January 31, 2012

Economics Group

Special Commentary

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Housing Chartbook: January 2012

Two Steps Forward, One Step Backward

There has been a great deal of excitement surrounding the housing outlook for 2012. Last year ended on a fairly solid note, with sales appearing to improve, inventories apparently declining and builder optimism posting four increases in a row. The latest data, however, are a little less heartening. New home sales for December showed sales weakening somewhat, and the latest reading for the S&P/Case-Shiller Home Price Index showed a larger-than-expected decline in November. We remain somewhat optimistic about the outlook for 2012, but we generally see less improvement than does the consensus. Sales of both new and existing homes will improve this year, and new home construction will post its first meaningful gain since the home-buyer tax credit frenzy. Unfortunately, there is still much work to be completed before a self-sustaining recovery in housing can take place.

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One of the most encouraging aspects of the housing outlook is that the policy environment is turning more favorable. The Federal Reserve and the Obama Administration both realize that the U.S. economic recovery is not likely to strengthen appreciably until residential construction recovers. To that end, we expect a whole host of policy initiatives to be thrown at the housing market in 2012. One of the most important developments is that there appears to be real progress being made at a final agreement between the state attorneys general and five large mortgage servicers. If a deal can be reached, we believe we will begin to make meaningful progress at clearing out some of the shadow inventory that is hanging over the market. While it will likely take years to clear out all of the excesses, just being able to clarify the size of the problem and clearing some of the inventory will go a long way toward helping normalize the unusually conservative appraisal process and helping loosen some of the more tight lending requirements in place today.

Figure 1

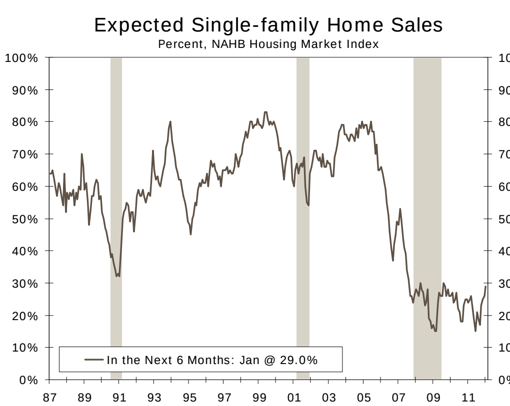
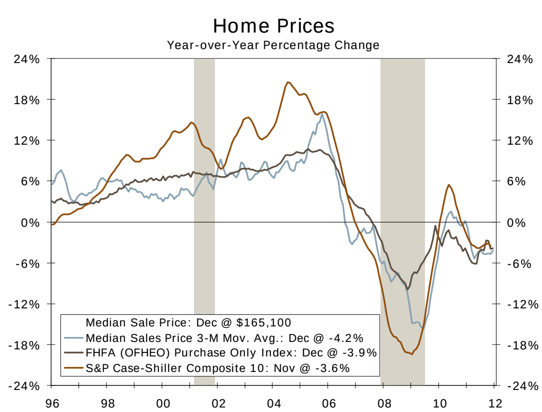


Figure 2



Source: U.S. Department of Commerce, S&P, FHFA, NAHB and Wells Fargo Securities, LLC

The other policy initiative that could come from Capitol Hill in 2012 relates to foreclosure holdings at Fannie Mae and Freddie Mac. On Jan. 4, the Federal Reserve released a "white paper" that highlighted the need for the Federal Housing Finance Agency to consider selling large blocks of real estate owned (REO) properties held by Fannie Mae and Freddie Mac to investors for rental conversion purposes. The general thinking is that since the rental market is in short supply and the homeowner market is in excess supply, REO rental conversions will help supply and demand normalize in both markets.

We expect vacancies to remain historically elevated through the end of the decade.

This is probably true in the short run, meaning that this policy would reduce the number of homes in the shadow inventory over the next few years. But depending on how long investors hold on to REO converted properties, those properties could easily end up back in the shadow inventory before the housing market fully recovers. We expect vacancies in the housing market to remain historically elevated through the end of the decade.[1] Therefore, given that investors will likely not hold on to REO converted properties for longer than a 5 year horizon, a policy that converts REO holdings at Fannie Mae and Freddie Mac into rental units probably would not meaningfully speed up the longer-term vacancy normalization process. The impact on rents would likely show up mostly in class B and class C properties, where the apartment market is not as tight and rents are not rising all that much right now. Most of the growth in the apartment market and pressure on rents is in the class A segment.

In terms of direct policy accommodation, we anticipate that the Fed may pursue a third round of quantitative easing directed toward the MBS market sometime this spring. The FOMC's latest central tendency forecast, which was released on Jan. 25, showed that Fed policymakers expect inflation to run below the FOMC's longer-run goal of 2 percent growth for the PCE deflator and the unemployment rate to trend lower only gradually. In addition, the FOMC's latest monetary policy statement concluded with the following language: "The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability." Given these realities, provided that the high frequency economic data do not improve significantly over the next few months, the stage has more or less been set for more quantitative easing from the Fed. Such a move would also likely ensure ultra low mortgage rates for the start of the important spring selling season.

Faster job growth and household formation would speed up the recovery in housing.

While lower mortgage rates may help a little, there are really no easy fixes. Faster job growth and household formation would definitely speed up the recovery in housing, but most forecasters, including ourselves, expect the labor market to remain sluggish for some time. We continue to see a long, gradual recovery ahead for the housing market, but have slightly raised our forecast in each of the past two months.

Figure 3

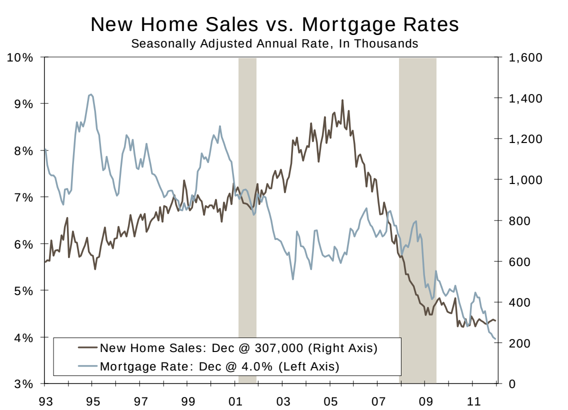
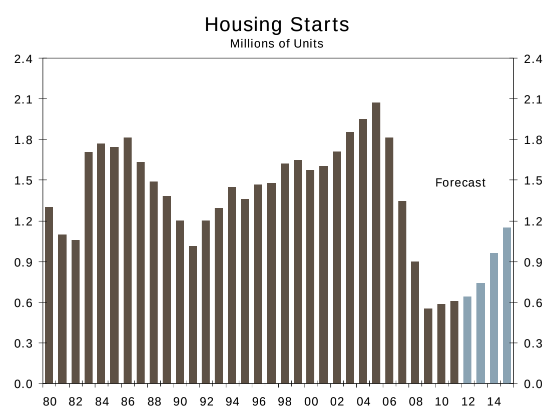


Figure 4



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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[1] **See, *Vacancies and The Housing Recovery: We Still Have Quite a Way to Go*, which is available at: www.wellsfargo.com/economics.**

National Housing Outlook

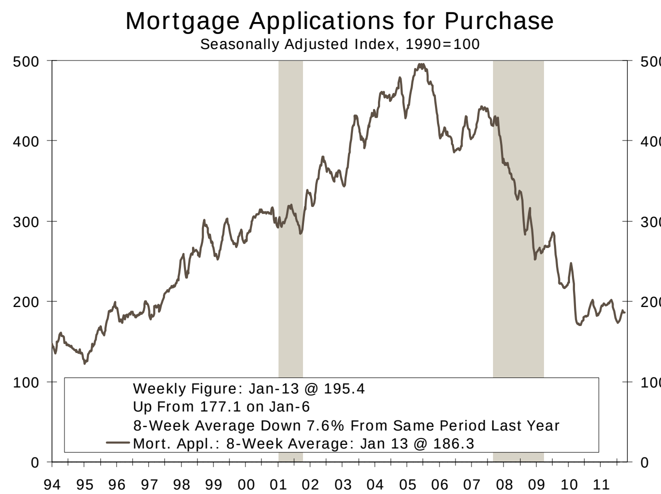
					Forecast	
	2008	2009	2010	2011	2012	2013
Real GDP, percent change	-0.4	-3.6	3.0	1.8	2.0	1.7
Nonfarm Employment, percent change	-0.6	-4.4	-0.7	1.0	0.9	1.0
Unemployment Rate	5.8	9.3	9.6	9.1	9.4	9.2
Home Construction						
Total Housing Starts, in thousands	900.0	554.0	586.9	606.8	665.0	770.0
Single-Family Starts, in thousands	616.3	442.4	471.2	428.6	460.0	525.0
Multi-Family Starts, in thousands	283.7	111.6	115.7	178.2	205.0	245.0
Home Sales						
New Home Sales, Single-Family, in thousands	485.0	375.0	323.0	302.0	325.0	360.0
Total Existing Home Sales, in thousands	4105.8	4334.0	4181.5	4264.0	4480.0	4620.0
Existing Single-Family Home Sales, in thousands	3655.0	3870.0	3707.5	3787.0	3970.0	4090.0
Existing Condominium & Townhouse Sales, in thousands	450.8	464.0	474.0	477.0	510.0	530.0
Home Prices						
Median New Home, $ Thousands	232.1	216.7	221.8	225.8	222.0	225.0
Percent Change	-4.8	-6.6	2.4	1.8	-1.7	1.4
Median Existing Home, $ Thousands	197.2	172.5	172.9	166.1	162.5	162.0
Percent Change	-9.2	-12.5	0.2	-3.9	-2.2	-0.3
FHFA (OFHEO) Home Price Index (Purch Only), Pct Chg	-7.4	-5.2	-3.0	-4.1	-2.0	-0.2
Case-Shiller C-10 Home Price Index, Percent Change	-16.7	-12.9	2.1	-3.4	-2.8	-0.4
Interest Rates - Annual Averages						
Prime Rate	4.88	3.25	3.25	3.25	3.25	3.25
Ten-Year Treasury Note	3.66	3.26	3.22	2.67	2.28	2.60
Conventional 30-Year Fixed Rate, Commitment Rate	6.04	5.04	4.69	4.39	4.20	4.30
One-Year ARM, Effective Rate, Commitment Rate	5.18	4.71	3.78	3.00	3.10	3.20

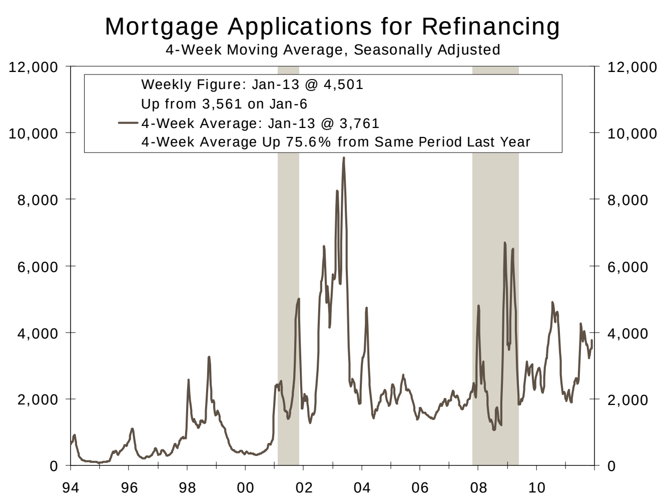
Forecast as of: January 31, 2012

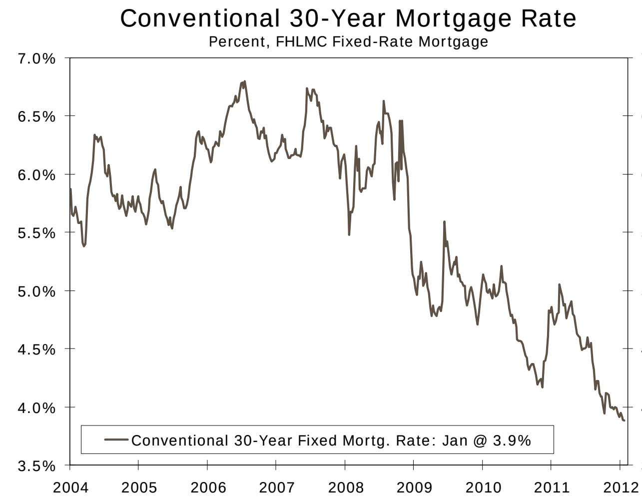
Source: Federal Reserve Board, FHFA, MBA, NAR, S&P, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

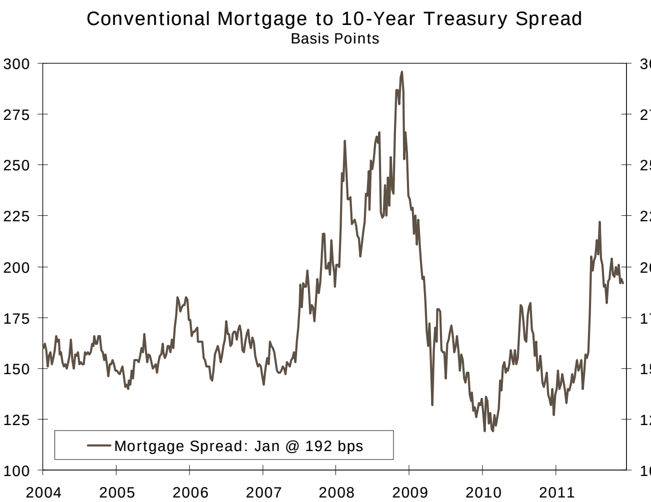
Mortgages

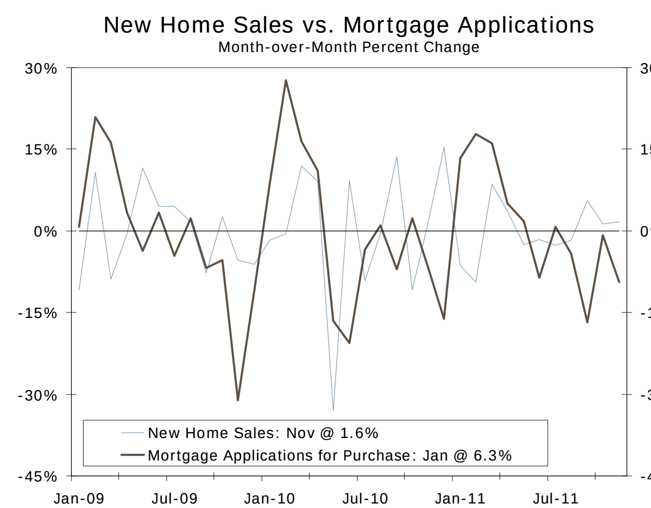
- Mortgage rates continue to trend lower, with the rate on the 30-year fixed mortgage below 4 percent. The spread between mortgage rates and Treasury yields remains high, implying mortgage rates may fall further if historical trends hold. This elevated spread results from lower rates on the 10-year Treasury note, stemming from investors' ongoing concerns about the European sovereign debt crisis.
- Mortgage refinancing activity has picked up. Since October, mortgage applications for refinancing have increased by more than 30 percent. Much of the pickup is likely due to lower mortgage rates as well as recent changes to the Home Affordable Refinance Program, aimed at allowing more underwater homeowners to refinance.
- Mortgage purchase applications remain weak, held back by sluggish job and income growth.









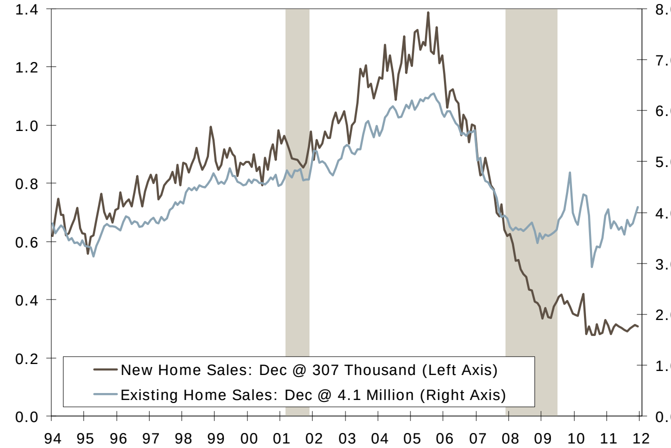


Source: Mortgage Bankers Association, FHLMC, U.S. Department of Commerce and Wells Fargo Securities, LLC

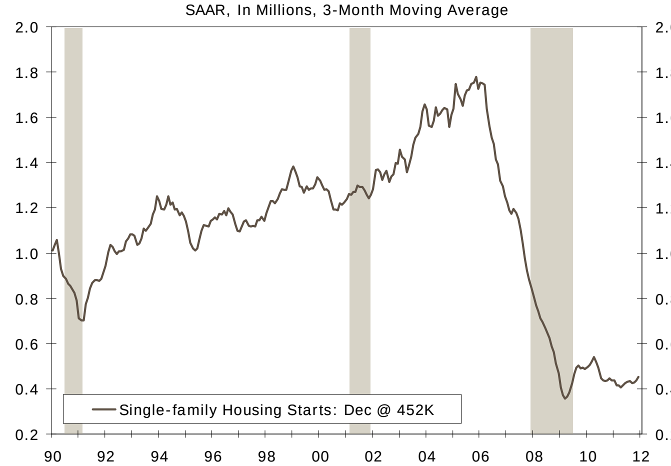
Single-Family Construction

- Single-family housing starts registered their lowest level on record in 2011, as the oversupply of existing homes continues to compete with new construction. The latest data suggest the inventory of existing homes is around 2.4 million units and the shadow inventory, which includes homes in the foreclosure process and homes 90 days or more delinquent, is around 1.6 million units. That said, with the supply of homes far surpassing demand, home prices have continued to drift lower. We expect single-family starts to rise modestly in 2012.
- Builder confidence continued to improve in January and has now increased for the fourth-consecutive month, according the NAHB/Wells Fargo Housing Market Index. The level, however, remains well below its long-run rate, as builders continue to contend with deeply discounted existing homes.

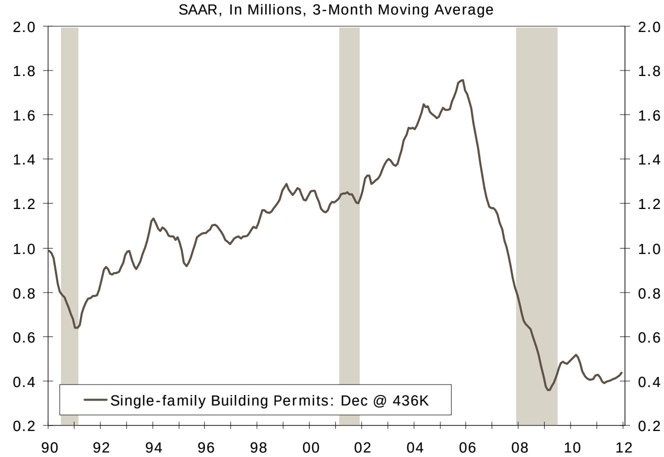
Existing & New Single-Family Home Sales
In Millions, Seasonally Adjusted Annual Rate



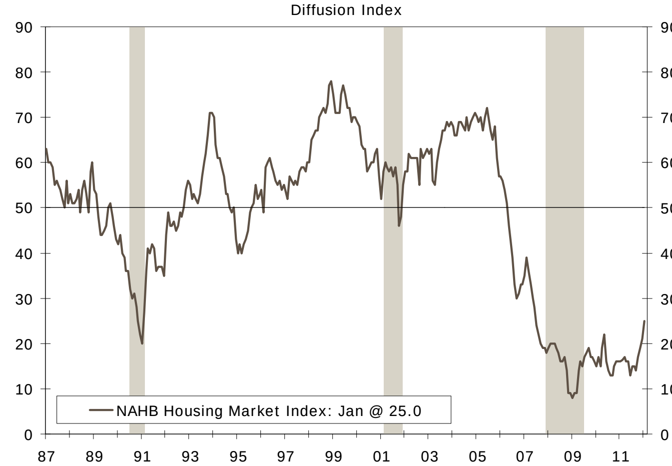
Single-Family Housing Starts
SAAR, In Millions, 3-Month Moving Average



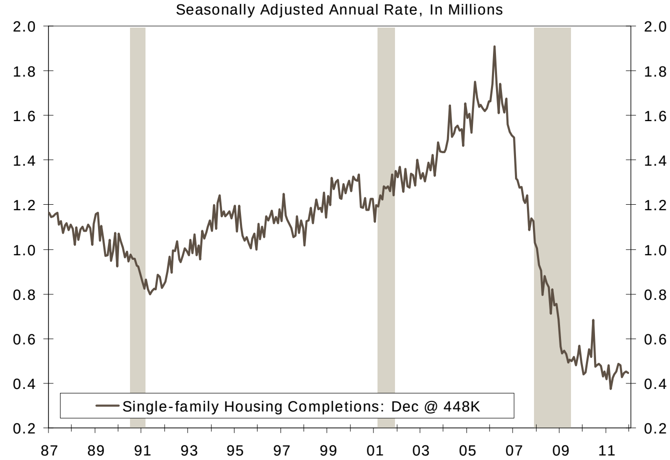
Single-Family Building Permits
SAAR, In Millions, 3-Month Moving Average



NAHB/Wells Fargo Housing Market Index
Diffusion Index



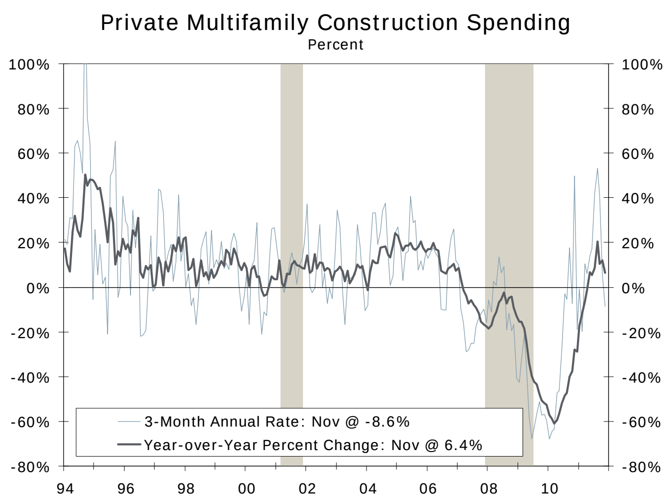
Single-Family Housing Completions
Seasonally Adjusted Annual Rate, In Millions

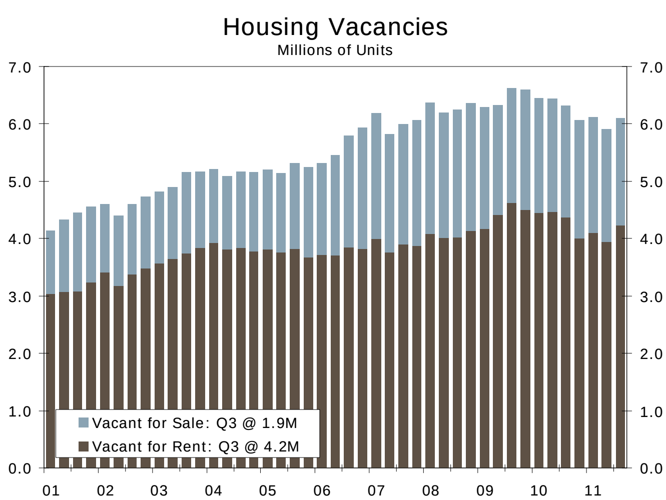


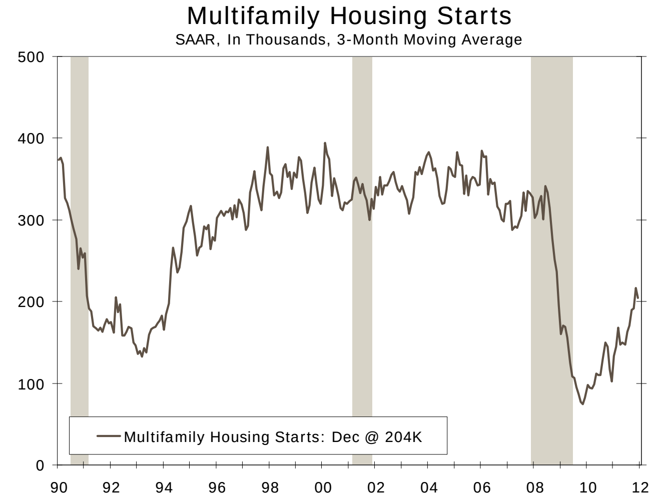
Source: National Association of Home Builders (NAHB), U.S. Dept. of Commerce, NAR and Wells Fargo Securities, LLC

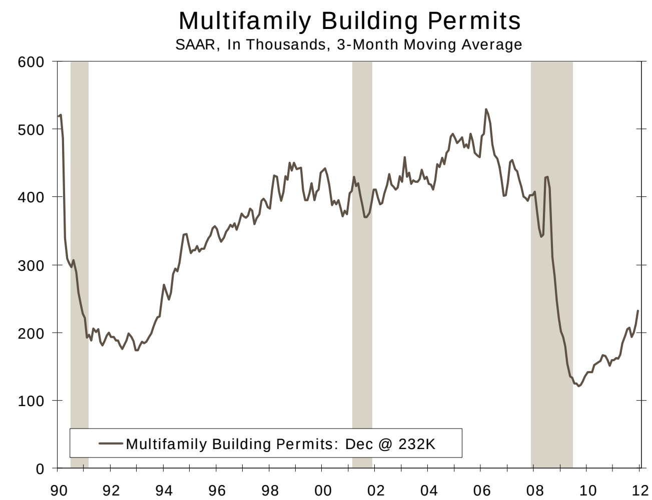
Multifamily Construction

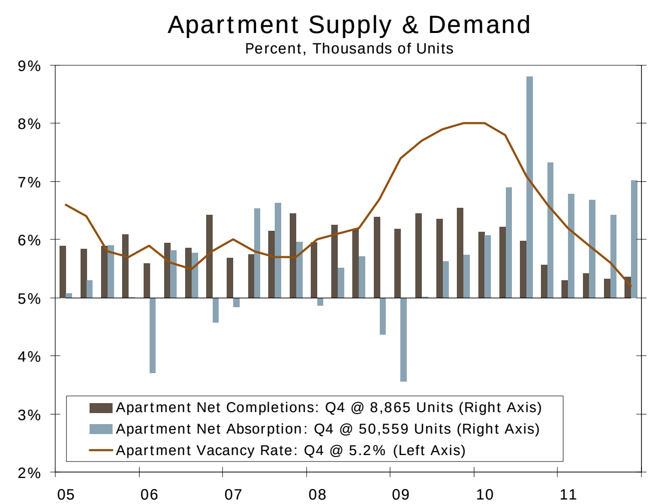
- Multifamily construction continues to outperform other property types due in large part to strong apartment demand. Despite the moderate pace of the economic recovery, net absorption continued to outpace completions for the seventh consecutive quarter. Vacancy rates for apartments have now fallen 1.4 percentage points over the past year to 5.2 percent, and rents have increased 2.4 percent.
- With few completions over the past two years, construction activity will continue to ramp up to meet demand. Multifamily starts are now up 78 percent over the past year and permits have risen 27 percent. With permits still running slightly ahead of starts, we expect further improvement in the coming months. Our outlook in terms of multifamily starts is for a 15 percent increase in 2012.







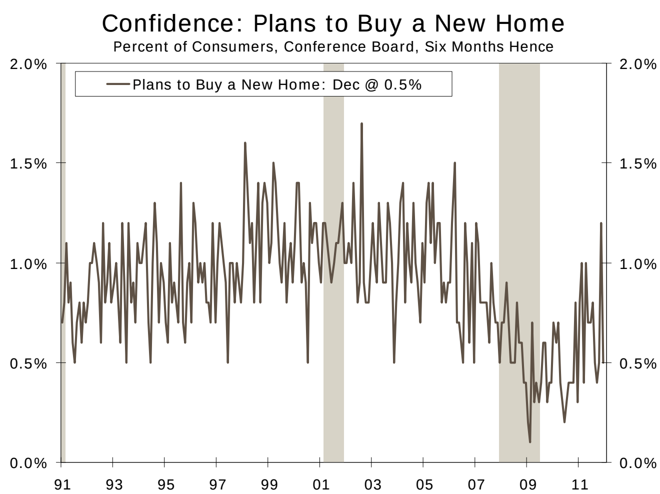


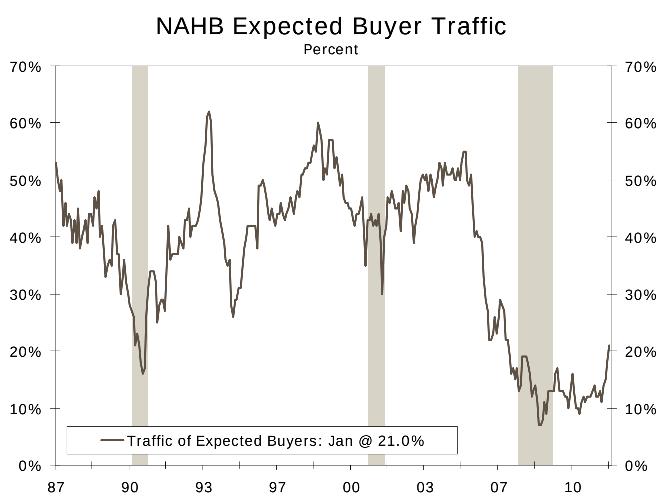


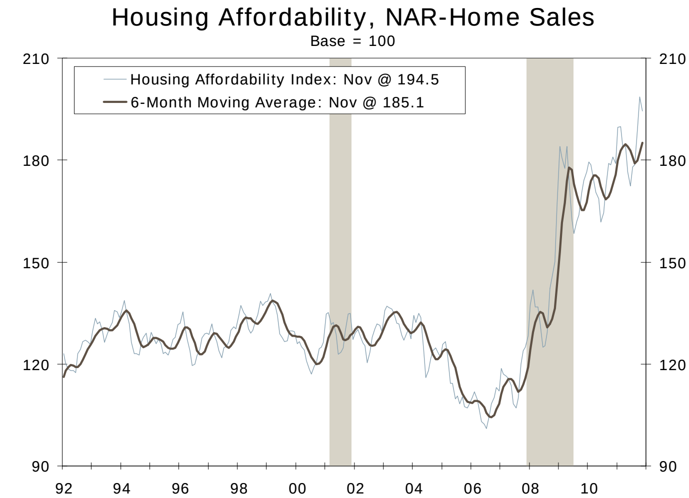
Source: U.S. Department of Commerce, REIS Inc. and Wells Fargo Securities, LLC

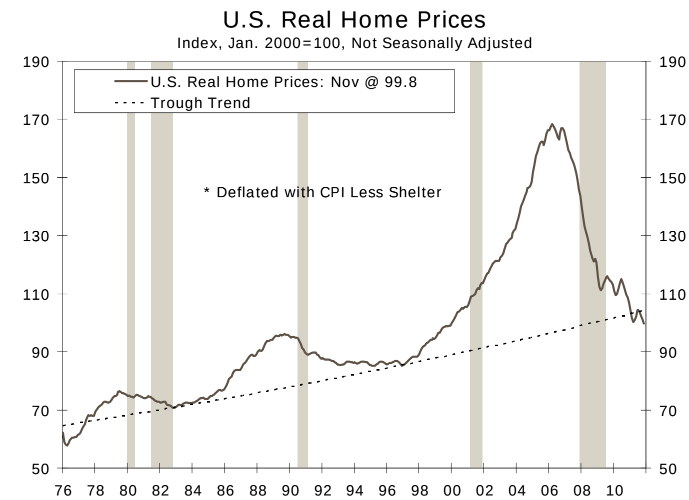
Buying Conditions

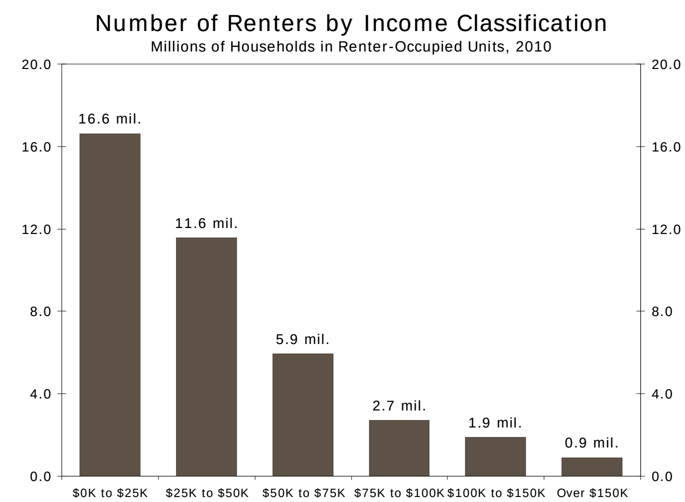
- With mortgage rates and home prices continuing to fall, affordability continues to rise. In real terms, home prices are now below their two-cycle trough trend, implying that it is now cheaper to purchase a home than at any point in the past three decades.
- Rising affordability has lifted buyer sentiment. The NAHB expected buyer traffic index rose 3 percentage points in January to 21 percent, the highest level since June 2007. That said, new home purchases remain tepid. New home sales ended 2011 on a weak note, falling 2.2 percent in December.
- Despite very favorable buying conditions, would-be buyers continue to choose renting over buying. Many of today's new householders are young and earn a relatively low income. Historically, low-income earners choose renting over buying. This trend has been particularly true in the current cycle.







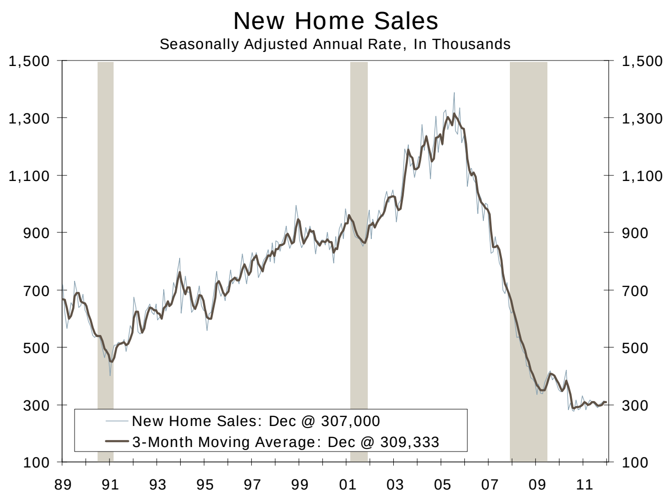


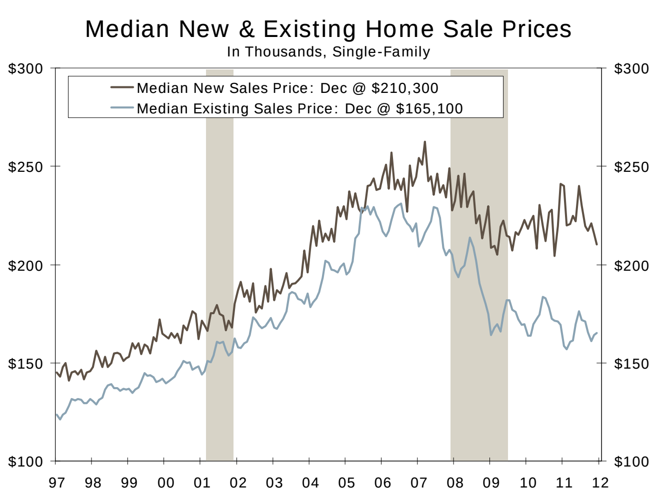


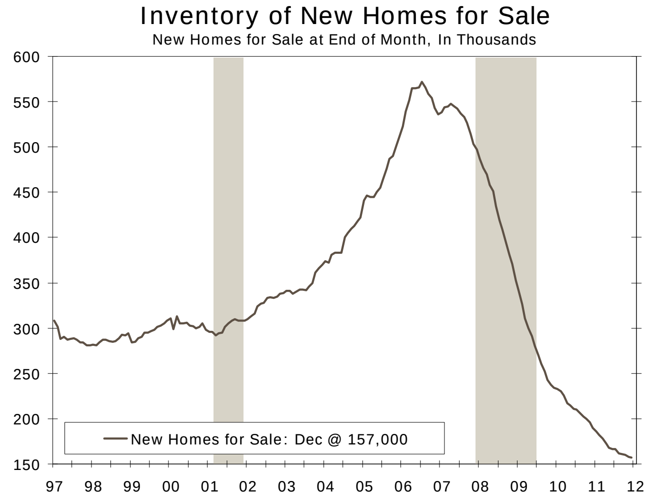
Source: U.S. Department of Commerce, NAHB, NAR, The Conference Board and Wells Fargo Securities, LLC

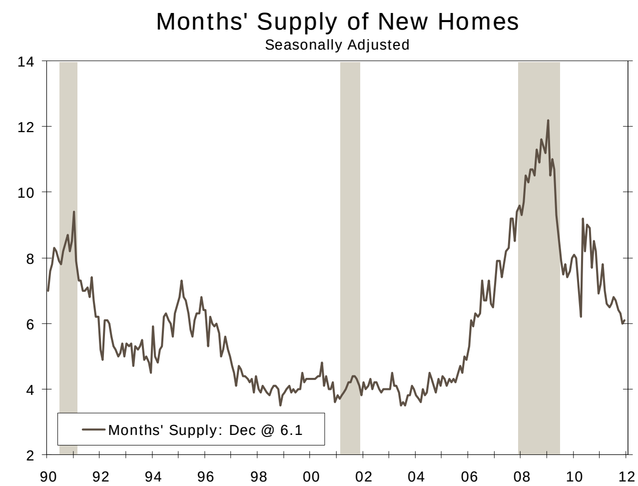
New Home Sales

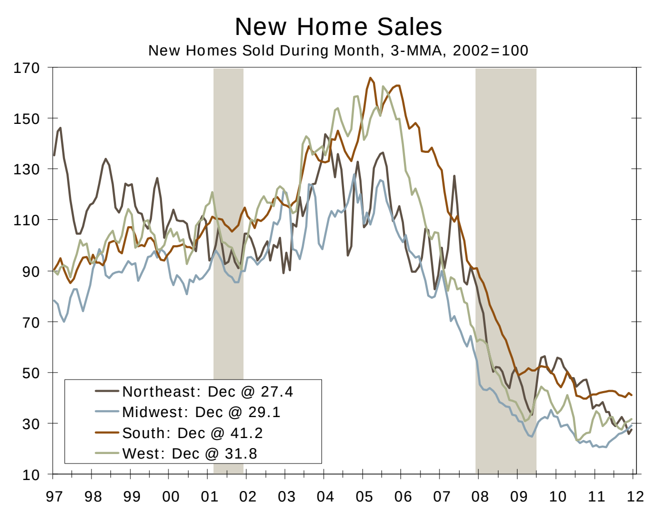
- Following three straight monthly gains, new home sales fell 2.2 percent in December to a 307,000-unit pace. We have written on numerous occasions that the recent improvement in the monthly series have been somewhat overblown. Much of the previous gains can be explained by temporary unsustainable factors—namely an exaggeration in activity due to the seasonal adjustment process and unseasonably mild weather.
- With new home sales still bouncing along the bottom, activity registered its lowest level on record in 2011, with just 302,000 homes sold. While it may be too soon to count our eggs before they hatch, modest improvement in the labor market and income gains could help boost sales in 2012. However, a meaningful increase will likely not occur until the slide in existing home prices dissipates.







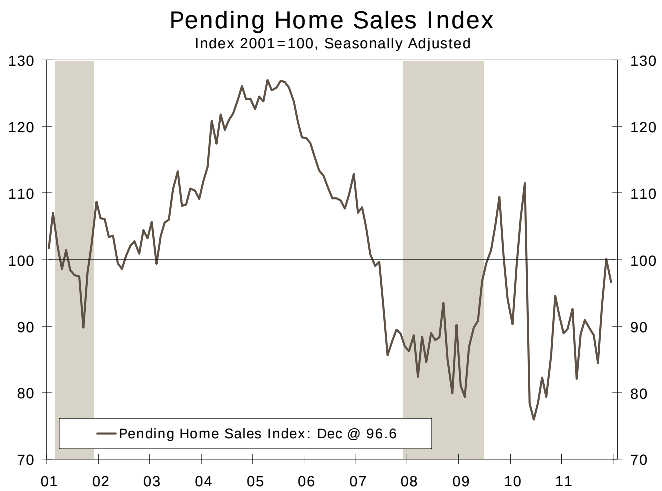


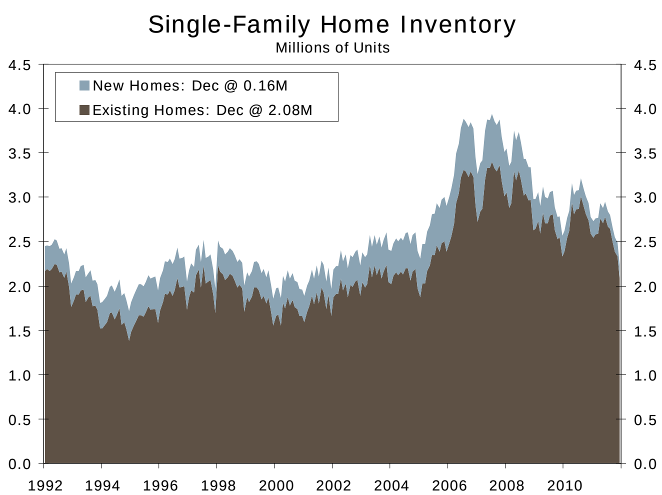


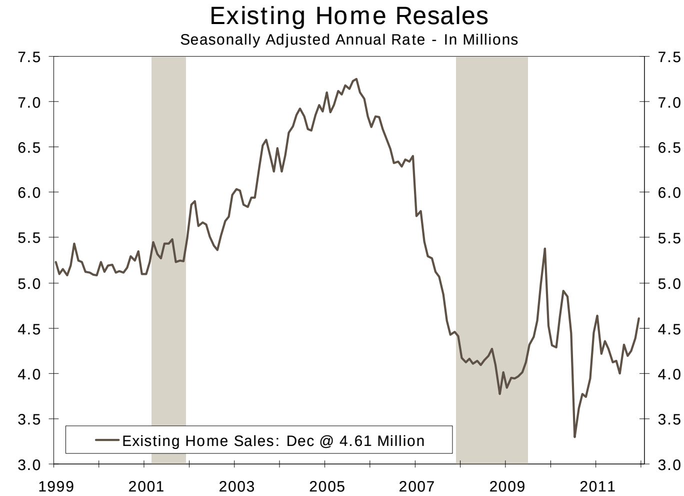
Source: U.S. Department of Commerce, NAR and Wells Fargo Securities, LLC

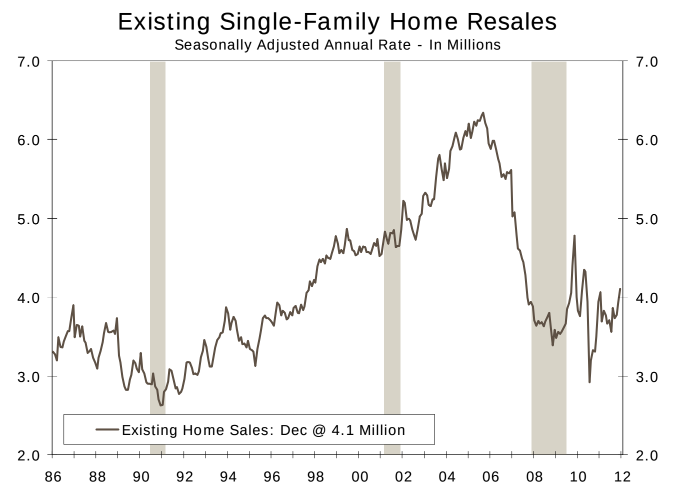
Existing Home Sales

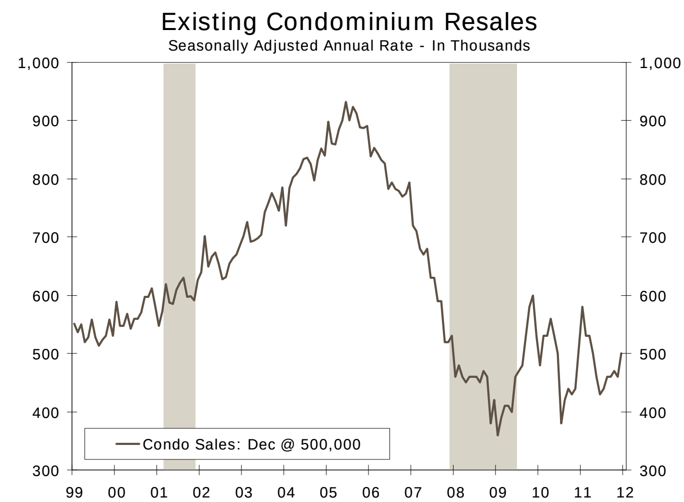
- Existing home sales have increased in each of the past three months, but remain stuck in low gear. Seasonal factors may also be behind much of the increase in existing sales. Milder than usual weather is also helping. Investors are still active in many long-depressed markets, with all-cash transactions accounting for 21 percent of sales in December.
- Reflecting rejected mortgage applications and weak appraisals, the NAR reported that a record 33 percent of contracts were canceled in December, which represents another formidable hurdle.
- Distressed transactions still comprise a significant portion of total sales, at 32 percent, which suggests home prices will remain under pressure.
- The inventory of single-family homes available for sale ended the year at 2.38 million units.









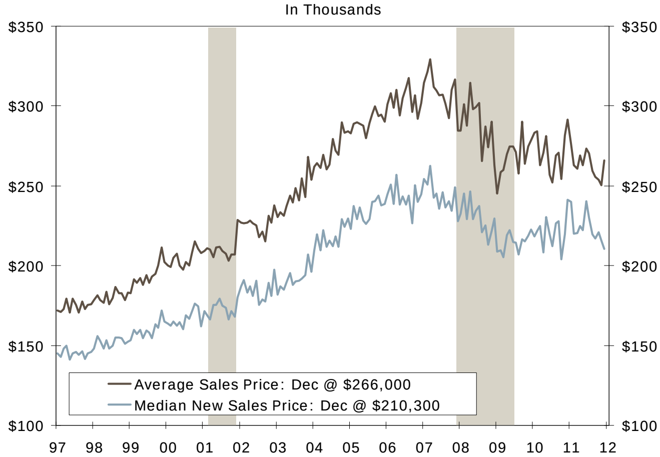


Source: National Assoc. of Realtors and Wells Fargo Securities, LLC

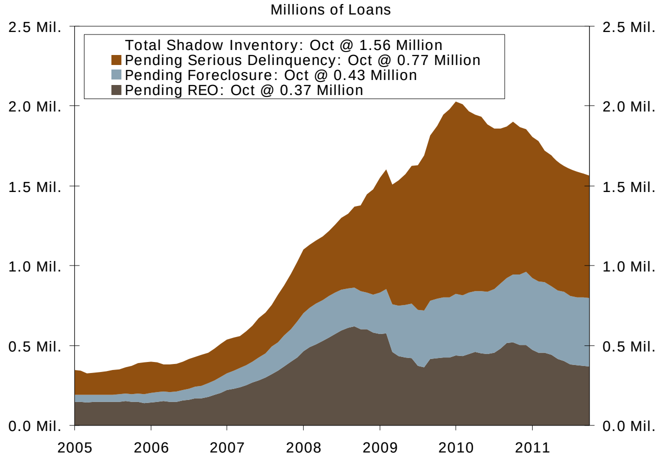
Home Prices

- Home prices will likely continue to come under pressure this winter, as more foreclosures come on the market during the seasonally slow period. According to CoreLogic, home prices including distressed sales declined 4.3 percent on a year-ago basis in November. Excluding distressed sales, home prices fell only 0.6 percent.
- The pipeline of troubled single-family homes has improved, but still remains elevated. Shadow inventory of single-family homes fell to 1.6 million units in November from 1.9 million units a year ago. Of the 1.6 million properties, nearly 50 percent are seriously delinquent and almost 30 percent are in some stage of foreclosure. On a regional basis, Florida, California and Illinois account for more than a third of the shadow inventory.

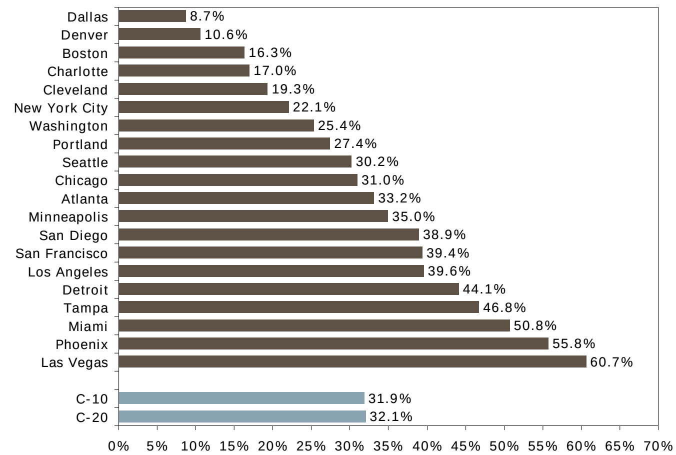
Average and Median New Home Sale Price
In Thousands



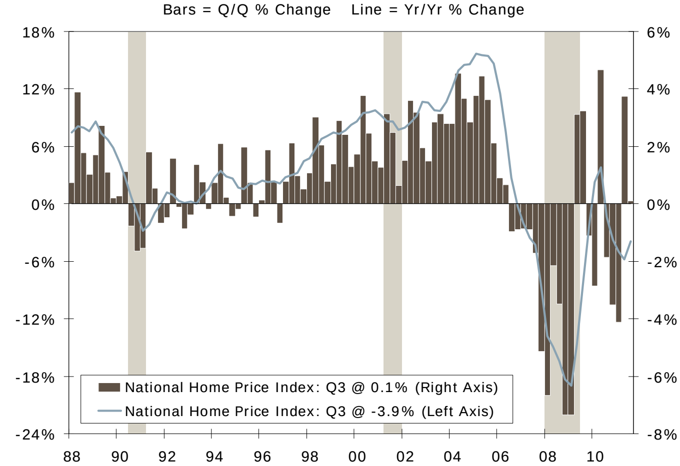
Total Shadow Inventory
Millions of Loans



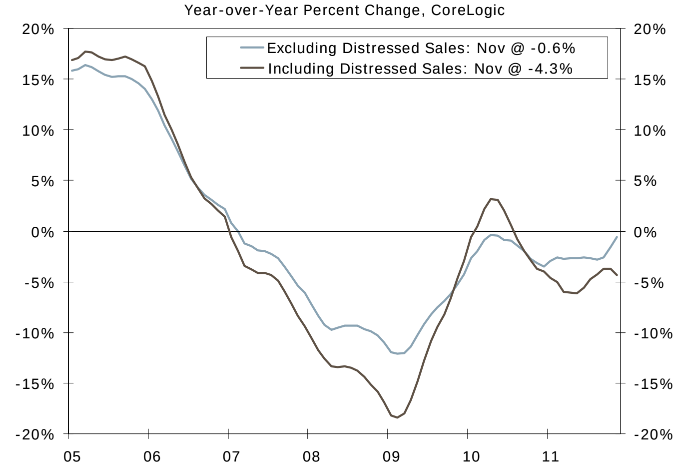
S&P Case-Shiller Home Prices
Percent Decline from Local Market Peak



S&P Case-Shiller National Home Price Index, NSA
Bars = Q/Q % Change Line = Yr/Yr % Change



Impact of Distressed Sales on Home Prices
Year-over-Year Percent Change, CoreLogic

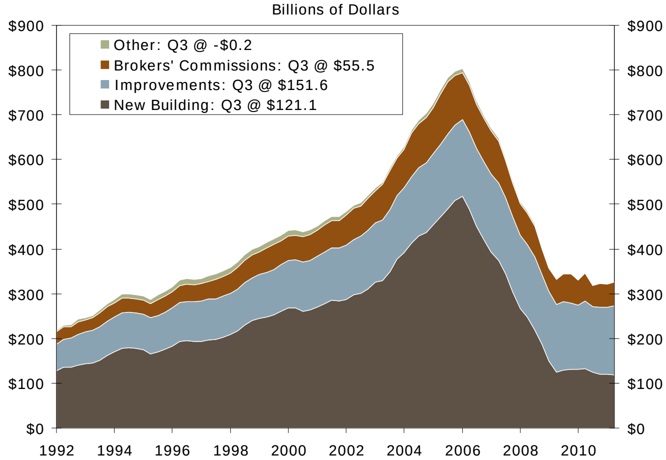


Source: CoreLogic, NAR, S&P Corp, U.S. Department of Commerce and Wells Fargo Securities, LLC

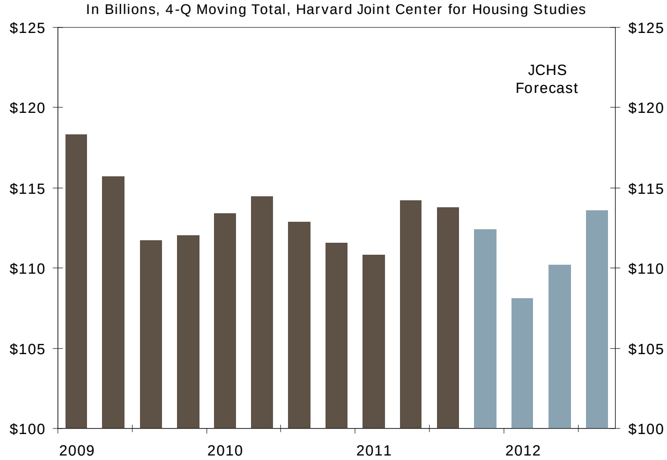
Renovation & Remodeling

- The Joint Center for Housing Studies (JCHS) at Harvard University recently released its forecast for remodeling activity out through Q3 2012. The JCHS forecast shows remodeling activity pulling back in the first half of the year, then picking up in the second half. Researchers at the JCHS cited gradually improving housing market fundamentals, especially increased financing opportunities for remolding projects, as the driver behind the improved forecast.
- Remodeling activity continues to be driven by practicality and maintenance needs, as opposed to remodeling for higher investment returns. Bathroom upgrades and roof replacements are the most common projects.
- According to Hanley Wood, the best performing markets for remodeling include Austin, Dallas, Houston, Kansas City and Oklahoma City.

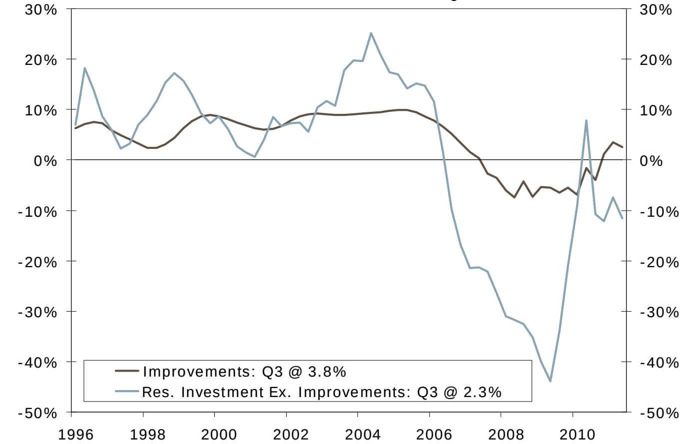
Residential Investment
Billions of Dollars



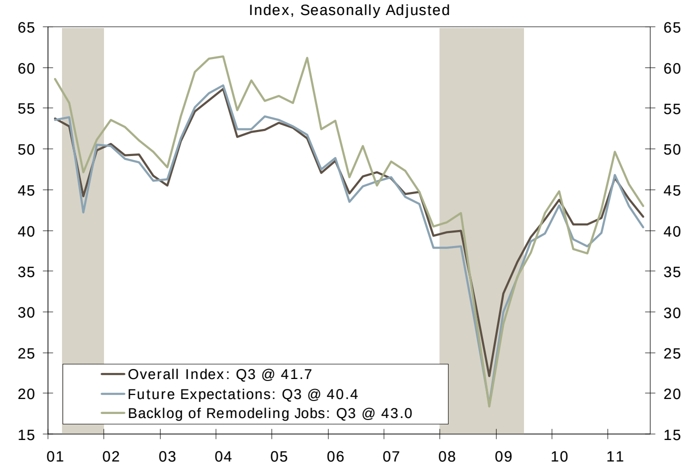
Leading Indicator of Remodeling Activity
In Billions, 4-Q Moving Total, Harvard Joint Center for Housing Studies



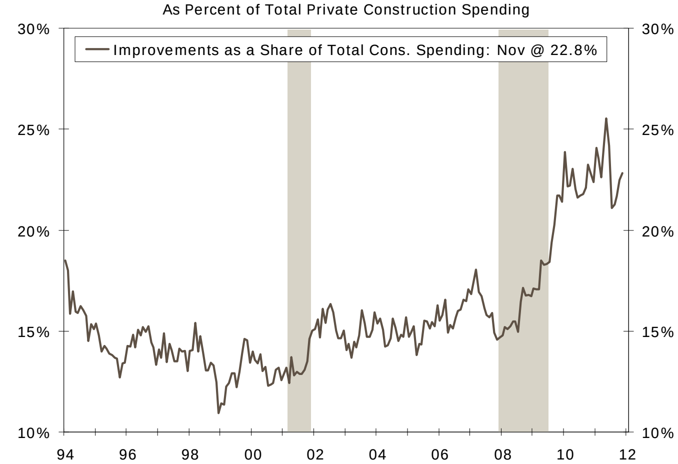
Residential Investment
Year-over-Year Percent Change



NAHB Remoldeling Market Index
Index, Seasonally Adjusted



Improvements' Share of Total Cons. Spending
As Percent of Total Private Construction Spending

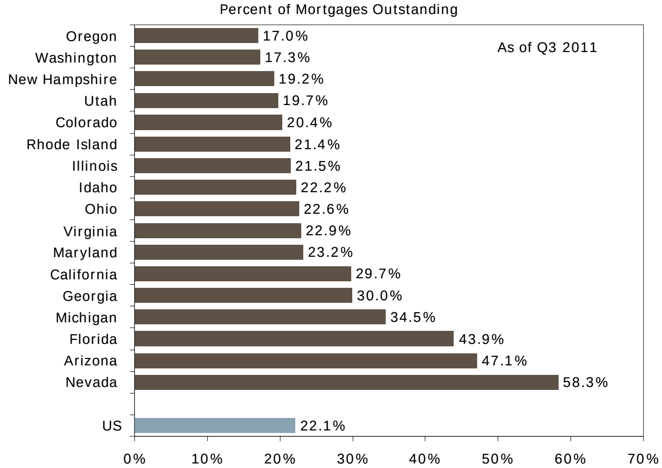


Source: Joint Center for Housing Studies, U.S. Department of Commerce and Wells Fargo Securities, LLC

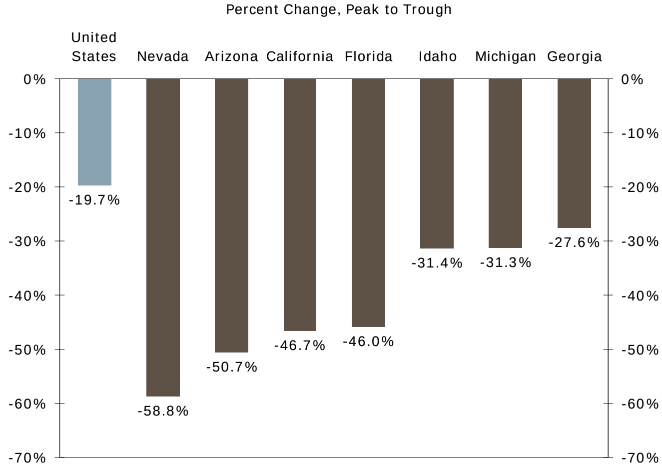
Regional Housing Trends

- While single-family building permits fell 7.4 percent nationally in 2011, recently released metro-level data showed that many areas experienced respectable gains in permits last year. The chart to the right shows the MSAs in which single-family construction permits grew the fastest in 2011. Surprisingly, many of the areas hit hardest by the housing bust saw an impressive rebound in permits (albeit from severely depressed levels), including many MSAs in Florida, Michigan and the Carolinas.
- We believe it is still way too early to get too excited about a recovery in the housing sector. Much of the recent rebound reflects builders completing partially built out developments, often where land prices have fallen substantially. There has also been a slight boost in a handful of in-fill locations. Large scale development is still pretty rare these days.

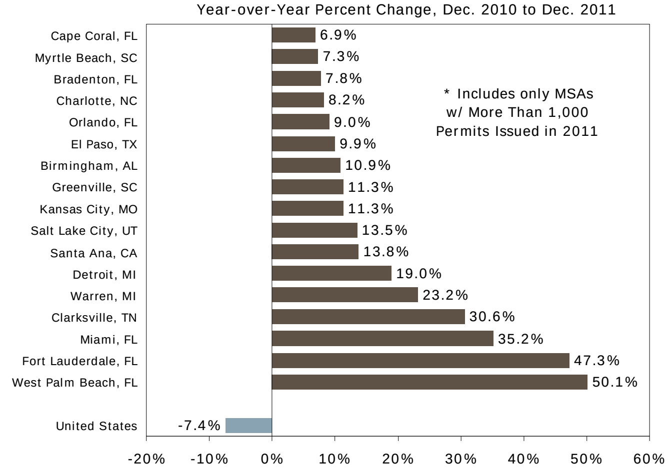
Negative Equity Mortgages - By State
Percent of Mortgages Outstanding



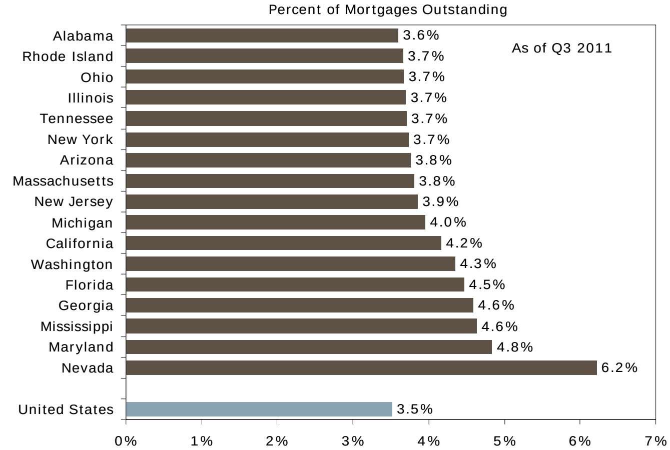
FHFA/OFHEO Home Price Index - By State
Percent Change, Peak to Trough



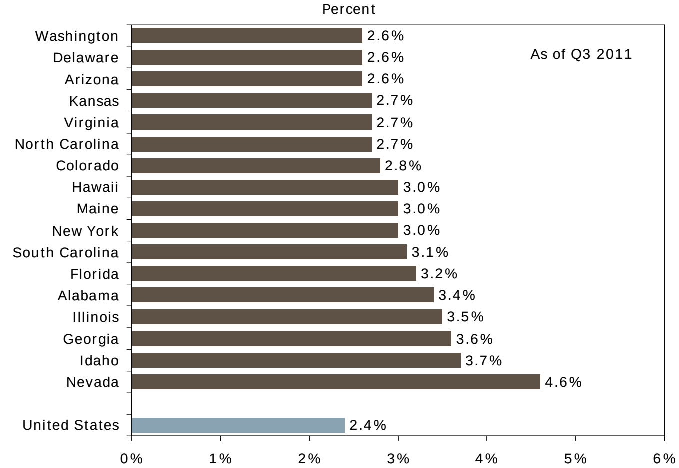
Single-Family Building Permits - By MSA
Year-over-Year Percent Change, Dec. 2010 to Dec. 2011



Mortgages 90+ Days Delinquent - By State
Percent of Mortgages Outstanding



Homeowner Vacancy Rate - By State
Percent



Source: FHFA, CoreLogic, Mortgage Bankers Association, U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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