



Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Meny Grauman
(416) 956-6527
meny.grauman@cibc.ca

Krishen Rangasamy
(416) 956-3219
krishen.rangasamy@cibc.ca

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US Housing—A Double Dip

by Benjamin Tal and Meny Grauman

The US economy may be on the mend, but a full-fledged recovery in the residential real estate market is still years away. After an unprecedented multi-year collapse most housing indicators have stabilized, but whatever signs of improvement do exist are more a function of a badly damaged market, and the distorting effect of temporary tax incentives, than evidence of a sustainable rebound. Starts, sales and prices are ended 2009 higher than they were earlier in the year, but we anticipate further weakness ahead as supply continues to outpace demand, mortgage rates head higher, and the government's generous home-buyers tax credit finally expires. That has significant implications for related equities which have already priced in a steady recovery in the US housing market.

Short-Lived Remedies

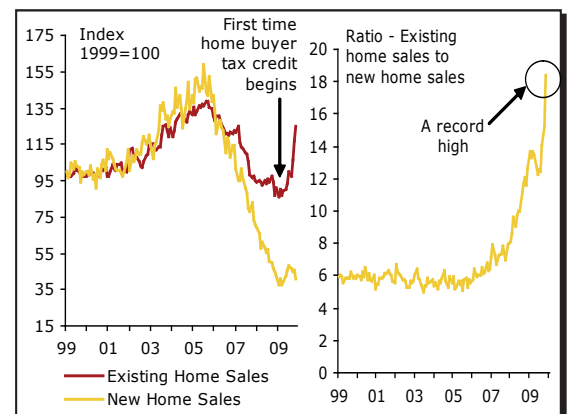
Just how strong an impact recent tax policy has had is clearly visible in the flood of purchases of existing homes, where foreclosures beat down prices to levels tempting to the first time buyers who initially qualified for the program. During the past year in which the program has been in effect, sales of existing homes have climbed by 15%, while new home sales have actually dropped by 5%. In fact, the usually stable sales ratio between the two has more than tripled, recently hitting a record high 18 (Chart 1). But after being extended once by the Obama Administration,

this tax credit will expire at the end of April—putting downward pressure on demand for existing home sales. That prospect will make it more difficult to clear out the next wave of foreclosures, prompting another down leg in US house prices.

Shadow Inventory

But the risk of a double dip in US home prices is not simply the result of properties being sold at "fire-sale" valuations, but also due to a deluge of shadow inventory coming onto the market. Although conventional inventories are trending lower, shadow inventories, capturing seriously delinquent and bank-owned properties, are just as large.

Chart 1
US Housing—Tax Credit Helped Existing Homes



Source: MBA, CIBC

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

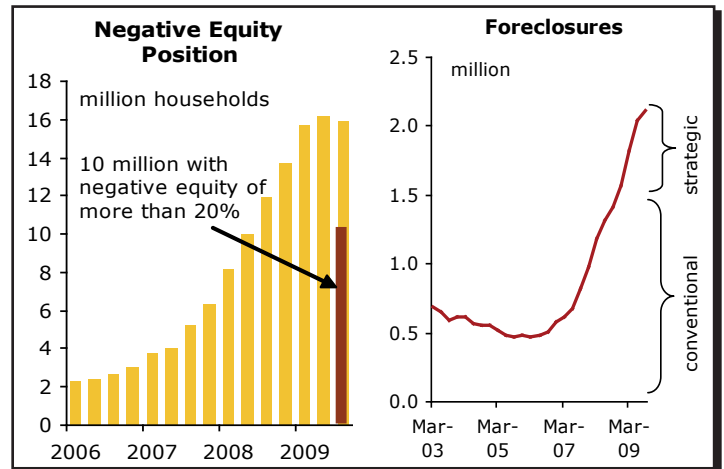
There are close to two million mortgages that are more than 90 days delinquent, and nearly all of these will end up in foreclosure, given that over the past three years the "cure rate" of this category fell from 40% to less than one percent. Add to that the 2.3 million properties that are in foreclosure or already seized by banks, and total inventories (conventional and shadow) are now running at over 8 million units (Chart 2). At current sales rates, that adds up to a record high 16 months of supply. True, this "shadow" stock will not hit the market all at the same time as banks manage their supply of seized properties, but this constant flow is likely to keep markets depressed for a while.

Note that default and foreclosure rates continue to rise despite a slowly improving economy and government efforts to stem the tide. Out of the nearly 730,000 mortgages in trial loan modification just 31,000 have been made permanent. And according to recent figures, despite managing to reduce monthly payments, the vast majority of modifications have actually raised loan balances—an important contributor in itself to the probability of foreclosure.

A big part of the problem is a still weak labour market, which has left a record 15 million Americans unemployed and another 9 million underemployed for economic reasons. However, just as significant is the roughly 10 million households in a negative home equity position of worse than -20%, for whom strategic default - failing to pay when one could - is a very real option. While negative equity is a necessary but not sufficient condition for default, it's a clear risk; out of the 2 million or so foreclosures in 2009, roughly 25% were strategic (Chart 3).

Chart 3

Strategic Defaults on the Rise



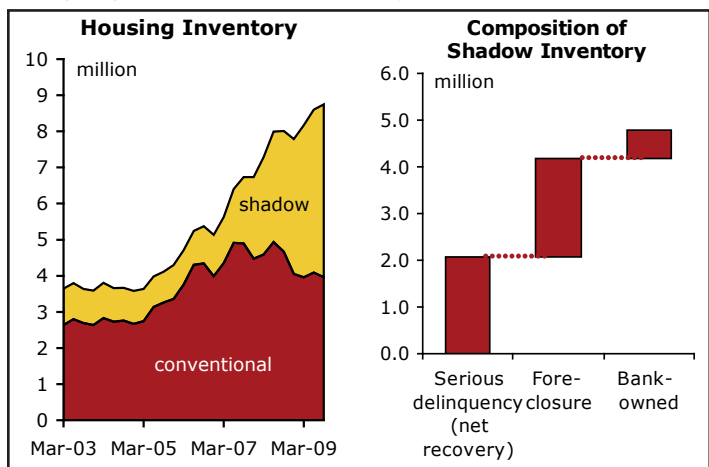
Source: Loan Performance, Equifax, CIBC

Fed About to Halt Purchases of Agency MBSs

It's not just inventories and tax credits that are looming large over the housing market, but also interest rates. Aggressive central banks' rate cuts along with large amounts of agency MBS purchases by the Federal Reserve have lowered mortgage rates by over 100 bps since the height of the financial crisis. That spurred a refinancing boom, which, according to First American Corelogic, saved \$2.3 billion in mortgage payments—a roughly 10% reduction—in 2009 alone. Although we don't expect policymakers to raise the fed funds rate until 2011, mortgage rates have already started to head higher, and could keep climbing towards the end of the first quarter when the Fed's \$1.25 trillion agency MBS purchase program is completed. Those

Chart 2

Surging Shadow Inventory



Source: MBA, NAR, CIBC

Chart 4

Fed MBS Purchases Held Down Mortgage Rates

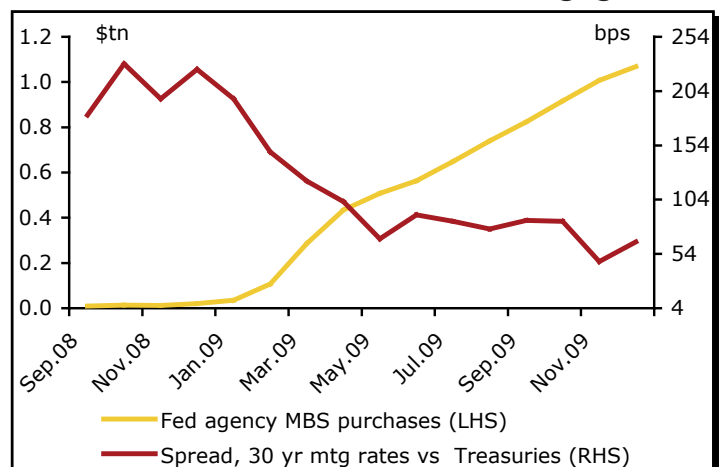
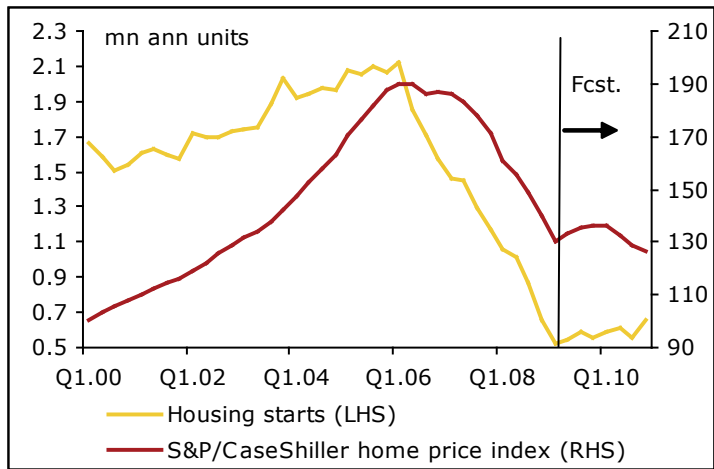


Chart 5
Housing Prices Head for a Double Dip



purchases made up almost 50% of all MBS issuance last year, and despite the improvements in the securitization market, their absence will likely have a material impact on rates (Chart 4).

In the final analysis, the end of unprecedented government tax support for housing, along with the looming overhang of supply and a higher cost of borrowing will keep new home building activity trudging along at historic lows over the next two years and could see prices drop again by 5-10% (Chart 5).

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