



# MONTHLY MARKET MONITOR

NOVEMBER 6, 2008

MMM 10-08

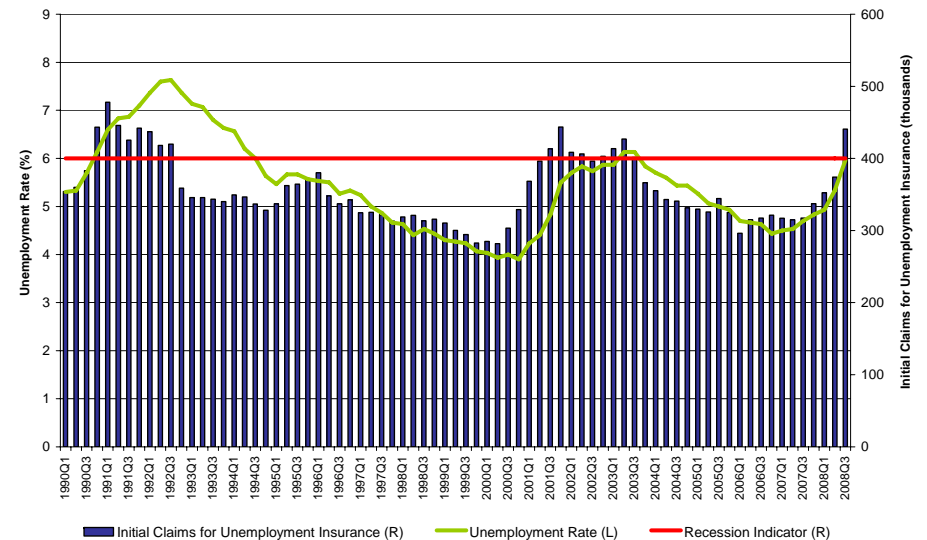
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## ECONOMIC COMMENTARY

There continued to be significant turmoil in U.S. financial markets during the month of October. The numbers for GDP growth, business investment, unemployment, and consumer confidence worsened in October. Although the Dow-Jones Industrial Average (DJIA) ended the month on a slight upswing, it closed on October 31 at 9,337 for a loss of 1,514 points – or nearly 14% – during the month. Stock price movements were also very large, spanning a range of 2937 points. The economic outlook remains poor, and many market economists are predicting a worsening of economic conditions, including negative real GDP growth in the fourth quarter of 2008 and first quarter of 2009. Unemployment also continues to be a concern, with forecasts indicating an increase from today's unemployment rate of 6.1% to around 8% in 2009, prompting calls for another fiscal stimulus package. Despite all the bad news, there have been some positive developments. *First*, at the beginning of the month, FDIC exposure to a resolution of Wachovia Bank was avoided when Wells Fargo stepped in with its bid to buy the bank. *Second*, on October 3, Congress passed the Emergency Economic Stability Act of 2008 (EESA), authorizing Treasury to spend up to \$700 billion to shore up the balance sheets of U.S. financial institutions. Under the EESA, the Treasury Department has already acquired significant equity stakes in nine of the largest U.S. bank holding companies, and additional investments at other financial institutions are currently under review. *Third*, there were Federal Reserve rate cuts on October 8 and October 29

of 50 basis points on each occasion, in both the fed funds target rate and the discount rate. The Fed's October 28 policy statement reflected unanimous support for the latest rate moves, and was unusually sweeping in its description of across-the-board slowing in spending, investment, and growth. In a final, unexpected positive development, third-quarter GDP growth, which was widely predicted to be significantly negative (around -2.0% range), and which may still be revised downward, came in at a barely negative -0.3% annual rate.

UNEMPLOYMENT, AS OF 3Q 2008 (CHART 1)



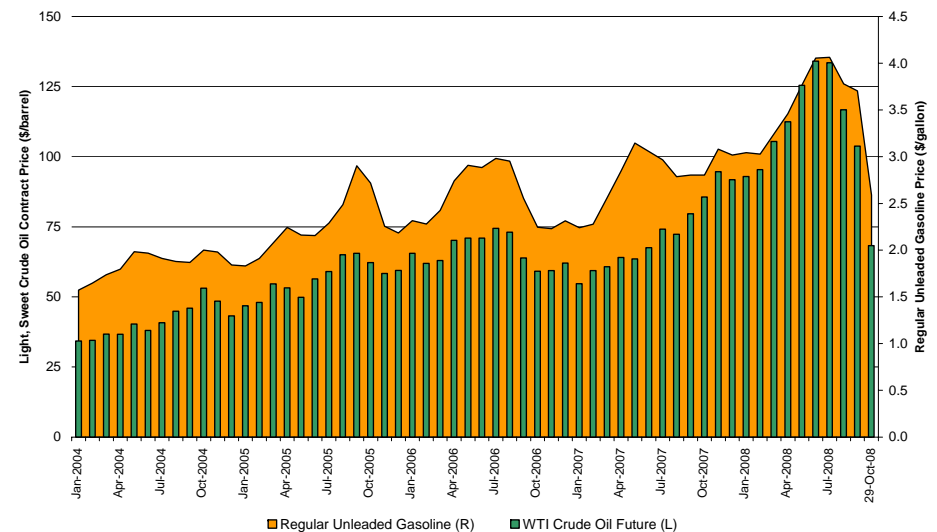
SOURCE: DEPARTMENT OF LABOR

The job market continued to soften over the past few months and remains one of the most important measures to watch, as rising unemployment leads to further weakening of consumer confidence, spending constraint, and other social and economic negatives. Chart 1 shows that the national unemployment rate increased to 6% in the third quarter of 2008, an increase of 0.7% from the second quarter. In September, the unemployment rate reached 6.1% (the October number will be released November 7). In September 2008, the number of unemployed persons reached 9.5 million, or about 2.2 million more than in September 2007, a 1.4 percent increase. Nonfarm payroll employment fell in the construction, manufacturing, retail trade, transportation, and financial sectors, and rose in mining and healthcare<sup>1</sup>. Another key indicator of job market and economic health is the number of initial claims for unemployment insurance (Chart 1). In the third quarter, seasonally adjusted initial claims – which generally rose throughout the month – increased to an average of 477 thousand a week for the four-week period ending October 25, compared to 332 thousand in the year-ago period. Meanwhile, the level of claims for the week ending October 25 was 485 thousand, compared to 325 thousand one year ago. Historical experience suggests that the job market is generally in recession when weekly initial jobless claims rise above 400 thousand, a point that was passed in July.

Falling crude oil and gasoline prices (Chart 2) were a source of some consumer relief over the past two months. The contract price of West Texas Intermediate (WTI) light, sweet crude oil topped out at over \$147 a barrel on July 11. Since then, it has fallen precipitously. The December delivery contract dipped to \$68.2 a barrel on the New York Mercantile Exchange on October 29, a 54% decline from the peak. Prices at the pump have, likewise, seen significant easing. The average price of regular unleaded set a record of above \$4.05 per gallon in June 2008 and July 2008, and dropped to \$2.59 per gallon on October 29 – a price level not seen in 18 months. The primary cause of this dramatic reversal in oil

and gasoline prices was reduced demand from businesses in the United States and other countries, largely as a result of the global economic slump, as well as changes in consumer behavior in response to higher fuel prices. For example, in August 2008, Americans drove 15 billion fewer miles, or 5.6% less, than they did in August 2007. This is the largest ever year-over-year decline recorded in a single month. From January 2008 through August 2008, Americans drove 67.2 billion fewer vehicle-miles than they did over the same eight-month period a year ago<sup>2</sup>. There has also been ample anecdotal evidence reported in the popular press about people trading in their SUVs for more fuel-efficient vehicles.

CRUDE OIL AND GASOLINE PRICE, AS OF OCTOBER 29, 2008 (CHART 2)



SOURCE: DEPARTMENT OF ENERGY, WALL STREET JOURNAL, NYMEX, AND AAA.

<sup>1</sup> Bureau of Labor Statistics report on *The Employment Situation: September 2008*.

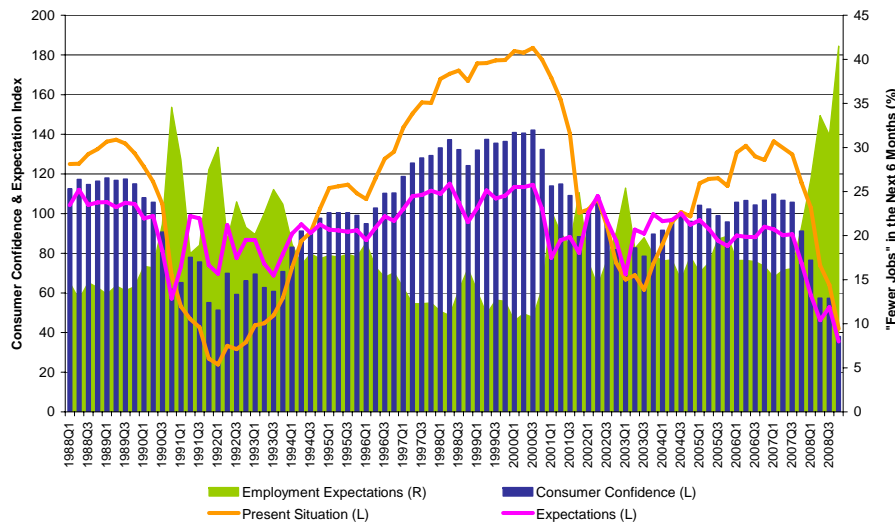
<sup>2</sup> Department of Transportation report on *Traffic Volume Trends, August 2008*.

**Measures of consumer confidence and expectations** are currently at their lowest levels in four decades (Chart 3). This weakness in confidence is weighing heavily on forecasts for fourth-quarter retail sales and other forms of consumer spending. Pressure on the job front, continued declines in home prices, increased foreclosure rates, and declining 401-(k) balances have clearly taken a toll on consumer confidence, with many consumers unsettled about their current financial situation and the job-market outlook. For October 2008, as shown in Chart 3, the Conference Board Survey (October 28) found that the U.S. consumer confidence index fell to 38.0 compared to a September level of 61.4. The Survey's result represents the lowest level on record since the Conference Board began tracking consumer sentiment in 1967.

According to the Conference Board's Survey, the consumers' appraisal of the economy's present situation had a reading of 41.9, a record low since the recession of 1991-1992. Consumer expectations – another measure from the Survey – fell in October to 35.5, its lowest level on record. Notably, 41.5% of the survey respondents, the highest figure on record, expected to see “fewer jobs” over the next six months. Given the importance of consumer spending for U.S. economic growth, this consumer pessimism portends on-going weakness, and underpins our overall expectation for further declines in domestic GDP for the fourth quarter, as well as throughout much of 2009.

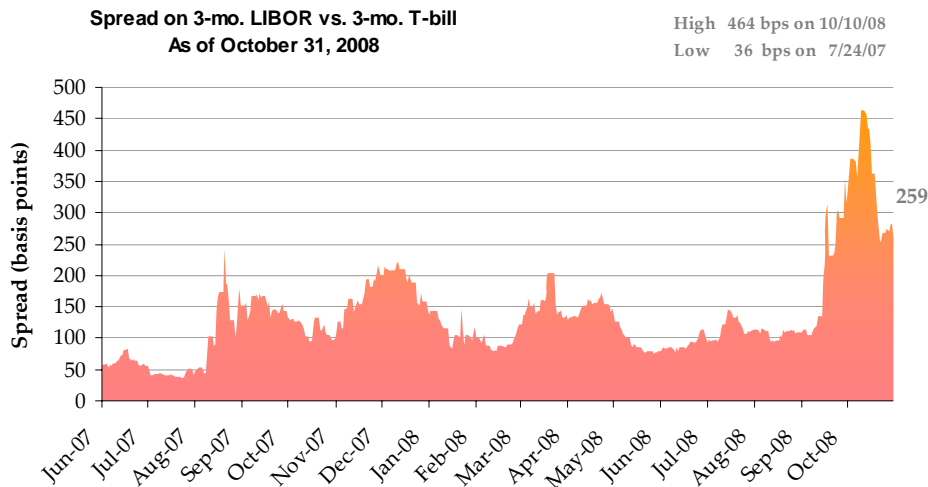
**Credit markets** were roiled in recent months by fears of worldwide recession as well as increasing uncertainty about the financial health of banking institutions and the integrity of their balance sheets. These fears were evident in a dramatic widening of the TED spread (Chart 4), a measure that is often interpreted as an indicator of willingness for short-term borrowing and lending among banks. The TED spread is the difference between the three-month LIBOR and the three-month T-bill rates. As noted in prior Monthly Market Monitor reports, the TED spread widened considerably in recent months, but did so especially in September and October. Over this time, there were numerous concerns that, as a result of increased unwillingness to lend in the interbank market, the credit markets were becoming “frozen,” the effect of which would be a seizing-up of credit availability from Wall Street to Main Street. On October 10, the TED spread reached a record high of 464 basis points. Since that time, the TED spread has begun to narrow, suggesting that the credit markets may be beginning to “thaw.” This recent loosening-up of the short-term money markets is largely due to the capital and liquidity injections, interest rate cuts, and other moves by governments and central banks to prop-up financial institutions and stimulate the money and credit markets. As such, the TED spread, and interbank lending rates more generally, remain important areas for on-going monitoring and as indicators of the strength and momentum of on-going efforts to unlock the credit markets.

CONSUMER CONFIDENCE AND EXPECTATIONS, AS OF OCTOBER 2008 (CHART 3)



SOURCE: THE CONFERENCE BOARD

(CHART 4)



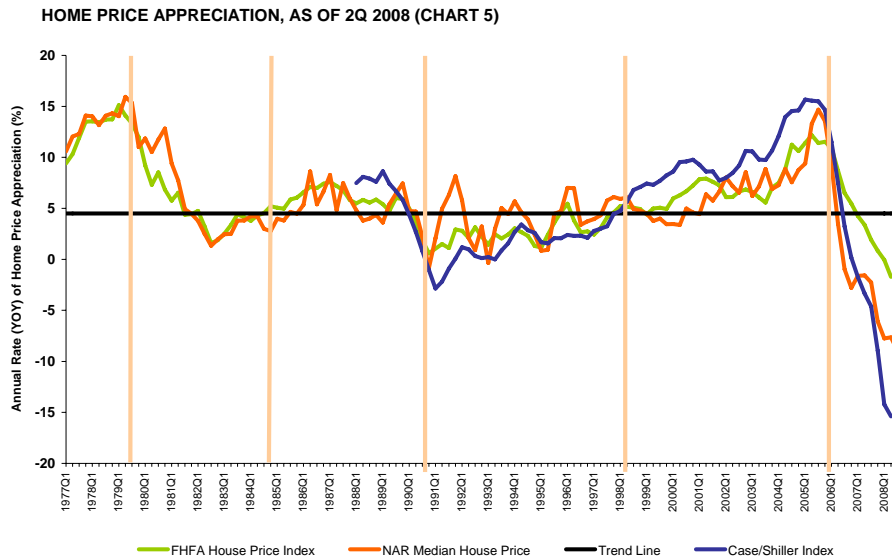
SOURCE: BLOOMBERG, LP.

## HOUSING CONDITIONS

**Home price movement in the United States** is cyclical, with the most recent cycle – an unprecedented boom – spanning over seven years and ending mid-year 2005 (Chart 5). In the current downturn, the growth rates of home prices have dropped sharply since early 2006, and have actually turned negative over the past several months. In the second quarter of 2008, for example, the *annual rate of change* in home prices was -15.4%, as recorded by the Case-Shiller National Index (CSI), and -1.7 % by the Federal Housing Finance Agency price index (OFHEO HPI-All Transactions). For the third quarter, the annual rate of change was around -9%, as calculated by the National Association of Realtors (NAR). The data sources, methodologies, and geographic coverage differ greatly among these three price indices, creating wide disparities in their results. Although covering all metropolitan areas, the FHFA price index is based only on conforming loans from Fannie Mae and Freddie Mac. As a result, it can mask the true picture of home price movements due to under-representation of high-priced properties and markets such as

those in California where jumbo loans dominate, as well as those properties financed with FHA loans and the majority of those financed with subprime, Alt-A, and Option-ARM loans. In comparison, the Case/Shiller National Index uses sales transactions data for all properties, providing a full and accurate picture of various home price tiers for the markets from which it has obtained data. The problem with the CSI is its limited geographic coverage; it covers less than 140 metropolitan areas, or only slightly more than one-third of the U.S. metropolitan areas. The CSI is thus skewed towards higher-cost and more volatile markets. Not surprisingly, as compared to other indices, the CSI seems to have systematically inflated home price appreciation rates during the boom cycle and exaggerated declines during the downturn. The NAR price index is based on the median sales price, rather than repeat sales methodology as employed in the other two indices. Although it is easily understood, it suffers from a fatal weakness: The homes sold and surveyed may be inconsistent in size, age, quality, and other characteristics from one period to the other, and these traits are not accounted for in the NAR home price calculations.

Despite the differing methodologies, these three price indices have performed similarly in depicting the overall patterns and trends of U.S. home price dynamics over time, each of which reflects dramatic declines in property values since the 2005 peak.



SOURCE: FEDERAL HOUSING FINANCE AGENCY, CASE/SHILLER INDEX, AND NATIONAL ASSOCIATION OF REALTORS

**Local housing market conditions can and do vary substantially.** As shown in Chart 6, in August 2008, home prices continued their sharp decline in the hardest-hit cities, including Las Vegas, Phoenix, Miami, San Francisco, Los Angeles, San Diego, Tampa, Detroit, and Washington, DC. While home price depreciation was widespread across all areas, it was less severe in Charlotte, Dallas, Denver, and Boston.

LOCAL HOUSING MARKETS (CHART 6)

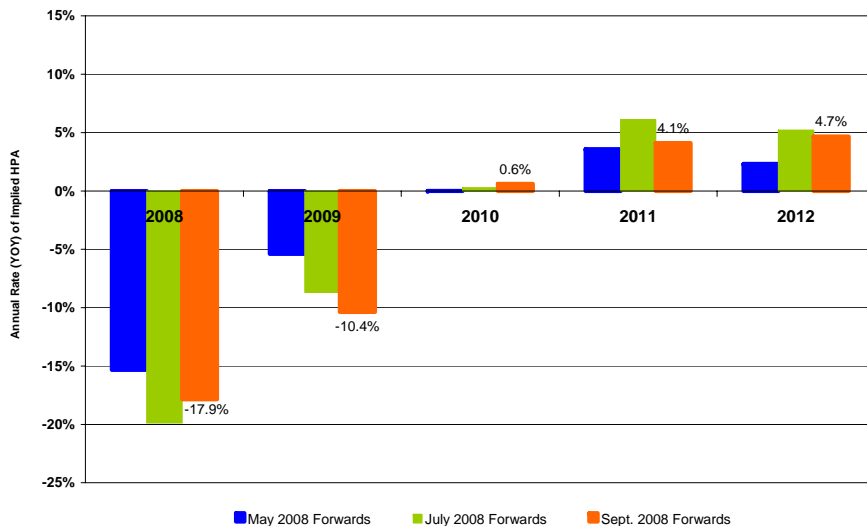
	August 2008	Year/Year %Change	Month/Month %Change
<b>West</b>			
Denver	132.64	-5.05	-0.02
Las Vegas	150.52	-30.58	-2.35
Los Angeles	189.18	-26.69	-1.75
Phoenix - AZ	144.83	-30.66	-2.86
Portland - OR	171.93	-7.56	-1.31
San Diego	168.23	-25.80	-2.31
San Francisco	151.42	-27.25	-3.48
Seattle - WA	175.24	-8.80	-0.72
<b>Midwest</b>			
Dallas - TX	122.90	-2.67	-0.21
Minneapolis - MN	141.94	-13.80	-1.04
<b>Central</b>			
Chicago	149.53	-9.80	-0.05
Cleveland - OH	110.54	-6.61	1.09
Detroit - MI	92.44	-17.16	-0.83
<b>Northeast</b>			
Boston	162.75	-4.74	0.10
New York	192.84	-6.92	-0.04
<b>Southeast</b>			
Atlanta - GA	124.82	-8.52	-0.33
Charlotte - NC	132.10	-2.78	-0.83
Miami	183.48	-28.13	-1.80
Tampa - FL	174.30	-18.14	-0.44
Washington, DC	194.86	-15.35	-0.32
<b>Composite</b>	176.60	-17.72	-1.04
<b>Composite-20</b>	164.57	-16.62	-1.00

SOURCE: STANDARD & POOR'S/CASE-SHILLER®

**When might the current housing downturn end?** In an attempt to forecast the end of the housing slump, Chart 7 shows the outlook on home price changes from 2008 through 2012 as implied by the Residential Price Index (RPX) composite forward contracts for 25 major U.S. metropolitan areas (measured by price per square foot for a typical home). Using these forward contracts, the most recent consensus of market participants is that home prices will decline by approximately 18% for 2008, and drop by another 10% in 2009, with stabilization and recovery beginning in 2010. Without a doubt, this outlook may change, due to uncertainty surrounding the effectiveness of policy interventions, changes in housing and mortgage market fundamentals, and market sentiment. However, these home price appreciation forecasts appear largely consistent with various economic forecasts and other indicators. *Two important factors that may explain the gloomy outlook on housing for the months to come are worth noting: the oversupply of homes on the market; and the foreclosure sales that have been surging in many parts of the country.*

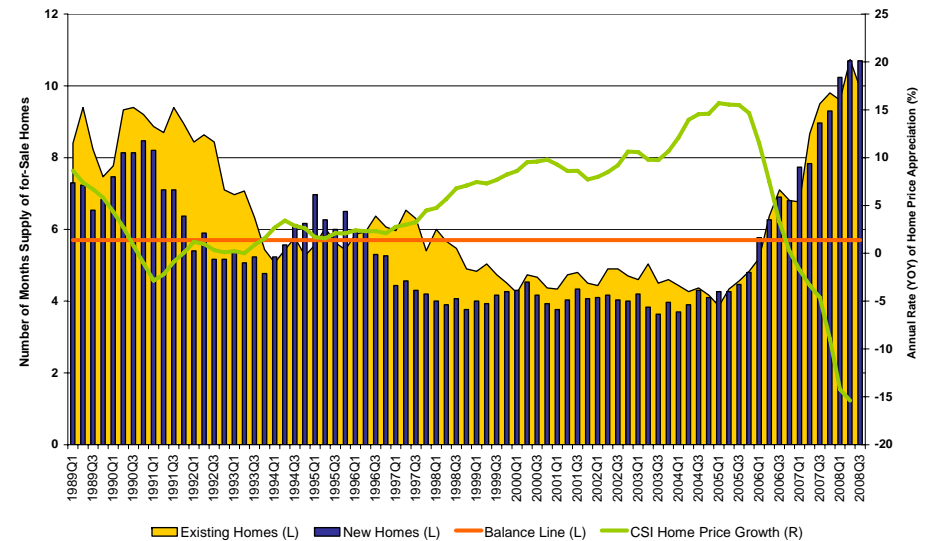
**The inventory of homes for sale** is a key measure of housing supply. Chart 8 shows that the inventory of homes for sale varies inversely with home price appreciation in the United States over time. Historically, when homes for sale are below the balance line of about 5.7 months supply, prices rise. When the homes for sale are above the balance line, prices typically decline. In the third quarter of 2008, the seasonally-adjusted inventory of new homes for sale stood at 10.7 months supply. At the same time, there was about 9.9 months supply of existing homes on the market (not seasonally adjusted). The oversupply of new and existing homes for sale is at or near its highest level in decades, and it is expected to take one to two years to return to normal levels.

HOME PRICE APPRECIATION IMPLIED BY FORWARD CONTRACT (CHART 7)



SOURCE: CALCULATED FROM RPX COMPOSITE FORWARD PRICES

INVENTORY OF HOMES FOR SALE, AS OF 3Q 2008 (CHART 8)



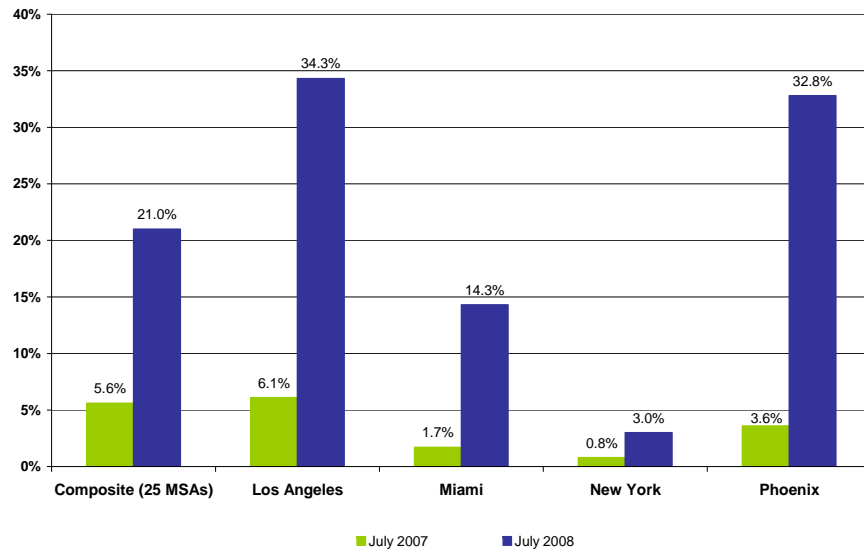
SOURCE: BUREAU OF CENSUS AND NATIONAL ASSOCIATION OF REALTORS



Home sales, particularly foreclosure sales, increased significantly in many parts of the country recently. According to the National Association of Realtors, existing home sales rose by 5.5% in the United States in September 2008, the largest monthly increase in more than five years. The West had the largest gain in sales (+16.8%), followed by the Midwest (+4.4%), and South (+2.2%); in contrast, sales fell in the Northeast (-1.1%).

Although the increasing sales reflect a market that is beginning to work off its excess inventory, it is doing so as a consequence of falling prices. As shown in Chart 9, foreclosure sales (for 25 MSAs combined) accounted for 21% of all sales in July 2008, compared to only 5.6% a year ago. The increase in the share of foreclosure sales was most dramatic in the hardest-hit markets, such as Los Angeles and Phoenix. The increase was less pronounced in Miami, and very negligible in New York.

FORECLOSURE SALES AS SHARE OF ALL SALES, JULY 2007 vs. JULY 2008 (CHART 9)



SOURCE: RADAR LOGIC INCORPORATED

Much of the increase in home sales has been driven by foreclosure sales by banks, as well as aggressive price-cutting for new homes by builders in order to meet liquidity needs. Because foreclosure sales typically offer deep discounts, they tend to further depress home prices in impacted markets.

### CONCLUSION

In this report, we have discussed the general economy, the labor market, crude oil and gasoline prices, consumer sentiment, and the credit and housing markets. Yet, it might be worthwhile in our concluding remarks to consider just how some of these pieces are interrelated – in particular, the housing and credit markets and the links between both of these and the general economy.

In the housing market, for example, we tend to look at the existing inventory of unsold homes, and, given current sales rates, attempt to figure out how long it will take to work off the excess inventory. Normally, an excess of inventory suggests that home prices will continue to decline until the market absorbs the excess inventory, at which time prices will level off and ultimately begin to increase. In other words, the number-of-months supply of homes should be seen as a measure of the degree of slack in the current market rather than an indicator of how many months it will actually take to work it off. What is preventing the price mechanism from working in the current market environment? Both the “freezing-up” of the credit markets and the continuous addition of foreclosed properties into the inventory of unsold homes are to blame. At the end of October, the spread between the Fannie Mae 30-year commitment rate and the ten-year Treasury Note stood in excess of 270 basis points. This spread is considerably out of line with historical norms, and can be attributed to the de-leveraging of financial institutions and the high degree of perceived credit risk in the financial system.

The recent extraordinary actions taken by the Federal Reserve and the Treasury Department were intended to bring renewed confidence to the credit markets and spur lending activity. Upon successful implementation of these stimulus packages, credit should start flowing again at reasonable rates throughout the mortgage markets, and the inventory of unsold homes should begin to fall. Indeed, we may be seeing the beginnings of the necessary “thawing” in what was happening to the TED spread toward the end of October.

There is, to be sure, a great deal of uncertainty surrounding the future course of the economy. Whether we are currently in a recession has been the subject of significant debate. To some extent, it is an academic question. What is clear is that, we are in the midst of a significant economic slowdown; indicators point to continued slowing in the quarters to come, and the housing and credit markets are the largest drags on the economy. The question that remains to be answered is whether the “fix” that is now in place (e.g., the EESA and the numerous Federal Reserve actions) will be enough to restore confidence and restart the normal flow of credit.

*The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by the Office of Thrift Supervision or the Department of the Treasury and is not a complete summary or statement of all available data. The information, analysis, and opinions expressed herein are subject to change without notice.*

SOURCE: CHARTS 10-17 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS

NOTE: DATA USES ACTIVE LOAN DOLLAR BALANCES ON A MONTHLY BASIS; DATA FOLLOWS THE MBA DEFINITION OF DELINQUENCY.

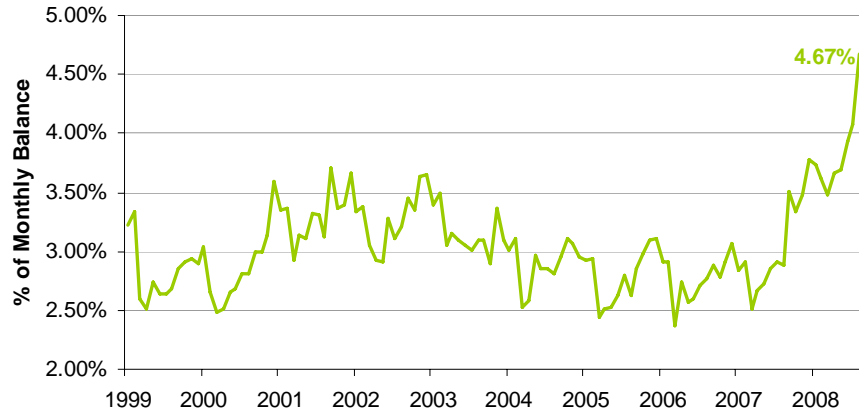




NATIONAL DELINQUENCY & FORECLOSURE RATES: FIXED & ARM LOANS

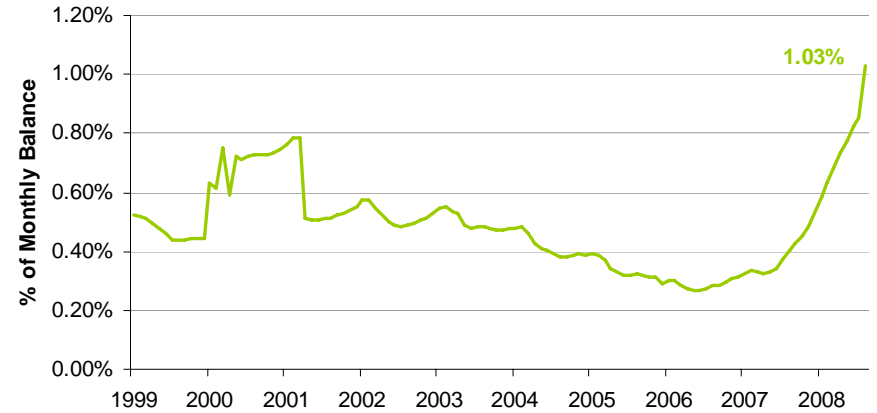
(CHART 10)

Fixed: 30, 60 & 90+ Days Delinquent  
1999 - August 2008



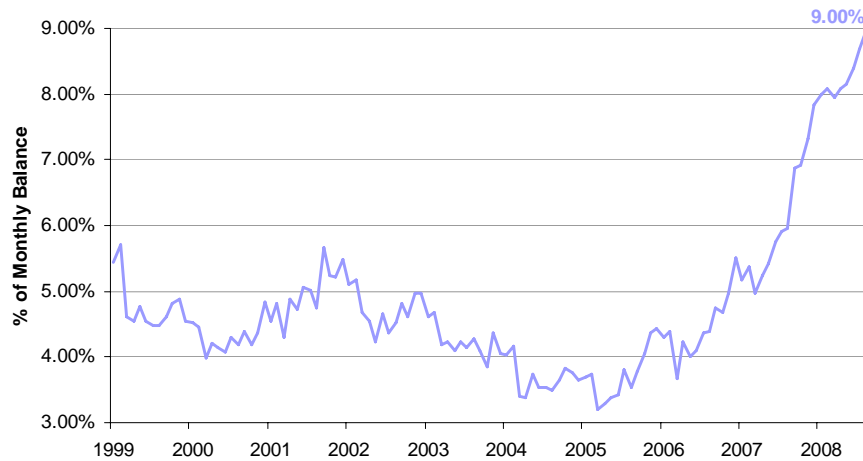
(CHART 11)

Fixed: Foreclosure  
1999 - August 2008



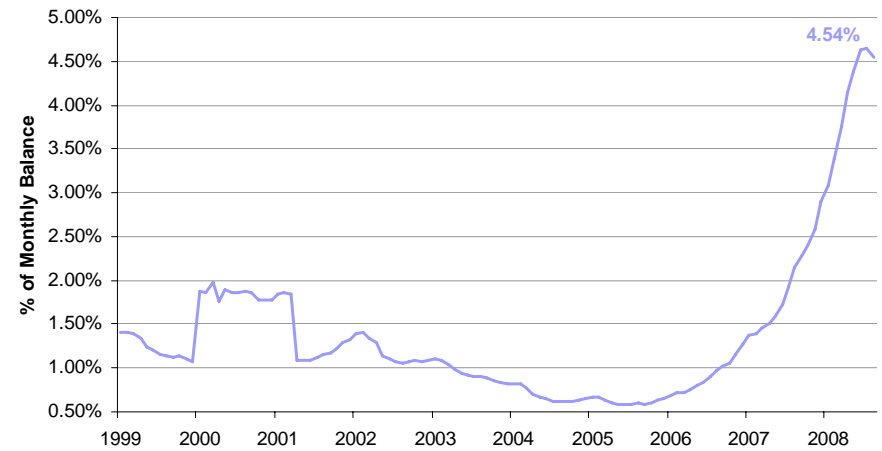
(CHART 12)

ARM: 30, 60 & 90+ Days Delinquent  
1999 - August 2008



(CHART 13)

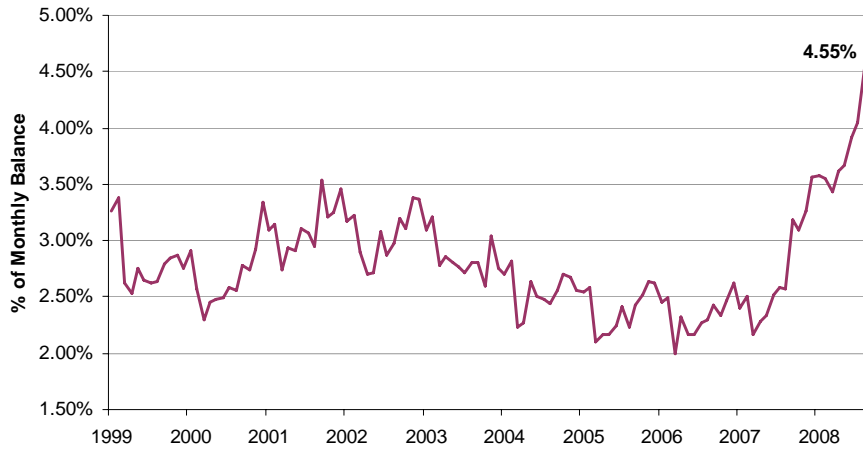
ARM: Foreclosure  
1999 - August 2008





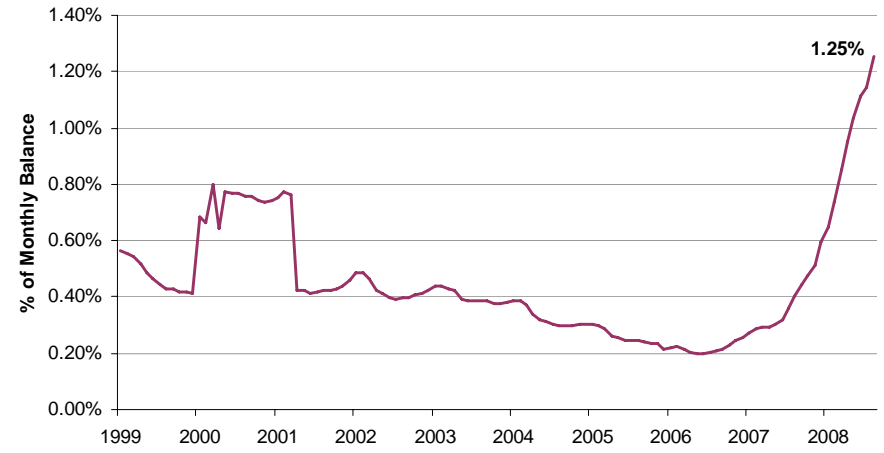
NATIONAL DELINQUENCY & FORECLOSURE RATES: PRIME & SUBPRIME LOANS  
(CHART 14)

Prime: 30, 60 & 90+ Days Delinquent  
1999 - August 2008



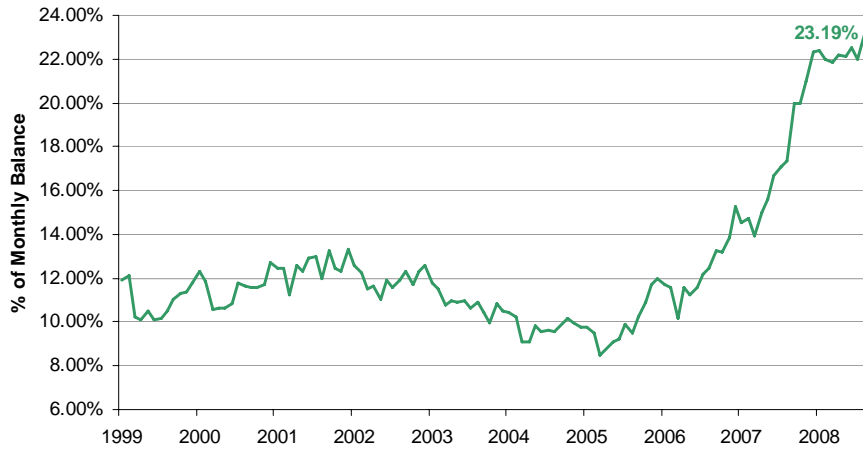
(CHART 15)

Prime: Foreclosure  
1999 - August 2008



(CHART 16)

Subprime: 30, 60 & 90+ Days Delinquent  
1999 - August 2008



(CHART 17)

Subprime: Foreclosure  
1999 - August 2008

