

**THIS WEEK'S NUMBERS**

		Prior	Consensus			FTN
			High	Low	Median	
Monday, Feb 1	Personal Income – Dec	0.4%	0.4%	0.1%	0.3%	<b>0.3%</b>
	Personal Consumption – Dec	0.5%	0.6%	0.0%	0.3%	<b>0.2%</b>
	PCE (YoY) – Dec	1.5%	2.3%	2.1%	2.2%	<b>2.1%</b>
	Core PCE (MoM) – Dec	0.0%	0.2%	0.0%	0.1%	<b>0.1%</b>
	Core PCE (YoY) – Dec	1.4%	1.8%	1.4%	1.5%	<b>1.5%</b>
	ISM Manufacturing Index – Jan	55.9	58.0	54.5	55.6	<b>56.0</b>
Tuesday, Feb 2						
Wednesday, Feb 3	ISM Non-Manufacturing Index – Jan	50.1	52.8	49.2	51.0	<b>51.0</b>
Thursday, Feb 4	Nonfarm Productivity – Q4	8.1%	8.4%	4.3%	5.2%	<b>6.0%</b>
	Unit Labor Costs – Q4	-2.5%	-1.0%	-2.7%	-2.1%	<b>-2.5%</b>
Friday, Feb 5	Nonfarm Payrolls – Jan	-85k	90k	-100k	20k	<b>100k</b>
	Unemployment Rate – Jan	10.0%	10.2%	9.8%	10.0%	<b>10.1%</b>
	Avg Hourly Earnings (MoM) – Jan	0.2%	0.2%	0.1%	0.2%	<b>0.1%</b>
	Avg Weekly Hours – Jan	33.2	33.3	33.2	33.2	<b>33.2</b>

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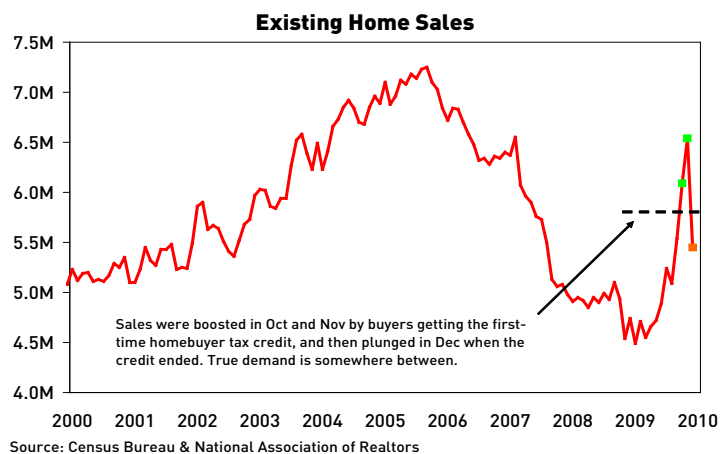
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## HOUSING UPDATE: TURNING THE CORNER

### Dependent on Government, Vulnerable to Foreclosures, But Recovering Nonetheless

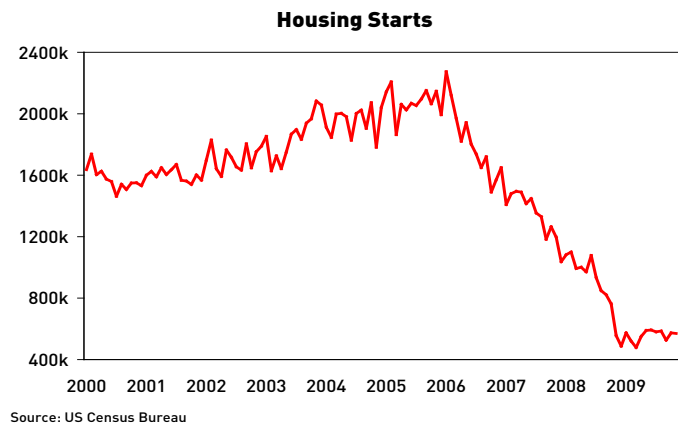
Our message on housing, even when bearish, has stressed that recovery — when it finally came — would be a four-step process. Because housing inventories were so overbuilt, we said home sales would have to recover first, inventories would have to drop next, prices would recover third and finally housing starts (new production) would resume.

Thanks in part to generous government support, home sales have bottomed, housing inventories are falling and prices are on their way to recovering. Still, there are enormous challenges to keep housing from fully recovering in 2010. First, there are millions of homes in delinquency and foreclosure, and potentially millions more on the way, thanks to looming mortgage payment increases on a host of pre-bust loans. This week, we look at progress made and challenges remaining in an effort to glean whether housing can stay on a recovery track.

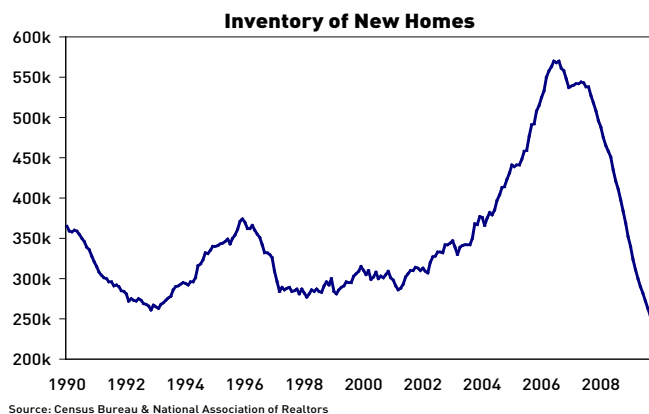


### No new supply

At the height of the housing boom in 2005 and 2006, 3.9 million homes were built in the US (a little less than 2 million a year). But after the peak in early 2006, housing starts tumbled for three years, until plateauing in a 500k and 550k range through 2009. To put the recent level of starts into perspective, the deepest previous trough of the last seven housing cycles was at the end of the 1981-1991 cycle. Starts fell to 798k in early 1991 before rebounding above a 1 million pace a year later. For a year, housing starts have been flat at a level 30-40% below the 1991 low.



The lack of new construction has allowed new home inventories (as reported) to clear to an all-time low despite slow sales, as the chart below shows. At this stage, then, the housing problem is an existing home problem, not a new home problem. Not to say homebuilders are in the clear to build again. Existing home inventories have to fall and prices have to recover first, but **it means the inventory clearing yet to be done is all on the existing home side.**

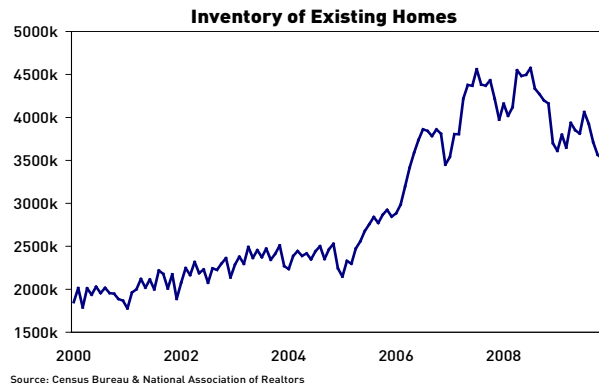


### An existential problem

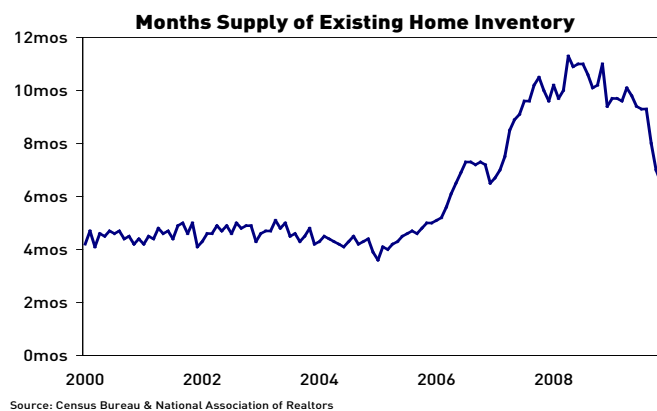
Existing home inventories are falling too, but slowly because they are being constantly augmented by foreclosures and by speculative investors now eager to unload their ill-considered bubble-era buys. Unlike new homes — where supplies fall as soon as new construction slows below sales<sup>1</sup> — it is not cut and dried on the existing home side.

First, a recap. Existing home sales fell 38.1% from their peak at a 7.25m rate in September 2005 to a trough at 4.49m (annualized) in January 2009. They have rebounded 21.4% through December. (The rise was 45.7% in November.) The chart on page 1 shows existing sales.

As for existing home inventories, there are two ways of looking at them. The first is the absolute level of inventories, which peaked at 4.6 million in July, 1998. Since then, they have fallen to 3.3 million, suggesting about half of the work has been done toward restoring them to their historic norm of 2.0-2.5 million.



Another way of judging inventory is the months supply of unsold homes. This is the ratio of homes on the market to the monthly sales pace, and is a better guide than the number of homes on the market because the appropriate level of supply depends on the strength of demand.



<sup>1</sup> Technically, starts are still outpacing new sales, but only because there is a difference in methodology. A fairly large chunk of housing starts are homes built by owner. Because there is no sale involved, these homes count toward housing starts but not new home sales.

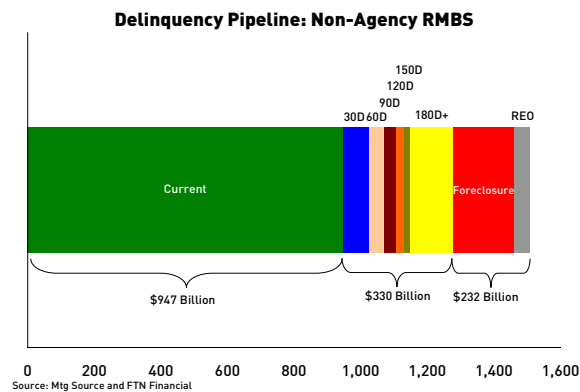
The range from January 2000 through January 2005 was 3.5-5.0 months. The current level is 7.2 months. The peak, in April 2008 was 11.3 months. Supply plunged in October and November of 2009 in part because the sales rate was elevated by the artificial deadline of the end of the first-time homebuyer tax credit. December's rebound was not too bad, despite the drop in sales, because inventories were further depleted. **In other words, the benefit to sales from the first-time homebuyer credit was temporary, but the bite out of inventories was a permanent benefit.** And, even though sales dropped significantly when the program ended (before it was later extended) the underlying rate of sales was fast enough to result in a further drop in inventories.

### Shadow inventory

One of the fundamentals of housing economics — that the supply of existing homes is more predictable than the supply of new homes because you can't build an existing home — has been turned upside down by the growing pipeline of delinquent mortgages.

The chart below, compiled by FTN's mortgage strategies group, shows the delinquency and foreclosure pipeline for non-agency backed mortgages, which account for \$1.5 trillion of the \$10.8 trillion mortgage market. A little more than one third of these loans are currently delinquent, in foreclosure or in REO (real-estate owned by lenders, foreclosed but not yet sold.)

The most striking detail about this data — aside from the appallingly high default rate — is the size of the 180-day delinquency tranche. A couple of years ago, it was almost unheard of for a mortgage to be more than 90 days delinquent, but the 180-day tranche is now the fastest growing.

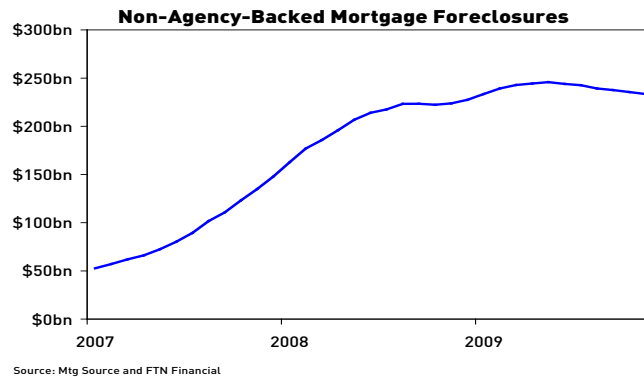


There are three likely explanations for the pile-up of delinquencies.

1. **Physical bottlenecks.** The number of employees, the computer systems and even the phone circuits at mortgage servicers are not designed to handle anything close to the number of foreclosures today, let alone the 90-day plus delinquent loans which would ordinarily already be in foreclosure.
2. **Government intervention.** The government has pushed hard to slow or reverse the foreclosure process by encouraging mortgage modifications, counseling and forbearance.

**3. Industry foot-dragging.** It is in the best interest of servicers to slow the rate of foreclosures if it means homes can be sold at a higher price than would be the case otherwise. Now that home values are stabilizing, it makes even more sense to move slowly on foreclosures given the low cost of carrying the properties.

Between these three factors, the rate of foreclosures, which ramped up in 2007 and 2008, has stabilized at a rate of about \$200-250 billion since early last year.



The non-agency market represents one of the poorer credit sectors, but the broader market demonstrates similar trends, including historically slow foreclosures relative to persistently high delinquencies. Fannie Mae and Freddie Mac have even organized programs — Deed for Lease — where delinquent homeowners stay in their homes after foreclosure, paying a market rent. (There are some qualifiers, including the rent must be less than 34% of the homeowner’s income.) The program is still so new there are no numbers yet. But the very existence of the program is consistent with the broad message from the three bullet points above: mortgage servicers, including the GSEs, are working with the government to slow the rate of foreclosures enough to allow prices to stabilize.

One reason this is so important is several waves of prime option ARM loans, many with negative amortization in the first several years, will reset in the near future. Many of these borrowers chose to make minimum payments, which means their monthly note could increase dramatically when the loans reset.<sup>2</sup> Many will eventually wind up in foreclosure.

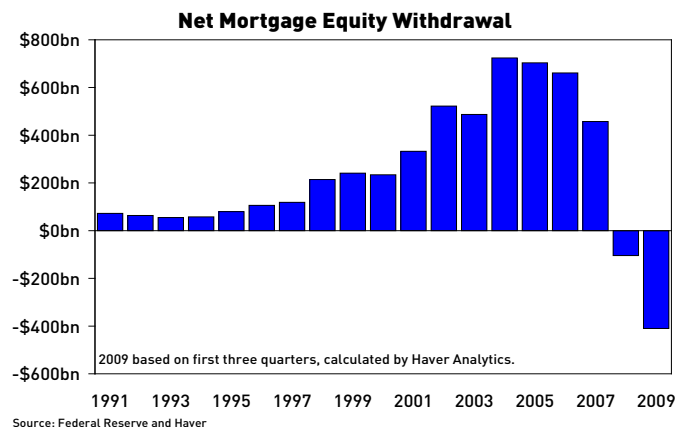
Nevertheless, we expect the rate of foreclosures to continue to be slower than the rate of sales. As a result, housing inventories should continue to fall and home price should rise.

<sup>2</sup> Or, more accurately, when the loans recast. Reset is when the initial fixed-period on ARM loan ends and the rate adjusts, often to a fixed rate. A recast is triggered when certain conditions — like a maximum LTV — are triggered. Payments on recast loans tend to be much higher than payments on reset loans relative to the initial payment on the mortgage.

## Conclusions

Three primary thoughts guide our expectations for housing and its impact on the economy going forward:

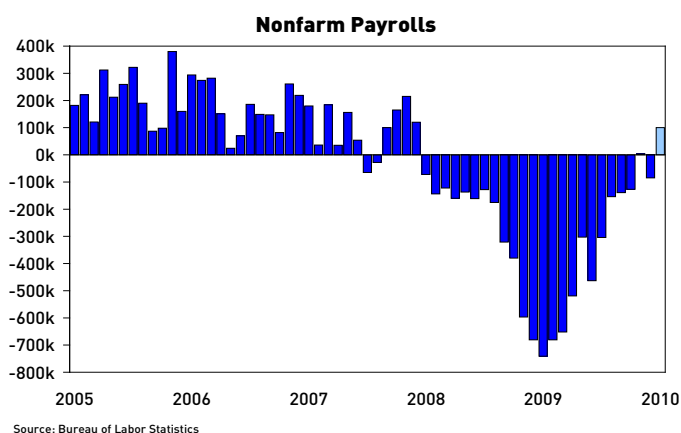
1. **The worst is behind us.** The pace of home sale — even without government support — is now faster than the combined pace of home construction and foreclosures. As a result, home prices will rise in 2010 and continue to rise in 2011.
2. **Real estate is local.** Some parts of the country will do better than others. The worst overbuilding was in California, Nevada, Arizona and Florida, so these markets are likely to recover more slowly than the rest of the country. (These are also the markets with the highest number of option ARMs.) Bob Hagerty's latest quarterly housing survey in *The Wall Street Journal* included some optimistic news from California, though, suggesting even these markets are not in the same distress they were a year ago. See Jim Vogel's January 22, 2010 *Weekly Report* for a look at consumer spending in some of the best and worst performing housing markets.
3. **We don't need housing the way we once did.** In 2004 and 2005, consumers subsidized spending with \$1.4 trillion in mortgage equity withdrawal. At that time it was not at all wrong to argue that whatever happened to housing would happen to the economy. Very few people have access to home equity debt now. Consumer spending is growing again without it. **As a result, if the housing recovery were to falter — something we do not expect — it wouldn't matter the way it did in 2007.** A housing recovery helps the economic recovery because higher house prices will improve bank balance sheets and will boost household wealth, which will have an incremental effect on spending. But the recovery in GDP so far has been achieved without much help from housing. In 2010, housing is no longer essential to growth.



## PREVIEWS

### Nonfarm payrolls

Nonfarm payrolls are likely to rise 100k in January, kicking off a year which should look decidedly better for employment than 2009. We expect job growth in the coming months as well, although it might not be continuous. Just this week, several large service companies announced thousands of job cuts, a reminder some companies still face layoffs. But on balance, most companies cut payrolls to the bone last year and many now have to add workers as orders resume.

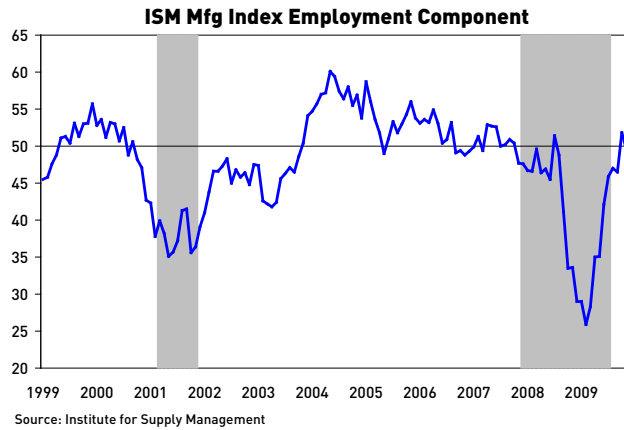


The unemployment rate is likely to rise one-tenth to 10.1%, only slightly below the cycle peak in October, 2009. The rate will rise for several months after job growth resumes as there are about 9 million discouraged workers who will start returning to the job market when word of the improvement starts to spread.

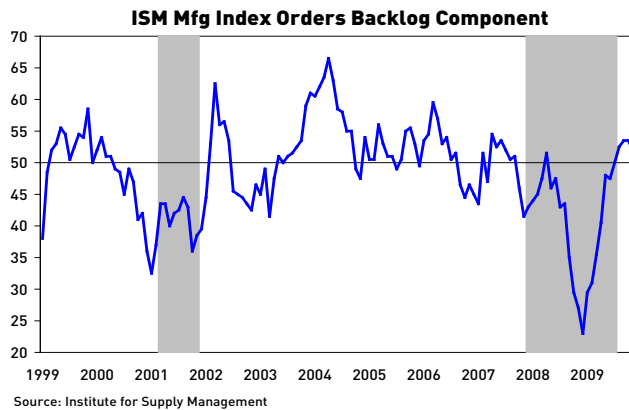
Average hourly earnings are likely to grow 0.1%, slightly below trend, pulling the year-on-year rate down from 2.2% to 2.0%.

Average weekly hours are likely to remain unchanged at 33.2. The workweek has been unchanged for the past three months after falling during the recession. It will rise again when economic conditions improve.

According to the ISM Index, hiring intentions have been positive for two of the past three months. There is typically a lag between the time employment intentions are reported and when those intentions come to fruition, but the lag is not usually more than a few months.



Additionally, the orders backlog has been growing for the past six months, indicating shipments falling behind orders. Some backlog is desirable as it allows companies to keep producing when demand dips. But as backlogs grow, eventually producers respond by increasing their operations.



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