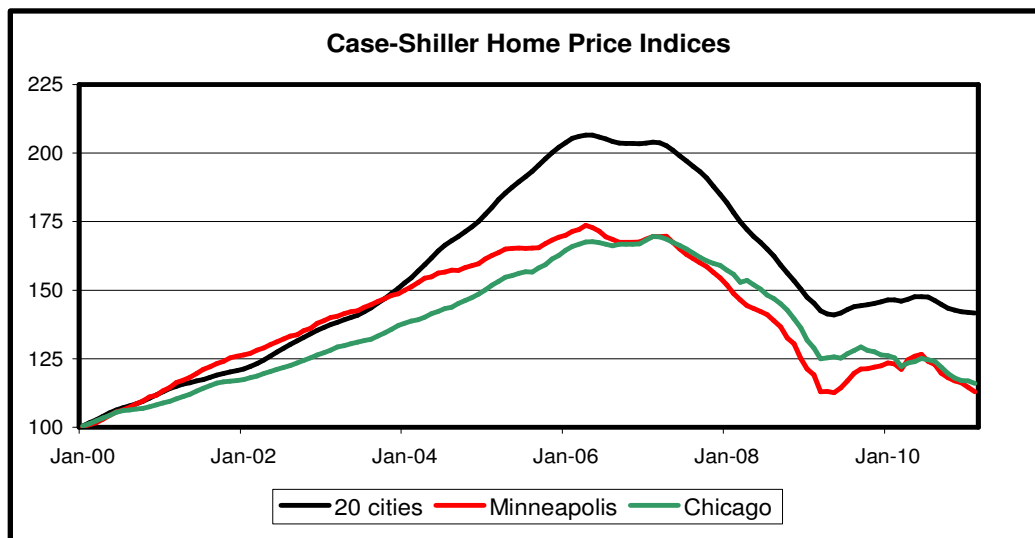


## A Double Dip in Housing?

We're of the opinion that the U.S. economy is like a huge supertanker, in that once it's going one direction, it is likely to maintain that direction for some considerable time. Thus we have not been believers in the double-dip scenario for the economy, even though several indicators have occasionally flashed warning signs since the end of the recession in mid-2009.

On the other hand, some segments of the economy are capable of double dips, and housing might be shaping up as one example. The latest Case-Shiller data on U.S. home prices seems to confirm this, as shown below:



Source: Standard & Poor's

As the chart suggests, home prices in Minneapolis and the U.S. are flirting with new low post-2004 ground after showing what turned out to be pretty modest recoveries from mid-2009 lows; unfortunately, Chicago didn't even really share in that rebound, and home prices are roughly back to 2002 levels.

More unfortunate perhaps is the growing perception that home prices have further to fall. To quote S&P's David M. Blitzer "January brings us weakening home prices with no real hope in sight for the near future...the housing market recession is not yet over...at worst, the feared double-dip recession may be materializing".

Disheartening as this is, there is not much reason to be surprised by these results; the "rebound" in housing prices really wasn't much of a rebound, and had some very serious internal weaknesses within it:

- The recovery was heavily influenced by government programs that had finite lives, and which restricted the supply of houses for sale and provided some boost to demand, thereby

making the health of the housing market appear better than the underlying fundamentals would support.

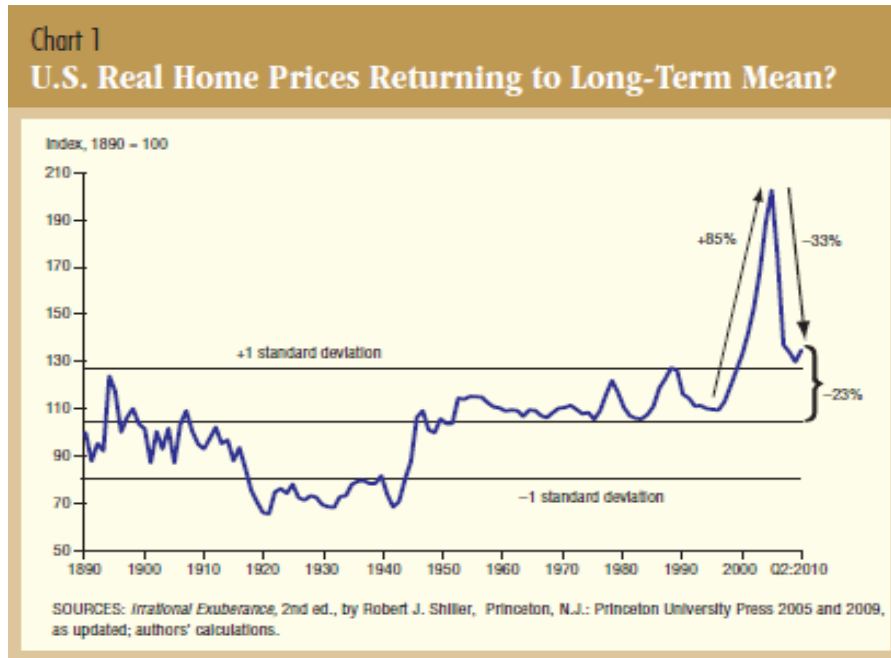
- Sources of credit were weakened or eliminated. For one thing, the securitization markets, which have certainly received their share of blame for the boom-bust housing market, have all but been eliminated except for high-quality mortgages sales to Fannie Mae and Freddie Mac. For another, new mortgage lending regulations were poorly established and understood, making lenders prone to caution. Risk-retention requirements are on their way for bank lenders, but no one knows what they will be, or what sort of mortgage will be high-quality enough to avoid the new requirements.
- Consumer confidence, after its own somewhat short-lived recovery, has slipped back into essentially negative territory. There is a bit of a chicken or egg question here – does consumer confidence drive real estate acquisition and real estate pricing, or does it work the other way. We doubt that there is any clear answer to that question, but it does seem clear that there is a feedback loop in operation, and when consumers get less confident because of ballooning gasoline and food prices and continuing sluggishness in home prices, their willingness to step up to a major purchase must be trimmed – especially when that purchase involves the assumption of a large amount of debt and the acquisition of an asset whose price could well be declining.
- The market wasn't cleared. In our view, this is probably the main reason for the renewed weakness, which has virtually erased whatever gains we saw between mid-2009 and late 2010. Government programs and government-induced delays in the foreclosure of seriously delinquent mortgages have kept the number of "forced" sales below what would have naturally occurred, and therefore have not allowed the houses in question to move into stronger hands (via even sharper price declines than we have seen). Until we see a major shrinkage in the number of foreclosed houses on the market and the "shadow inventory" of houses in weak hands (seriously delinquent homeowners who have not yet lost their houses and far under-water borrowers just waiting for a chance to liquidate and move on), it is unlikely that we will get housing fundamentals back on a firm footing.

Finally, we point to a rather convincing study reported in a December 2010 Economic Letter from the Dallas Fed. Excerpts from that study:

*Housing construction boomed, reaching a postwar high—9.1 million homes were built between 2002 and 2006, a period when 5.6 million U.S. households were formed. The resulting oversupply of homes presents policymakers with a formidable challenge as they struggle to craft a sustainable economic recovery. Usually a driver of economic recoveries, the housing market is foundering as an engine of growth.*

*One factor inhibiting the new-home market is a growing supply of existing units. The 3.9 million homes listed in October represent a 10.5-month supply. One in five mortgage holders owes more than the home is worth, an impediment that could hinder refinancings in the next year, when a fresh wave of adjustable-rate mortgages is due to reset. The number of listed homes, in other words, is at risk of growing further. This so-called shadow inventory incorporates mortgages at high risk of default; adding these to the total implies at least a two-year supply*

In fact, home prices still must fall 23 percent if they are to revert to their long-term mean, as shown in the following chart:



It is too early to tell if we are going to drop significantly further. In fact, we suspect that we are on a long basing plateau. In any case, any sort of vigorous rebound seems unlikely over the near term. The following table was developed by MacroMarkets LLC from its March 2011 Home Price Expectations Survey, compiled from 111 responses of a diverse group of economists, real estate experts, and investment and market strategists. The survey is based upon the projected path of the S&P/Case-Shiller U.S. National Home Price Index over the coming five years.

**Expected Home Price Changes By Year**

S&P/Case-Shiller U.S. National Home Price Index (Mean of all Panelist Responses)

Year	Year-over-Year (Q4 vs. Q4 Prior Year)	Cumulative (Q4 vs. Q4 2010)
2011	-1.38%	-1.38%
2012	1.26%	-0.09%
2013	2.72%	2.67%
2014	3.19%	5.98%
2015	3.42%	9.64%

Source: MacroMarkets Home Price Expectations Survey, March 2011

If this table is at all correct, housing values are unlikely to be meaningfully above year-end 2010 levels even at the end of 2012. Ultimately, the negative pressures will be resolved, and housing values will stabilize and probably start appreciating moderately along with the relevant economic drivers – family formations, consumer incomes – making mortgage lending a viable business once more. Don’t expect it to be a windfall business, as it was in the middle part of the previous decade, however; regulatory and market oversight should keep a lid on crazy financing schemes, and we suspect that most people now (properly) see residential real estate as a form of housing rather than an investment vehicle.

The direct implications for any given bank depends on its business model, and to a certain extent its geography, but at a minimum we expect it to take an uncomfortably long time (or uncomfortable further write-downs) to move problem mortgages and repossessed real estate off the books. Furthermore, housing investment (about 5% of GDP) will not be able to stimulate much economic growth as it has done in previous recoveries, joining state & municipal spending (about 12% of GDP) as significant drags on the economy.

### **First Quarter Bank Results: Positive Earnings Surprises, Stock Prices Drop**

By and large, we could characterize first quarter earnings reports (mostly larger banks) this way: revenues were disappointing (loan growth negative, net interest margins flat to slightly lower, fee income mixed), offset by pretty good news in credit costs (lower charge-offs, and lower nonperforming assets that allowed loss provisions to be even lower than charge-offs). According to a Bloomberg report, the six largest U.S. banks reported an average year/year revenue decline of 13.3%, while pretax, pre-provision earnings dropped 40%. So once again, reserve releases had to carry the day. Interestingly, and in what may prove to be an indicator of future results, many of the positive earnings surprises were significantly influenced by lower than expected operating costs, a logical response to continuing weakness in revenues.

In any case, the positive news on earnings was not met with investor enthusiasm, to say the least. The same Bloomberg report noted that the Keefe bank stock index, made up of the country's 24 largest banks, has dropped 3.5% in the two weeks since the earnings reports began, versus a gain of 1.6% for the S&P 500.

The implications of the early first quarter earnings reports are not particularly positive for our community bank universe. Credit quality is improving more slowly, especially in the real estate sector that is more important to community banks than to the large banks, stronger loan demand from large corporations is irrelevant to smaller banks, and the mixed results in fee income (better capital markets fees, lower deposit-related fees) is OK for the big banks but not the small banks.

In sum, earnings trends for community banks, viewed with a broad-brush approach, are pretty sluggish. Furthermore, the ability to reduce cost ratios is likely to be constrained by new regulatory costs, which are not truly variable in line with bank size, and thus present a relatively larger cost burden for smaller banks. We see this as contributing to a pickup of merger & acquisition activity in the next few years, with many smaller banks deciding to sell rather than struggle with an increasing cost load on a listless revenue base. And, of course, adding on a new acquisition does create the potential for the acquirer to reduce costs and improve profitability even in a slow-growth environment.

Oak Ridge Financial is an independent, full-service financial services firm providing Private Client and Investment Banking Services to individual, institutional and corporate customers. Oak Ridge's Financial Institutions Group specializes in providing investment banking and fixed income sales and trading services to financial institutions. Our team consists of professionals with over 70 years experience with in-depth knowledge of the capital markets and financial services industry. Web: [www.oakridgefinancial.com](http://www.oakridgefinancial.com) Member: FINRA/SIPC