTY

by Steve Brown

Since so many eyes are watching the housing sector, we thought we would drop a little knowledge on everyone to find out if the glass is half empty or half full. And so, our discussion begins. The glass is half empty: Residential housing construction is now almost 30% below its level just 12 months ago. Housing starts in the past 3 months have tanked more than 22% from the same period last year, reaching their lowest level in 6 years. Homeowner vacancy rates reached their highest level on record at 2.5% in the 3Q. Stockpiles of completed but unsold homes have soared nearly 50% from last year. At the current sales pace it will take 7 months for them to be sold (more than twice that of last year). Builders are responding by cutting back on new construction, walking away from options to purchase land and offering significant incentives to boost sales. Building permits have fallen for 9 straight months. Through October, foreclosures have jumped 42% since year-end and now represent one in every 1,000 households. Colorado had the highest foreclosure rate in the nation with one in every 327 homes. In addition, of the top 10 cities with the highest foreclosure rates, only one showed any sort of recovery during the 3Q (2.5% improvement in Indianapolis), while the other 9 got worse. Through October, the median sales price has experienced its largest year-over-year decline on record. Meanwhile, the OFHEO announced it would hold conforming mortgage limits at current levels, saying that although home prices had fallen (and the limits should reflect that), they were concerned any cut might disrupt mortgage markets (they also said they had never gotten around to devising a procedure to deal with a decline in prices). Other facts include cash out withdrawals composed 84% of the total increase in consumer spending in the 2Q. A slowdown in this cashflow and a corresponding drop in consumer spending power is a key reason Goldman Sachs is predicting the FRB will have to cut rates about 100bp in 2007. That could be good news as more than $1T in adjustable rate mortgages will reset in 2007. ARMs represent about 26% of all mortgages in the country these days. Without a rate cut, monthly payments are poised to increase by about 44% for the average borrower. The ratio of home values to incomes in some areas is 40% above its historical average. A decline of 5% more in home prices would push the percentage of homeowners with negative equity to 38%. Bernanke has said, "The slowing pace of residential construction is likely to be a drag on economic growth into next year," and estimates the impact at 1% off GDP. The glass is half full: The economy remains strong, so any slowdown in housing will run its course quickly. Given an unemployment rate of 4.4% (a 5 Â½ year low), consumers are more confident and more willing to buy homes. While the National Association of Realtors is forecasting a 17% drop in hew home sales this year, even at that level, it would still be the 4th highest on record. BofA upgraded homebuilder stocks today, citing improvement in traffic, affordability and construction. The bank also said lower mortgage rates, price decreases and higher personal incomes are adding support to the sector. A 2005 study from multiple universities working in concert finds "declines in housing market wealth have no effect at all upon consumption (consumer spending)." A survey of real estate agents this month indicates 33 of 39 major markets have shown improvement. Bernanke has said, "Some indications suggest that the rate of home purchases may be stabilizing." Obviously we will have to wait and see, but we think more softness is likely.

BANK NEWS

Wells Fargo

At an investor conference, the Bank announced that for 2007, its M&A strategy will include purchasing independent banks within its current footprint.

SFR Loans

Limits for FNMA and FHLMC conforming single family mortgages have been set for 2007 and will remain unchanged from 2006 at $417k for 1-unit properties. This is the first time since 1993, that average home prices on a national level have remained unchanged.

Capital Standards

The FDIC will meet early next week to review comments and a proposed rule on risk-based capital under the new Basel II guidelines.

The Philly Swipe

About 1,600 cabs in Philadelphia will install payment card terminals in the back of their taxis by the end of the year. The terminals will allow customers to either swipe or waive credit cards for payment.

Early Payment Defaults

The number of missed payments during the first 90-days of a SFR loan's life is up 19% from last year and more than 80% from 2004. Fraud accounts for almost 40% of these numbers.