



Weekly Market Commentary



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Healing In Housing

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Highlights

A housing turnaround may be underway, as mortgage rates are falling sharply and sales are beginning to rise.

Housing-related stocks and bonds may be already beginning to reflect the improving trend.

The housing market, the catalyst to the recession and bear market of 2008, may hold the key to improvement across all financial markets in 2009.

The 7% gain in the S&P 500 last week brings the rally from the low on November 20, 2008 to 24%. Encouragingly, last week's rally was led by early cyclical sectors like Consumer Discretionary, Industrials, and Technology. While January is likely to present several challenges to the rally in the form of weakening economic data reported for the month of December, weak earnings reports for the fourth quarter of 2008, and lackluster earnings outlooks from corporate leaders, there are some signs of improvement on the horizon.

The housing market may finally be showing some early signs of healing. While on a national basis home prices are likely to have some additional downside, we expect the housing market to begin to improve during 2009 and contribute to an economic and market recovery. The key drivers of this improvement are the cost and availability of credit to current and potential homeowners.

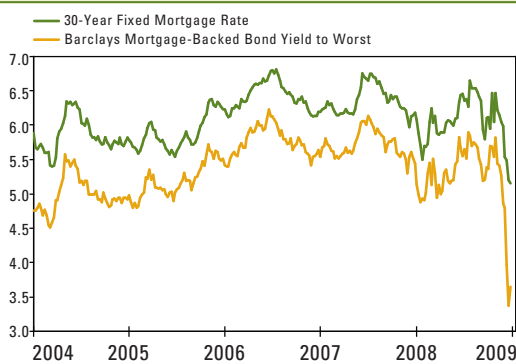
The cost of credit is falling rapidly. The 30-year fixed mortgage rate has fallen to 5%. With Mortgage Backed Securities (MBS) yields below 4% and the Fed making plans to buy \$500 billion in MBS by June, mortgage rates could fall well below 5%. If that were to occur, refinancing activity would very likely surge, and homeowners would enjoy an increase in their discretionary income similar to what a tax cut would provide. [Chart 1]

For lower rates to have a meaningful effect, lenders must extend credit to borrowers. It appears that this process is beginning to happen. As mortgage rates have started to fall, borrowers have responded. Last week, mortgage applications jumped to a five year high as the average rate on a 30-year fixed-rate loan dropped to 5.03%, well below the 6.47% rate at the end of October. Applications are likely to soar to a new all time high if rates continue to fall well below 5%. [Chart 2]

Housing is increasingly being viewed as attractive by buyers. In December, the widely-watched University of Michigan national consumer sentiment survey reflected an improvement in potential home buying attitudes, with 72% of respondents indicating it was a "good time to buy a house". Falling home prices and interest rates have led to improvement in housing affordability. The survey and affordability index were key leading indicators of the turnaround in housing activity following the housing downturns in 1982, 1990, 1995 and 2001.

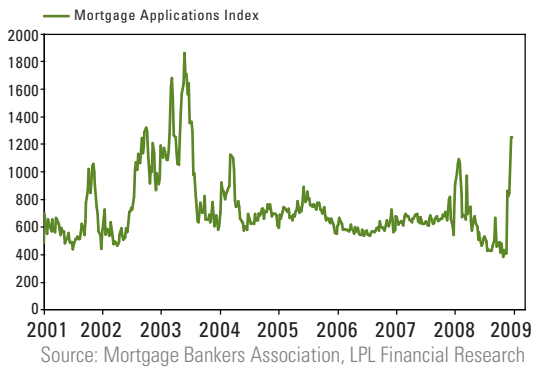
Increasing applications for mortgages is a good start, but making loans that lead to home sales is what really matters. Lenders must be willing to extend credit to borrowers for the efforts of the Federal Reserve to bear fruit in the form of home sales. Fortunately, lending is taking place and

1 Mortgage Rates Heading Lower 30-Year Fixed Mortgage Rate and Yield on 30-Year Mortgage-Backed Bond Index





2 Mortgage Applications Have Jumped to Five Year High



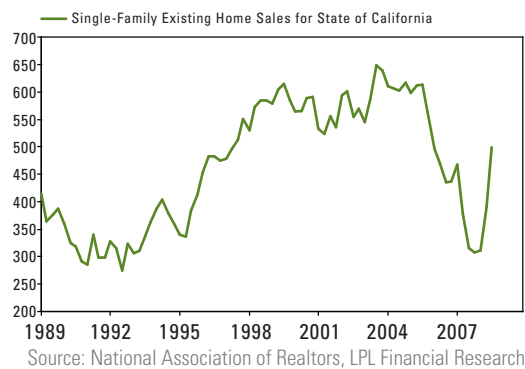
sales are on the rise—particularly in the hardest hit markets. The low rates make bargain hunting attractive and may be helping to drive increasing housing transactions. Foreclosures and desperate homeowners in states like California result in sales of properties to new owners, including “vultures” buying up large numbers of distressed properties. While the latest data is three months old and does not capture the impact of the changes in the fourth quarter, it reflects a rebound in housing sales halfway back to the prior peak. While prices are likely to continue to fall in the coming months, the early signs of healing are welcome news. [Chart 3]

That welcome news is translating into gains for housing-related stocks, including both homebuilders and housing-focused retailers. Both are rebounding and have helped to lead the market rally of the past month. The S&P 500 Homebuilders Index is up 70% since the low in the S&P 500 on November 20, 2008 and the S&P 500 Home Improvement Retailers Index is up 32%. [Chart 4]

In addition, the housing-related portions of the bond market have shown signs of improvement. The MBS market has posted gains in recent weeks, as mortgage backed bond spreads have narrowed.

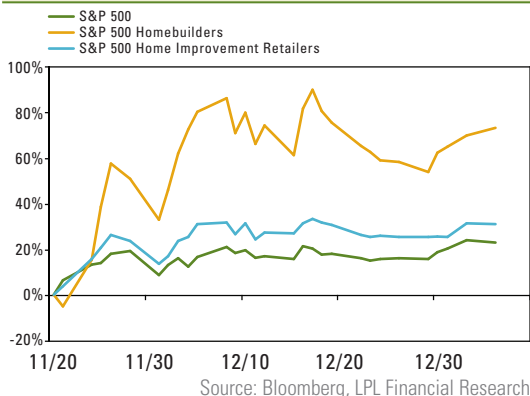
Improvement in the value of housing-related investments is a positive for troubled financial institutions, whose leveraged exposure to these types of investments magnified the effects of the crisis as values deteriorated. The downturn in housing was the key catalyst to the recession and bear market. Early signs of healing in housing are a key sign that the pressure on the economy and markets may begin to abate and we can look forward to a turnaround in housing in 2009.

3 California Home Sales Rebounding



4 Housing-Related Stocks Rally

S&P 500, S&P 500 Homebuilding, and S&P 500 Home Improvement Retailers Indexes





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