More Structural Change, Changes the Dynamic

April, 2012

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"Housing in the New Millennium: A Home Without Equity is Just a Rental With Debt" - Graham Fisher & Co. (June 2001)

"we believe there are elements in place for the housing sector to continue to experience growth well above GDP. However, we believe there are risks that can materially distort the growth prospects of the sector.
Specifically, it appears that a large portion of the housing sector's growth in the 1990's came from the easing of the credit underwriting process. Such easing includes:

- The drastic reduction of minimum down payment levels from 20% to 0%
- A focused effort to target the "low income" borrower
- The reduction in private mortgage insurance requirements on high loan to value mortgages
- The increasing use of software to streamline the origination process and modify/recast delinquent loans in order to keep them classified as 'current'
- Changes in the appraisal process which has led to widespread overappraisal/ over-valuation problems

If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated. Despite the increasingly more difficult economic environment, it may be possible for lenders to further ease credit standards and more fully exploit less penetrated markets. Recently targeted populations that have historically been denied homeownership opportunities have offered the mortgage industry novel hurdles to overcome.

…The virtuous circle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures.

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Tail-winds Reversing

- Three former tail winds (and an end to declining rates) are and will remain generational headwinds:
  - Democratization of credit which began as asset prices outpaced real wage growth during the inflationary late 70’s.
  - Inflation of the 70's also drove acceleration of move from one income to two income families and supported a one time boost to housing and other consumption. Prior to the crisis:
    - Majority of top quintile of household income had two earners
    - Majority of mid quintile had one income per household
  - Largest generation of consumers (baby boom) entered peak consumption years as the economy came out of the recession of the early 80’s. Now they will consume less and need more.

Coupled with behavioral changes toward homeownership, by potential first time buyers, we are likely underestimating non-economic impact on ownership.

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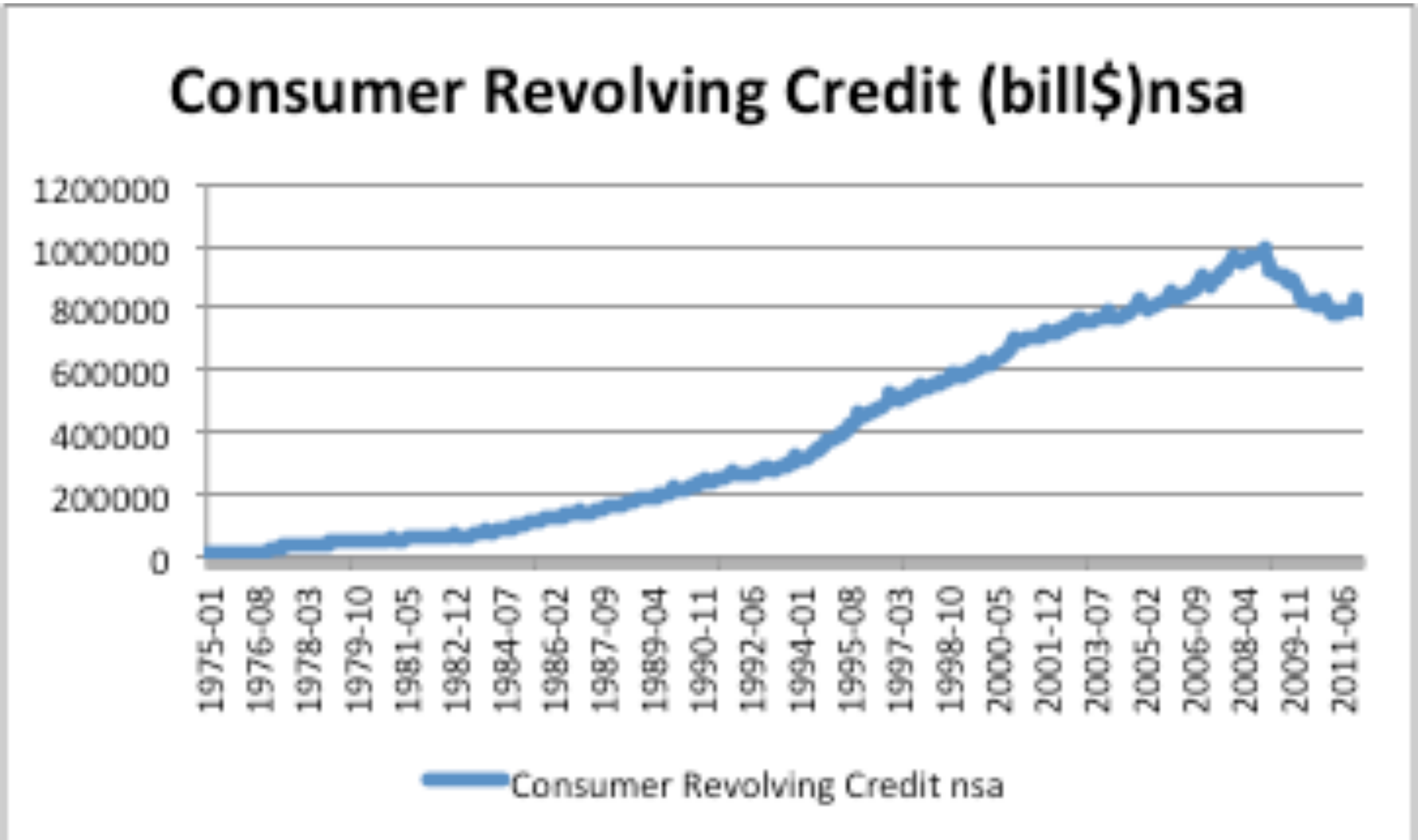
Consumer Revolving Credit



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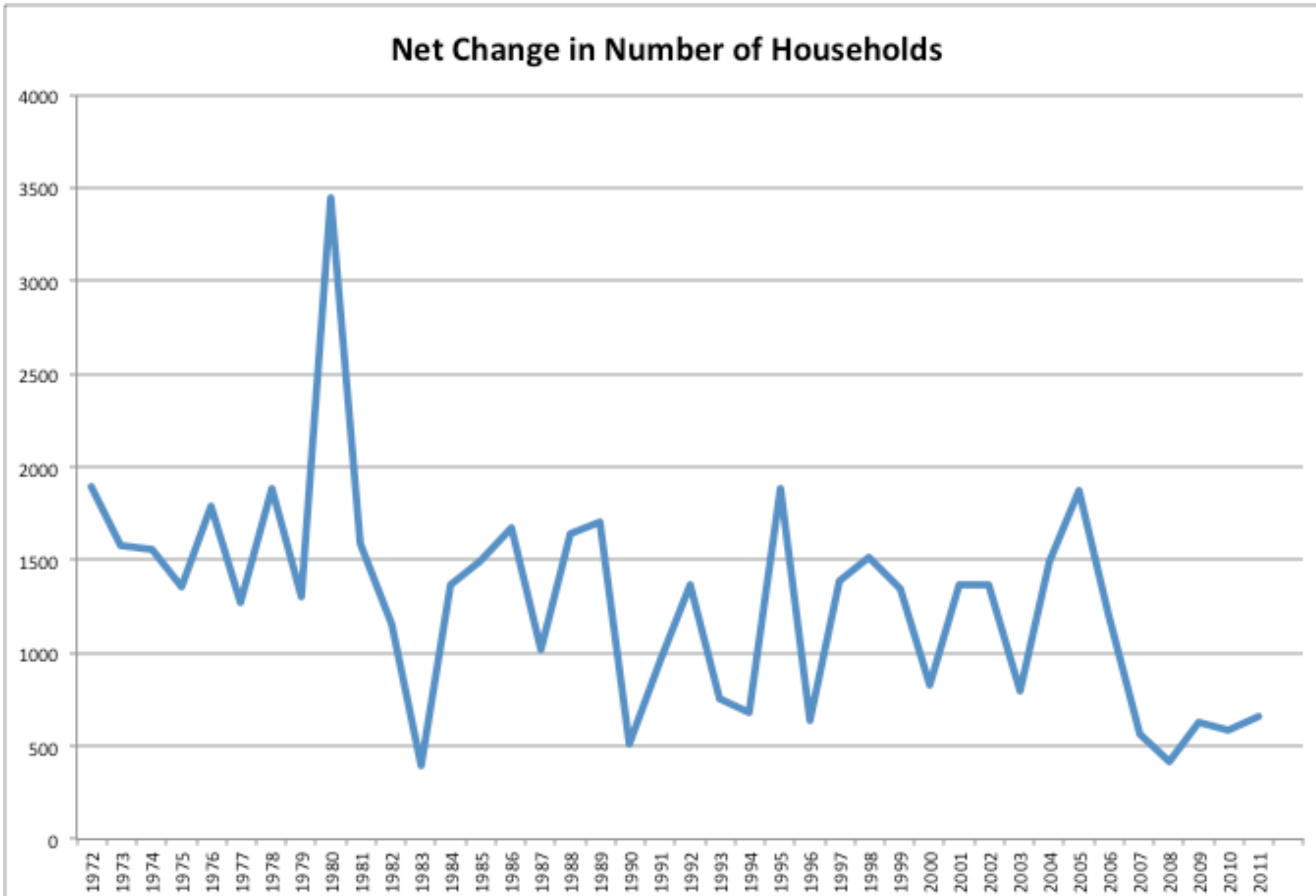
Net Change in Number of Households/ Structural Change



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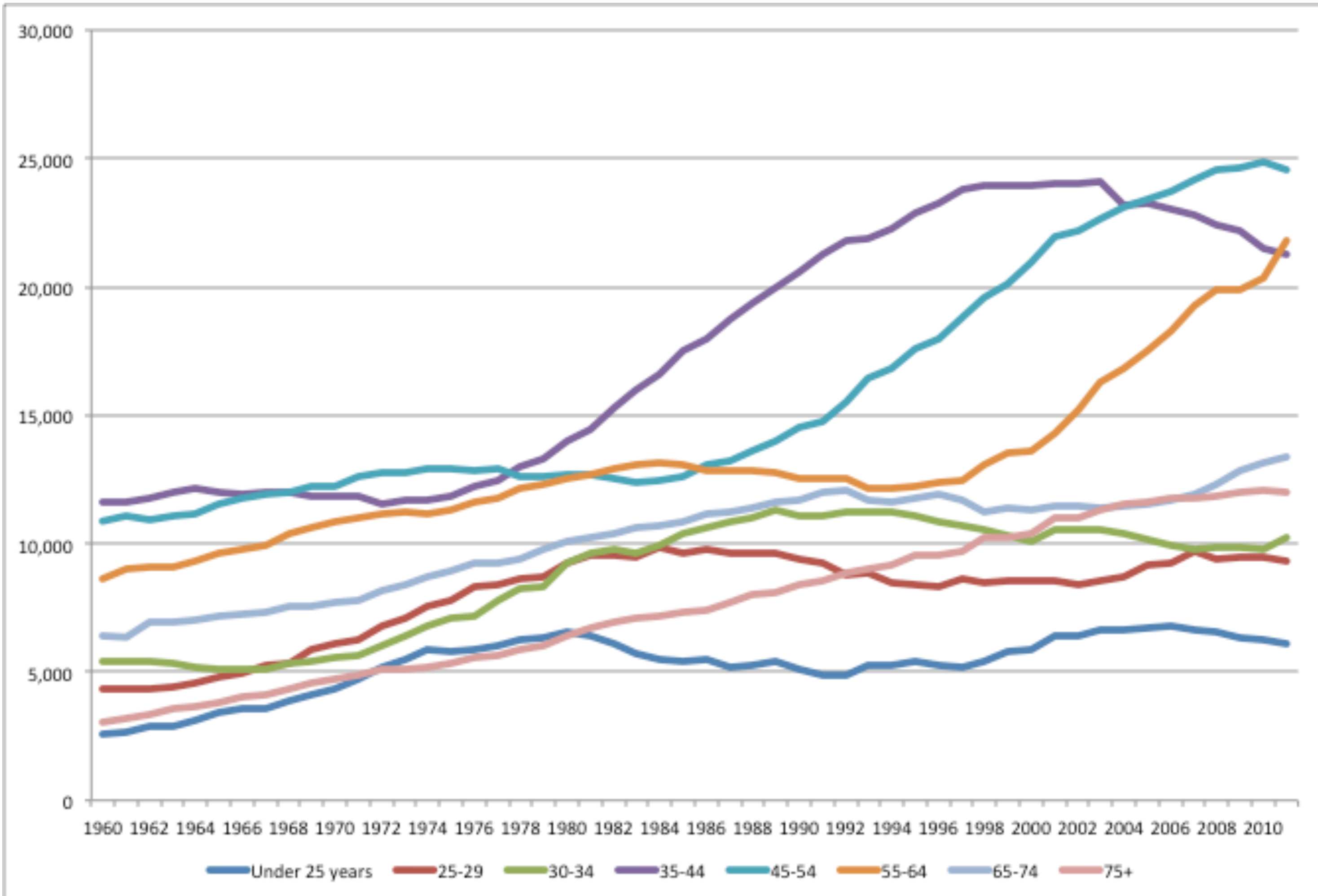
Number of Households by Age



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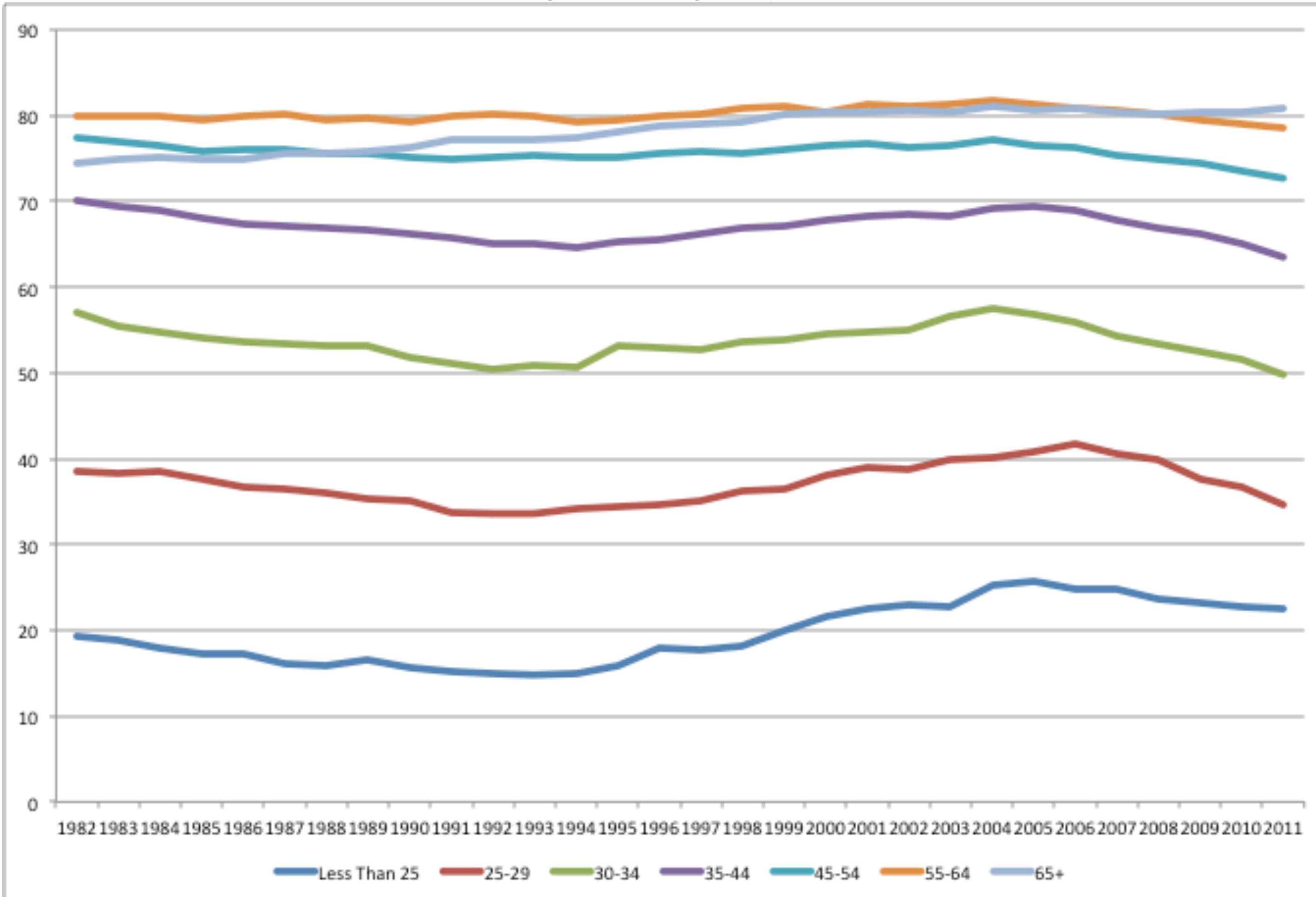
Ownership Rates – An Aging Population & Structural Change. Household formation is in demographics that already own homes



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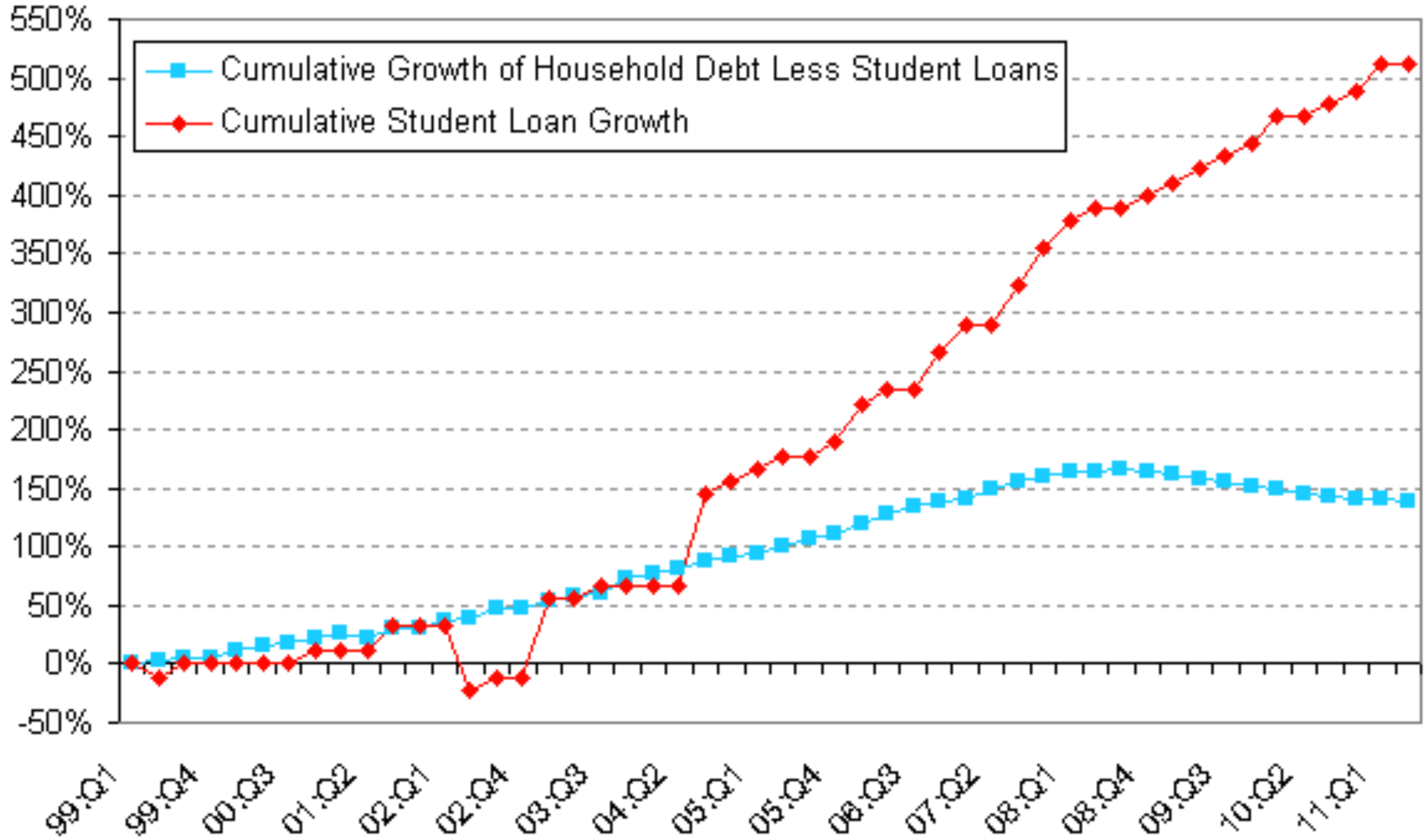
Younger cohorts are saddled with increasing student debts that will hamper home purchases.



Sources: New York Fed, Bureau of Economic Analysis

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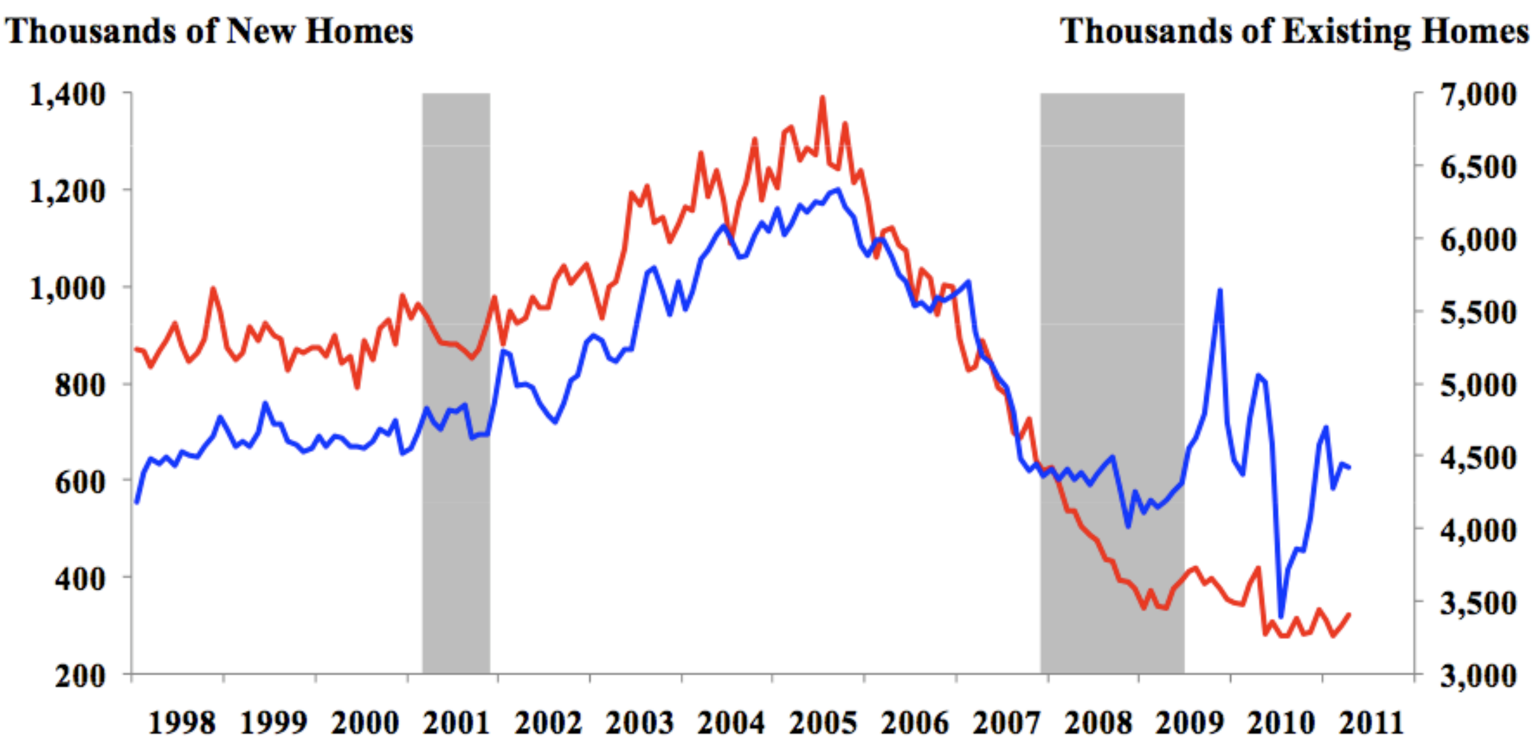
Home Sales – Just a Recessionary Blip? (new is red, existing is blue)



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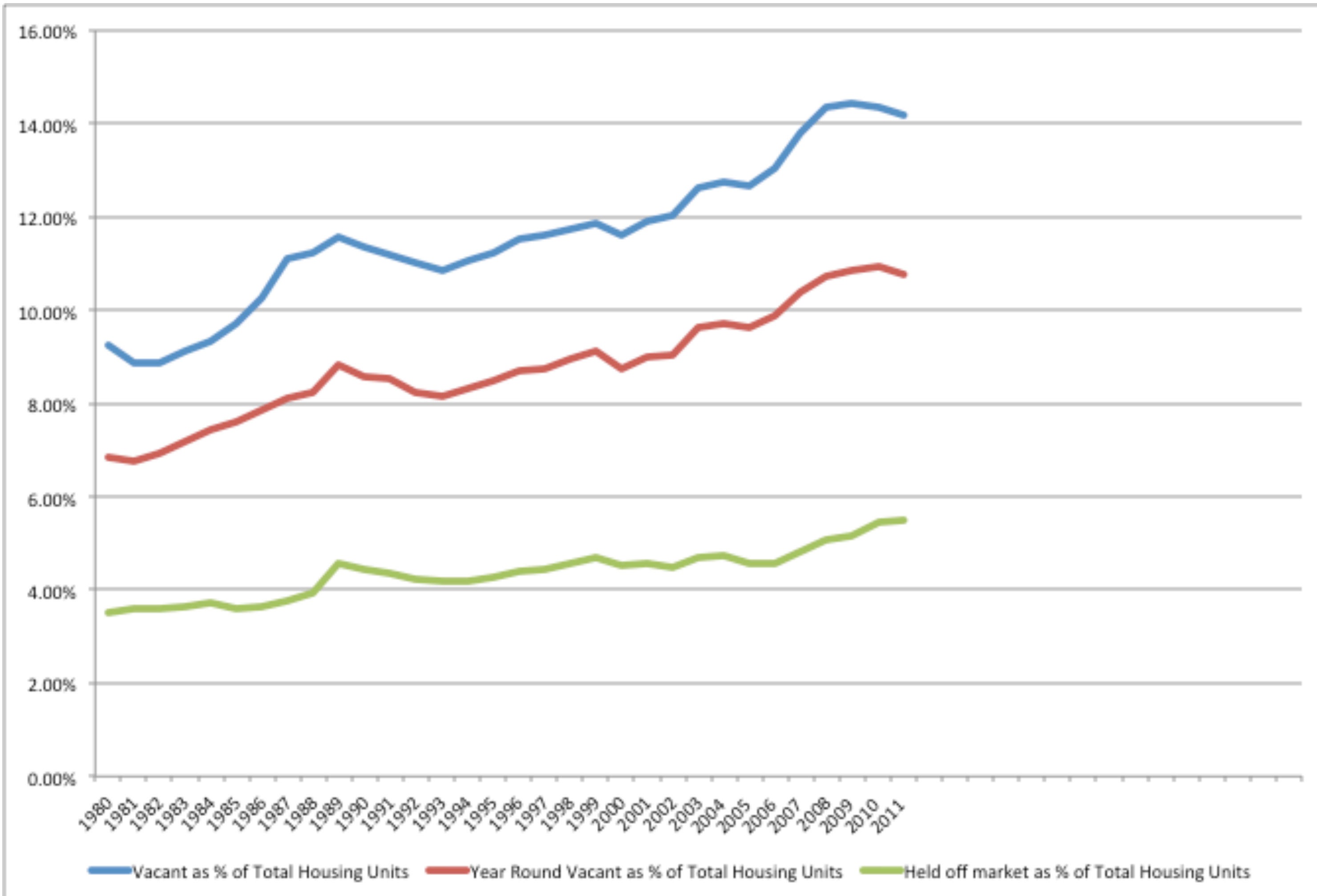
Vacancies to Total Inventory – Increased inventory was driven by speculative purchase (these are NOT second homes)



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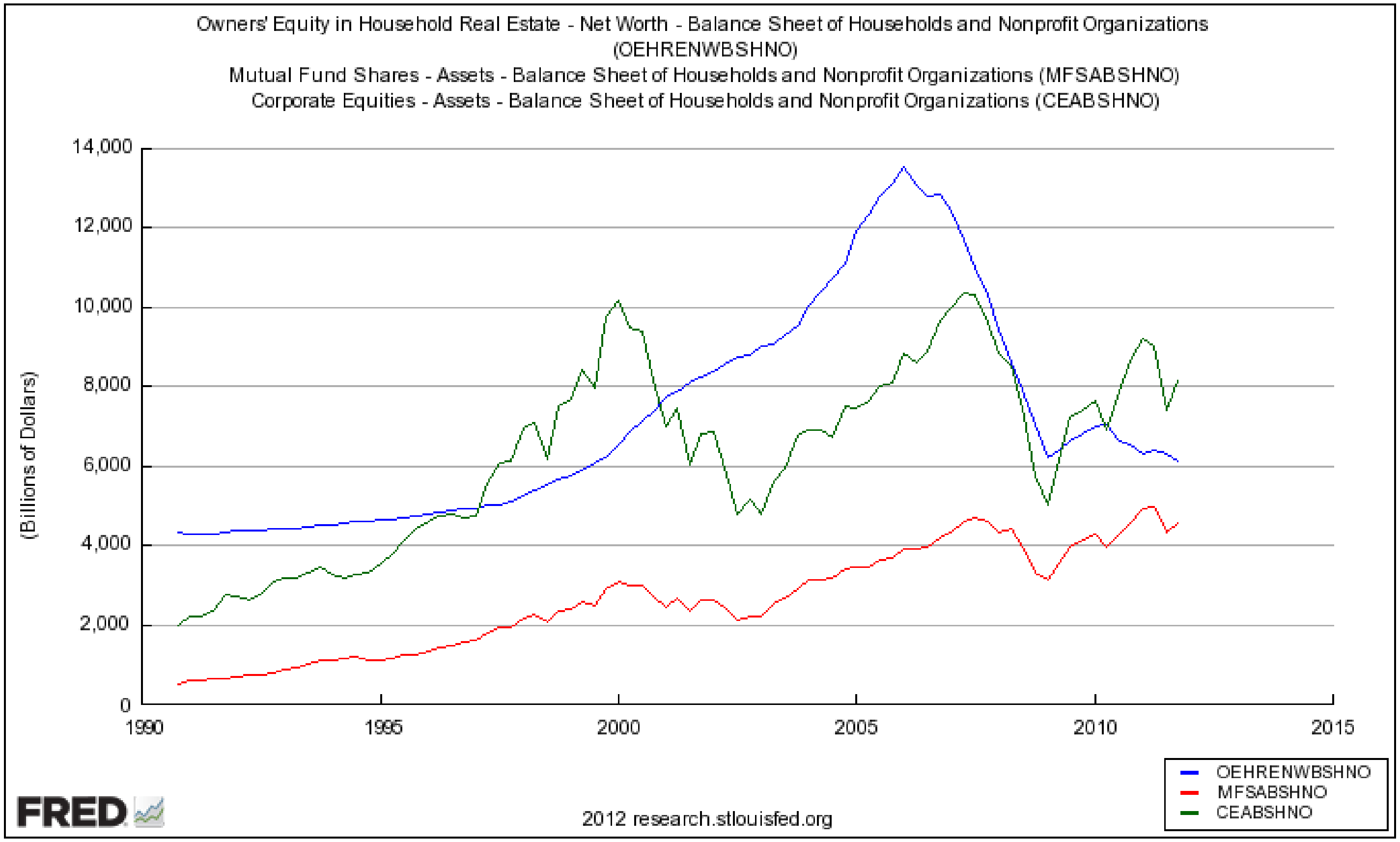
Home Sales by Purpose - Homeownership rates PEAKED in 2004. Is this a healthy market? How long will investor holding on for returns?

	Primary Residence	Vacation Hom	Investment Property
2003	67	12	22
2004	64	11	25
2005	60	12	28
2006	64	14	22
2007	67	12	21
2008	70	9	21
2009	73	10	17
2010	73	10	17
2011	62	11	27

What if markets fall? Equities have replaced home equity as the driver of confidence and consumption



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Macro Risks

- Ownership peaked in 2004. Refinancing and the 27-40% of sales that were investment or vacation homes stoked the bubble. Much of this is now phantom inventory. Though much of it was likely strategic defaults that have already occurred there is no government bid behind this segment.
- Largest risk to UST will come when the largest generation retires with less value in what has been the largest retirement and intergenerational asset (homes)
- Financial stress by seniors will put more stress on social safety net programs (social security, medicare, medicaid...)
- REO has barely begun to liquidate.

Time is short

- On January 1, 2011 the first baby-boomers began to retire. Each day for the next 19 years 10,000 Baby Boomers will reach the age of 65
  - Boomers have not adequately saved for retirement and, unless we create incentives for rapid savings in a discreet asset, the loss of home equity will lead to increased social safety net burdens on UST
    - Principal equity tax credit
    - Tax free housing savings account
    - Sunset Investor Principal equity tax credit to absorb inventory and reduce tail risk to prices
  - America's elderly are living longer and the cost of health care is rising dramatically
  - Underfunding of corporate pensions will become an accelerant to this crisis
    - California's three biggest pension funds are as much as $500 billion short
    - state and local government bodies in the state of California have $325 billion in combined unfunded pension liabilities
    - 50 states are collectively facing $5.17 trillion in pension obligations, but they only have $1.94 trillion set aside in state pension funds
  - According to estimates more than 30% of investors in their sixties have greater than 80% of their 401k invested in equities (what happens as they redeem?)