

STILL SWAMPED- US REAL ESTATE

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Since baseball's World Series nears, recall Ernest Lawrence Thayer's famous poem, "Casey at the Bat":

"Oh, somewhere in this favored land the sun is shining bright;
The band is playing somewhere, and somewhere hearts are light,
And somewhere men are laughing, and somewhere children shout;
But there is no joy in Mudville- mighty Casey has struck out."

CONCLUSION

The United States real estate marketplace, despite some improvement relative to winter 2008-09's abyss, remains in mournful shape. During the ongoing terrible global economic crisis, nervous politicians, fearful central bankers, and enthusiastic real estate business promoters have devoted much effort and creativity in their quest to rescue the real estate arena. How should we characterize their overall performance to date? Despite their numerous at-bats and vigorous swings at the real estate debacle, the financial and political guardians have often struck out and their overall batting average remains low.

Perhaps the real estate scene will become brighter. After all, central bankers and politicians always have upcoming opportunities to step up to the plate. They will keep swinging and whacking at real estate problems. Nevertheless, the still-feeble US real estate world underlines the fragile foundation and structure of the economic revival fabricated by the Federal Reserve (and its overseas central bank teammates) and political crews. Despite some progress, the shattering damage of the international economic disaster that commenced in 2007 has not been substantially fixed. The economic crisis persists and will continue for several more innings. Though the worldwide economic advance that emerged in spring 2009 reflects repairs and is not entirely a house of cards, it's not entirely built on solid ground. Money printing and deficit spending are not genuine (enduring) cures for economic problems.

The recent slowdown in the overall economic landscape will hinder the US real estate recovery. Therefore American real estate prices will remain relatively weak.

THE PLAYING FIELD

The United States of course is not the only competitor in the global economic game. And America of course does not stand alone at the plate in the fervent effort to spark and propel economic growth. Let's nevertheless focus on the American arena and its real estate neighborhood.

To assist American and international economic recovery during the economic disaster, the Federal Reserve Board pitched in its scheme of sustained rock bottom rates and massive money printing. Mammoth deficit spending by United States politicians stimulated activity. Much consumer and some business debt and leverage thus was transferred to the public sector. Over the past couple of years, and particularly since the second round of quantitative easing unveiled in August and November 2010, the Fed and other American financial sentinels encouraged dollar

weakness. By July 2011, they managed to produce a record monthly low in the broad real trade-weighted dollar.

Some promising signs of economic health appeared due to these assorted policies. There were some base hits. Real GDP moved upward. Exciting leaps in equities and dramatic jumps in commodities in general ensued.

However, 2011 brought slowing US (and worldwide) GDP growth and greater worries about fiscal disasters in America and Europe. The S+P 500 (5/2/11 at 1371; 1357 on 7/7 and 1347 on 7/21/11) and the broad Goldman Sachs Commodity Index (762 on 4/11 and 5/2/11; 712 on 6/9 and 705 on 7/26/11) dived from their spring and summer peaks. Frantic “flights to quality” into US Treasury securities ensued. Fretful central bank and political comments and sustained lofty unemployment levels likewise hint at a rickety US recovery. So does the modest dollar strength since late July 2010. In America (and many other regions), the potential for an extended term of sluggish growth (or even a renewed recession) looms larger.

What about the real estate playground since the dismal time of early 2009? In the past few months, a few indications of strength have emerged. Yet look at the overall performance of property. United States real estate marketplaces have recovered very little after their precipitous falls from their ceilings of the enchanting Goldilocks Era.

One should pay close attention to real estate in the context of consumer confidence and consumer and bank balance sheets. Especially in light of slowing GDP growth, high unemployment levels, declines in stocks, and so forth, the continued substantial overall weakness in the US real estate marketplace reflects persistent overall US financial difficulties and the likelihood of mediocre economic growth. As in 2007-09, what happens to American real estate still matters a great deal for the global economy.

THE US CONSUMER BALANCE SHEET

“The horror...the horror.” From the war film, “Apocalypse Now” (Francis Ford Coppola, director)

The roof fell in on United States household net worth during the worldwide economic crisis. The loss totaled about \$15.5 trillion from end 2007 to end first quarter 2009 (\$64.2-48.7tr). This awesome collapse exceeds full year 2010 nominal GDP of \$14.5tr and the current GDP rate around \$15.0tr. By end 2010, nominal net worth had increased about \$9.1 trillion to \$57.8tr, with the 2Q11 level rising a bit to \$58.7tr. However, end 2Q11 net worth languishes around \$5.5tr beneath 2007’s. (Federal Reserve Board, “Flow of Funds”, Z.1, Tables B.100 and B.100.e; 9/16/11). And these levels do not account for inflation, however modest, since 2007. Players should adjust the nominal end 2Q11 net worth total about five percent lower for a better perspective on the fragile balance sheet.

About 81 percent of that \$9.1 trillion net worth climb up from the basement to end 2010 derived from \$7.4tr higher equity prices. Contrast 1Q09’s \$10.9tr value in stocks with end 2010’s \$18.3tr (end 2Q11 \$19.2tr). However, based on the roughly eight percent S+P 500 slump from end 2010 to recent S+P 500 levels around 1150, household net worth sagged \$1.5tr dollars since end 2010 via this factor.

However, relative to the equity region, the US home front displays a more dreadful picture. Walk further into the Fed's Flow of Funds field. Owners' equity in household real estate was about \$12.9 trillion at end 2006 (56.6 percent of real estate value) and \$10.3tr at end 2007 (49.5pc). By end 1Q09, owners' equity had decayed nearly seven trillion dollars from end 2006, to just over \$6.0tr (a mere 36.4pc of household real estate value). It indeed rose one trillion dollars by end 1Q10. However, despite all the economic easing and extraordinary (even extravagant) government spending, by year end 2010 owner's equity eroded about \$500 billion, leaving it just under \$6.5tr (39.1pc owner's equity). By end 2Q11, it tumbled a bit lower, to under \$6.3tr, with owners' equity mired at 38.6pc.

Consumers represent about seventy percent of America's GDP. US consumer confidence (Conference Board) established a floor at 25.3 in February 2009, not long before the S+P 500's major bottom at 667 on 3/6/09 (broad GSCI low 2/19/09 at 306). Although real GDP increased since end 2Q09, with 2010 up 3.0pc, confidence nevertheless expanded only to 72.0 by February 2011, well below the 111.9 in July 2007 at the height of faith in the Goldilocks economy. This significant yardstick has fallen since mid-winter 2011, with both August (45.2) and September 2011 (45.4) stuck well below the 61.4 valley of March 2003.

The current consumer confidence level and trend warn of danger for the overall economy, equities, and real estate. The S+P 500 made its final low back in March 2003 (3/12/03) at 789, way under current prices. Equity bulls and others might bellow that 2011 is not 2003. Yes, times change. And real estate and equities indeed are different marketplaces. It's usually easier to buy some stock than a house. The US housing territory arguably is "less international" than the province of stocks in general. Yet US housing and US (and worldwide) equities do intertwine, don't they? Witness the recent global financial crisis.

Mediocre consumer confidence results from a mixture of interrelated factors. In addition to severely injured net worth, high unemployment surely is very important, with September 2011's headline rate at 9.1pc. A broader unemployment measure (U-6) ominously indicates a more massive amount- 16.5pc (Bureau of Labor Statistics, Table A-15, 10/7/11). Weak household income trends are another. For example, real average hourly earnings have declined in seven of the last 12 months (with two other months flat); August 2011 is down .6pc versus a year ago (Bureau of Labor Statistics, 9/15/11). The federal deficit disaster (as well as troubles in many states and municipalities) does not make most observers joyous. Look at the White House and the Houses of Congress. Are the current and prospective fiscal deficits and noisy partisan debates regarding them indicative of an orderly household? Inflation concerns, although fuel and food prices have subsided some relative to their 2011 peaks, still weigh on many consumers. Moreover, ongoing substantial weakness in home prices plays a key role in producing recent grim confidence levels.

Debt remains a heavy load on many consumers. So why should they feel happy and eagerly rush out and purchase a new or better house? Survey the NY Fed's "Quarterly Report on Household Debt and Credit" (August 2011). Consumer indebtedness (of which mortgages equal about 71pc) is down 8.6pc to \$11.4 trillion at the close of 2Q11 versus the \$12.5 trillion top of 3Q08. However, the current level remains high (see p3 chart). And at around 7.5pc of all debt, delinquencies remain substantial (charts at pp8-9).

In any event, decrepit home prices alongside dismal consumer confidence (and related evidence) underline that a fair amount of the recovery and stock marketplace rally did not rest on a solid foundation. Second quarter 2011 US real GDP advanced only 1.3 percent (1Q11 merely .4pc).

THE HOME FRONT

Ty Cobb, a baseball star, declares in his autobiography: “Away from baseball, I had a lot of fun, and much of it came in pitting myself against the odds found in the financial world, which are somewhat longer against success than getting a base hit.” From “My Life in Baseball” (written with Al Stump)

On balance, housing indicators still are bearish. However, not all of them are. Bullish considerations extend beyond ongoing population growth. Glimmers of hope include rises in an affordability index as well as steadying sales prices of existing homes. Existing home sales rates have marched somewhat higher (though this partly reflects foreclosures). The inventory of existing homes, though still high, has declined. Inventory of new homes is low. Perhaps houses have become less expensive relative to rentals. And the Fed’s sustained fight to slash long term Treasury and commercial interest rates is reflected by falling yields on the mortgage battlefield.

From various perspectives, home prices remain bogged down at low levels relative to their pre-crisis pinnacle. These feeble prices persist despite slides in mortgage rates since mid-2008. The 30 year fixed national average high was around 6.5 percent on 7/23/08. By early October 2011, it was four percent (Bankrate.com). According to Freddie Mac, the September 2011 30 year fixed rate mortgage level was 4.11pc, down from the peaks over 6.7pc in July 2006 and July 2007. On 9/21/11, the Federal Reserve reached into its trusty toolbox in its effort to drive long term rates lower. It pulled out Operation Twist. For the week ending 10/6/11, these fixed rate mortgage levels averaged 3.94pc. According to Freddie Mac’s chief economist, this is the first time in history these rates dipped under four pc (Financial Times, p21, 10/7/11).

National Association of Realtors (“NAR”) data reveal the August 2011 mean price (not seasonally adjusted) for existing homes is down about 21.4pc from the June 2006/June 2007 tops. The median price is off even more from its July 2006/June 2007 summits- about 26.8pc. However, US existing home sales in August 2011 are up 18.6pc year-on-year, to a yearly rate of 5.03 million (seasonally adjusted). Yet this August improvement still leaves it below even calendar 2009’s 5.16 million and not much over 2008’s 4.91mm. Besides, it is far distant from full year 2005’s booming 7.1mm and 2006’s impressive 6.5mm, and a fair amount down the road from 2007’s 5.7mm.

The Case-Shiller composite housing index for July 2011 (9/27/11 report; not seasonally adjusted) was 142.8, continuing to creep higher from its March 2011 low at 137.6. The July 2011 level, however, remains about 30.8pc beneath the July 2006 peak at 206.5.

The National Association of Home Builders/Wells Fargo Housing Market Index for May 2011 remains moribund at 14. January 2009 at 8 was its lowest depth. The highest since that 2009 low was over a year ago- June 2010’s 22. The highest in recent years was 72 in June 2005. It faded under 50 in May 2006.

The NAR’s composite Housing Affordability Index mounted substantially higher over the past couple of years. As of August 2011, this measure is about 184, not far from February 2011’s 192. These 2011 levels are the highest for data going back to 1989 and almost double the low of 101 in July 2006. US home prices and sales rates appear relatively cheap according to this index. On a

full year average basis, 2010's average was 174, with 2009 about 169 and 2008 138. Compare the pricey time of 2006's mere 108. The recent support in existing home prices and signs of higher existing home sales reflect this enhanced affordability.

However, inventories of existing homes remain ample. According to NAR, there were 3.6 million at end August 2011. In months of supply terms, end August 2011 slipped to 8.5 months from July 2011's 9.5. It is even further down from July 2010's stratospheric 12.5 months supply (August 2010 11.7 months). Nevertheless, the August 2011 stockpile remains clearly above calendar 2006's 6.5 month average as well as the typical inventory total of fewer than five months in prior years.

Second quarter 2011 commercial bank charge-off rates for residential real estate loans were 1.68 percent, down from 4Q09's 2.82pc peak. However, they remain far above the basement of .12pc of 4Q06. And delinquencies remain very elevated. They peaked at 11.22pc in 1Q10; 2Q11's 10.53pc remains near that summit. Compare the 2.03pc delinquency rate of 1Q07. (All banks; Federal Reserve data).

NAR's "Confidence Index" reported that distressed property sales (foreclosures plus short sales) were 40 percent of total sales in March 2011 and 37pc in April 2011. That certainly reflected a bleak housing horizon. The situation looks marginally less depressing now; the July 2011 rate was 29pc, though August 2011 climbed to 31pc (p11, 9/21/11). In a short sale, the sale proceeds fall short of the balance owed on the property's loan, but enable the borrow and lender to avoid foreclosure. Continued considerable liquidations risk further significant wounds to consumer net worth (and confidence) as well as to banking capital strength.

Underscore the International Monetary Fund's ("Global Financial Stability Report"/"GFSR", April 2011; ch1, pp22-23 and Figure 1.24) dreary assessments regarding the US real estate context. The GFSR states that American "households are highly leveraged, with many in a negative equity position on their home loans" (p22). The share of residential mortgages with negative equity is about 23 percent. The shadow inventory of houses potentially for sale (in millions of loans) grew from around two million in 2007 to around 6.3 million in 2010 (or, about one in seven home loans). The IMF notes (citing CoreLogic) that in 4Q10, over 23 percent of US homeowners owed more on their mortgages than their homes were worth (Box 1.3, p43).

The IMF's September 2011 perspective on the US housing quagmire remains similar to its April viewpoint. "News from the housing market has been disappointing, with no end in sight to the overhang of excess supply and declining prices..." ("World Economic Outlook", "Executive Summary", p xv). It adds: "House prices show no signs of stabilizing in key crisis-hit economies such as the United States and Spain. A large overhang of unsold properties with underwater mortgages continues to present a major downside risk to consumption in the United States." (WEO, chapter 1, p5).

The IMF's July 2011 Country Report on the United States ("2011 Article IV Consultation", Box 6, p21) evaluates the "US Administration's Response to the Housing Crisis". It lists the Troubled Asset Relief Program ("TARP"), Home Affordable Modification Program ("HAMP"), the "Hardest Hit Fund Program", and others. The IMF emphasizes: "The Administration has undertaken a variety of measures to tackle the foreclosure epidemic, but so far with limited results."

Yet housing players have managed a few singles and doubles (though no home runs). The Country Report cheers: “Other policy initiatives were relatively more successful in supporting the housing market.” It mentions the homebuyer tax credit (which expired last summer) and loan modifications (via the private sector, including the GSEs) under the Hope Now program. It notes that support to Fannie Mae and Freddie Mac facilitated household access to affordable mortgage credit. Purchases by the Federal Reserve and US Treasury of over \$1.4 trillion of agency mortgage-backed securities helped to keep mortgage rates low.

Nevertheless, supporting the housing marketplace is not the equivalent of a sustained recovery in it.

What about new residences (one family; Census Bureau, Dept of Housing and Urban Development; 9/26/11)? At end August 2011, only 162 thousand new houses were for sale (seasonally adjusted). This level partly reflects mediocre demand. It is the lowest for any month going back to 1963, and far below the July 2006 peak of 572m. However, new home sales mounted about 6.1pc versus August 2011. In addition, August 2011’s 6.6 months of new home inventory is much less than the 12.2 months of January 2009. So although there are stacks of old homes for sale, if the housing economy ever becomes more robust, the meager absolute level of new homes inventory may be perceived as a shortage.

Over the past couple of years, the median new home US sales price has swung up and down from month to month (for example, \$204m low in October 2010, \$241m December 2010). August 2011’s \$209m level falls well within the 2009 to 2011 range.

Let’s peer through the windows of the rental housing domain.

The US rental housing vacancy rate in 2Q11 was 9.2 percent, down from the 3Q09 high of 11.1pc (Census Bureau, Department of Commerce; “Residential Vacancies and Homeownership”, 7/29/11). The 2Q11 vacancy rates are about average relative to the second quarter range of 7.8 to 10.6pc for 1996-2010 (10.6pc was the high in both 2009 and 2010), but are the lowest 2Q since 2003’s 9.6pc.

Apartments make up about half the nation’s rental supply, with single family homes and condominiums the rest. According to a USA Today story (online; 5/4/11), some soothsayers believe US apartment rents will ascend at least four or five pc this year.

However, recent US government data do not show a general rise in national rents. The US median asking rent in 2Q11 is flat versus 1Q11; it is thus down 2.1pc from the full year 2010 average and off 5.4pc from the 1Q09 peak (Census Bureau, Table 11A; 7/29/11).

If renting becomes expensive relative to buying homes, that obviously may encourage home purchases. The rent ratio is the average home sales price divided by the annual cost of renting an equivalent house. The appropriate breakeven rent to buy ratio varies according to the observer’s selection and evaluation of costs and geographic region. A NYTimes article (Business Day, 5/11/11, ppB1, 9) states: “As a rule of thumb, buying often makes more sense than renting when the rent ratio is below 15.” A small graph in this article places the US metropolitan area average at around 15, down from slightly over 20 around five years ago. It is challenging to dig up and evaluate national renting versus buying ration data. Anyway, here’s a second viewpoint. As of

7/1/11 (according to Trulia's survey; 8/22/11), in 74 percent of the 50 largest US cities, it was cheaper to buy a house rather than rent a two bedroom apartment.

COMMERCIAL REAL ESTATE

The US commercial real estate marketplace remains stuck in quicksand, though it has perhaps escaped a little bit in recent months.

The Moody's/Real Commercial Property Price Index rose for the third month in a row, and now stands 12.6 percent above the post-peak floor. However, it remains pretty smashed up, at 42.5 pc below the October 2007 top. Also, nearly 28 percent of all repeat sales transactions in July 2011 were distressed, around the average of the past two years. July 2011's distressed sales percentage marked the 22nd month out of 24 surpassing twenty pc. (Moody's; MIT Center for Real Estate; July 2011, 9/21/11).

The International Monetary Fund's April 2011 GFSR's (ch1, p26) scorecard points out that US (and United Kingdom) commercial real estate "loan performance continues to deteriorate and prices remain depressed". In addition, "refinancing needs over the next three to five years are daunting." A scan of Figure 1.30 indicates the US refinancing appetite from 2011 through 2015 averages about \$350bb per year.

The Fed reports the commercial 2Q11 charge-off rate for all banks at 1.66pc, notably under the 2.79pc height of 4Q09. Yet it's miles over the .01pc of 4Q06 in the "good old days" epoch of easy money and eternally rising prices. The 2Q11 delinquency rate depicts a similar pattern. Though its 7.05pc falls somewhat from 2Q10's 8.75pc plateau, it towers far above that at the advent of the worldwide economic crisis (1Q07 was 1.43pc).

GREEN ACRES

Not all US real estate prices have suffered hammer blows. Scan farmland. Not everyone laments high food prices. According to the Chicago Fed, the seventeen percent year-on-year advance in farmland values for the Seventh Federal Reserve District in 2Q11 was the largest year-on-year climb since the 1970s.

BANKS

Given the still-weak home and commercial real estate marketplaces, the net worth of many banking institutions probably would be vulnerable to marking-to-market of existing real estate loan portfolios. Renewed economic weakness of course would worsen that problem. In any event, banks concerned about their actual capital strength will not scramble to significantly expand their overall lending.

Let's charge into the underbrush of the IMF's April 2011 GFSR in this context (ch1, p 11). Focus on the following remarks and then ask if the worldwide economic crisis is close to finished. "Second, some banks have been rolling over loans that would otherwise have been considered delinquent, a practice that may have been exacerbated by the persistence of low interest rates. Third, banks- particularly in the United States- have built up an inventory of repossessed

properties, and a key challenge is how to reduce that stock without further destabilizing house prices...”

Of roughly \$13.6 trillion in total assets of US FDIC insured institutions at end 2Q11, loans secured by real estate were about 4.1tr, or just over thirty percent. Real estate loans therefore are almost 2.75 times bank equity capital of just over \$1.5tr. (“Quarterly Banking Profile”, Second Quarter 2011, Table II-A; FDIC-insured institutions).

If all of these property loans were marked-to-market, how badly would bank capital be crushed? In view of the 2Q11 charge-off and delinquency rates for residential and commercial real estate discussed above, a realized loss estimate of three percent is rather conservative. For \$4.1tr, that is around \$120 billion. This is a major league loss, even if it is a bearable one, for it represents about eight percent of bank capital. Doesn’t such a large implicit hidden loss in the overall banking balance sheet partly account for the reluctance of many banks to lend to those with less than all-star credit ratings?

Such a substantial asset writedown of real estate loans by banks perhaps will never occur. Or, maybe the damage will materialize slowly. But it is prudent to consider the potential. Is an even larger percentage markdown worth contemplating?

Many American (and other) banks and real property owners probably lament the Fed’s inability to purchase real estate directly via its beloved quantitative easing enterprise.

INFLATION AND REAL ESTATE

Focus on the US Consumer Price Index for All Urban Consumers (CPI-U) for August 2011 (Table 1, p10, 9/15/11). “Housing” is 41.5 percent of this key inflation measure. As part of the housing category, the “shelter” element equals 32.0pc of the entire CPI (fuels and utilities make up about 5.1pc, and household furnishings and operations about 4.4pc). Within the 32.0pc, “rent of primary residence” is 5.9pc, with “owners’ equivalent rent of residences” over 24.9pc.

The August 2011 year-on-year increase in this 32.0pc “shelter” category was 1.6pc (unadjusted). The past three month-on-month increases in it (seasonally adjusted) show somewhat greater signs of inflation, at around a 2.4pc annual rate. The increase from May to June 2011 was .2pc, June to July .3pc, and July to August .2pc.

The Federal Reserve and many of its fans keep shouting that inflation is low and not a substantial danger. The Fed nevertheless seeks two percent inflation over the long run. If the economy weakens further- and keep a close eye on the stock marketplace, the Fed may begin a new series of money printing (QE3).

Anyway, imagine that the quest to resuscitate real estate prices becomes more productive, particularly in the home sector. What happens if fewer houses are built, foreclosure rates decline, home inventories plummet from high levels, rents move upward, and consumer incomes and confidence grow? A wide-ranging real estate sector rally in percentage terms probably will be far less than the gigantic stock marketplace one which began in March 2009. However, it still may translate into higher levels in the CPI “shelter” measure. If this occurs, the inflationary consequences for the overall CPI could be significant- and surprising to many financial observers.