MONTHLY MARKET MONITOR

JULY 30, 2008

MMM 07-08

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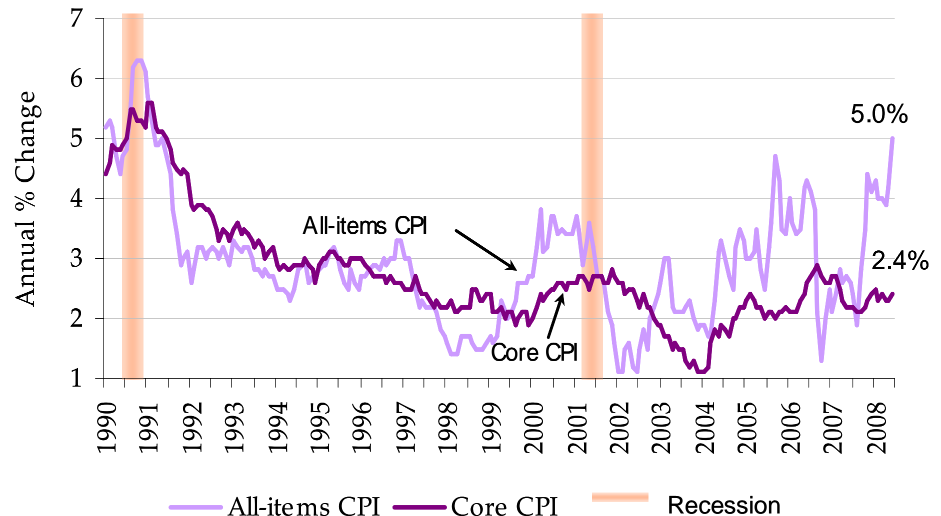
ECONOMIC COMMENT

A perfect storm has descended on the financial markets with a faltering economy, job losses, accelerating inflation and rising interest rates threatening growth in the United States. The economic weakness, specifically in the housing and financial institutions sectors, resulted in profit shortfalls in the past quarter. A palpable lack of confidence in the financial system contributed to further declines in share prices and funding costs for banks and thrifts, already suffering under the weight of loan related losses.

The consumer is struggling to move forward against strong headwinds. The highest inflation rate in 17 years is proving to be a formidable force. The consumer price index, CPI, is rising at a 5.0 percent annual pace as of June of this year, far exceeding a 3.4 percent growth rate in average hourly earnings. The 7.9 percent second quarter gain in the CPI was largely led by surging energy prices. Energy costs continue their ascent, rising 6.6 percent in June, and up 53.6 percent at a compound annual rate for the three months ended in June.[1] Food costs are also high, increasing 1.00 percent in June and 8.15 percent annualized for the last three months. The surge in prices for these two household staples is likely to curb discretionary spending in the coming months.

CONSUMER PRICE INDEX (CPI), AS OF JUNE 2008 (CHART 1)



SOURCE: BUREAU OF LABOR STATISTICS

The absence of home equity and stock gains has pushed consumer debt levels to 18.06 percent of GDP, approaching the May 2003 historic peak of 18.95 percent. As a percentage of disposable income, the debt load stands at 19.15 percent as of the first quarter of the year; down from its peak of 19.46 percent in the last three months of 2006.[2] Debt payments consist of the estimated required payments on outstanding mortgages

[1] Bureau of Labor Statistics, Press Release: "Consumer Price Index," July 16, 2008.

[2] Federal Reserve Board report on Household Debt Service and Financial Obligations Ratios, June 10, 2008.

and consumer debt. The elevated debt burden has not only led to rising mortgage loan delinquencies, but also higher late payments on auto, credit cards and home equity loans.

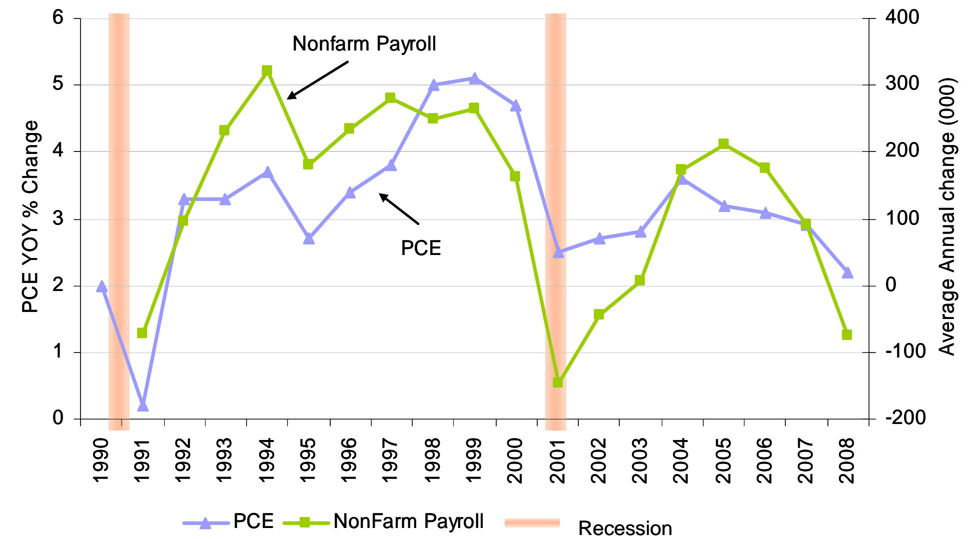
Not surprising, is the deep decline in consumer confidence as measured by the Conference Board. The index on consumer confidence stands at its lowest level since July 2001, with a current reading of 51 in June 2008. The present conditions indicator posted a 64.5 reading last month, and has fallen for ten consecutive months. Consumer expectations about the future also faltered as that index registered at 41.4, a seven year low.

In addition to higher gasoline and food prices, consumers also have to deal with job losses and fewer positions available. Nonfarm payroll employment fell for the sixth consecutive month in June, and is down 430,000 from the peak levels in December 2007. Job losses are broad-based, with only healthcare and educational services, mining, and government entities adding positions. Construction firms, manufacturers, and employment service providers shed jobs in June, while health care and mining companies increased payrolls last month. The contraction in the housing sector has resulted in the loss of 528,000 construction jobs since September 2006, when payrolls peaked.[3] Manufacturers shed positions in all areas, and have reduced jobs by a total of 353,000 in the last twelve months. Finally, temporary employment, generally a leading indicator of employment trends, fell by 30,000 in June and has fallen by an average of 26,000 per month this year.

The one sector that has enjoyed consistent job growth is healthcare where employers have added 348,000 new positions in the past twelve months. A boom in mining and oil and gas extraction has allowed for job growth in these sectors. Since reaching a low in payrolls in April 2003, mining companies have added 208,000 jobs, an increase of 42 percent. The downward trend in job creation has pushed the nation's unemployment rate to 5.5 percent in June, compared to a 4.6 percent rate a year ago. Overtime hours have been substantially reduced, and many workers have moved from full-time to part-time positions.

The impact of employment on consumer spending is illustrated in chart two. In previous recession periods a drop in nonfarm payrolls was followed by a decline in consumption. Current conditions suggest a similar result as payrolls have contracted for six consecutive months, while spending growth decelerated. At this time, consumption is still rising at a 1.1 percent pace as of the first quarter; however the surge in gasoline prices, persistent decline in home prices and pull back in equity values may cause the consumer to retrench and discover the benefits of saving once again.

PERSONAL CONSUMPTION EXPENDITURES (PCE) AND NON-FARM PAYROLL, AS OF MAY 2008 (CHART 2)



SOURCE: BUREAU OF LABOR STATISTICS & BUREAU OF ECONOMIC ANALYSIS

[3] Bureau of Labor Statistics, Press Release: "The Employment Situation," July 3, 2008.

MARKET COMMENTARY

The financial markets are beset with uncertainty and as a result, have behaved erratically in the past weeks. Earnings announcements by financial companies generally disappointed investors as banks and thrifts increase loan loss provisions in anticipation of further credit losses. The result is wider credit default spreads for various bank and thrift entities and credit rating downgrades. Treasury yields have risen across the maturity curve as inflation pressures accelerate. Libor rates have shifted higher and remained elevated due to credit concerns in financial institutions. Agency issued debt, once the investment of choice by global investors, is struggling to regain its prominence in the fixed income markets, and may have received a boost by the passage of housing legislation by Congress in the past week. Finally, market conditions in the mortgage market remain strained, thus restricting the availability of financing for potential homeowners.

(CHART 3)

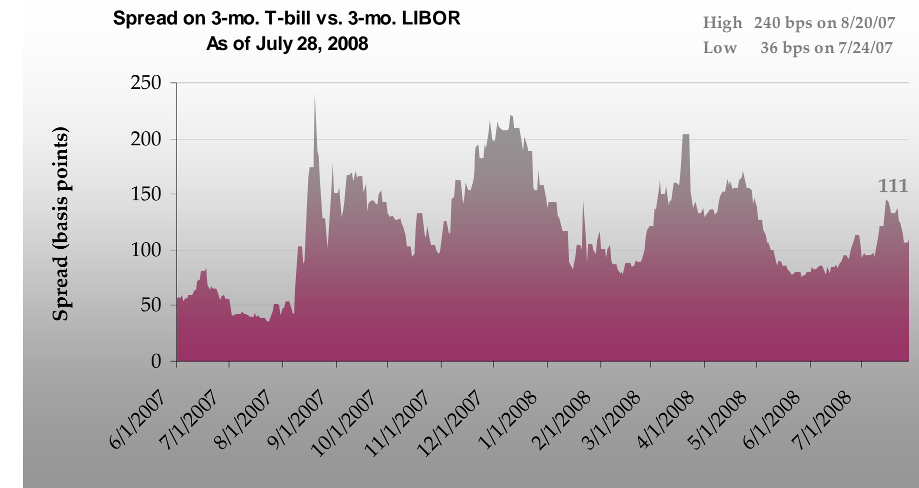
Current Interest Rates

	7/24/2008 Yield	3/31/2008 Yield	bp change
Short-term			
Federal Funds Target	2.00%	2.25%	-25
Prime Rate	5.00%	5.25%	-25
Libor (1-mo.)	2.46%	2.70%	-24
Libor (3-mo.)	2.79%	2.69%	10
Libor (6-mo.)	3.16%	2.61%	55
3-mo. T-bill	1.52%	1.32%	20
6-mo. T-bill	1.86%	1.48%	38
2yr T-note	2.74%	1.58%	116
Longer-term			
5yr T-note	3.47%	2.44%	103
10yr T-note	4.10%	3.41%	69
30yr Bond	4.67%	4.29%	38

Source: BLOOMBERG L.P. as of 7/24/2008 8:30 a.m.

An indication of market stress may be gleaned by reviewing the spread between 3-month Libor and 3-month Treasury bill yield. Chart four shows the significant spread widening between the two short-term rates.

(CHART 4)



SOURCE: BLOOMBERG, .LP.

This occurred as investors flocked to the safety of Treasury bills over the past twelve months, pushing its yield down while the Libor rate ascended as the need for credit accelerated. The current spread of 111 basis points (bps) is slightly higher than the average of the past year, but far tighter than the 240 bps peak realized in August of last year.[4]

[4] Bloomberg L.P., July 28, 2008.

Yields for non-Treasury securities have skyrocketed in the past year as the fixed income markets continue to reprice credit risk. Chart five illustrates the widening spreads over comparable maturity Treasury securities for FannieMae debentures over the last twelve months.

(CHART 5)

Fannie Mae Benchmark Notes

	7/23/2008 bp	7/24/2007 bp	bp change
2-Year	75	35	40
5-Year	78.5	44	34.5
10-Year	70	54	16

Source: Stifel Nicolaus Fixed Income Trading 7/23/2008
bp = basis point

These securities have a wide audience from sovereign funds to banks and thrifts. Investor concerns over the financial condition of the two mortgage agencies led to the increase in the yield spreads for both the debentures and mortgage-backed securities. The passage of the housing bill by Congress, and its approval by the President, may offer some relief on spreads, but that will not be known for some time. The liquidity for the agency debentures has remained relatively stable and demand appears solid.

While liquidity has improved in the mortgage securities market, it remains less than where it was more than a year ago. A review of spreads on 30-year mortgage securities shows that average spreads relative to the 10-year Treasury remain elevated at roughly 197 bps as of July 28, 2008, although lower than the peak of 237 bps realized on March 6, 2008 of this year.

(CHART 6)

Mortgage-Backed Securities Spreads

	7/28/2008 bp	6/30/2008 bp	3/30/2008 bp	12/30/2007 bp
FNMA 30yr*	197	186	184	149
FNMA 15yr**	211	199	220	148

Source: Bloomberg, L.P., Current Coupon MBS
* Spread over 10yr Treasury Note
** Spread over 5 yr Treasury Note
bp = basis point

The inability to securitize non-Agency eligible loans has resulted in a surge in Agency mortgage securities issuance to $692 billion year-to-date[5] versus $554 billion a year ago, and higher yields to attract buyers. Investors' appetites for credit risk are muted due to the large sum of losses previously taken on private-label securities and uncertainty regarding the level of future problems. Private-label mortgage securities issuance was a scant $46.96 billion in the first six months of this year compared to $530.37 billion for the same period in 2007. Loan originators report little interest in non-Agency eligible loans among buyers and thus a backlog of inventory remains on the balance sheets. The inability to sell or securitize the loans has resulted in a significant decline in available financing for homebuyers in need of jumbo loans or terms that deviate from Agency underwriting guidelines.

Spread levels in the fixed income markets do show a market in repair with spreads narrowing, but posting wider than average levels. Agency debentures may receive a lift from the passage of housing legislation and higher yields on mortgage-backed securities may attract investors. Nonetheless, the mortgage securities market remains broken and continues its process of healing. It is still unclear what portion of the private-label market will return and if so, in what form the bonds will be issued.

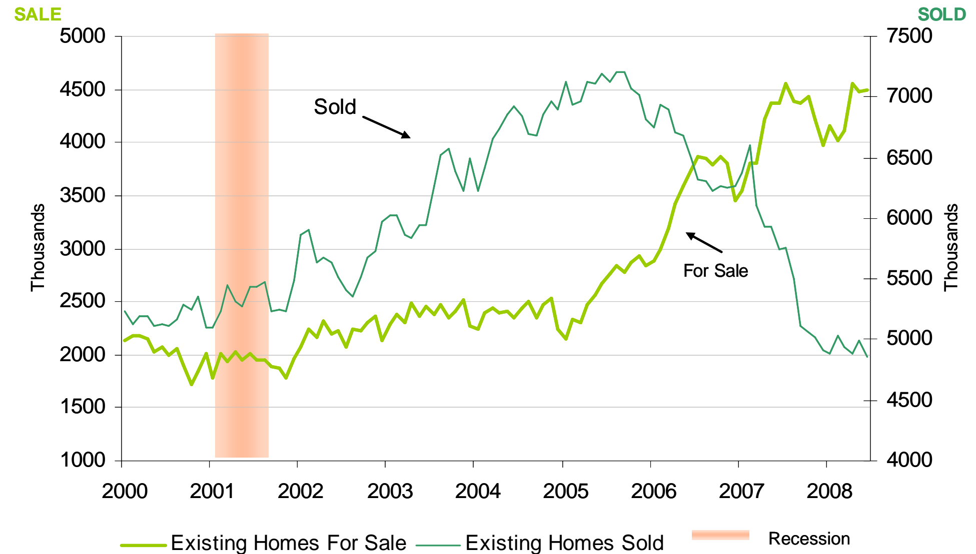
[5] As of June 30, 2008. FannieMae and FreddieMac.

HOUSING CONDITIONS

The lack of available financing, rising mortgage rates, and falling home prices have led to a protracted contraction in the U.S. housing market. The total number of homes in the U.S. as of the end of the second quarter of this year was 129.6 million of which a record 18.6 million houses, apartments and condominiums stood empty in the three months ended in June.[6] Of this amount, 4.49 million previously owned homes were available for sale in the U.S., and is constantly supplemented by the growing number of foreclosed homes resulting in 11.2 months of homes available for sale as of June 2008. The National Association of Realtors has noted that five to six months supply reflects a balanced market. Existing home sales, which comprise 85% of all U.S. home sales, are down 15.5 percent from a year ago even with a 6.1 percent decline in the average price.[7] New home sales have fallen to 512,000 units, the lowest since March of this year, and significantly lower than average of approximately 1 million units the last six years. On an absolute basis, the number of homes available for sale is at its lowest level since July 1995; however, the slow pace of sales has kept houses on the market longer.

Sales volume is down across the country with areas that experienced significant investor buying suffering a disproportionate amount of price declines. The S&P/Case-Shiller composite price index for 20 cities has fallen 17 percent from its peak level in October 2006, and was down 16 percent for the month of April 2008 (chart 8). Given the backlog of homes available for sale, the downward price trend is expected to persist, although unevenly throughout the country. Miami and Las Vegas possess a large percent of investor purchases, and as a result, prices have fallen more than 20 percent from the peak and are likely to continue falling until supply levels approach equilibrium. Cities that had rapid price appreciation, and low affordability, such as San Francisco, San Diego and Los Angeles, have had slower price declines in the past year.

EXISTING HOME SALES, AS OF JUNE 2008 (CHART 7)



SOURCE: NATIONAL ASSOCIATION OF REALTORS

[6] National Association of Realtors, July 24, 2008.
[7] National Association of Realtors, July 2008.

(CHART 8)

	April 2008	Year/Year %Change	Month/Month %Change
West			
Denver	128.49	-4.72	0.83
Las Vegas	165.89	-26.81	-2.02
Los Angeles	202.52	-23.10	-2.22
Phoenix - AZ	161.33	-24.98	-3.38
Portland - OR	174.87	-4.73	0.28
San Diego	180.57	-22.83	-2.63
San Francisco	164.63	-22.15	-2.23
Seattle - WA	179.57	-4.93	0.72
Midwest			
Dallas - TX	120.41	-3.43	1.12
Minneapolis - MN	139.19	-15.53	-2.14
Central			
Chicago	150.44	-9.30	0.06
Cleveland - OH	109.55	-6.82	2.94
Detroit - MI	93.79	-18.00	-1.86
Northeast			
Boston	158.68	-6.44	0.09
New York	193.93	-8.31	-1.35
Southeast			
Atlanta - GA	124.19	-7.51	-0.34
Charlotte - NC	131.82	-0.12	0.23
Miami	200.42	-26.73	-4.05
Tampa - FL	178.50	-20.36	-2.06
Washington, DC	201.21	-14.81	-0.56
Composite	183.15	-16.34	-1.56
Composite-20	169.85	-15.29	-1.34

SOURCE: S&P/CASE-SHILLER

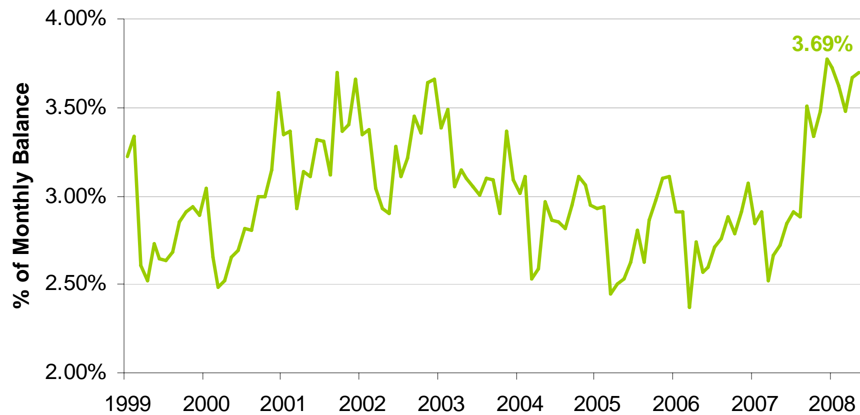
Loan performance across all loan and borrower types show rising delinquencies, albeit at a slower rate than the previous quarter. The number of foreclosures has risen as borrowers have been unable to cure payment shortfalls through available financing alternatives and inability to sell homes. We appear to be in the third stage of foreclosures with those in 2006 spurred by borrowers who were unable to meet mortgage obligations at the lower initial rates, followed by defaults by mortgage holders faced with interest rate resets in 2007. We would characterize 2008 the year in which negative equity impacts the ability of borrowers to refinance into a more affordable loan, and thus may have no alternative than to default on the loan. According to Mark Zandi, of Moody's Economy.com, approximately 9.6 million home owners have negative equity in their home, of which 5.0 million are faced with negative amortization on their loans. Lenders continue to afford borrowers opportunities to modify loans; however with income growth stagnating and negative equity in homes, the ability of borrowers to qualify at even the most lenient of loan terms is severely limited.

CONCLUSION

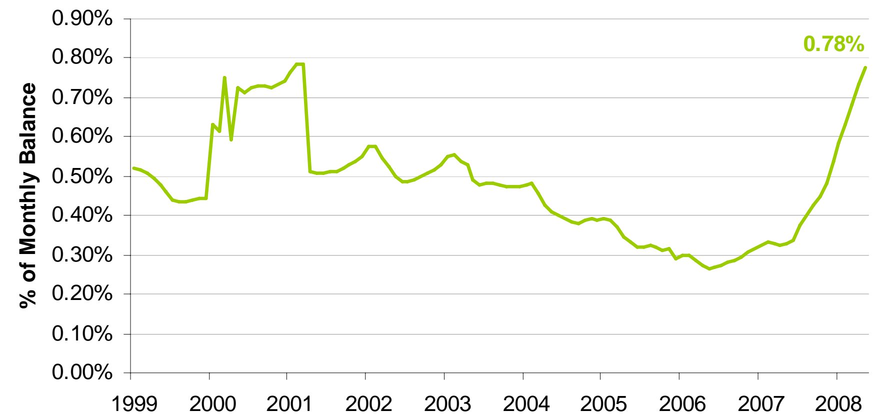
The economic environment is challenging, with a myriad of forces converging to damp growth in the coming quarter. Housing activity continues to contract causing financial institutions to elevate loan loss provisions or curtail or exit portions of the lending business altogether. Home prices continue their descent, while mortgage rates rise, making it difficult for existing home owners to refinance loans. Falling to stagnant income coupled with tighter underwriting standards create a difficult environment for new borrowers to qualify for home financing. Are we near the end? That remains the million dollar question.

NATIONAL DELINQUENCY & FORECLOSURE RATES: FIXED & ARM LOANS

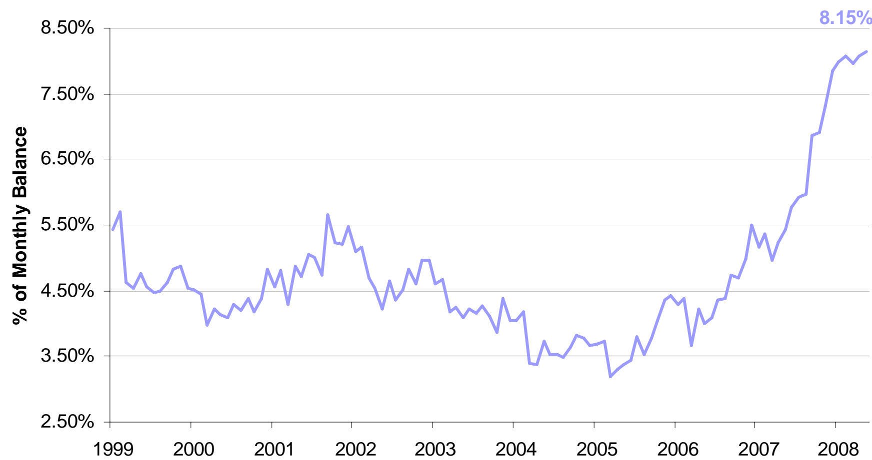
(CHART 9)



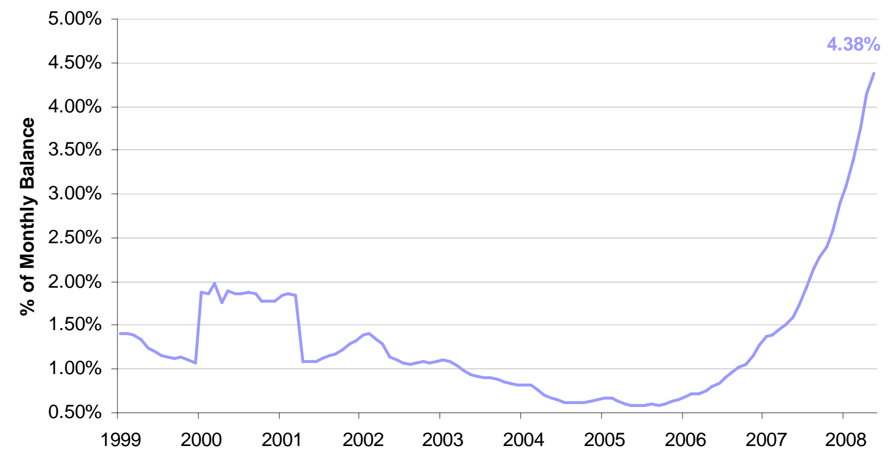
(CHART 10)



(CHART 11)

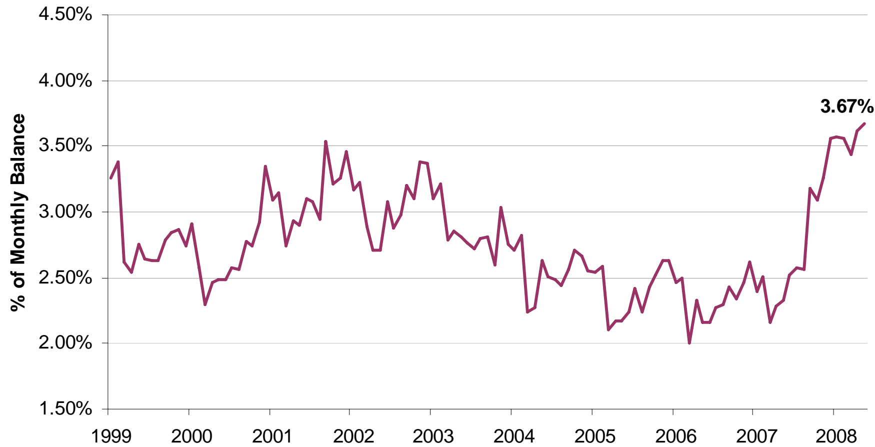


(CHART 12)

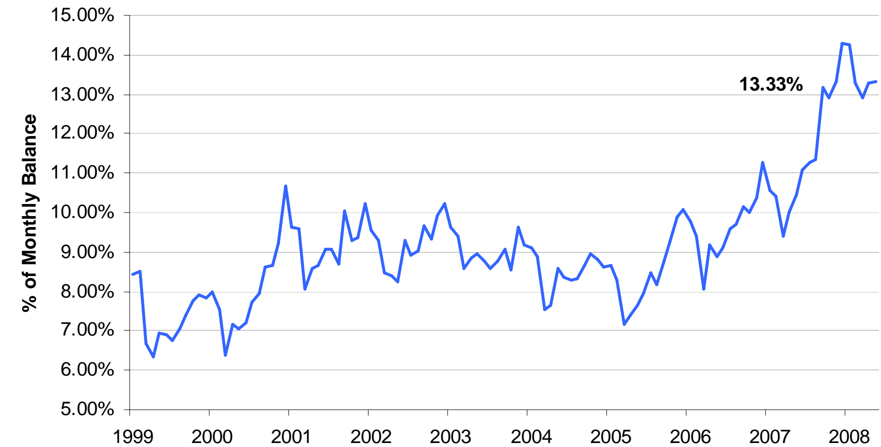


NATIONAL DELINQUENCY RATES: PRIME, ALT-A & SUBPRIME LOANS

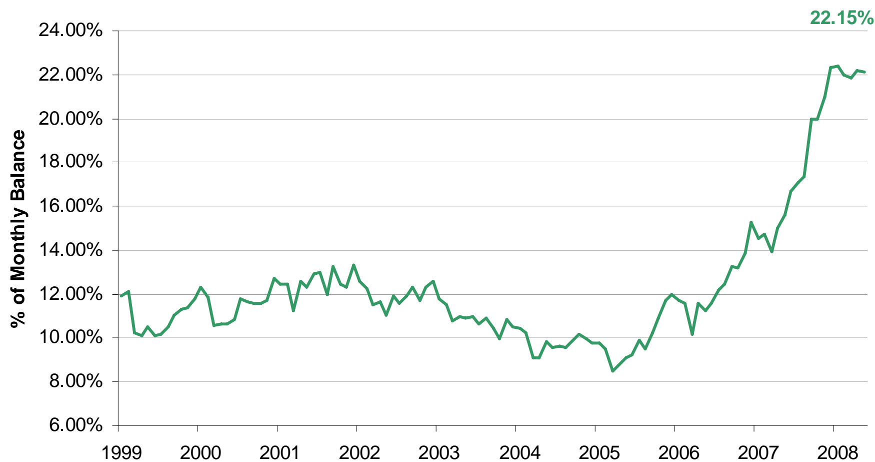
(CHART 13)



(CHART 14)



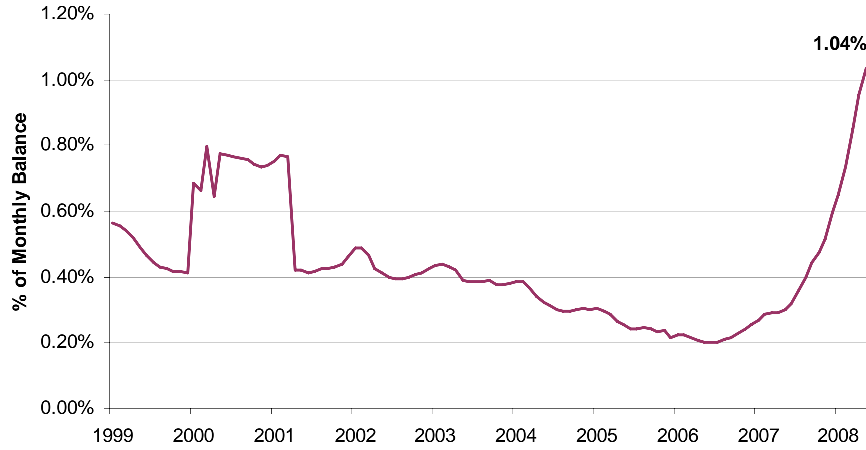
(CHART 15)



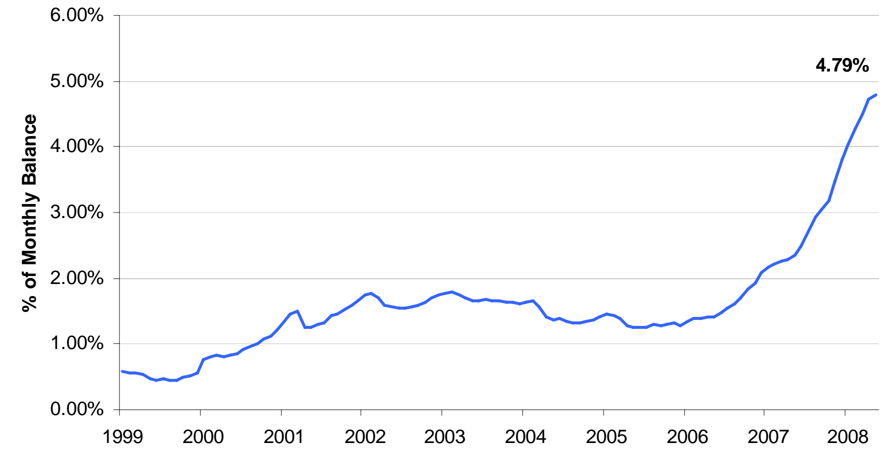
SOURCE: CHARTS 9-18 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS
NOTE: DATA USES ACTIVE LOAN DOLLAR BALANCES ON A MONTHLY BASIS; ALT A IS DEFINED AS ORIGINAL CREDIT SCORE 620-659 AND LTV AT ORIGINATION > 80%.
ALL VARIATIONS OF DOCUMENTATION ARE INCLUDED. DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

NATIONAL FORECLOSURE RATES: PRIME, ALT-A & SUBPRIME LOANS

(CHART 16)



(CHART 17)



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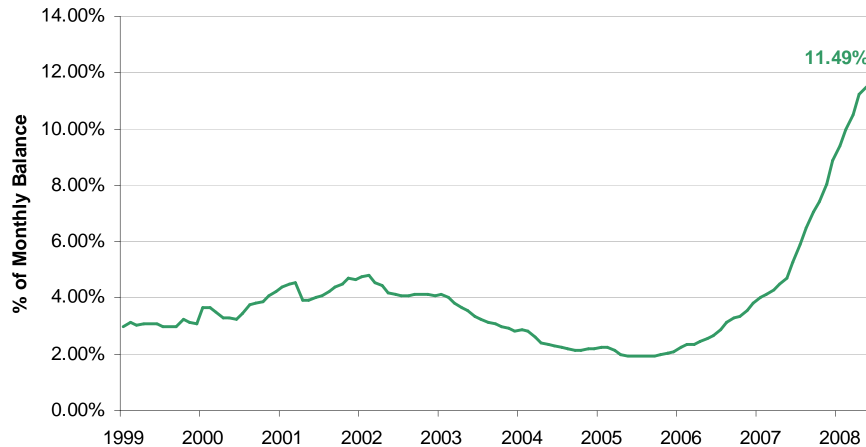

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