630-517-7756
www.ftportfolios.com

First Trust

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

No Double-Dip for Housing

With evidence of a self-sustaining economic recovery now hard to deny, many pundits are finding new reasons to be bearish. The most recent is that the Federal Reserve has officially ended its massive ($1.25 trillion) mortgage purchasing program. This, some say, will lead to another downturn in housing, which could drag the economy down all over again.

Although the end of the Fed's purchases will certainly not *help* the housing market, we do not believe it will result in a "double-dip" for housing or the economy. Instead, we expect home building, home sales, and home prices to all be up a year from now versus where they are today. Not on every street or in every community, but for the nation as a whole.

First, it's important to recognize that while the Fed has stopped buying mortgage-backed securities, it is not planning on suddenly selling its holdings. Most likely, the Fed will hang onto the vast bulk of them for at least several years and allow the natural process of refinancing and principal repayment to gradually reduce the size of its portfolio.

Second, we do not expect mortgage rates to suddenly spike as the Fed exits the market. The Fed announced the eventual end to their mortgage purchases back in September 2009, when long-term mortgage rates were about 160 basis points above the yield on the 10-year Treasury (roughly the 20-year average). But today, even though the Fed has ended its program of purchases, the "spread" between mortgage rates and the 10-year is only 120 basis points. If mortgage lenders are suddenly having extra trouble finding the funds they need to lend, they sure have a funny way of showing it.

Third, watchful observers of the mortgage market know that the total amount of lending necessary to support the housing market in the next year is not particularly large by historical standards. Lower home prices, relatively low levels of sales, and the high loan-to-value ratios that prevailed during the bubble years mean that the capital needed to support housing in the next year is not that substantial.

The average price of an existing home sale right now is roughly $220,000. Meanwhile, the typical homeowner now has a mortgage worth 62% of their home's value. So, if a buyer has to make a 20% down-payment (which means the new mortgage equals 80% of the home's value) and the debt that is retired by the previous owner is 62% of value, the demand for mortgage credit goes up by only 18% of $220,000, or approximately $40,000.

So if existing homes sell at a 5.75 million rate in the next twelve months (a 10% increase versus the previous twelve months), that should require about $230 billion in net new lending. Meanwhile, new home sales should require about another $90 billion. (New homes average $275,000 and we're assuming 20% down and sales equal to 400,000.)

In other words the total new lending needed to support a 10% increase in housing activity over the next 12 months is just $320 billion. Compare this to the $150 - 200 billion in principal repayments over the next year and it is easy to see that mortgage lenders do not need a large increase in their loan book to finance a rise in home sales.

Fourth, housing prices have fallen below fair value. Relative to rents, national average home prices are about 10% below fair value and have been the lowest relative to replacement cost in more than thirty years.

Markets are efficient and participants in the housing market are well aware of its problems, so we believe these prices already reflect the "shadow inventory" of foreclosures and short sales in the pipeline. Buyers and sellers are not blind, they don't have to wait to see homes pop up on the MLS to factor them into the price they are willing to bid or ask. That's why in the past three months some of the places with the largest excess inventories have seen the biggest gains in prices, including San Diego, Phoenix, and Las Vegas.

Fifth, and perhaps most important, the labor market – the last of the lagging economic indicators – has finally fallen into place as a positive for the economy. Private sector payrolls increased 123,000 in March (198,000 including upward revisions to prior months). Meanwhile, civilian employment, an alternative measure of jobs that includes the self-employed and start-up businesses, is up 1.36 million in the past three months, the most for any 3-month period since 1994.

Yes, the housing market has taken it on the chin. And, yes, the Fed is finally backing out of the market. But for the five reasons above, we think the battered and bruised housing market is going to be in better shape one year from now than it is today.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-5 / 9:00 am	ISM Non-Man. - Mar	54.0	**53.8**	55.4	53.0
4-7 / 2:00 pm	Consumer Credit – Feb	+$0.5 Bil	**-$8.7 Bil**		+$5.0 Bil
4-8 / 7:30 am	Initial Claims - Apr 3	435K	**436K**		439K