



# MONTHLY MARKET MONITOR

DECEMBER 9, 2008

MMM 11-08

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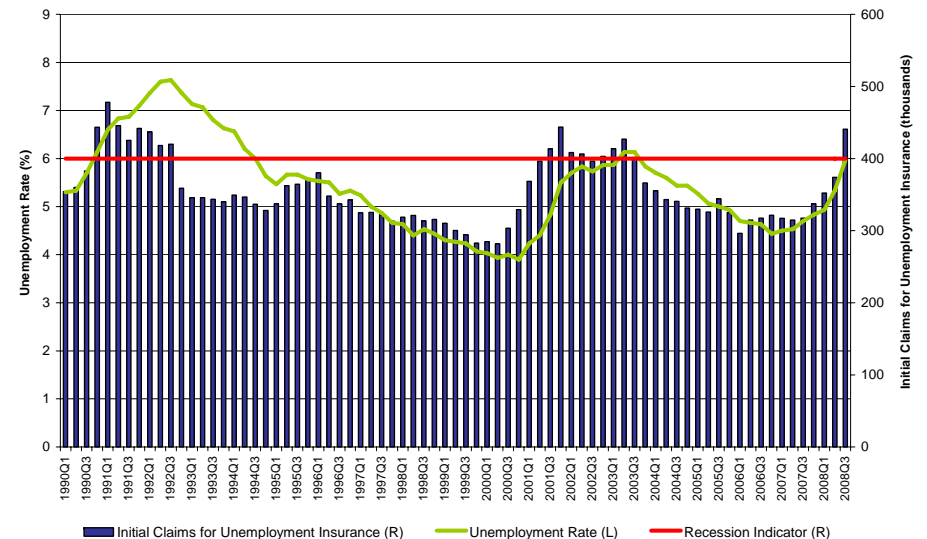
## ECONOMIC COMMENTARY

Gloom continues in the U.S. economy. The triple threat of worsening conditions in the labor, housing and credit markets pose serious challenges to government policymakers. The stock market – a leading indicator of where the nation is headed – turned in another poor month in November. Although the Dow-Jones Industrial Average (DJIA) ended the month with a strong upward move, it was a turbulent month. The DJIA closed the month at 8,829 for a loss of 508 points – or about -5.4%. While this performance is not nearly as bad as October’s 14% loss, it is sobering to recognize that the DJIA was down more than 20% at one point during the month. The broader S&P 500 Index fell 7.5% in November, closing at 896.24.

In November, the numbers all worsened for GDP growth, durable goods orders and retail sales, and initial claims for unemployment. The Bureau of Economic Analysis announced that its estimate of third-quarter GDP growth was revised downward from -0.3% to -0.5%. This announcement was greeted with a certain amount of relief that the decline was not worse. With their worst fears having failed to materialize, forecasters have shifted their attention to the fourth quarter, with many predicting further declines.

On December 1<sup>st</sup>, James Poterba, President of the National Bureau of Economic Research, made the NBER’s official pronouncement that the economy is, indeed, in a recession, and that it began in December of 2007. This pronouncement is consistent with data we have been tracking and reporting on unemployment. As the data in Chart 1 show, initial claims have been on the rise since about the fourth quarter of 2007, and the unemployment rate has been rising for an even longer period.

UNEMPLOYMENT, AS OF 3Q 2008 (CHART 1)



SOURCE: DEPARTMENT OF LABOR

With the recession now having been officially declared, and with government policymakers now facing the aforementioned triple threats of weak labor, housing, and credit markets, it is useful to consider how we got to this point. While the recession officially began in December of 2007, the structural fragility that brought on recession was in place well before this date. As home prices began to flatten out and, in some areas, started to fall in 2006, we began to see increases in defaults, particularly in the cases of certain new, highly *creative* affordability mortgage products. In some cases, borrowers never even made the first payment. By the following summer (i.e., 2007), we saw large loan losses and numerous failures of mortgage lenders, particularly non-traditional mortgage lenders. The asset-backed commercial paper market had also broken down because so much of it was believed to be backed by non-traditional (or suspect) mortgages. Then on August 17, 2007, the Federal Reserve reversed itself on rate-setting policy and made unscheduled cuts in both the Fed Funds target and discount rate by 50 basis points each. These were the first rate cuts in over four years, and many followed. It seems odd to think of it now, but just prior to those cuts, the Fed Funds target and discount rate stood at 6.25% and 6.75%, respectively. The credit crunch that began in mid-2007 ultimately – through various machinations – led to rising initial claims for unemployment, and the onset of what has now been officially declared a recession by the NBER.

Lehman Brothers failed in September 2008 (Bear Stearns having failed six months earlier). Since then, there have been a series of unprecedented moves by the federal government – to some extent, in concert with major foreign governments – in an attempt to restore liquidity and confidence in financial institutions and capital markets. In the meantime, and somewhat contrary to all official attempts to curtail the declines, the housing and labor markets maintained their stubborn persistence downward, and continued to generate poor numbers.

## LABOR MARKET CONDITIONS

**Job market** data released in November indicated continued weakness. The data in Chart 1 show that the national unemployment rate increased to 6.5% in the month of October 2008, an increase of four tenths of a percentage point over the prior month. This trend is expected to increase in coming months. The number of unemployed persons reached 10.1 million in October, about 2.8 million more than in October 2007. This equates to a 38% increase in the number of unemployed persons, and a 1.7 percentage-points increase in the rate of unemployment. Nonfarm payroll employment fell in the construction, manufacturing, and certain service-providing industries, while it rose once again in mining and healthcare<sup>1</sup>. Meanwhile, seasonally-adjusted initial claims for unemployment insurance generally rose throughout the month of November, and reached an average of 518 thousand a week for the four-week period ending November 22. This compares with the 477 thousand that we reported in last month's *Monthly Market Monitor* for the period ending October 22<sup>nd</sup> and 336 thousand in November of last year. The level of initial claims for the week ending November 22<sup>nd</sup> was 529 thousand, compared with 349 thousand one year ago. It was, however, a modest improvement over the 543 thousand initial claims reported for the week ending November 15<sup>th</sup>. The recent well-publicized travails of the auto industry suggest that the data likely to be forthcoming over the next few months will bring further increases in initial claims for unemployment and in the unemployment rate.

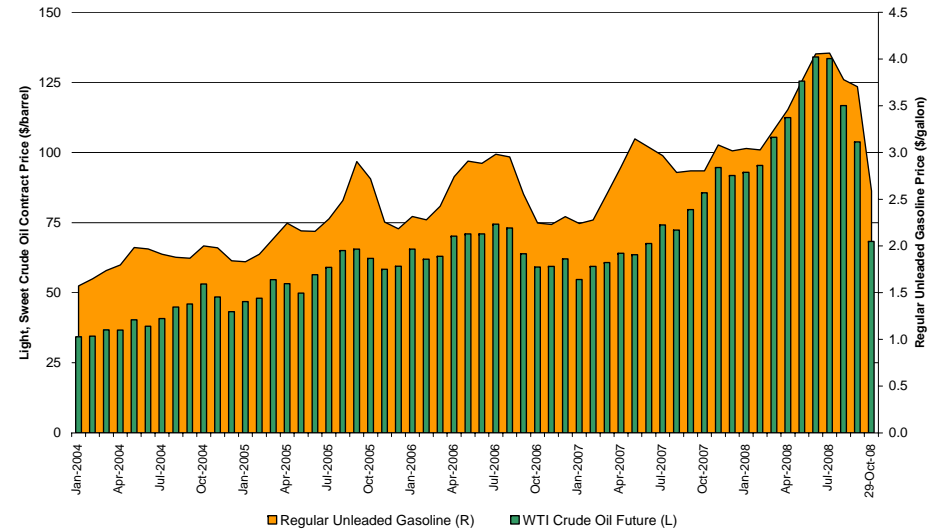
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<sup>1</sup> Bureau of Labor Statistics report on *The Employment Situation: September 2008*.

**Crude oil and gasoline prices** (Chart 2) continued their decline in November. The contract price of West Texas Intermediate (WTI) light, sweet crude oil, which topped out at over \$147 a barrel on July 11, has since fallen precipitously. On November 28<sup>th</sup>, the December delivery contract closed at \$54.43 a barrel on the New York Mercantile Exchange – a 63% decline from the peak, and a 20% decline from its October close of \$68.2. Pump prices have also been falling. According to the Department of Energy, the average price of regular unleaded, which set a record of above \$4.05 per gallon in June and July 2008, fell to \$1.86 a gallon on November 24<sup>th</sup>. That’s a 54.1% decline from the peak, and an 8.3% decline from the end of October.

This decline in fuel prices has provided some relief to motorists, however temporary it may be. The dramatic decline also is indicative of the worldwide nature of the economic slump, as the prior dramatic rise in fuel costs was related to the expected strength of global oil and fuel demand. The steep decline in prices may, therefore, suggest elevated concerns regarding the broader impact of the U.S.-led recession upon the global economy. While the effects of high fuel prices may have abated domestically, we are still in the throes of a potentially deep recession, with increasing unemployment, malfunctioning credit markets, and a deteriorating housing market.

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



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

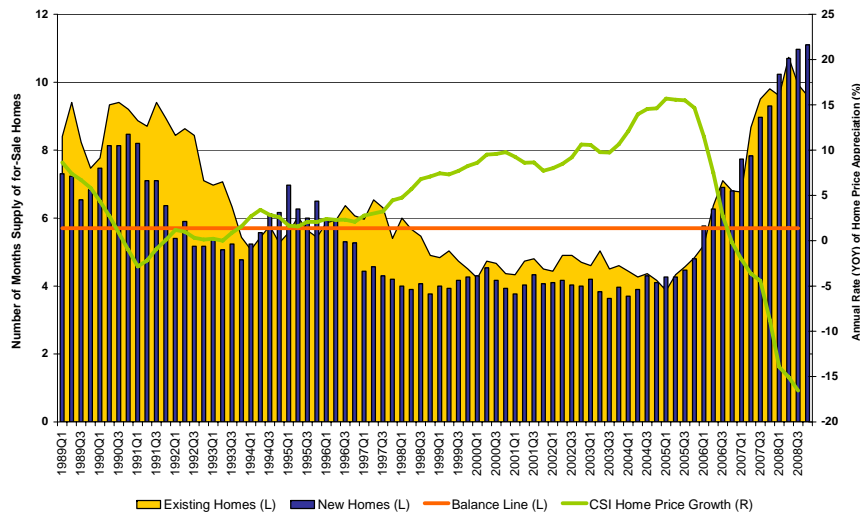
## HOUSING CONDITIONS

**Regarding the housing market** – which we reported on extensively in last month’s issue – home sales and prices continued to show weakness in the latest reported data (see accompanying Charts 3 and 4). On November 25<sup>th</sup>, the National Association of Realtors (NAR) reported that, nationally, existing home sales in October 2008 were down 3.1% from the prior month, and down 1.6% from the year-ago month. The inventory of existing homes declined by 38 thousand units in October. However, when measured in terms of the number-of-months-worth of supply, there was an increase from 10.0 months in September to 10.2 months in October (because the sales rate declined.) Meanwhile, the sales price of existing homes declined 11.3% year-over-year, nationally, according to the NAR, and more than 4% from the prior month. On November 26<sup>th</sup>, the Census Bureau reported that new home sales declined 5.3% in October, while the price of a new home declined 4% from September, and the supply of new homes increased from 10.9 months in September to 11.1 months in October.

Also reported on November 26<sup>th</sup> were the Case-Schiller indexes for the month of September. According to Case-Schiller, the decline from August to September for their 20-city composite index was just shy of 2% (based on seasonally-adjusted data).

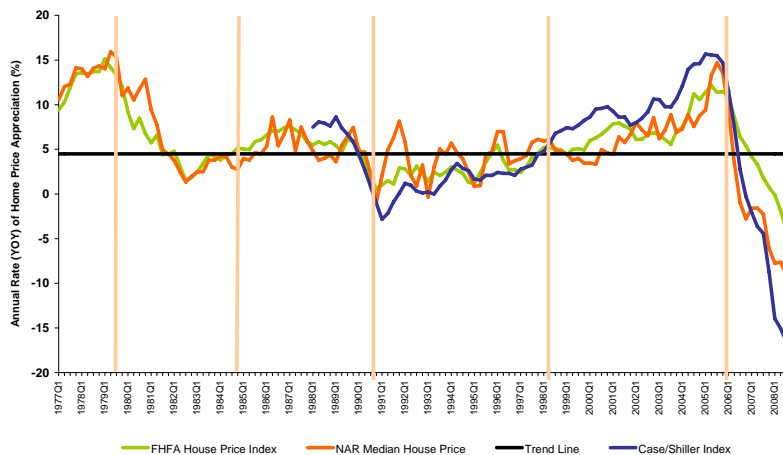
Chart 5 shows the national outlook on home prices for 2008 through 2012, as implied by the Residential Price Index (RPX) composite forward contracts for 25 major U.S. metropolitan areas (measured in terms of price per square foot for a typical home). These contracts indicate that home prices are expected to decline by approximately 18% for 2008 (they have already fallen by 14% according to the Case-Schiller 20-Cities Index), and an additional 12% in 2009. This suggests the outlook for home prices will remain fairly bleak for the near term.

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



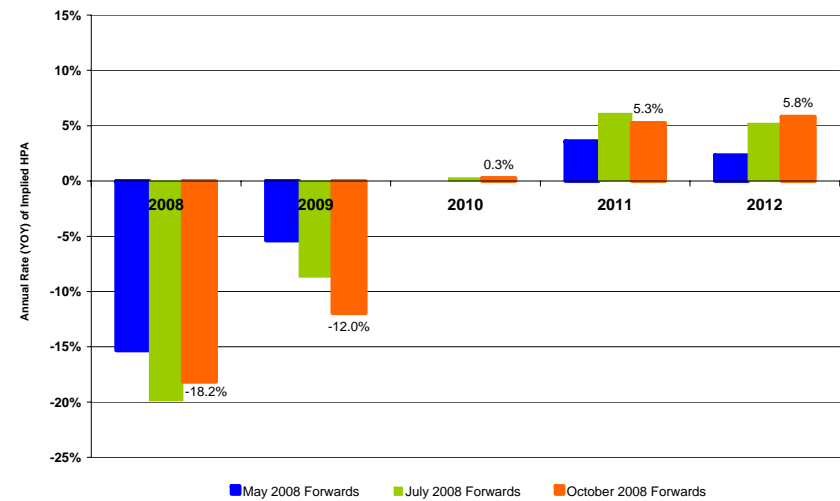
SOURCE: BUREAU OF CENSUS AND NATIONAL ASSOCIATION OF REALTORS

HOME PRICE APPRECIATION, AS OF 3Q 2008 (CHART 4)



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

HOME PRICE APPRECIATION IMPLIED BY FORWARD CONTRACT (CHART 5)

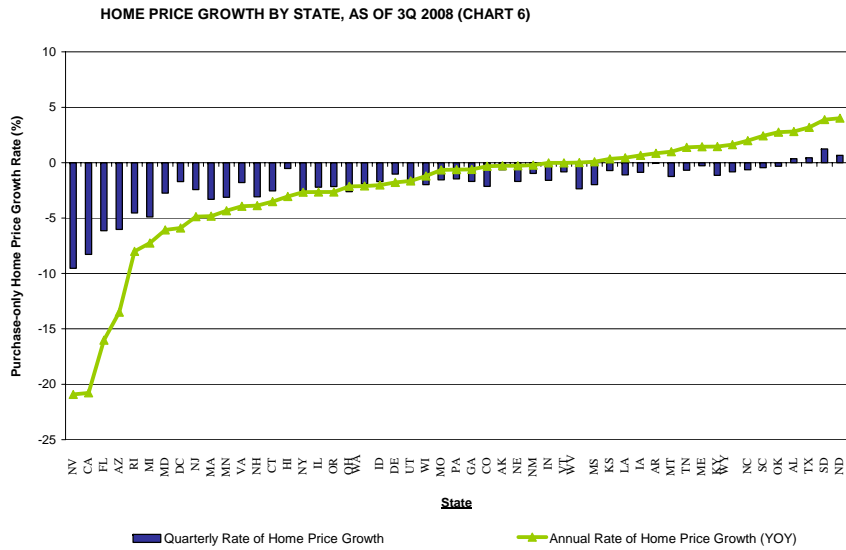


SOURCE: CALCULATED FROM RPX COMPOSITE FORWARD PRICES

**Regional and Local housing market conditions vary significantly.** As shown in Chart 6, in the third quarter of 2008, home prices declined in the majority of the 50 states and the District of Columbia, and gained only in a handful of states, as measured by both quarterly and annual rates of price appreciation. The states with the sharpest price depreciation from a year ago were Nevada (-20.9%), California (-20.8%), Florida (-16%), Arizona (-13.5%), Rhode Island (-8%), Michigan (-7.3) and Maryland (-6.1%). The states with the highest price appreciation rates from a year ago were North Dakota (4%), South Dakota (3.9%), Texas (3.2%), Alabama (2.8%), Oklahoma (2.8%), South Carolina (2.4%) and North Carolina (2%).

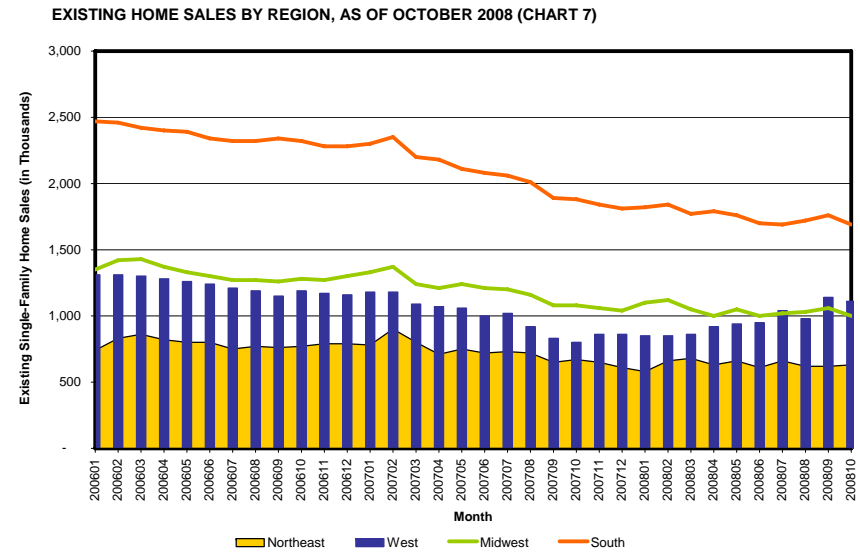
Despite the widespread and severe price declines in the Western states and in some other parts of the country, we observed some important market developments in these distressed areas recently – particularly in home sales.

This is due to continued excess supply in these markets, as the inventory of unsold homes remains at near historic record levels. Moreover, the rebounding sales in the West appear to be primarily driven by the sales of foreclosed properties, which typically offer large discounts. In many cases, the foreclosure properties are priced at 30% or more below the prices of similar non-foreclosure properties.



SOURCE: FEDERAL HOUSING FINANCE AGENCY

**Home sales rose unexpectedly in the West region** over the past two months (especially in comparison to depressed year-earlier levels). As illustrated in Chart 7, existing single-family home sales in the West Census Region increased to seasonally-adjusted annual rates of 1.14 million units in September and 1.11 million units in October. These home sales were about 37.3% and 38.8%, respectively, higher than those in the same month a year ago. In contrast, existing-home sales in the Northeast, Midwest, and South U.S. Census Regions either continued to decline or remained flat in September and October. While this is definitely a positive development, we will have to wait and see if this trend continues.

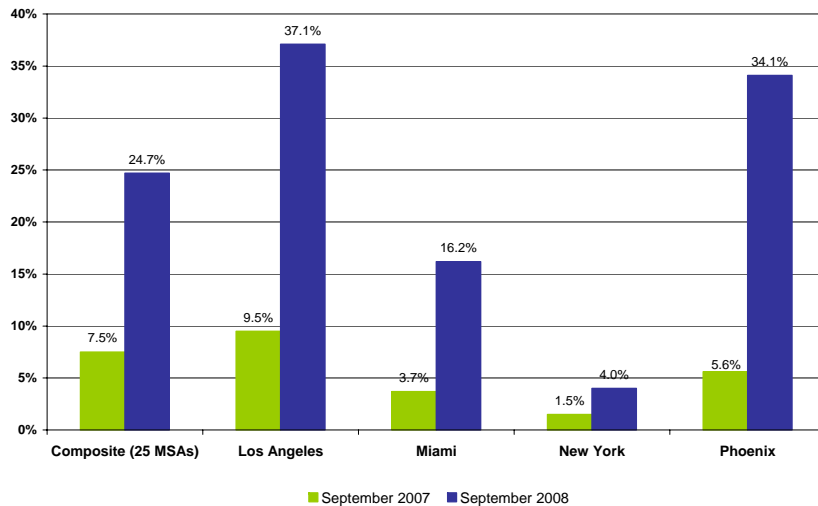


SOURCE: NATIONAL ASSOCIATION OF REALTORS

While sales were up in the West, home prices in the Western states, such as California and Nevada, still experienced the sharpest declines recently.

Indeed, foreclosure sales continued to rise substantially in many parts of the country recently, particularly in the West and other hardest-hit areas. Chart 8 depicts foreclosure sales as share of all home sales in 25 metropolitan areas. It shows that, in September 2008, foreclosure sales (for 25 MSAs combined) accounted for 24.7% of all sales, compared to only 7.5% a year ago. The increase in the share of foreclosure sales was notably pronounced in the Los Angeles and Phoenix markets, while much less so in Miami, and New York. In September 2008, foreclosure sales accounted for more than 37% of all home sales in Los Angeles, and more than 34% in Phoenix, while they only accounted for single-digit shares in these markets a year ago.

FORECLOSURE SALES AS SHARE OF ALL SALES, SEPT. 2007 vs. SEPT. 2008 (CHART 8)



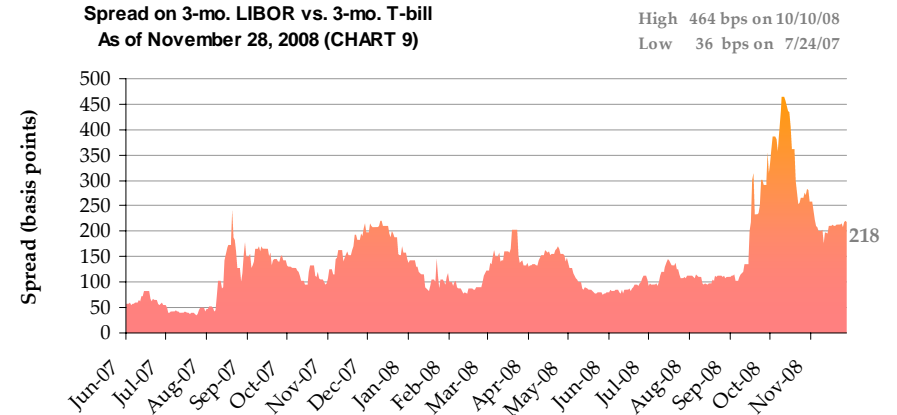
SOURCE: RADAR LOGIC INCORPORATED

## BANKING AND CREDIT MARKETS

**Government actions** to shut-down or prop-up failing banks continued in November. Notably, the Office of Thrift Supervision (OTS) closed Downey Savings on Friday, November 21<sup>st</sup> and turned it over to the FDIC for ultimate disposition. Downey had \$12.8 billion in total assets at the end of September. This news, however, was dwarfed by the announcement on Monday morning, November 24<sup>th</sup>, that late on the previous evening, the government had agreed to an unprecedented bailout plan for Citigroup. Under this plan, the government agreed to inject \$20 billion in equity capital and to backstop about \$306 billion in loans. The market seemed to approve the moves; the S&P 500 Index climbed 6.5% that day.

The extreme turbulence that U.S. capital markets has experienced in recent months continued in November – owing to fears of worldwide recession and uncertainty regarding the health of financial institutions. Nevertheless, the TED spread (the difference between the three-month LIBOR and the three-month T-bill rates, Chart 9) showed signs of settling down during the month.

Spread on 3-mo. LIBOR vs. 3-mo. T-bill  
As of November 28, 2008 (CHART 9)



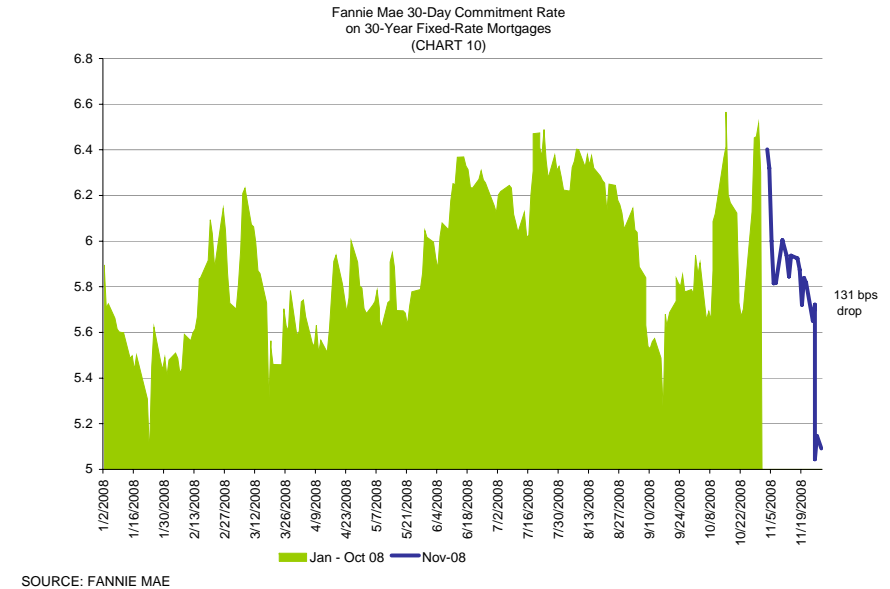
Source: BLOOMBERG, LP

This measure – an indicator of banks’ willingness to lend to one another – had widened considerably in September and October. The TED spread reached a record high of 464 basis points on October 10<sup>th</sup>. It began to narrow in the second half of October after the introduction of the U.S. Treasury’s TARP Capital Purchase Program (CPP), as well as the rate cuts and liquidity injections by the Fed and foreign central banks. The TED spread stood at 259 basis points at the end of October. Its volatility eased considerably in November as the TED spread settled into a range just slightly over 200 basis points. It ended November at 218 basis points. While the current levels are still very high in comparison to historical norms, they represent a vast improvement over the September-October period.

**The ills of the credit markets** are at the core of the nation’s, and the world’s, current economic woes. Policymakers have recognized that the problems with the housing market, retail sales, job losses, etc. cannot be fixed as long as capital markets are not functioning properly. This recognition has led to a series of unprecedented government interventions in recent months, most especially in October and November.

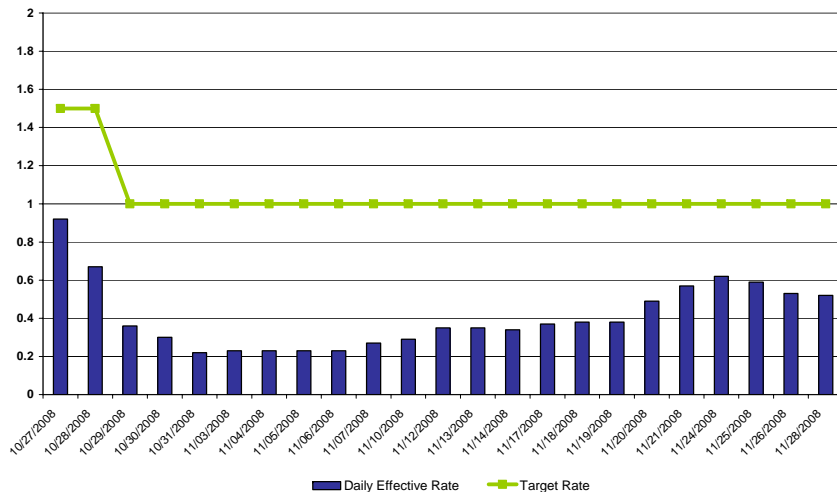
By the final week of November, the continued stall in the economy, as well as its predicted steep decline in the fourth quarter, prompted even bolder federal action. On Tuesday morning, November 25<sup>th</sup> – just one day after the announcement of the Citigroup bailout – Treasury Secretary Henry Pauslon announced that the Treasury and the Federal Reserve were embarking on a new \$800 billion program to purchase mortgage-backed and asset-backed securities. Under this program, the government would buy up to \$600 billion worth of Fannie Mae and Freddie Mac securities (\$500 billion in mortgage-backed securities, and another \$100 billion in GSE debt). In addition, the Treasury and the Fed announced they would create a \$200 billion program to lend money against securities backed by auto-loans, student-loans, and credit card receivables. According to news reports, the effect on the mortgage market was immediate, with retail rates on 30-year fixed-rate mortgages

dropping by about 80 basis points. In fact, on the morning of the announcement, the Fannie Mae 30-day commitment rate on 30-year fixed-rate mortgages was posted at 5.72% at 8:15 A.M. That same morning, at 9:15 A.M., the rate was re-posted at 5.04%. That’s 68 basis points below where it was immediately prior to Secretary Paulson’s announcement, and 126 basis points lower than the 6.30% that Fannie Mae posted for this rate on October 31<sup>st</sup>.



But while events such as the Citigroup rescue plan and the massive federal interventions in the mortgage and asset-backed securities markets grabbed the headlines, the Fed has been quietly working below the radar to pump massive amounts of liquidity into the system. Chart 11—which displays the *effective* versus *target* Fed Funds rates – tells an interesting story in this regard. While there were two Fed Funds target rate cuts of 50 basis points each in October, there were no changes made to the target rate during November. The Fed was clearly getting increasingly aggressive in its pursuit of monetary policy over the course of the month. The Fed is currently engaging in what some are calling “quantitative easing.” What this means is that the Fed is pushing far more liquidity into the system than the amount necessary to maintain the target Fed Funds rate. Chart 11 shows that the daily effective Fed Funds rate has been consistently below the targeted rate since about October 10<sup>th</sup>. At that time, the targeted rate was 1.5%, while the daily effective rate was 0.79%. The latest data point reported, November 26<sup>th</sup>, shows a targeted rate of 1.0% and a daily effective rate of 0.53%.

FEDERAL FUNDS RATE: TARGET VS EFFECTIVE RATE (CHART 11)



SOURCE: FEDERAL RESERVE BOARD

It is hoped that these massive injections of liquidity will actually result in some new lending.

## CONCLUSION

The negative news on the economy that we have seen for more than a year continued during November. The Dow-Jones Industrial Average declined 5.4% during the month, the latest jobless number showed that unemployment increased in October to 6.5%; credit spreads remain high in comparison with historical norms; and the housing market remained in a deep slump. Yet there were a few optimistic signs during the month of November. First, there was a further 28% decline in the price of regular unleaded gasoline. Second, the TED spread, while still very high, came down by more than 50% from its peak. Third, the massive federal injections of capital and liquidity into the marketplace do not seem to have touched off any inflation just yet – the October CPI actually declined by 1.0% – and the U.S. dollar has been significantly strengthening on world markets. Fourth, the funding of these programs – such as the TARP and the intervention in the asset-backed market – looks like it will be coming off at bargain basement financing rates, as investors flock to U.S. Treasury securities. At the end of November, the rate on the 10-year U.S. Treasury note stood at 2.93%, down 108 basis points from where it stood at the end of October, and the 30-year T-bond stood at 3.45% at the end of November, down 90 basis points from the prior month.

We also witnessed sharp declines in the Fannie Mae commitment rates in November. In last month’s *Monthly Market Monitor* we reported that “the spread between the Fannie Mae 30-year commitment rate and the ten-year Treasury note stood in excess of 270 basis points.” We attributed this spread to “the de-leveraging of financial institutions and the high degree of perceived credit risk in the financial system.” The Paulson announcement of the joint Fed/Treasury program to backstop the ABS market (and in particular, the Fannie/Freddie MBS market) to the tune of \$800 billion had a dramatic impact on the Fannie Mae and Freddie Mac commitment rates, a trend we will be watching closely. As a result, at the end of November, the spread between the 10-year T-Note and the Fannie Mae 30-year commitment rate was only 216 basis points, and the





commitment rate itself stood at 5.09%. These are very definitely positive developments. These rates should help make more loan workouts possible which, in turn, should dampen the rate of foreclosures. They should also allow credit to flow to potential homebuyers at more affordable rates, thus helping to work off some of the excess inventory of new and existing homes.

November ended on a very positive note. The last week of the month saw the Citigroup intervention, the new ABS program, as well as a number of highly-regarded economic policy appointments (Larry Summers, Christina Romer, Tim Geithner, and Paul Volcker) by President-elect Obama. All of these, it seems, were collectively hailed by the stock market, which rallied 12% over the Thanksgiving week.

At the close of last month's issue we raised two questions: (1) Are we in a recession? (2) Is the fix now in place to get us out of our current economic difficulties? The first question has been answered for us by James Poterba of the NBER, who recently announced that we are indeed in a recession and that it began in December 2007. With regard to the second, it's still an open question. However, the events of November give us more reasons for optimism than we had in October. The reasons to be somewhat more optimistic have to do with some early signs that the massive amounts of liquidity being supplied by the Fed and the Treasury are beginning to produce some loosening in the credit markets, as witnessed by the falling TED spreads and GSE commitment rates. Now the questions are: Will these translate into real increases in credit flow? Will increased credit flows and lower mortgage rates result in serious reductions in the excess inventories of homes for sale all around the nation? We look forward to monitoring these trends and reporting them to you. Happy Holidays!

*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.*

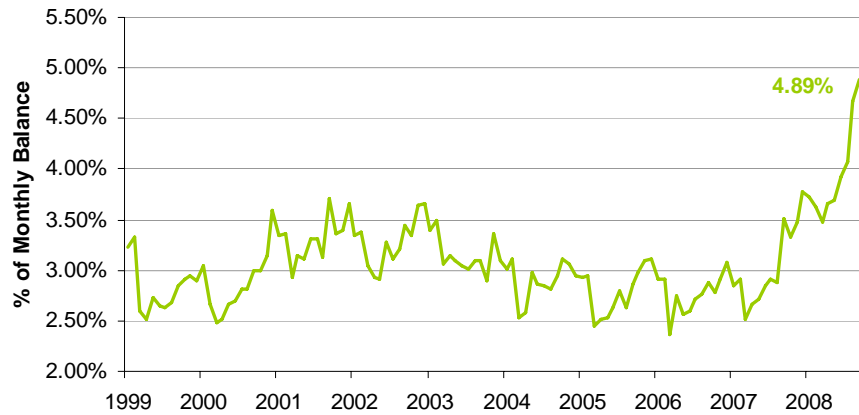
SOURCE: CHARTS 12-19 LOANPERFORMANCE, A SUBSIDIARY OF FIRST AMERICAN REAL ESTATE SOLUTIONS

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



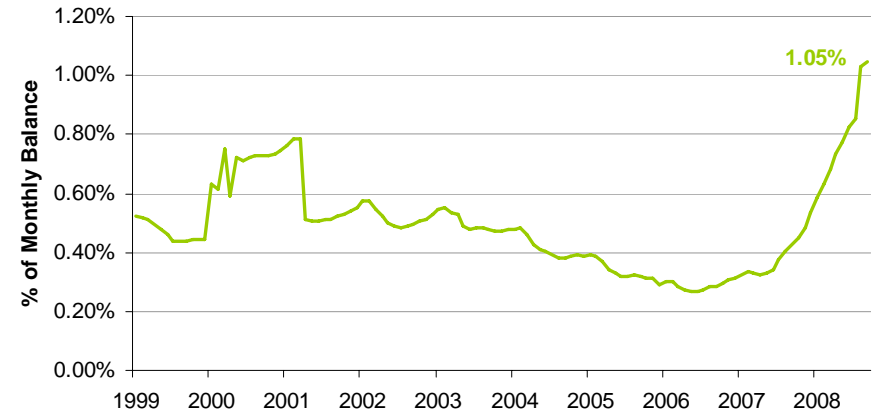
NATIONAL DELINQUENCY & FORECLOSURE RATES: FIXED & ARM LOANS  
(CHART 12)

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



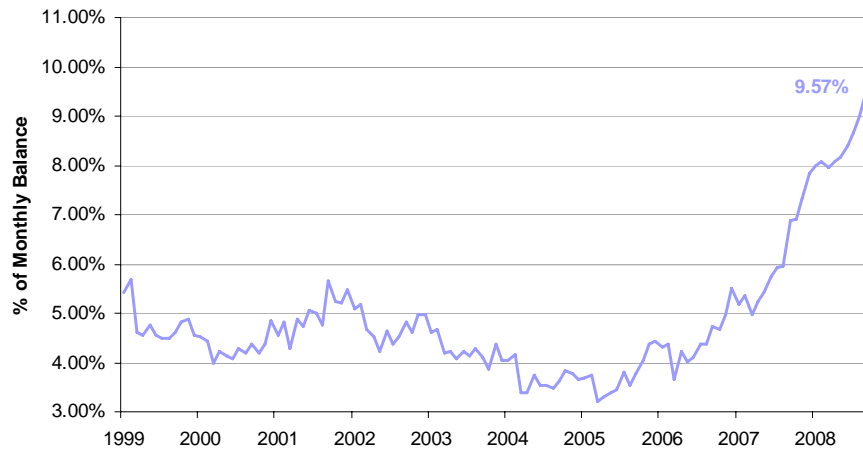
(CHART 13)

Fixed: Foreclosure  
1999 - September 2008



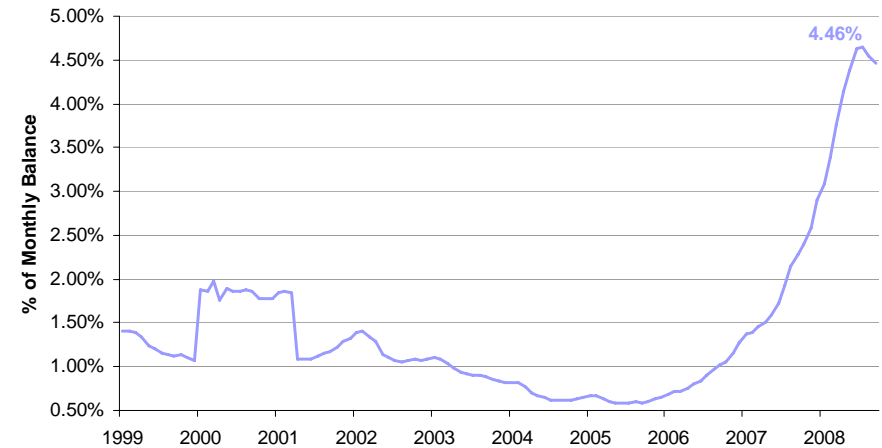
(CHART 14)

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



(CHART 15)

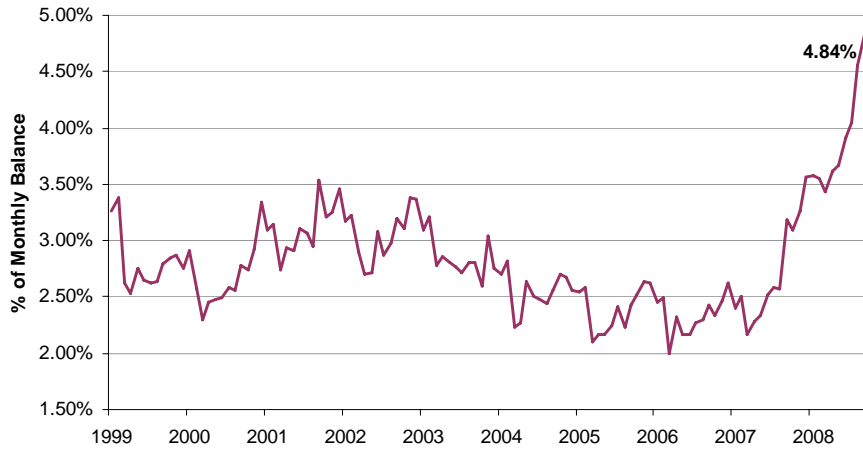
ARM: Foreclosure  
1999 - September 2008





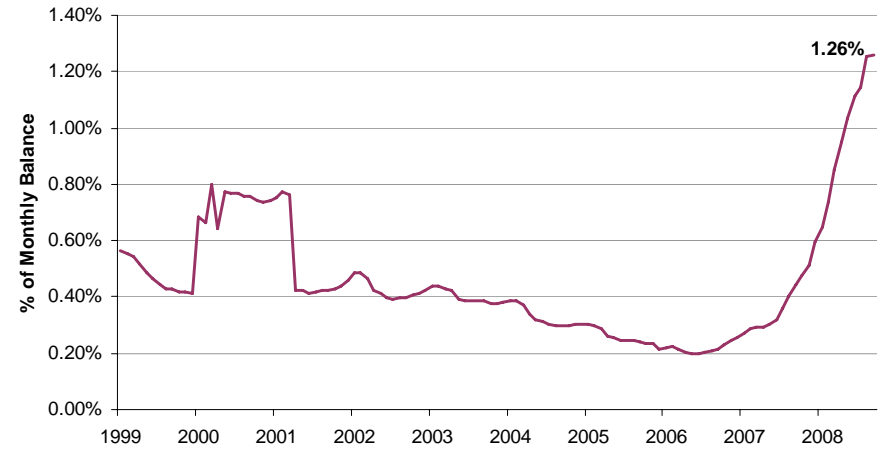
NATIONAL DELINQUENCY & FORECLOSURE RATES: PRIME & SUBPRIME LOANS  
(CHART 16)

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



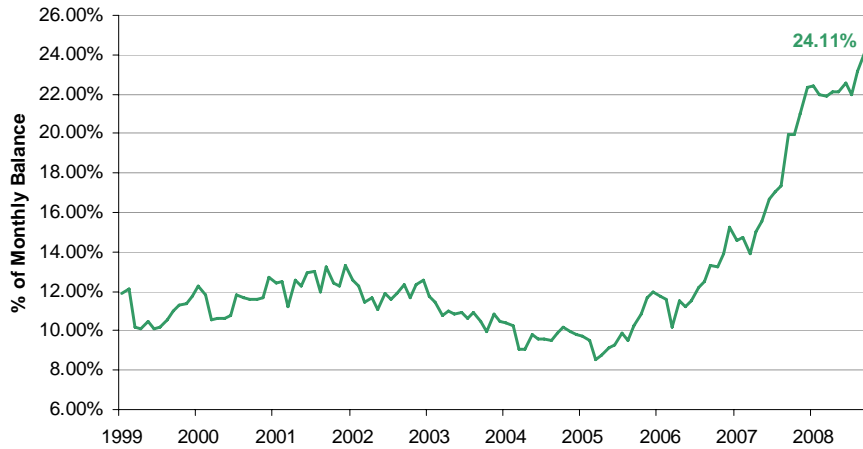
(CHART 17)

Prime: Foreclosure  
1999 - September 2008



(CHART 18)

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



(CHART 19)

Subprime: Foreclosure  
1999 - September 2008

