Musings from Harley Bassman:

The Convexity Maven

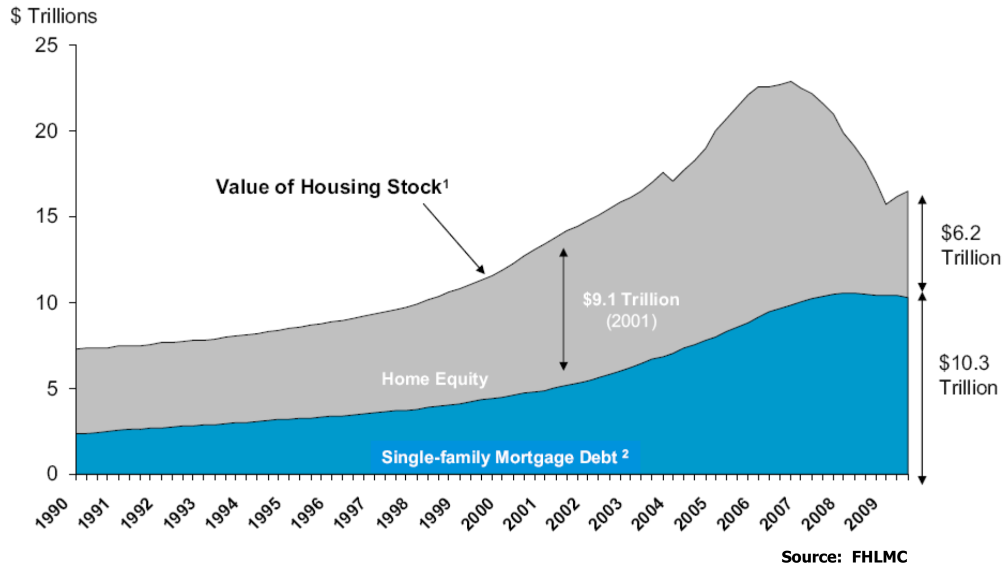
Value Concepts from the BAS/ML Trading Desk
April 15, 2010

"This is the Big One……."

Special bonus points for anyone under 30 who "gets" this reference

At the top of the market, US Households owned residential housing with a total Market Value near $23 Trillion. At the same time, they owned about $12 Trillion of Corporate Equity (stocks) and equity Mutual Funds. This would imply that the **average** person in the US had double the exposure to housing as to stocks. But we all know this is a "fun with statistics" mistake. Since the Top tier of households hold a disproportionate share of the Equity wealth in the country, the more important dispersion statistic to look at would be the **median**. Although this fact is not at my fingertips, I can assure you that vast majority of households in our country have most of their assets "in the ground" in some sort of real estate. Consequently, as the housing market goes, so goes the country: It is the BIG ONE. *(Source: http://www.federalreserve.gov/releases/z1/Current/)*

The chart below shows, in broad terms, the stupendous rise and tragic collapse of the US housing market. It would have been enough *(dayenu)* for the entire asset class to decline in value by over 27%, but the true "salt in the wound" was that households lost 52% of their net Home Equity. More often than not, this was the ultimate long-term savings account for most citizens.



So when you wonder why this recession has been so much more painful than past economic setbacks, look no further than the housing market. In fact, a housing collapse tends to go hand in hand with a financial crisis since real estate is most often the largest asset on a bank's balance sheet. (For vastly greater detail, we urge you to review the recent works published by Reinhart and Rogoff that we summarized in the RateLabs of April 16 and April 21, 2009.)

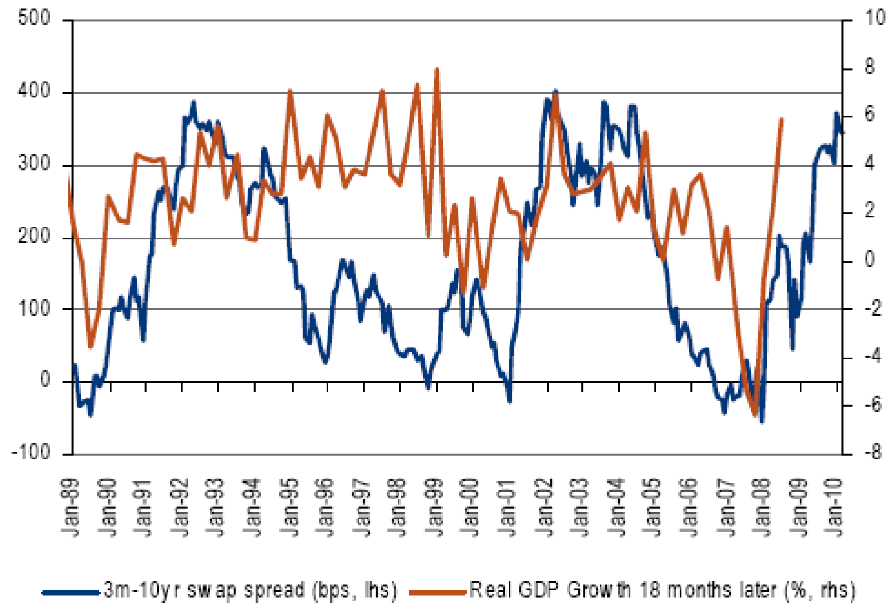
Our point here is that as much as a shrinking housing market led the entire economy to the brink, a rejuvenated market for real estate will be the precursor to financial stability and economic growth.

One of our key Mantras has always been: *"It is never different this time".*

This is reason we still read the Greek tragedies 2500 years later and the explanation for why the "hundred years flood" tends to occur every seven years. In this light, we do not believe that our crack MBS research team, led by Chris Flanagan, is off base when they step out on a limb and postulate that the HPA (home price appreciation) rate for calendar 2010 could be as high as +3%. While most analysts are wailing about the risk of a "double dip", Flanagan + team have outlined the case for a return to historical norms. This is big news for more than just the middle tranches of structured mortgage products. As

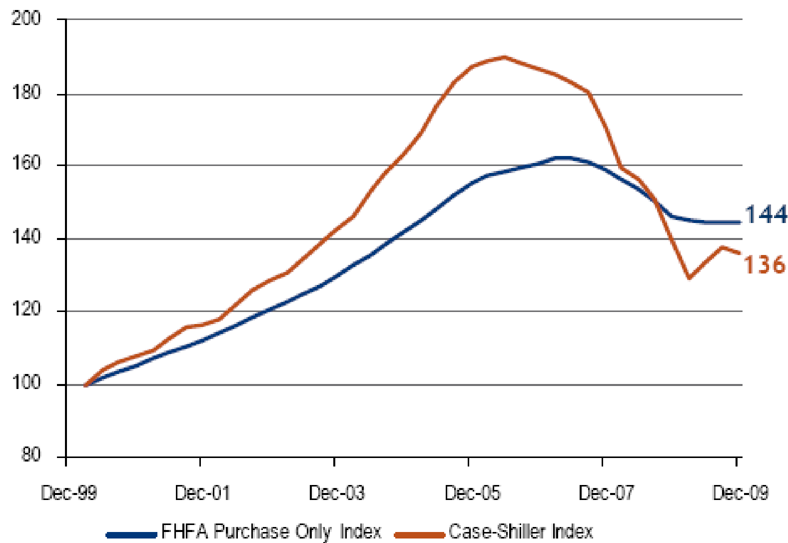
advanced above, if housing has indeed stabilized, then the entire financial market will improve.

The chart below shows how the FED's magic of steepening the Yield Curve into the teeth of a recession tends to work quite nicely.



All charts, unless otherwise noted, are sourced from BAC/MER data

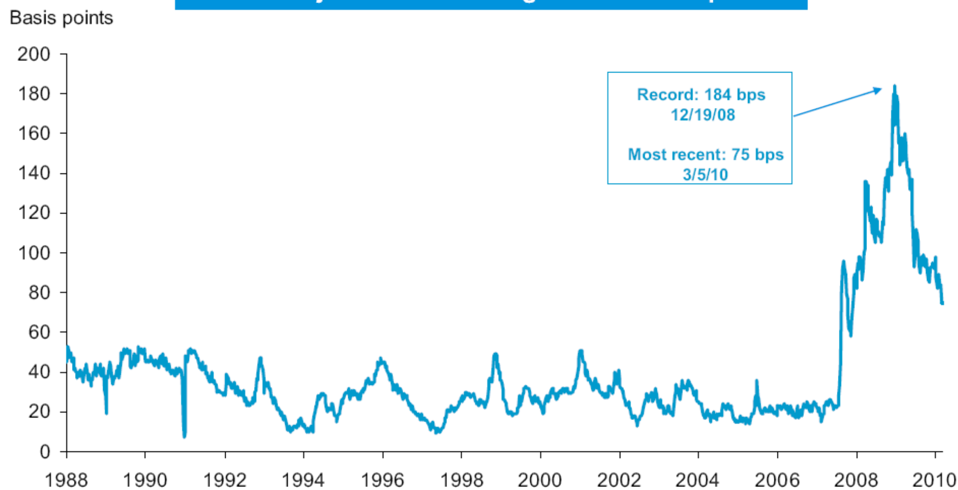
More powerful still is the impact of reduced interest rates in combination with



lower housing prices. Above, the –tan line- is the national Case-Schiller housing Index while the -blue line- is the alternate FHFA Index. Both demonstrate the large decline in home prices over the past few years.

When these two factors are combined with the general level of Personal Income, the Homebuyer's Affordability Index is created (below).

So the obvious question is why has housing activity been so muted, especially for purely financial ReFinancings ? The answer is two fold. First, homeowners with



stable employment and low LTV housing often do not "conform" to GSE requirements and therefore are not eligible for Agency rates. As shown above, the blow-out of the Jumbo versus Conforming spread removed the economic incentive for borrowing. Second, and certainly more important, most banks have tightened their credit standards tremendously. Here we are not referring to sub-prime borrowing; we mean bread and butter lending standards.

Where in past times banks would lend at the traditional 80% LTV, they now want to portfolio loans with a 75% LTV. While a "Prime" borrower has always been defined to be anyone with a FICO score of better than 720, presently lenders want scores of 750. The reason for this is obvious, if banks are going to keep these loans on their books, they need to be sure the collateral is "money good" and that the borrower has the means to keep current.

However, if lenders become convinced that housing has bottomed, and indeed is now starting to rise, the risk to lending is dramatically reduced. This is because in the event of a default, the proceeds of the foreclosure will cover the principal of the note.

It was the Vicious Cycle of lower home prices and higher defaults that collapsed the economy and forced the markets to massively tighten credit. <u>But ponder the implications of the Virtuous Cycle that will be created by a solidly positive HPA</u>.

If banks know for sure that the collateral backing their loan portfolio will not decline, they will not need the extra cushion of conservative (below 80%) LTV lending. Soon after that, banks will be climbing over each other to make solid Jumbo loans to their own customers at 5.50% rather than buy seven-year Treasuries at 3.25%.

Once lending standards normalize, the power of "cheap" housing (via the metric of affordability) will kick-in and increase housing activity. The increase in turnover will add confidence to the market. Soon after that, the large inventory of unsold homes, currently estimated at about 600,000 (an eight month supply) will shrink. This will occur via the magic of demographics, also known as population growth. The cohort of people who have advanced to the "home buying age" but have put off a purchase, due to fear or tight lending standards, will absorb this inventory. This can occur either by their direct purchase of housing or via the rental market as financial buyers purchase homes and rent them out for a profit.

This is precisely how the economic cycle, that Greenspan's *Great Moderation* was supposed to have buried, is supposed to work. As per Reinhart and Rogoff, our housing and equity markets as well as our unemployment rate all moved, peak to trough, well near the middle of the pack for countries that experienced a

banking crisis. If we hold to form, all that is left to complete the process will be the doubling of the public debt (US Treasuries) over a three year period.

As we have noted so many times over the past eighteen months, this entire process has almost been an instant replay of the 1989 to 1994 economic cycle. To remind you, a "Blue State" property market crash led to a financial market crunch. The S&L industry was closed and merged into the commercial banking complex. The US borrowed $260 Billion to fund the RTC (rhymes with TARP). The FED steepened the Yield Curve and allowed banks to "earn out" their bad loan portfolio. Housing in Los Angeles and NYC declined by 30% and Wall Street firms all traded under Tangible Book Value. Real estate churned from 1992 to 1997 before finally gaining traction in 1998. Unless the world has changed, this is what is going to occur again.

If our MBS research Aces are correct about a positive HPA, the cycle has turned and will gain momentum over the near-term. Signs of a shift abound as the middle of the Credit stack has tightened significantly.

What this means for Rates is unclear. There is no question the Yield Curve will flatten. The issue is how long the FED will keep rates low as an insurance policy against a 1937 redux.

So if you are trapped on a desert island and can only watch one economic indicator, keep your eye on the housing market, it's the BIG ONE.

Harley S. Bassman

BAS/ML US Rates Trading
April 15, 2010

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