Weekly Economic Commentary

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Highlights

Looking ahead to the remainder of 2012, we see only a modest contribution to Gross Domestic Product (GDP) growth from housing, as the positives slightly outweigh the negatives.

We take the pulse of the health of the housing market, by reviewing a range of indicators, in this report.

Economic Calendar

Monday, March 26
Pending Home Sales
Feb

Dallas Fed Mfg. Index
Mar

Tuesday, March 27
Consumer Confidence
Mar

Wednesday, March 28
Durable Goods Orders and Shipments
Feb

Thursday, March 29
Real GDP
Q4

Initial Claims
wk 3/21

GDP Price Index
Q4

Fed's Bernanke Gives Lecture at George Washington University

Friday, March 30
Personal Consumption Expenditures
Feb

Personal Income
Feb

Chicago Purchasing Managers Index
Mar

U of M Consumer Sentiment
Mar

The Long Road Home

This week brings a mix of policy and data, but the Supreme Court's consideration of the Affordable Care Act will likely draw most of the media's attention. This week's U.S. economic data is a mix of data on: 1) manufacturing in February (durable goods orders) and March (Richmond, Kansas City and Dallas Fed manufacturing indices along with the Chicago area Purchasing Managers Index-PMI); 2) housing (pending home sales in February); 3) and consumer sentiment for March. Markets will be looking for signs of slowdown in the United States after seeing the weaker data in Europe, the U.K. and China last week. The release of the German IFO index for March and the March PMI in China are the data highlights overseas. The real action, however, may be on the policy front this week, at home and abroad.

The U.S. Supreme Court will hear arguments this week on the Affordable Care Act. The hearings will get a lot of media attention, though a decision by the Supreme Court is not due until the end of June. While the Federal Reserve's (Fed) next Federal Open Market Committee (FOMC) meeting is still five weeks away, the debate over whether or not the Fed will conduct another round of quantitative easing (QE3) will be in the news this week, as no fewer than 10 Fed officials make public appearances. There are more policy hawks (those favoring the low inflation side of the Fed's dual mandate) than doves (those who favor the full employment side) on the docket, and so by the end of the week, the market may doubt that QE3 is still on the table. Our view remains that unless the economy accelerates noticeably in the next several months, the Fed is more likely than not to do another round of quantitative easing in the second half of the year. In addition to the Fed speakers, there are several key finance ministers' meetings (and debt auctions) in Europe this week, and leaders of the BRIC nations (Brazil, Russia, India, China) will meet in India amid slowing growth in many emerging market economies.

Still on the Road to Recovery

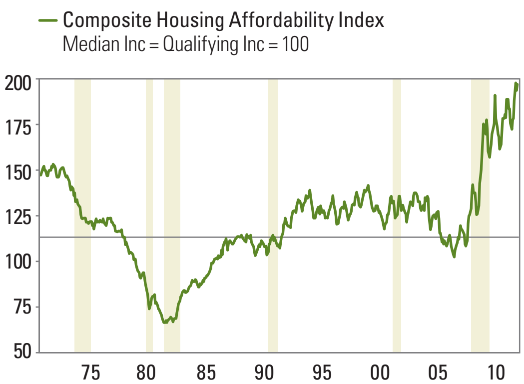
Housing was in the news last week, and there are several housing-related reports due out this week as well. As we have noted in recent commentaries, the U.S. housing market is still in the process of recovering from the 2006–09 bust that followed the housing boom that began to show severe cracks in 2007 and collapsed in 2008. The collapse in housing, in turn, was a major contributor to the financial crisis and Great Recession of 2007–09. The housing market, along with many financial markets, and many economies around the globe are still feeling the after-effects of the housing collapse.

As the old saying goes, the real estate market is all about "location, location, location." When we discuss the housing market, we do so from a national perspective: what is happening to the housing market on your street or in your neighborhood, town, city or state may be completely different (better or worse) than what is happening nationwide.

With that important caveat in mind, we can say that the housing market (sales, prices, construction, etc.) hit bottom in early 2009 and has been moving sideways to slightly higher since then. Housing construction (which is the most direct way housing impacts gross domestic product–GDP) has not been a significant, sustained contributor to economic growth (as measured by GDP) since 2005. The lack of participation from housing has been one of the main reasons (along with the severe cutbacks in state and local governments) behind the so far sluggish economy recovery. Looking ahead to the remainder of 2012, we see only a modest contribution to GDP growth from housing, as the positives slightly outweigh the negatives.

There are a number of direct (housing starts, housing sales, construction spending, home prices) and indirect (homebuilder sentiment, mortgage applications, foreclosures, inventories of unsold homes, mortgage rates, housing vacancies, lumber prices, prices of publicly traded homebuilders) ways to measure the health of the housing market. These data are collected and disseminated by both the U.S. government and by private sources. A quick recap of these various indicators is below.

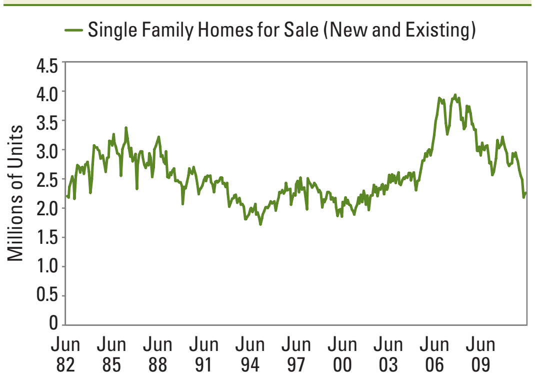
1 Housing Affordability Is at an All-Time High, but Difficulty Qualifying for a Mortgage Remains a Key Roadblock



Source: National Association of Realtors, Haver Analytics 03/26/12

(Shaded areas indicate a recession)

2 The Visible Inventory of Unsold New and Existing Homes Is Close to Normal, but a Shadow Inventory of up to 2 Million Homes Remains a Concern

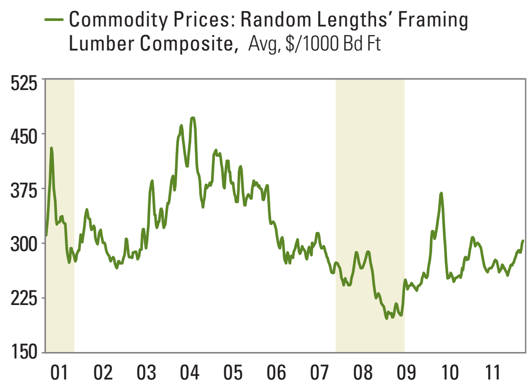


Source: National Association of Realtors, Haver Analytics 03/26/12

Taking the Pulse

- **Near-record housing affordability.** Housing affordability, the ability of a household with the median income to afford the payments on a median priced house at prevailing mortgage rates, is at an all-time high. Rising incomes, record-low mortgage rates, and the aftermath of the 20–30% drop in home prices nationwide account for the record level of affordability.
- **Homebuilder sentiment.** At 28 (on a scale of 0 to 100, where zero is the worst and 100 is the best) the index of homebuilder sentiment has surged over the past nine months and now sits at a four-and-a-half-year high albeit still at a very low level. The homebuilder sentiment data is compiled by the private sector's National Association of Home Builders.
- **Inventories of unsold homes are low.** Despite a "shadow inventory", homes in or close to foreclosures and homes still sitting on bank balance sheets, inventories of unsold existing homes are the lowest they have been since 2006–07. The official count of the inventory of unsold single family existing homes (from the National Association of Realtors) tells us that 2.1 million existing homes are for sale. Depending on the data source (there is no "official" number for shadow inventory) cited, the shadow inventory is in the range of 1.5–2.0 million. While still well above average, the shadow inventory has come down over the past few years as well. It may rise later this year as foreclosures ramp up again after the moratorium was lifted earlier this year.

3 Lumber Prices Are a Good Market-Based Indicator of the Housing Market, and They Have Moved Up Sharply in the Recent Months



Source: FIBER, Haver Analytics 03/26/12

(Shaded areas indicate a recession)

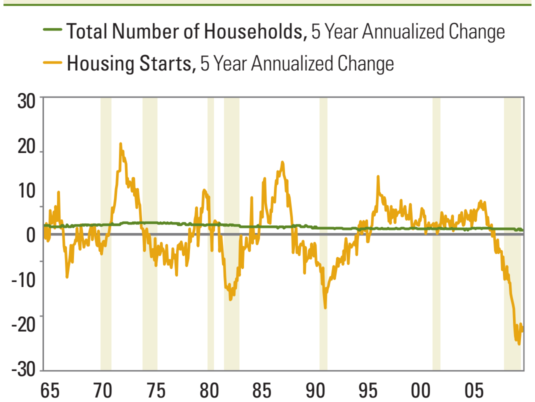
- **Housing starts and building permits.** Responding to less demand for housing, difficult credit conditions and a glut of unsold inventory, homebuilders drastically cut the number of new housing starts in recent years. Housing starts peaked at 2.4 million units in early 2006 and by early 2009 had dropped to under 500,000 units, an 80% drop. Since then, as inventories of unsold new and existing homes shrunk and the economy and financing conditions improved, starts have moved 50% higher. Despite the 50% move off the bottom, housing starts remain 70% below their all-time high. Both housing starts and building permits (a key leading indicator of starts) are collected by the U.S. Commerce Department.
- **Homebuilder stocks.** Although they are not a perfect leading indicator of the health of the housing market, the S&P 500 Homebuilders Index has rallied by nearly 80% since October 2011. Despite that dramatic rally, homebuilding stocks are still 75% below the peak hit in mid-2005.
- **Lumber prices.** Lumber is a key input to the homebuilding process. Lumber prices peaked in mid-2004—a year or so before the housing market peaked—and declined by nearly 70% by early 2009. Since early 2009, lumber prices have increased (in fits and starts) by 75%, but remain more than 40% below their 2004 peak. Lumber prices are set in the open market, trading on several global commodity exchanges.
- **Supply and demand for housing credit, bank lending to consumers for mortgages.** From the mid-1990s through late 2006, bank lending standards (down payment required, credit scores, work history, etc.) for residential mortgages were relatively easy. Coupled with low rates and rapid innovation in financial products backing residential mortgages, this easy credit helped to fuel the housing boom. The banking industry began tightening lending standards in early 2007, and continued to tighten for more than two years. Lending standards eased in 2009 and 2010, and have only recently returned to where they were in 2003. On the demand side of the equation, consumer demand for mortgages remains muted, as consumers are uncertain about prospects for home price appreciation and their own financial and labor market status in the years ahead. This data is compiled by the Federal Reserve in the Senior Loan Officer Survey, which is released quarterly.
- **Mortgage applications.** Measured by the private sector's Mortgage Bankers Association, the volume of mortgage applications has increased fourfold since late 2008, but remains well below its mid-2000s peak. Weekly mortgage applications are a key gauge of consumer demand for housing, and as we enter the key spring selling season—40% of home sales occur between April and July—weekly mortgage applications will be a key metric to watch. Mortgage applications are a component of our weekly Current Conditions Index.
- **Foreclosure activity.** After a de facto moratorium on new foreclosures was put into place in late 2010 as the United States and individual state governments sued mortgage processors and banks, the pace of new foreclosures slowed down. By early 2012, new foreclosures were at the lowest level since mid-2007. Now that the legal action has been settled,

there is a concern that the foreclosure pipeline will fill back up again. While we may see some spike higher in foreclosures and sales of foreclosed-on bank-owned properties in the coming months, it is important to note that the pipeline of new defaults and overall mortgage delinquencies are falling, aided by a better economy and job market. There are various public and private sources for foreclosure and delinquency data. On the private sector side, firms like RealtyTrak, Lender Processing Services and the Mortgage Bankers Association provide data. Freddie Mac, Fannie Mae, and the Federal Housing Finance Administration (FHFA) are among the government agencies that compile data on delinquencies and foreclosures.

- **Construction employment.** As measured by the U.S. Department of Labor, construction employment increased by more than one million between the early 2000s and 2006 to nearly 3.5 million workers. Since then, workers employed in the construction of new homes has dropped by nearly 50%, bottoming out at just under 2 million in late 2010. Since then, construction employment has held steady, but has yet to make a decisive turn higher.
- **Construction already put into place.** The value of new residential construction put into place peaked at $535 billion in early 2006. Since then, construction of new homes has plummeted, and by mid-2009, just $122 billion in new home construction was underway. This data series moved sideways for about 18 months, hitting another low ($120 billion) in late 2010. Since then, there has been a modest uptick in construction of new homes, but new home construction is still running 75% below its peak. This data is collected by the U.S. Commerce Department.
- **Home prices.** There are a variety of sources for home prices from both the private sector—Case Shiller Home Price Index, CoreLogic, Zillow, RadarLogic, National Association of Realtors—and the U.S. Government—Freddie Mac, Fannie Mae, Federal Housing Finance Agency, etc. In general, these indices all suggest that home prices fell by between 20% and 30% between mid-2005 and early 2009, and are at best unchanged since then. Price changes before, during and after the bubble vary widely by region, price of home and type of property (single family versus condo, distressed and non-distressed, etc.).
- **Demand for housing.** New household formation is running just under 1% per year. Contrast that against the 80% drop in new housing starts over the past five years. The gap between new household formation and new housing starts had never been wider, leading some analysts to suggest that we are quickly running out of houses. But, with so many vacant homes (18 million or so), and young people (and older relatives) living with other relatives, it is difficult to say just how quickly we will run out of housing. The U.S. Census Bureau collects the data on household formation and the housing vacancy data.

On balance, the housing market continues to struggle three years after hitting rock bottom, and in some cases seven years after it peaked. How quickly housing can recover from here will help to determine the pace of the overall economic recovery. Warmer and drier than usual weather

4 The Gap Between New Household Formation and New Housing Starts Has Never Been Wider



Source: Census Bureau, Haver Analytics 03/26/12

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this winter may help to explain some of the better housing data of late. Warmer weather generally means better housing data (sales, construction, showroom traffic, etc.), so it may be that the better tone to the housing market is purely a function of the weather. We need to see some more normal weather and get past the traditional spring selling season to be sure. Our best bet is that the slow recovery in housing will pick up some steam in 2012, but that it will still take several more years before the national housing market is back to normal. ■

LPL Financial Research 2012 Forecasts

- GDP 2%*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:
- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

The Chicago Area Purchasing Manager Index that is read on a monthly basis to gauge how manufacturing activity is performing. This index is a true snapshot of how manufacturing and corresponding businesses are performing for a given month. A reading of 50 or above is considered a positive reading. Anything below 50 is considered to indicate a decline in activity. Readings of the index have the ability to shift the day's trading session one way or another based on the results.

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