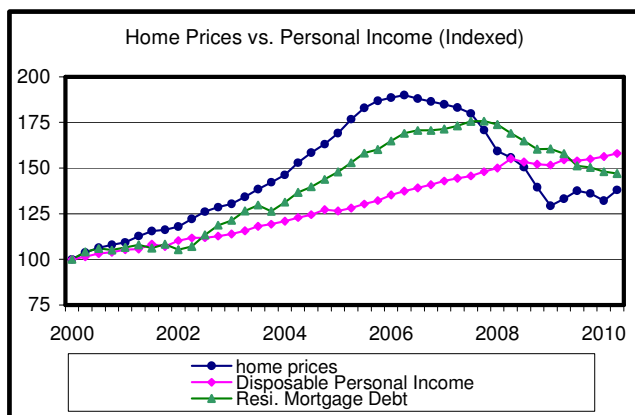


Housing – Once a Driver, Now an Anchor

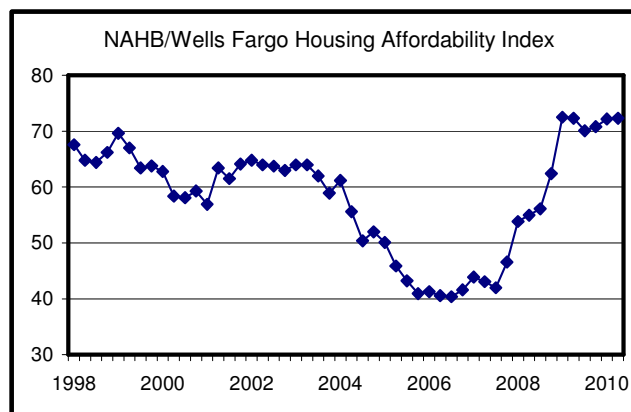
Housing typically leads our economy out of recessions, but the previous economic expansion was atypical – instead of the goods-producing part of the economy taking over as the next generator of job and income growth, housing continued to be the key economic driver. Unfortunately, it did so based on unhealthy factors – excessive debt creation and a mentality that saw housing more as a “can’t lose” investment and wealth creator rather than a desirable form of residence.

Although housing construction activity by itself is not a particularly large part of our economy – less than 3% in the past couple of years – housing’s economic impact was greater and much more widespread due to the wealth effect; as housing values increased, consumers felt wealthier (housing is the number one asset for most families), leading them to increase spending even if their income growth did not justify it. This is shown in the chart below left; home prices (as measured by S&P’s Case-Shiller report) expanded very rapidly in the previous decade, allowing substantial growth in consumer wealth even though disposable income was moving up at a more modest pace. This imbalance gap was filled by sharply increased mortgage debt, which generated the funds for spending in excess of income growth. In effect, the home became an ATM. This was obviously neither healthy nor sustainable, and has given way to a very deep correction in home values in a sharper than normal swing of the pendulum.

Another way of looking at this is via housing affordability, as measured by the National Association of Home Builders/Wells Fargo Housing Opportunity Index published by the NAHB and shown in the chart on the right. This index measures the percentage of the population with a household income that makes the median home price affordable. Note that this index reached all-time lows in the middle of the recent decade before rebounding to all-time highs just recently.



Source: S&P, Bureau of Economic Analysis



Source: NAHB

This disconnect between housing values and core underlying consumer income was fueled by several things: the herd mentality of home buyers and home owners (housing ownership was viewed as a “can’t lose” proposition) was one, the growth-oriented aggressiveness of Fannie Mae and Freddie Mac that (with the apparent approval and support of some legislators) dangerously broadened the mortgage product into very problematic forms (e.g., interest-only and/or teaser rate mortgages) was certainly

another. An equally important factor was the growth of the volume-oriented (and relatively credit quality-insensitive) securitization markets, with the critically-important assistance of the overly-generous rating agencies, too-aggressive mortgage originators, and yield-hungry but apparently risk-ignoring investors all over the world.

At any rate, we had a ballooning of housing values, followed in a typical cyclical fashion by a popping of that balloon. What had been an extraordinary boost to the economy became a heavy burden. And while the above charts might seem to suggest that the damage has been done, and that we might now be positioned for a fairly vigorous recovery, we see several issues that argue against any meaningful rebound for at least the next couple of years:

1. The securitization model, which was critical to the generous supply of mortgage financing, has been significantly weakened due to tougher underwriting and reporting requirements, more cautious regulatory attitudes toward big-bank participation in the business, more regulation of non-bank lenders, restricted access to low-cost capital for the still-stressed non-bank lenders, and a probability that a new and more conservative Congress will rein in Fannie Mae and Freddie Mac. And if mortgage originators (such as banks) are unable to sell the mortgages in a relatively smooth and efficient manner, but must keep them on their balance sheets for some possibly extended time, they will be much less interested in making new mortgage loans.
2. The huge inventory of unsold and foreclosed homes and undeveloped lots should help keep a lid on home price appreciation. We're unlikely to get a healthy housing environment until the bulk of these homes have been resold and moved off the balance sheets of the banks and/or investors, and out of the available supply of homes.
3. The foreclosure and subsequent sale process, which is necessary to clear the market of overhanging potential supply of houses, has been set back by legal questions such as:
 - Were fraudulent, or at least improper, practices employed in the origination and subsequent sale of mortgages? If so, many mortgages may be "put back" to their originators, which could add months, even years to the ultimate resolution of nonperforming mortgages.
 - Who actually owns the mortgage note, and is therefore the only entity that can legally pursue a foreclosure? Did the ownership get transferred properly, and can they prove they own it? This, too, may require many months of legal wrangling to settle.

These issues will ultimately be resolved, but probably not soon.

4. The U.S. consumer's belief in ever-increasing home values has certainly been punctured, and it seems unlikely that we will see any kind of near-term rebound in the appetite for residential real estate as an investment.
5. Since we believe that the upside ballooning in home prices and housing activity were mostly driven by an excessive buildup in debt, and that consumers will now trim their use of debt in order to repair their tattered balance sheets, consumer spending (roughly 70% of GDP) is likely to remain constrained for some time. We are firm believers that the U.S. is in a deleveraging cycle that will last for several more years, and this is not compatible with strong housing markets.

In sum, we believe that the excesses of the previous housing cycle, and the need to mend them, suggest that housing is not positioned to be a strong part of the economy for at least the next few years. While housing may have been a sled we rode on during better times, it has now become a sled we're dragging behind us, one that is slowing us down because of its unwanted cargo of foreclosed and other unsold houses, and the over-leveraged consumer balance sheets that it has left in its wake.

Implications for Community Banks

These trends are likely to have several implications that are mixed, though mostly negative for the banking industry.

- Potentially the most dramatic near-term issue, though not affecting many community banks, is the possibility that some originating banks may be required to buy back a substantial amount of nonperforming mortgages from Fannie Mae and Freddie Mac (and perhaps other investors) because of improper underwriting procedures.
- Another much broader, though indirect issue is the probability of slower economic growth due to the impact of deleveraging. Banks are, after all, more tied to economic activity than almost any other industry, and a slow-growth economy implies limited growth in loans and many fee revenue sources. Furthermore, credit problems in mortgage portfolios are likely to be a lingering earnings depressant.
- Additionally, if we are correct in expecting a less efficient (and less generous) securitization market, then mortgage rates will tend to be higher relative to other interest rates (reducing mortgage demand), and gains on sale of originated mortgages (mortgage banking profits) are likely to be lower than in the past.
- If mortgage growth does indeed remain sluggish or non-existent, those banks that have mortgage lending as a key element in their business strategies should find it harder to show anything approaching vigorous earnings growth. Since 1-4 family loans represent 26% of loan portfolios for all banks between \$100 million and \$1 billion of assets (34% for the industry as a whole), it would be hard to offset the balance sheet impact of a no-growth mortgage market.

On the positive side, there is almost certainly going to be less competition on the mortgage origination side; as one measure of this, we have been told that the number of mortgage banking companies operating in Minnesota has dropped from a peak of over 4,000 mortgage banking companies to under 600 and expect further dropping due to new tougher requirements and regulations. In effect, we expect housing finance to return to a model more like that of 15 or 20 years ago, which implies that the banks might be able to regain some significant market share of mortgage originations, and thus partially offset the impact of a sluggish mortgage market.

First Cut on Third-Quarter Results

There was little question that third-quarter earnings would be up sharply on a year-over-year basis, given the disastrous level of earnings last year. The better question was whether or not earnings would show any real upward momentum over the second quarter, in contrast to the pretty flat sequential comparisons we saw in the results reported in July.

Unfortunately, there appears to be very little upward momentum in the basic business of banking, with the only thing driving higher earnings being welcome reductions in loan loss provisions. While the larger, early-reporting banks have typically reported better than expected third quarter earnings, this was overwhelmingly due to declines in loan loss provisions; loan portfolios typically declined, the margin increases of the first part of the year seem to have run out of steam, and fee income was weak again.

Don't get us wrong -- we are very happy to see lower credit costs, although we note that the declines in loan loss provisions were usually not matched by equivalent declines in charge-offs or nonperforming assets (there was a large amount of reserve release), and reserve/nonperforming loan ratios tended to erode somewhat.. Earnings gains due to loss reserve releases are neither a sustainable nor a highly-valued generator of long-term earnings growth -- this requires expanding loan portfolios and increasing fee income, and we're not seeing any of that yet. To us, the banking industry looks like a patient who has licked cancer after a long and difficult period of treatment -- recovering, but emaciated (still-low profitability) and without much energy (very little revenue growth). We would like to see some top-line growth before getting too excited about the prospects for healthy gains in bank earnings and bank stocks.

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