



U.S. Housing Still Weak Amid High Joblessness & Distressed Sales

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Executive Summary

Given the central role the collapse of the U.S. housing market played in the recent financial crisis, the Structured Products Group at Standish closely monitors developments in U.S. home sales and the mortgage market. As the protracted unwinding of housing debt continues, the group points out that the latest U.S. housing data remains weak, with high unemployment and distressed selling weighing on demand and prices. In their view:

- U.S. housing data remains weak with very strong headwinds expected for the near term.
- Distressed home sales as a percentage of total sales are historically high and should weigh negatively on prices.
- A high percentage of investor and all-cash sales shows lower priced homes have good demand, while demand is weak for higher priced homes.
- The key points from the government's White Paper on Government Sponsored Enterprises (GSE) Reform suggest that mortgage credit will likely continue to tighten, and the cost to obtain a mortgage will likely increase as the government's role in the mortgage market is reduced.
- High unemployment should continue to hamper demand for housing. Employment is improving slowly, but other factors are also preventing improvement in housing.
- Government intervention is a concern. The Obama administration has stated that the housing sector would be its focus once the debt ceiling issue was resolved.
- A possible consequence of mortgage reform is tighter credit. We think the current definition of a Qualified Residential Mortgage (QRM) in the Dodd-Frank legislation is very restrictive. If banks decide to retain originations within that bucket, we believe many potential home buyers will not qualify for credit. This would mainly affect higher priced homes, which already have low demand.

Consistent with the seasonal nature of home buying, home prices were steady on a month-over-month basis in the spring 2011 buying season, but continue to fall compared to last year. The four major home price indices (see Exhibit 1) were flat to slightly positive in May compared to April, but are down an average of 6.0%



from June 2010.¹ With the spring buying season coming to an end, home sales were weak in June. Existing home sales are down 8.8% from June 2010, and new home sales continue to bounce around all-time lows.² Conversely, some of the forward-looking indices came in better than expectations.

Leading Indicators

June was a strong month for the leading indicators. All indices had better-than-expected results.

Exhibit 1

Series	Period	Bloomberg Survey	Actual	Prior Month Revisions
NAHB Housing Market Index	JUL	14	15	
Housing Starts MoM	JUN	2.7%	14.6%	0.0% from 3.5%
Building Permits MoM	JUN	-2.3%	2.5%	8.2% from 8.7%
Pending Home Sales MoM	JUN	-2.0%	2.4%	

Source: Bloomberg, July 2011

The monthly U.S. Census report on building permits came in stronger than expected for June, up 2.5% from May.

- The NAHB Housing Market Index (HMI) rose in July to 15 from a 2 year low of 13 in June, and slightly beat expectations. "We view the upward movement in the July HMI as a correction from an exceptionally weak number in June that was at least partially attributable to negative economic news and the close of a disappointing spring selling season."³ The index ranges from 0 (negative) to 100 (positive), so a neutral reading for this index is 50.
- The U.S. Census Bureau reported total housing starts rose 14.6% in June. May was revised down to 0.0% from 3.5%. Single family starts were up 9.4% in June from May, and multi-family rose 30.4% in June from May. Single family starts are up 0.4%, while multi-family starts are up 100.0% from June 2010. Single family starts are at their highest level since November 2010.
- The monthly U.S. Census report on building permits came in stronger than expected for June, up 2.5% from May. Single family permits rose 0.2% in June from May, and are down 6.9% from June 2010. Multi-family permits continue to be strong, rising 6.9% in June from May. Multi-family permits increased 34.0% from June 2010. Strength in single-family permits was centered in the Midwest.
- The National Association of Realtors in their June report said that pending home sales were better than expected, up 2.4% from May, and up 19.8% from June 2010. All regions were better than June 2010: Northeast 19.4%, Midwest 26.3%, South 19.1%, and West 16.4%. Despite the bounce in the Pending Home Sales Index, the Mortgage Bankers Association (MBA) Purchase Index has not increased much, which could be a sign of heavier cancellations in pending sales.

¹ Federal Housing Finance Agency, Seasonally Adjusted Monthly House Price Index, July 21, 2011; RadarLogic, 25-MSA RPX Composite Price Index, July 21, 2011; CoreLogic Home Price Index, July 6, 2011; Standard and Poor's, Case-Shiller Seasonally Adjusted Home Price Index, July 27, 2011.

² "June Existing-Home Sales Slip on Contract Cancellations, but Prices Stabilize," National Association of Realtors, July 20, 2011; "New Residential Sales In June 2011," U.S. Census Bureau, July 26, 2011.

³ "Builder Confidence Gains Two Points in July," National Association of Home Builders, July 18, 2011.

The spring season has largely been underwhelming as existing home sales are down 8.8%, and new home sales are up 1.6% from June 2010, based on a very low 312,000 annualized home sales.

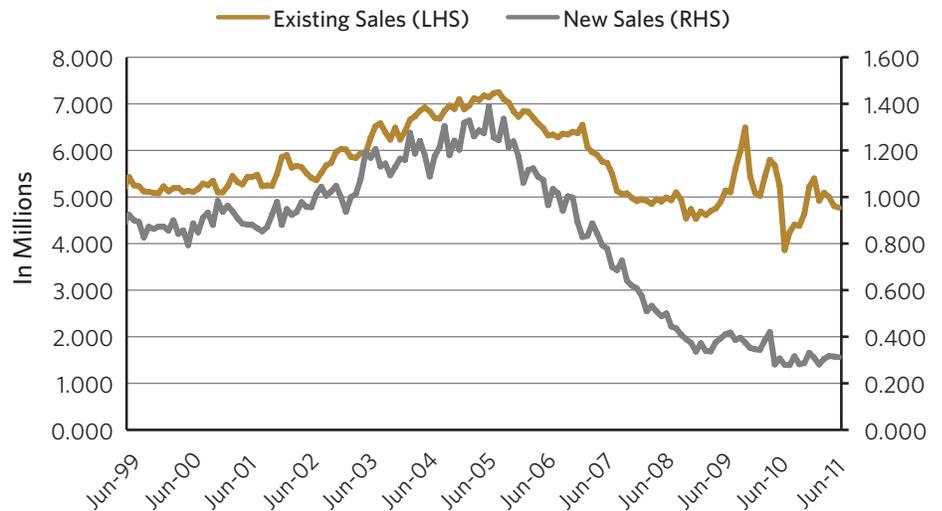
Home Sales

The National Association of Realtors (NAR) reported that June existing home sales fell -0.8% from May, and are down 8.8% from June 2010. Distressed sales fell to 30%, down 1% from May. Investor sales were flat at 19%, while all-cash sales fell 1% to 29% in June from May. First-time buyers fell 5% to 31% in June from May. Investor and all-cash sales are up 5% and 6%, respectively, from June 2010. First-time buyers are down 12% from June 2010. Demand for non-distressed houses is evident in another rise in the median sale price to \$184,300, a gain of 8.9% in June from May, although prices are only up 0.8% from June 2010. Inventory increased, up 3.3% in June from May. At the current pace of existing home sales, it would take 9.5 months to sell the current inventory of homes for sale. Interestingly, the NAR also reported that there was a sharp increase in the cancellation rate from 4% in May to 16% in June.

The U.S. Census Bureau reports that new home sales fell 1.0% in June from May to 312,000 home sales annualized. In June the median new home price increased for the third consecutive month to \$235,200, an increase of 5.8% from May. The gain price is consistent with what we see in existing home sales, and can be attributed to seasonal effects.

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Exhibit 2 — U.S. Home Sales



Source: National Association of Realtors, U.S. Census Bureau through June 2011

All four home price indices we track were flat to positive in May compared to the prior month.

Home Prices

All four home price indices we track were flat to positive in May compared to the prior month. The indices are still down approximately 4-7% from May 2010. We are seeing a seasonal increase in demand for non-distressed homes which is causing a short-term stall in home price declines. This dynamic is exaggerated in this housing cycle since overall sales are lower and the distressed portion of sales in the winter months has been very large.

The Case Shiller Index reported that 19 of the 20 Metropolitan Statistical Areas (MSA) in the index declined from May 2010. The index is down 4.5% from May 2010. Washington D.C. was the only MSA to post a gain from May 2010. The CoreLogic index in May rose for the second consecutive month. The index declined 7.4% from May 2010, worse than the -6.7% reported in April. CoreLogic reported that 91 of the top MSAs declined from May 2010 levels. RadarLogic's RPX (Residential Property Index) Index fell 6.0% from May 2010, slightly worse than April's 5.8% decline from April 2010. After observing a weak spring buying season, RadarLogic is predicting new index lows this fall. "Given the time of year, the results of our RPX analysis are far weaker than we had hoped. Prices are falling year over year as activity continues to languish."⁴

The median price of an existing home rose 8.9% to \$184,300 in June from May.⁵ This was the fourth consecutive monthly increase in the median sale price. In June, distressed sales fell to 30% of existing home sales, the third consecutive monthly decline.⁶ Investor sales are at their lowest levels since February, and all cash sales are down for the third consecutive month.⁷ We expect to see this seasonal trend reverse in the next few months. In our view, demand continues to be constrained by tight mortgage credit, negative equity, and slow job growth.

Exhibit 3 — Home Price Indices

Index	Period	MoM Change	YoY Change
FHFA (SA) monthly	MAY	0.4%	-6.3%
RadarLogic RPX.28	MAY	0.5%	-6.0%
CoreLogic HPI	MAY	0.7%	-7.4%
Case Shiller HPI (SA)	MAY	0.0%	-4.5%

Source: FHFA, Radar Logic, CoreLogic, Standard & Poor's through July 2011

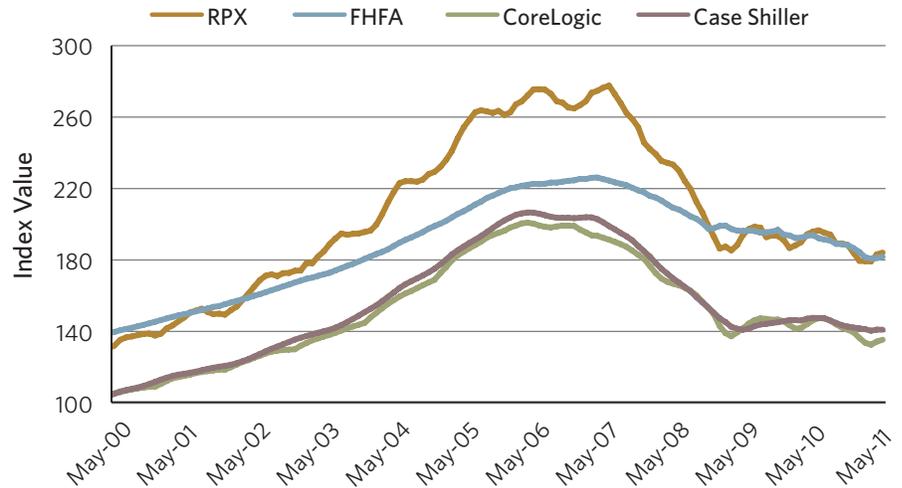
⁴ "Weak Fundamentals Undermine Expected Seasonal Strength in Home Prices," RadarLogic, July 21, 2011.

⁵ "June Existing-Home Sales Slip on Contract Cancellations, but Prices Stabilize," National Association of Realtors, July 20, 2011.

⁶ *Ibid.*

⁷ *Ibid.*

Exhibit 4 — Home Price Indices



Source: FHFA, Radar Logic, CoreLogic, Standard & Poor's through May 2011

While bills have been introduced in both the House and Senate to delay the change in loan limits for two years, it is unclear whether there is majority support for the delay.

Private Mortgage Market

The *Wall Street Journal* reported that RMBS (residential mortgage-backed security) deals are uneconomical due to the extremely conservative methodology now in place from the ratings agencies in order to get a AAA rating.⁸ The additional credit enhancement required by rating agencies increases the cost of a securitization. According to the report, BlackRock and Two Harbors Investment Corp said they are considering a securitized deal that does not have a AAA class of bonds, and would look for a AA rating for the most senior class. A double-A rating would require approximately 200 basis points less credit enhancement. Redwood Trust's deal earlier this year had 7.5% credit enhancement on the AAA bonds, but the loans were very high quality and difficult to source.⁹

Maximum conforming loan limits are scheduled to drop to \$625,500 from \$729,750 on October 1st. While bills have been introduced in both the House and Senate to delay the change in loan limits for two years, it is unclear whether there is majority support for the delay.¹⁰

The Obama administration has said they will focus on housing once the debt ceiling issue has been resolved. The government has not introduced a new plan to help housing since the home buyer tax credit expired last year. Ideas under consideration include principal reductions, renting GSE-owned homes, and helping investors buy foreclosed homes with government-backed mortgages.

8 "BlackRock, Two Harbors Eye Alternative to AAA Mortgage Bonds," *The Wall Street Journal*, July 14, 2011.

9 *Ibid.*

10 Jon Prior, "Senators Submit Bill to Extend Conforming Loan Limits," *HousingWire*, August 4, 2011.

In terms of GSE financial reform, the U.S. Treasury issued its GSE Reform Treasury White Paper in February 2011, aimed at reducing government involvement in the agency mortgage market and increasing the role of private markets.

Mortgage Reform and Legislation

The following is a summary of the latest developments in housing-related reforms and legislation:

In terms of GSE financial reform, the U.S. Treasury issued its GSE Reform Treasury White Paper in February 2011, aimed at reducing government involvement in the agency mortgage market and increasing the role of private markets.¹¹ The Treasury Proposal's near-term solutions are to increase guarantee fees, tighten underwriting guidelines, let temporary loan limits expire, and wind down the GSEs' portfolios. The Treasury Proposal's longer-term solution is to more fully privatize the system with some type of government backstop in times of crisis. Given the fragile housing market, we believe all changes will take between five and ten years to implement.

In addition, Republicans have introduced a broad array of bills on GSE financial reform aimed at limiting the government's role in housing and curtailing the authority of Fannie Mae and Freddie Mac. These bills (identified below) have been approved by the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises and were supposed to go before the full House Committee on Financial Services this summer.

- Equity in Government Compensations Act would better align compensation packages of Fannie Mae and Freddie Mac executives with those of other employees of the Federal Government.
- GSE Mission Improvement Act to end the government's affordable housing goals.
- Fannie Mae/Freddie Mac Accountability and Transparency for Taxpayers Act requiring the GSE Inspector General to report to Congress on a regular basis.
- GSE Subsidy Elimination Act aimed at increasing the guarantee fee over two years to eliminate the GSE subsidy.
- GSE Portfolio Risk Reduction Act to cap current Fannie Mae and Freddie Mac portfolios and increase the annual attrition rate.
- GSE Risk & Activities Limitation Act to prohibit Fannie Mae and Freddie Mac from engaging in new activities or businesses.
- GSE Debt Issuance Approval Act aimed at prohibiting Fannie Mae and Freddie Mac from issuing any new debt without approval from the Secretary of the Treasury.
- GSE Credit Risk Equitable Treatment Act of 2011 to prohibit exempting the GSEs from the risk retention requirements under the Dodd-Frank Act.

¹¹ <http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf>

As part of the Dodd-Frank regulations, there is a proposed rule for FDIC Risk Retention.

On May 12, House Financial Services Committee members John Campbell (R-CA) and Gary Peters (D-MI) introduced the "Housing Finance Reform Act of 2011," which would wind down Fannie Mae and Freddie Mac and set up a system that allows new entities, called housing finance guaranty associations (HFGAs), to replace them. These privately owned associations would wrap mortgage-backed securities with their guarantee and purchase catastrophic insurance from the government. The associations would be required to purchase mortgages with loan-to-value ratios of at least 80% unless the seller retains 10% or there is private mortgage insurance. Also, the loan may not exceed 150% of the U.S. average home price or 150% of the median home price in the area. This would preserve the forward mortgage-backed securities market. Portfolio functions of the new entities would be limited; affordability goals would be abolished in favor of stability as the new goal; mortgage-back securities would be explicitly government-guaranteed.

As part of the Dodd-Frank regulations, there is a proposed rule for FDIC Risk Retention. This defines QRM that would be exempt from risk retention: 28% maximum front-end debt-to-income ratios (DTI) and 36% back-end DTI; maximum loan to value (LTV) purchase of 80%; maximum LTV refinancing of 75%; maximum LTV cash-out refinancing of 70%; no delinquency on any debt over the past 24 months. Agency securities qualify as QRM since the GSEs already retain the credit risk. Forms of risk retention would include horizontal slices (retaining the first-loss position), vertical slices (retaining a portion of the risk across the capital structure), L-shaped interest (50% horizontal slice and 50% vertical slice) and representative samples (statistically similar sample of loans from the collateral pool). It also prohibits issuers from taking up-front profits on securitizations. In our view, QRM rules are restrictive and may continue to prohibit the private market and securitization from restarting in any meaningful way and work against the goal of limiting government involvement.

In addition, we believe covered bond legislation is likely to pass in early 2012, which would set up regulatory supervision for a covered bond program in the U.S.

In other important developments, in April the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) entered into settlement agreements, in the form of consent orders, with 14 mortgage servicers. The agreement requires servicers to take action to address residential loan servicing and foreclosure processing practices by establishing a single point of contact for borrowers and by hiring and training additional staff.

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