

VAKIFBANK GLOBAL ECONOMY WEEKLY

The reasons behind the weakness in the
US housing sector..



T. Vakıflar Bankası T.A.O



Introduction

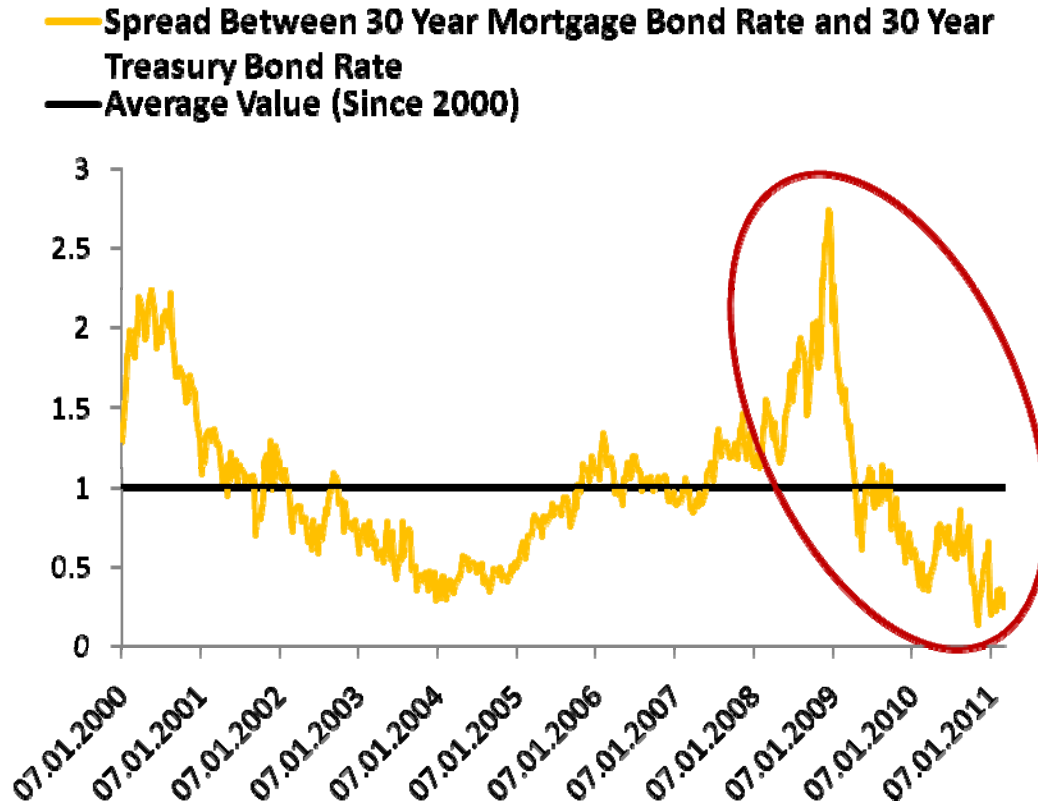
Thanks to sharp decline in interest rates since 2001, households in the US have increased their demand to the housing sector. From 2001 to 2006, the US housing sector recovered rapidly based on the credit expansion and this created new financial innovations that made loans easy to obtain. However, following the slowdown in the housing sector starting from the collapse of the US housing bubble decreased the values of these securities and damaged the financial institutions globally. Economies worldwide quickly entered into recession, unemployment rates reached historic high levels and inflation rates fell sharply in this period. Central banks and governments quickly began to take measures including fiscal stimulus, monetary policy expansion and institutional bailouts to prevent the credit crises. With these measures, since the middle of 2009, the US economy has started to recover rapidly. However, the recent data releases of housing sector in US have indicated that the recovery in housing sector has still been very slow. In this report, the reasons behind this weakness in housing sector are going to be analyzed through 3 following topics;

1- Demand and Supply

2- Households

3-Banking Sector

Spread between 30 year mortgage rate and 30 year treasury bond rate continues to decrease...

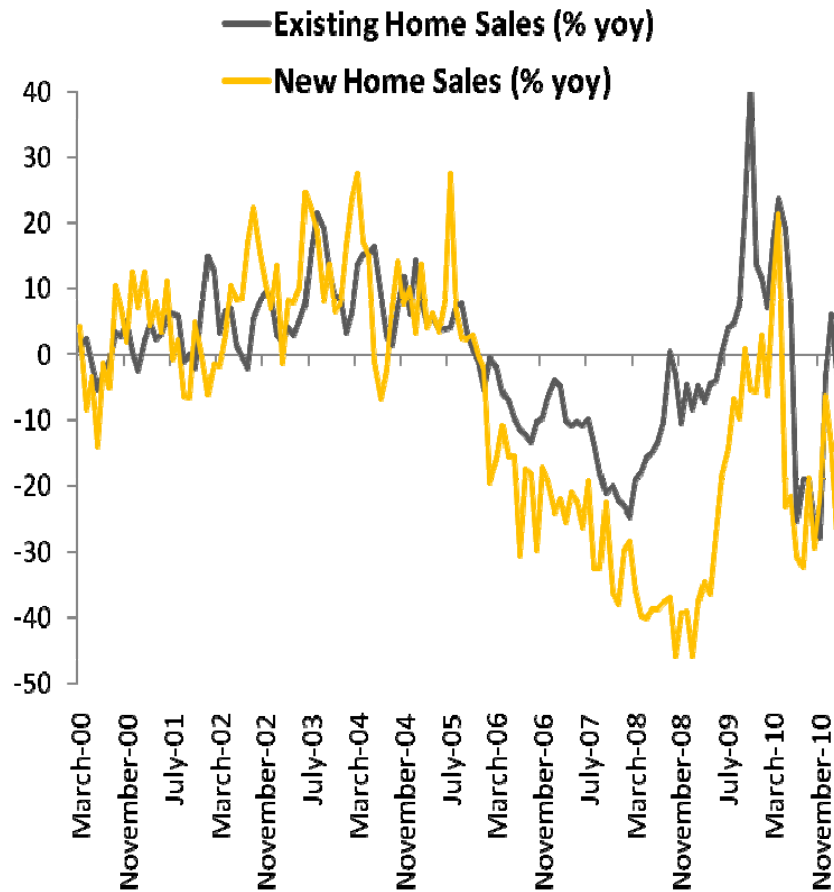


Source: Bloomberg

- Spread between 30 year mortgage bond rate and 30 year Treasury bond rate is again testing historical lows.
- During the US subprime mortgage crises, the US 30 year Treasury bond rate has decreased by 2.55% with safe heaven demand and mortgage rates have preserved high levels. Hence, the spread has increased by 2.70% which has been the highest level since 2000.
- In 2010, FED preserved low interest rate policy, bought financial assets and injected liquidity to the markets. Hence, mortgage bond rate and treasury bond rate decreased.

In the recent period, although the spread is below the average value and historical lows, housing demand doesn't increase and reaches pre-crisis level.

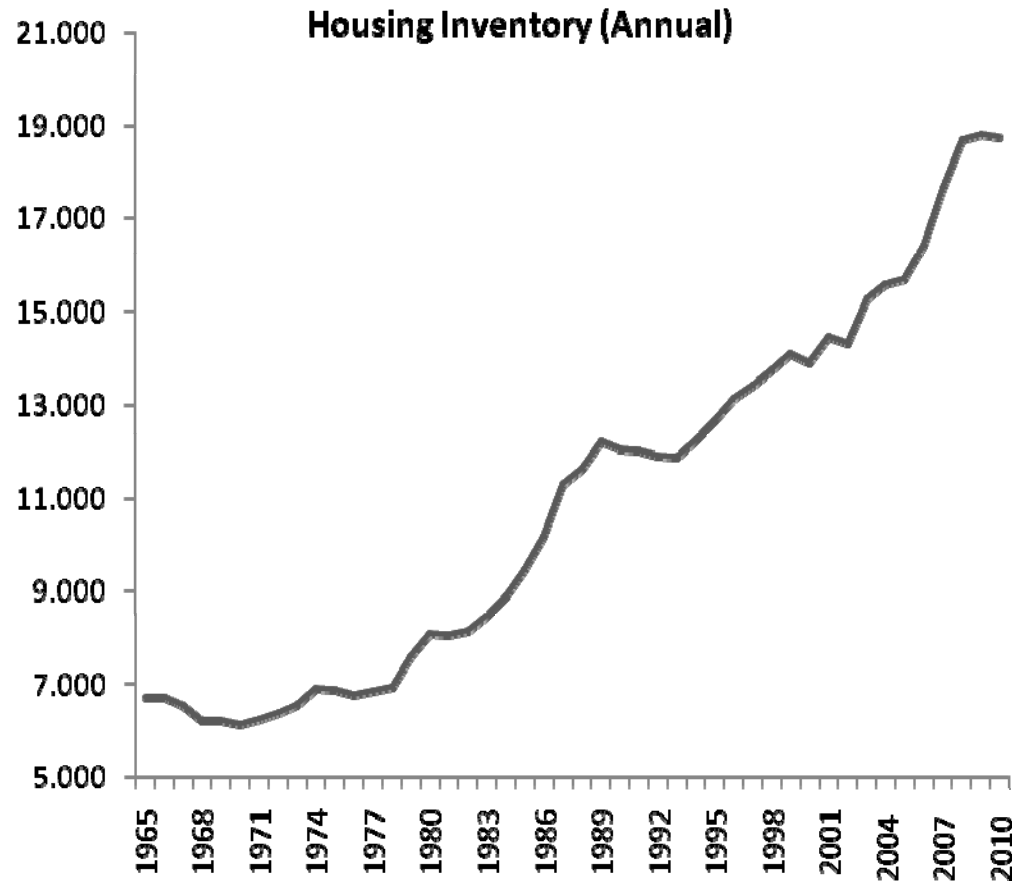
1a- Demand Side..



Source: Bloomberg

- ▣ According to market expectations, the problems in housing market will continue for a while. Last announced data of the housing sector supports aforementioned forecasts.
- ▣ Existing home sales decreased to 4.88 million in February. Moreover US new home sales fall to lowest monthly level on record in February.
- ▣ Because of changing consumer preferences, demand will continue to be weak in the near future.
- ▣ Another reason for weak demand is low income levels of households. Disposable incomes have not reached pre-crisis period yet.
- ▣ Although the measures including tax and interest rate cuts have promoted the households demand during the crisis, housing sector demand has not yet increased significantly.

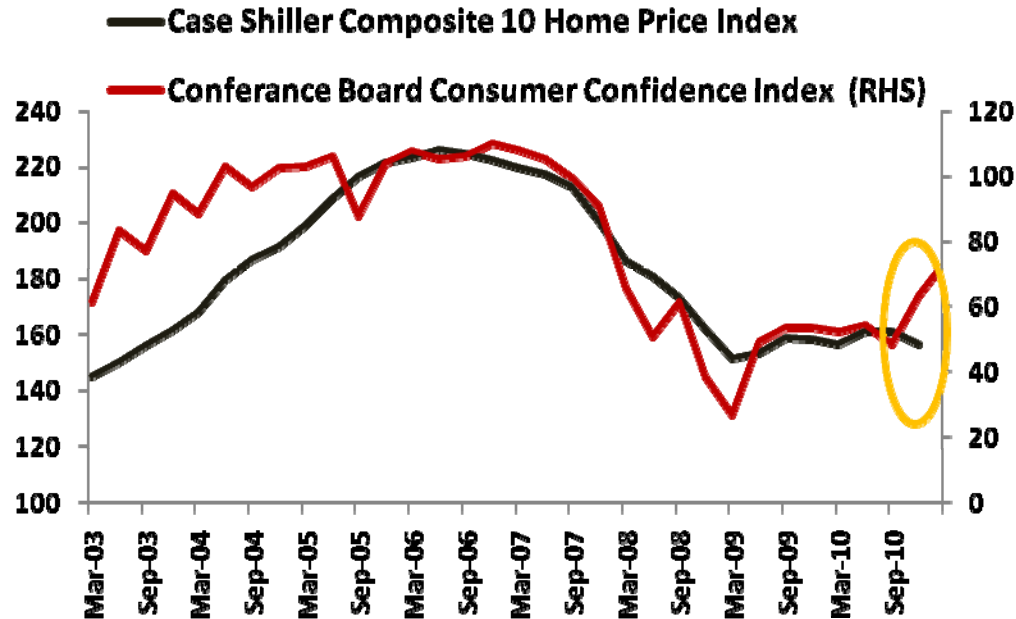
1b- Supply Side...




Source: U.S. Census Bureau


- ✔ In the last released data, building permits declined 8.2% to an all time low of 517k and housing starts plunged 22.5% to 479k in February.
- ✔ Since surplus in housing sector supply is high, house prices will continue to decrease in the forthcoming months.
- ✔ Due to mounting numbers of foreclosures, excess supply is expected to reach 20% of the housing sector in the end of 2011.
- ✔ These high levels in inventories in housing sector create downward pressure on house prices, prevent new constructions and employment opportunities.

2-The household side...

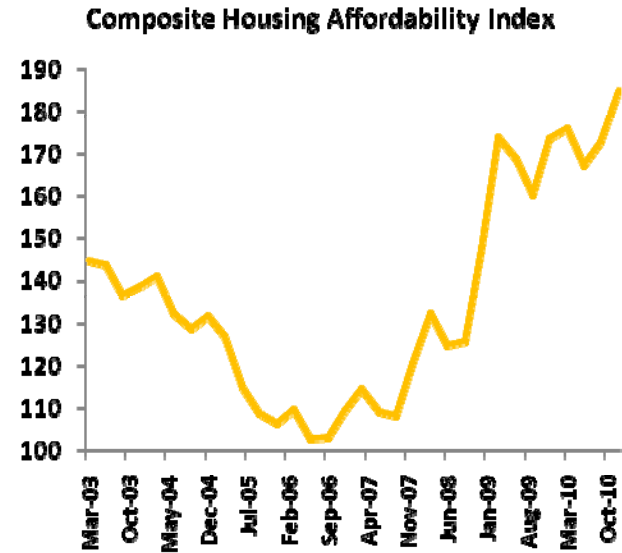


 The correlation between Case-Shiller 10 Home Price Index which is one of the leading measure of U.S. home prices and Conference Board Consumer Confidence Index collapsed in the recent period. As it is seen in the graph LHS, house prices decrease in contrast to the increase in consumer confidence.

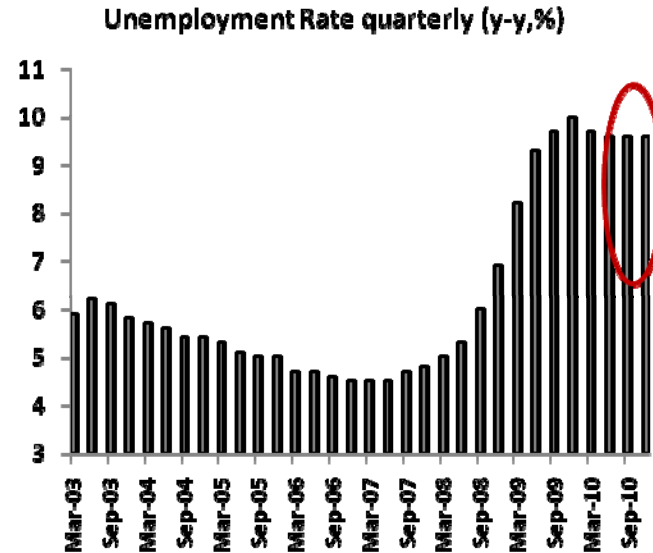
Source: Bloomberg

 As consumer confidence has been boosted by the Fed's on-going low interest rates, it has reached to its highest level since the beginning of 2008. However loose monetary policy and the absence of a medium term plan to address the growing fiscal deficit have increased the uncertainty towards the economy. In this environment mounting numbers of foreclosures have increased the housing inventory and kept house prices adjusting downwards.

Low interest rates and falling home prices have increased housing affordability...

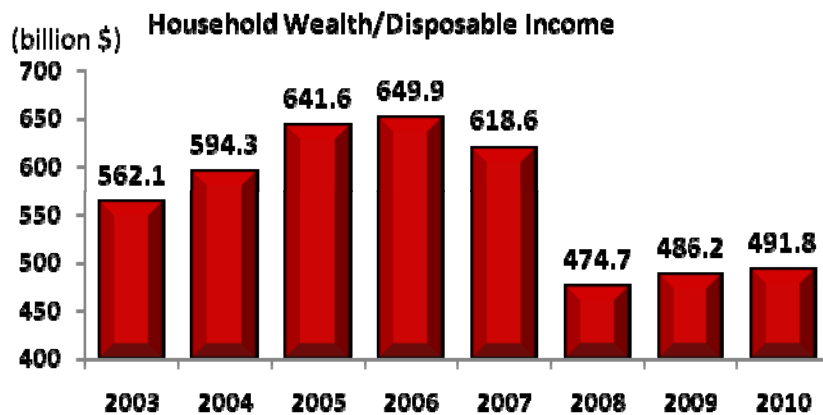


Source: Bloomberg



Source: Bloomberg

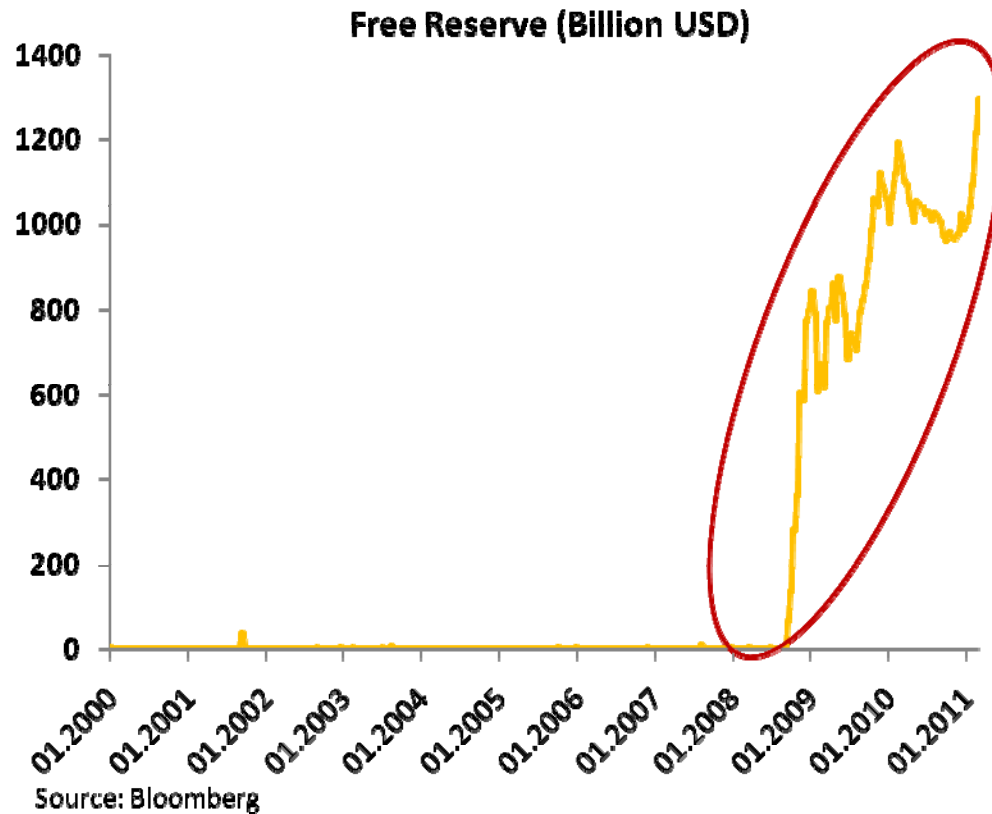
A counter-argument is that solid growth in incomes and a fall in house prices should help to boost the housing demand. On the contrary to this argument, house demand has depressed on the account of the slow recovery in the jobs market, with unemployment rate is still hovering above 9%.



Source: Fed

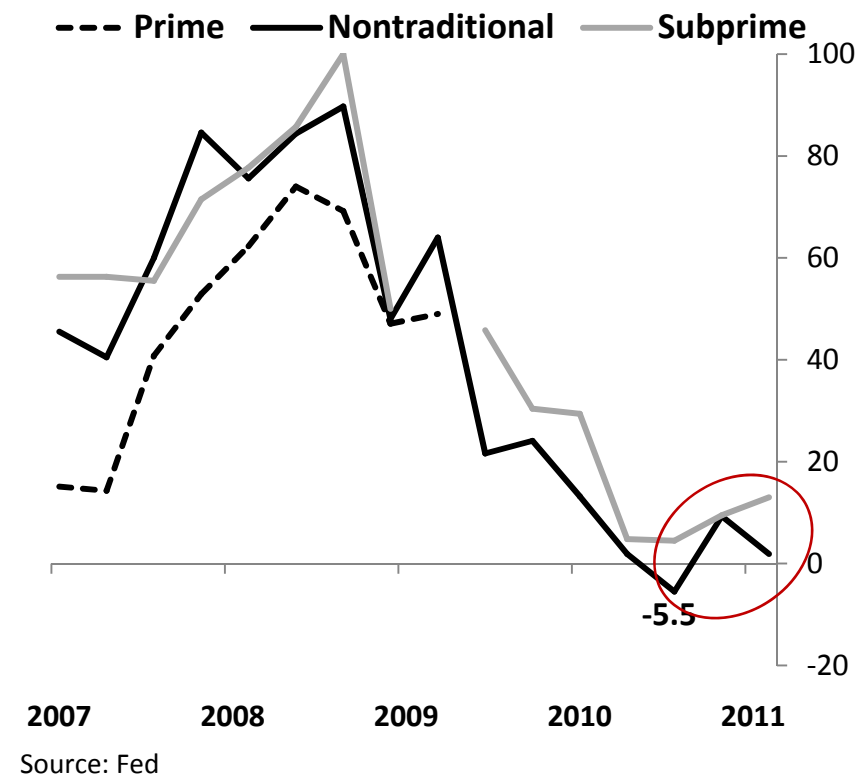
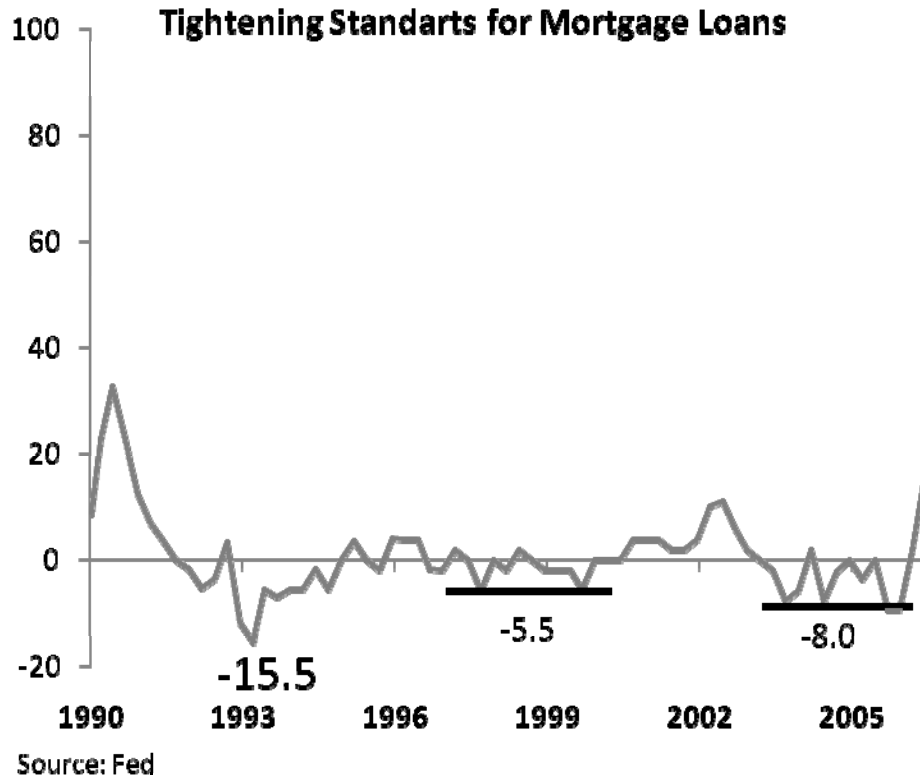
Moreover, the housing affordability has been increasing since 2009 but house sales have continued to decrease. This could be explained by household wealth which stays at a relatively low levels compared to pre-crisis levels. Household wealth/Disposable income ratio has displayed moderate recovery and still stayed at low levels compared to the period of 2003 to 2007.



3-The banking sector side...



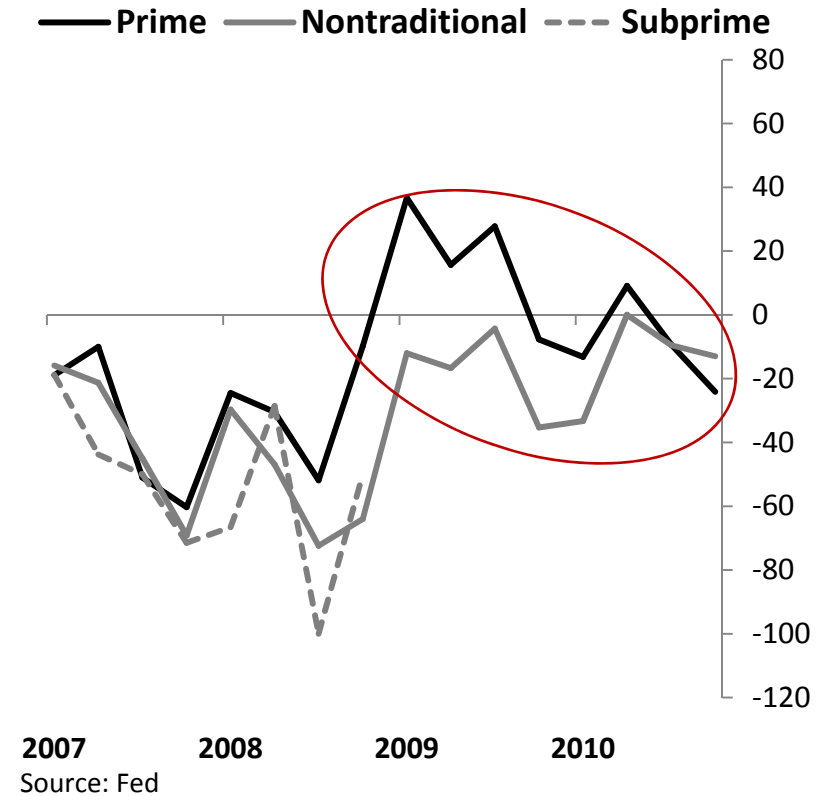
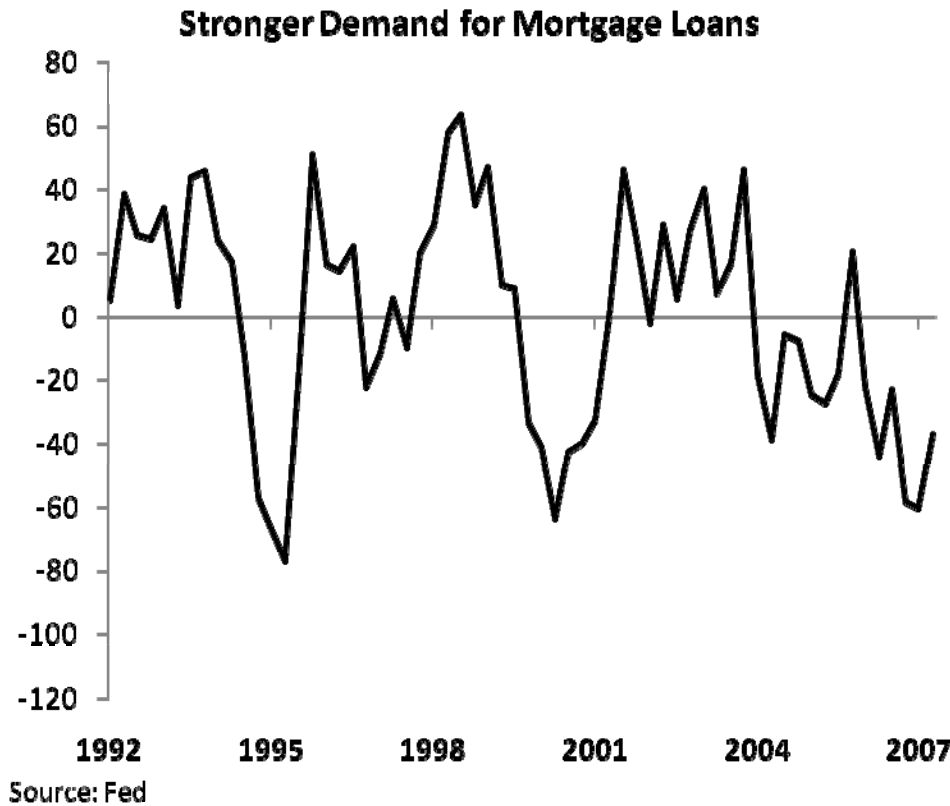
- After the crisis in addition to the rate cuts, FED used additional quantitative easing tools such as open market operations and asset purchasing.
- Despite all these expansionary measures, the banks preferred to hold the liquidity provided by Fed instead of credit extension.
- Thus, this situation damages the working of the money multiplier system, which is one of the biggest obstacles in front of the housing sector.



The credit standarts especially subprime mortgage credit standarts have become tightened recently...






-  According to Fed Senior Loan Officer Opinion Survey-January 2011, changes in standards for prime, nontraditional, and subprime mortgage loans have been reported separately since 2007.
-  Tightening credit standards have peaked at the end of 2008 and then started to loose since the begining of 2009. However, recently credit standarts especially subprime mortgage credit standarts have become tightened again.

Demand for mortgage loans have been decreasing drastically from the second half of the 2009...



-  In addition to tightening credit standards, banks are reluctant to give loans. This situation is currently limiting the credit use of household who has already high debt ratio and this forcing them to save more.
-  According to Fed Senior Loan Officer Opinion Survey-January 2011, demand for prime, nontraditional and subprime mortgage loans have been decreasing drastically from the second half of the 2009.

To sum up;

-  Recent data for the housing sector have not reached pre-crisis levels and have not recovered as expected. Some obstacles for the housing sector;
- ✓ With increasing foreclosures, house stocks have risen since the beginning of 2011.
- ✓ Although some measures such as tax reductions or low interest rates have been taken to increase demand, the demand is still weak since consumer preferences have shifted from buying to renting a house.
- ✓ Increasing public deficit, low household assets, high unemployment rate and recently increased oil prices are raising uncertainties about the economy and housing sector.
- ✓ On the other hand, banks prefer to hold liquidity in the central bank reserves instead of giving it to the market.
-  All these situations show that it is not easy to increase demand and prices in the housing sector in the near future.
-  Moreover, the negative impacts of the housing sector recession in 1986 were maintained until the second quarter of 1991. When we compare these two recessions in the housing sector, it is clearly seen that the last crisis damage on the housing sector was more severe than the 1986. Therefore, this signals that the recovery in the housing sector may take longer time than expected.

Serkan Özcan
Chief Economist
+ 90 312 455 7087
Serkan.ozcan@vakifbank.com.tr

Cem Erođlu
Senior Economist
+ 90 312 455 8480
Cem.eroglu@vakifbank.com.tr

Bilge Özalp Türkarıslan
Economist
+ 90 312 455 8488
Bilgeozalp.turkarıslan@vakifbank.com.tr

Seda Meyveci
Economist
+ 90 312 455 8485
Seda.meyveci@vakifbank.com.tr

Elif Artman
Researcher
+ 90 312 455 8490
Elif.artman@vakifbank.com.tr

Senem Güder
Researcher
+ 90 312 455 8476
Senem.guder@vakifbank.com.tr

Halide Pelin Kaptan
Researcher
+ 90 312 455 8483
Halidepelin.kaptan@vakifbank.com.tr

T. Vakıflar Bankası T.A.O
Ataturk Bulvarı No: 207
Kavaklıdere 06683 Ankara, Turkey
www.vakifbank.com.tr

Vakıfbank Economic Research
ekonomik.arastirmalar@vakifbank.com.tr

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