

## FOCUS

October 2011

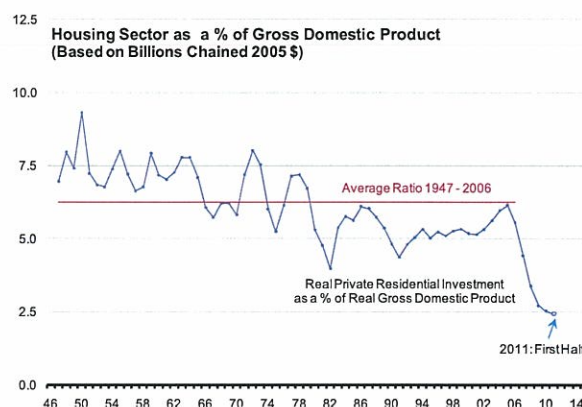
## Housing: A Blurred Horizon

The missing ingredient in the recovery from the worst recession since the Great Depression is a rebound in housing. We all know that housing will recover when all the pieces fall in place for a release of considerable pent-up demand. However, at this point, visibility as to when that will happen remains clouded—a condition exacerbated by recent U.S. and global shocks to confidence. For now, housing activity generally remains in a bottoming mode, with the multi-family sector showing a recovery that is getting traction and home improvements drifting up very gradually and unevenly. Home sales, new single-family-home construction and home prices show stabilization, while most leading indicators of housing demand are flattish and could potentially be pressed lower in the near term. Sustained job growth is paramount, given so much excess supply still to be absorbed, and the recent slowing in employment threatens to prolong that process. The Federal Reserve Board's Operation Twist helps, but there is growing recognition that mortgage-market problems have stymied the impact of record-low interest rates, so other forms of intervention are being discussed in Washington as politicians eye the 2012 presidential election.

## HOUSING IN CONTEXT

It helps to begin by putting current housing activity in perspective. Relative to the overall economy, as measured by real or inflation-adjusted private residential fixed investment as a percentage of real gross domestic product (GDP), housing is at historically low levels, as Exhibit 1 shows. The first half of 2011 is running just under 2.5% of GDP, compared to a historical average of 6.25%, suggesting not only limited downside but considerable pent-up demand to be visibly unleashed perhaps within three to five years. An eventual rebound from such deep underinvestment bodes well for a sustainable economic expansion, provided current financial market jitters don't culminate in a recession. Be it during the current expansion or a subsequent one, a true recovery in housing, when it comes, should constitute a powerful driving force.

## Exhibit 1: Considerable Pent-up Demand Bodes Well for an Eventual Recovery.



Source: Bureau of Economic Analysis/Haver Analytics.  
Data as of September 29, 2011.

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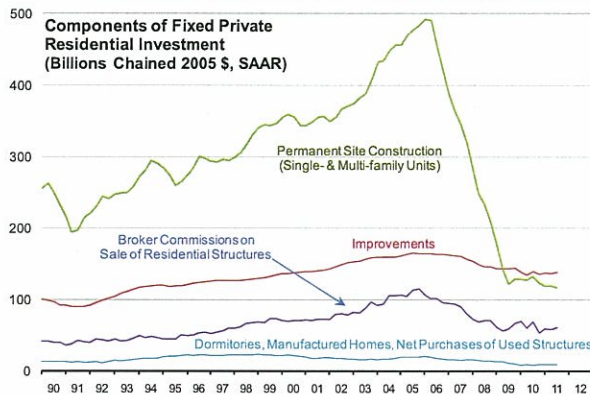
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It also helps to examine briefly where we are with respect to the three major components of private residential fixed investment, especially since two of them have become equally significant. As Exhibit 2 shows, the brutal decline in new construction of single and multi-family housing has left new construction at levels comparable to outlays for home improvements. From its peak in the fourth quarter of 2005 to date (the second quarter of 2011), real or inflation-adjusted permanent site construction has fallen by a staggering 76.3%. It stands at the lowest level on record (beginning in the first quarter of 1958). Although the second quarter marks the lowest point yet in this correction—and on record—note that since early 2009, such construction has been steady.

**Exhibit 2: Modest Improvement in Two Out of Three Major Segments.**



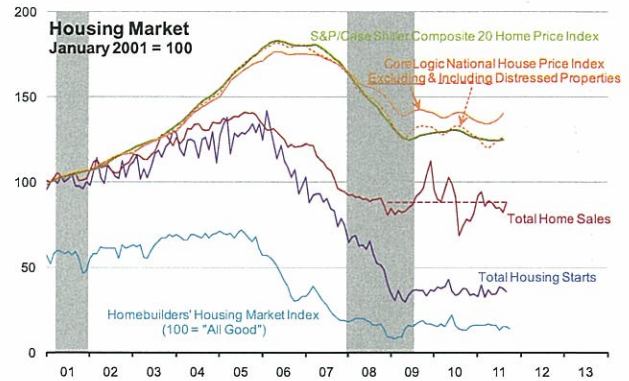
Source: Bureau of Economic Analysis/Haver Analytics.  
Data as of September 29, 2011.

Home improvements showed a sizable but comparatively smaller 18.7% decline from their peak in the second quarter of 2005 to their trough in the first quarter of 2010. In real terms, they have drifted up gradually and unevenly since then, and in the second quarter of this year they stood 2.8% above that trough. The third major component, broker commissions on the sale of residential structures, fell 53.5% from its peak in the third quarter of 2005 to its trough in the third quarter of 2010. After rising unevenly since then, in the second quarter broker commissions were 13.3% above their trough. On balance, housing may be in the doldrums, but some of its segments have improved, if only modestly.

## STABILIZATION CLOSE-UP

By nature, housing activity comprises a multitude of very localized markets, and it is no wonder that homebuilders and some analysts depict mini-pockets of strength here and there, especially after such a brutal correction. Viewed in the aggregate, however, housing activity is on a protracted stabilization path, as shown by various high-frequency indicators illustrated in Exhibit 3.

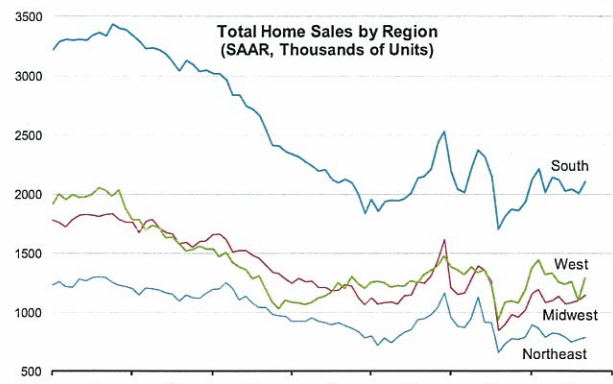
**Exhibit 3: Higher Sales and Prices Would Lift Homebuilder Spirits.**



Sources: Census Bureau; CoreLogic; National Association of Homebuilders; Standard & Poor's MBA/Haver Analytics.  
Data as of September 27, 2011.

Clearly, homebuilding activity and homebuilder sentiment are still generally quite depressed, even though, as we note below, the multi-family segment is reviving. The problem lies primarily in the excess of housing supply, which is concentrated in the larger, single-family segment including both new and existing homes. Nonetheless, home prices in general are stabilizing, whether including or excluding distressed properties. Note also in Exhibit 3 that, while total home sales have drifted down so far this year, they are running more or less in line with the average level since their recession lows (late 2008 to early 2009) and are well above the lows hit in mid-2010, when double-dip fears soared as the housing tax incentive program expired. *This speaks to some resilience despite all the negative headlines.*

**Exhibit 4: Home Sales Stabilization is Fairly Widespread.**



Source: Census Bureau/Haver Analytics.  
Data as of September 26, 2011.

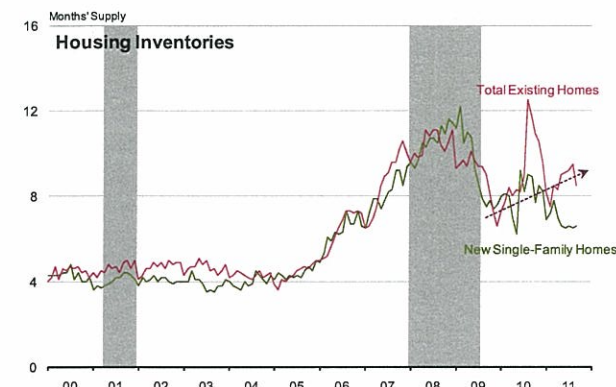
Indeed, as Exhibit 4 illustrates, regional data show stabilization in home sales is very broad-based, with the South and Northeast somewhat ahead of both their recession lows and mid-2010 lows and the West and Midwest ahead of their mid-2010 lows. *The underlying resilience thus seems fairly widespread.*



## THE ELEPHANT IN THE ROOM: EXCESS SUPPLY

What has brought new home construction to historic lows is the monumental excess supply of new and existing homes for sale that accumulated as home sales plummeted. Measures of excess supply show a gradual absorption of inventory under way, which should continue provided current global financial market turmoil does not induce a recession at home.

**Exhibit 5: Diverging Inventory Ratios.**

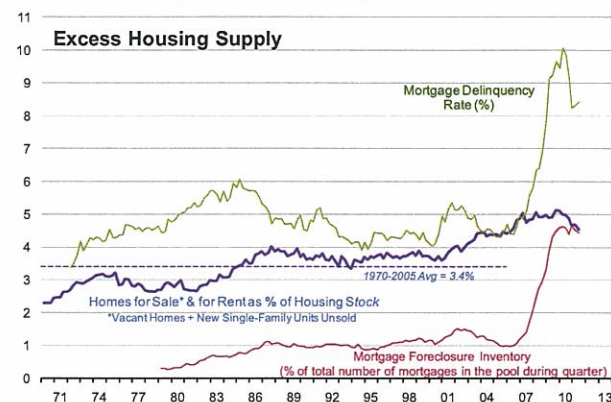


Sources: Census Bureau; National Association of Realtors/Haver Analytics.  
Data as of September 26, 2011.

Exhibit 5 illustrates inventories of new and existing homes in terms of the number of months of supply—that is, a ratio of monthly inventories to monthly sales. In both instances, inventories have come down from their respective peaks but are now diverging. Though not shown here, we note that the level of unsold, new single-family homes is at the lowest point on record dating back to 1963, with inventories down nearly 72% from their July 2006 peak. The staggering plunge in construction and stabilizing sales have helped, but the inventory ratio depicted in Exhibit 5 remains uncomfortably high. Unless sales pick up, this suggests some more downside to single-family-home construction even though single-unit building permits (see Exhibit 10), a near-term leading indicator, show a mild updrift since February.

As also shown in Exhibit 5, the inventory ratio for existing homes has come down but not as much as it has for newly built homes. In fact, the existing ratio shows an upward tendency throughout the extra volatility triggered over the last two years by the housing tax incentives. This is a function of lackluster home sales and an inventory of unsold homes that is being fed by the still-high rate of foreclosures shown in Exhibit 6.

**Exhibit 6: Hefty Foreclosure Rate Exacerbates Inventory Overhang.**



Note: The U.S. Census Bureau states that foreclosures may be in any of the housing stock categories: owner-occupied, renter-occupied, vacant for rent, vacant for sale, or "vacant other."

Sources: Census Bureau; Mortgage Bankers Association/ Haver Analytics.  
Data as of August 22, 2011.

While it is comforting that the mortgage delinquency rate has come down some and the mortgage foreclosure rate has leveled off, both are still in record-high territory, meaning the pipeline feeding the pool of inventories is far from thinning out (Exhibit 6). Particularly troubling, given the recent weakness in job growth, is the rise in the mortgage delinquency rate during the first half of this year, following successive quarterly declines during most of 2010. Potential additional increases in delinquency rates on the back of the expiration of the moratorium on foreclosures at year-end 2010 point to a sticky foreclosure rate at best.

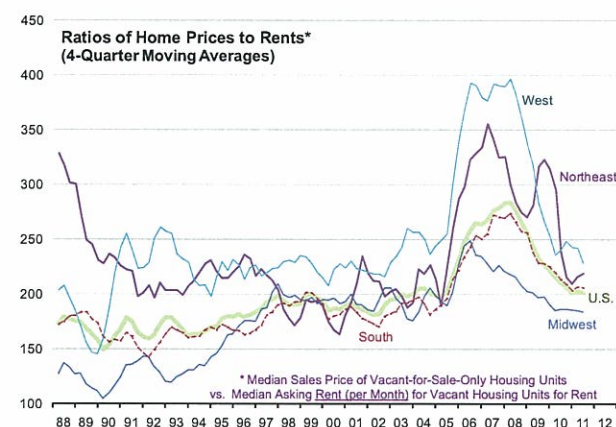
All this suggests slower progress over the medium term in the reduction of the overall excess supply of housing shown in Exhibit 6 (thick blue line). *These considerations make it difficult to envision a real recovery in home prices in the foreseeable future.*

## HOME PRICES IN PERSPECTIVE

A real recovery in home prices may take some time to materialize, but some measures of *relative* home prices suggest that prices have corrected to reasonable levels and there is limited downside, even if the apparent stabilization we have seen (Exhibit 3) gets derailed by current market turmoil. Exhibit 7 shows the swift correction in overblown home price-to-rent ratios for the four regions and for the U.S. as a whole. The national ratio is back down to where it was in 2004 – 2005, suggesting a healthier, more sustainable balance between prices and rents. Regionally, the Midwest and the West have made the most progress, while respective ratios for the Northeast and South are modestly above pre-2005 levels. This is consistent with the message in Exhibit 4, suggesting somewhat more resilience in home sales in the Northeast and South versus the West and Midwest.



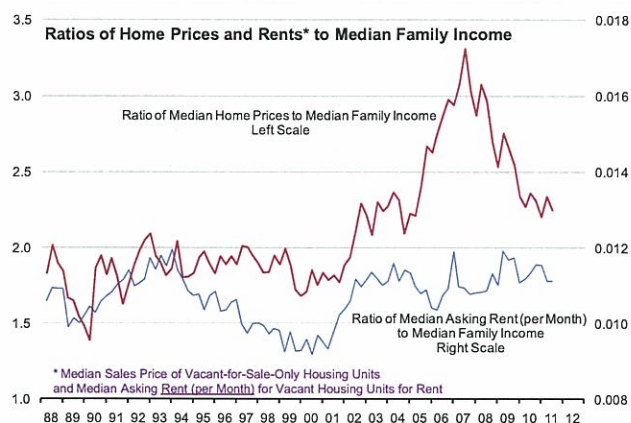
**Exhibit 7: Relative Home Prices Have Fallen Closer to Sustainable Levels.**



Source: Census Bureau Housing Vacancy Survey/Haver Analytics.  
Data as of July 29, 2011.

Exhibit 8 shows home prices and rents relative to income and here, too, the restoration of a healthier balance between home prices and incomes is evident. It is not clear, however, if this ratio will need to adjust to pre-2002 levels to be sustainable. In light of the current environment of murky visibility and heightened risk aversion, we would not be surprised to see this ratio drop further. In the meantime, rents are keeping up with incomes, so this ratio has been more or less steady.

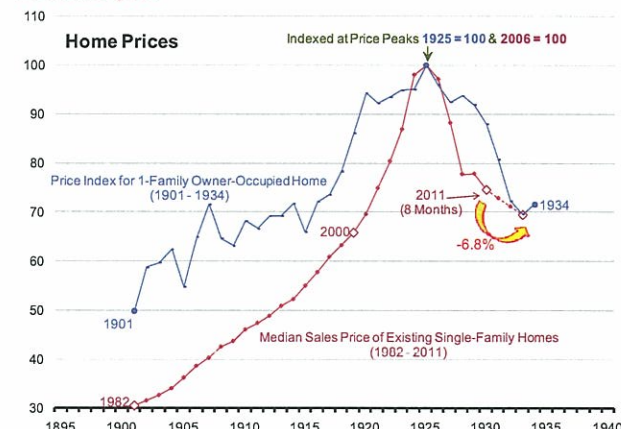
**Exhibit 8: Will the Home-Price-to-Income Ratio Need to Fall to Pre-2002 Levels to be Sustainable?**



Sources: Census Bureau; National Association of Realtors/ Haver Analytics.  
Data as of September 1, 2011.

In terms of potential downside to home prices, it helps to go back in time and compare the recent house price bubble with the one in the early part of the 20th century, as shown in Exhibit 9. With prices indexed at their respective annual peaks (1925 and 2006), it's clear that, while the recent price bubble was of shorter duration than the earlier one, the magnitudes of both the surge in prices and the correction are comparable.

**Exhibit 9: Remarkable Similarity Between Two Price Bubbles Nearly 100 Years Apart.**



Sources: National Association of Realtors; Historical Statistics of the U.S./Haver Analytics.  
Data as of September 21, 2011.

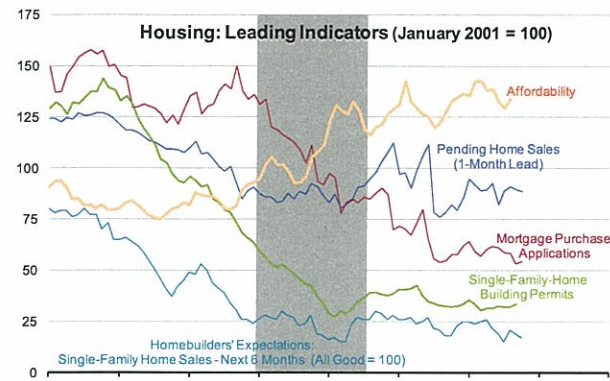
Some analysts and economists anticipate a further 10% decline in home prices, a prospect whose probability has grown in light of current financial market convulsions and heightened uncertainty about the economic outlook. If home prices were to hit a bottom comparable to that hit in 1933, prices would have to fall by a further 6.8%, which is not inconceivable if current turmoil persists. *A 5% to 10% decline could occur over a shorter period of time than the three-year span plotted in Exhibit 9.*

Considering that prices have fallen 25.5% from their annual peak, an additional 6.8% decline from 2011 would match the total peak-to-trough decline of 30.5% from 1925 to 1933. These calendar-year comparisons mask the fact that we are actually closer to a 30% decline, as existing single-family home prices have fallen 27.1% from their July 2006 peak through August 2011.

## LEADING INDICATORS OF HOUSING: MIXED

Leading indicators of housing activity for the near and medium terms are generally lackluster, with the exception of housing affordability (Exhibit 10), which is in record-high territory—and likely to remain so with help from the impact of the Federal Reserve's Operation Twist on mortgage interest rates. Conventional 30-year fixed mortgage rates are already at record lows—they slipped just below 4% in early October.

**Exhibit 10: Affordability in Record-high Territory; Other Leading Indicators Lackluster.**

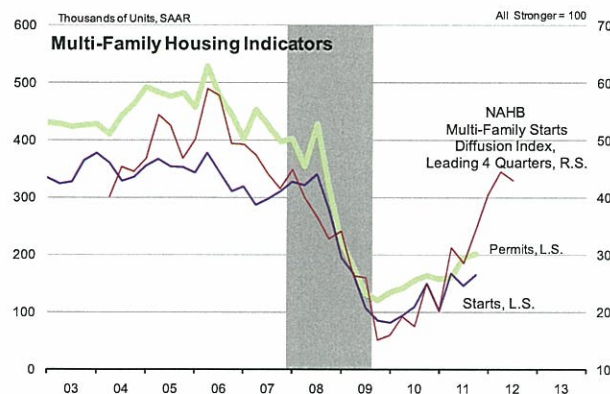


Sources: Census Bureau; National Association of Realtors; National Association of Home Builders; Mortgage Bankers Association/Haver Analytics.  
Data as of October 5, 2011.

It's possible that mortgage applications for purchase have begun bottoming, which would be welcome. Yet, it is important to keep in mind that though purchase applications are a reliable leading indicator of home sales, these days nearly 30% of existing home sales are all-cash purchases, with investors accounting for the bulk of these transactions, according to the National Association of Realtors report for August. In terms of home construction, the slight firming in single-family building permits is reassuring, but sagging homebuilder expectations for sales in the next six months inject caution, especially in light of potentially more downward pressure on all home prices coming from foreclosures.

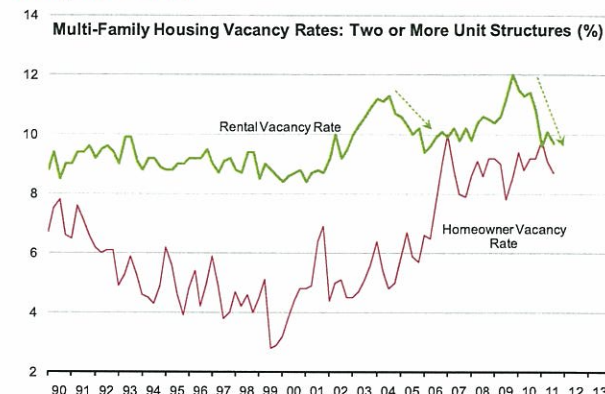
*One bright light emanates from the multi-family sector, where new construction is gathering some traction and leading indicators, including new permits, signal more upside (Exhibit 11). It is also worth noting that the backlog of multi-family permits (authorized units not yet started) is building up, in contrast to that for single-family units, which is drifting down. Falling rental vacancy rates shown in Exhibit 12 and firming rents add support.*

**Exhibit 11: Multi-family Construction Gathering Traction.**



Sources: Census Bureau; National Association of Home Builders/Haver Analytics.  
Data as of September 20, 2011.

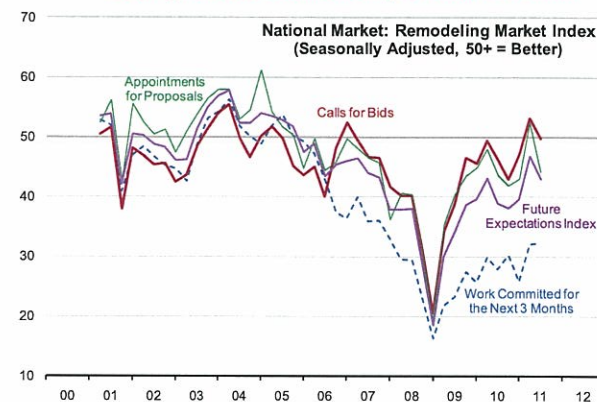
**Exhibit 12: Current Decline in Rental Vacancy Rate Steeper than During 2004 – 2005.**



Source: Census Bureau/Haver Analytics.  
Data as of July 29, 2011.

The home-improvements segment looks a little challenged in the near term, as suggested by various leading indicators from the National Association of Home Builders shown in Exhibit 13. It is not surprising that, with softer job growth and concern about the economic/jobs outlook, outlays for home improvement are hesitating, we hope, temporarily.

**Exhibit 13: Leading Indicators of Home Improvements Hesitate.**

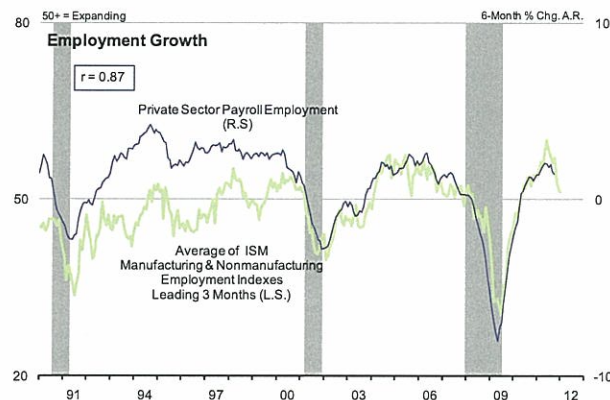


Source: National Association of Home Builders/Haver Analytics.  
Data as of July 28, 2011.

In the end, it all boils down to solid, sustained job growth, which is critical for a sustainable economic recovery and the eventual lifting of all boats, including residential investment. At this point, weak employment reports add to uncertainty, especially when a key leading indicator of near-term job growth is signaling some deceleration (Exhibit 14). Nonetheless, strikes and flooding from Hurricane Irene have temporarily exacerbated labor-market weakness and their fading impact should lift some uncertainty in coming months.



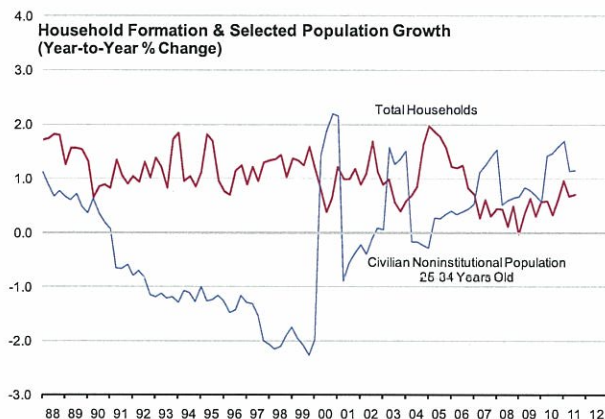
**Exhibit 14: Near-term Leading Indicator of Job Growth Signals Deceleration.**



Sources: Institute for Supply Management; Bureau of Labor Statistics/Haver Analytics. Data as of October 7, 2011.

Lastly, the behavior of two longer-term leading indicators (Exhibit 15) is consistent with the accumulation of pent-up demand and thus with an eventual significant recovery in housing demand. The segment of the population most likely to become first-time home buyers is growing at a healthy pace—all it needs is sustained job/income growth—and household formation is also picking up. However, we are told that at any given time the household formation estimates for the two most recent years tend to be flaky and subject to significant revision. The important thing is that growth in household formation is off its late-2008 lows.

**Exhibit 15: Two Longer-term Leading Indicators of Housing Demand Point in the Right Direction.**



Sources: Census Bureau; Bureau of Labor Statistics/Haver Analytics. Data as of September 2, 2011.

## CONCLUSION

A key ingredient still missing in this recovery is a rebound in housing. The good news is that housing activity is bottoming; the bad news is that a real recovery is not yet visible largely because of an inventory overhang of homes for sale, potentially exacerbated by the looming impact of a still-high rate of foreclosures—the so-called shadow inventory. This raises the risk of further downward pressure on home prices. However, various measures of *relative* home prices show prices have corrected closer to reasonable/sustainable levels, so the downside is limited.

The generally weak state of housing is getting more attention from policymakers as they position themselves for the 2012 Presidential election. Options under consideration include the conversion of distressed properties owned by government agencies into rental properties and the modification of the Home Affordable Refinance Program to remove obstacles to mortgage refinancing. Above all, political dysfunction anchored on pre-election posturing makes it difficult to be optimistic about any significant bipartisan agreement. *In the meantime, considerable pent-up demand is accumulating, suggesting that when a housing recovery comes, it is likely to become a growth leader.*

Nora C. Mirshafii

Senior Vice President & Senior Analyst

U.S. Trust, Bank of America Private Wealth Management

October 10, 2011



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