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ECONOMIC TALKING POINTS

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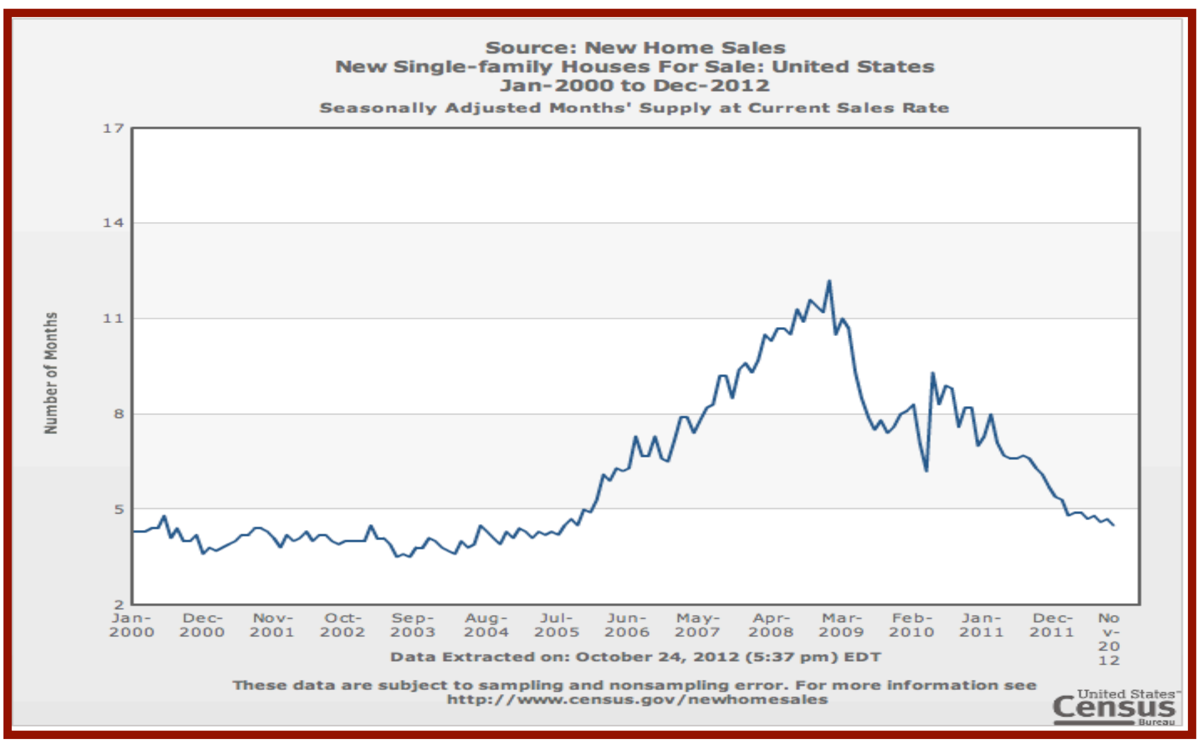
All signs point to a genuine housing recovery. But threats still lurk.

For those still unsure about the sustainability of the housing recovery, let me point out some interesting metrics on residential real estate.

First, today's report on new homes sales shows that homebuilders had a mere 4.5 months of supply in new homes on the market in September, based on the latest sales rate. That's the lowest inventory/sales ratio since October 2005 --- and back then homebuilders were so concerned about the lack of adequate supplies they boosted single-family construction starts that month to a 1.74 million unit annual rate, which is more than twice the current pace!

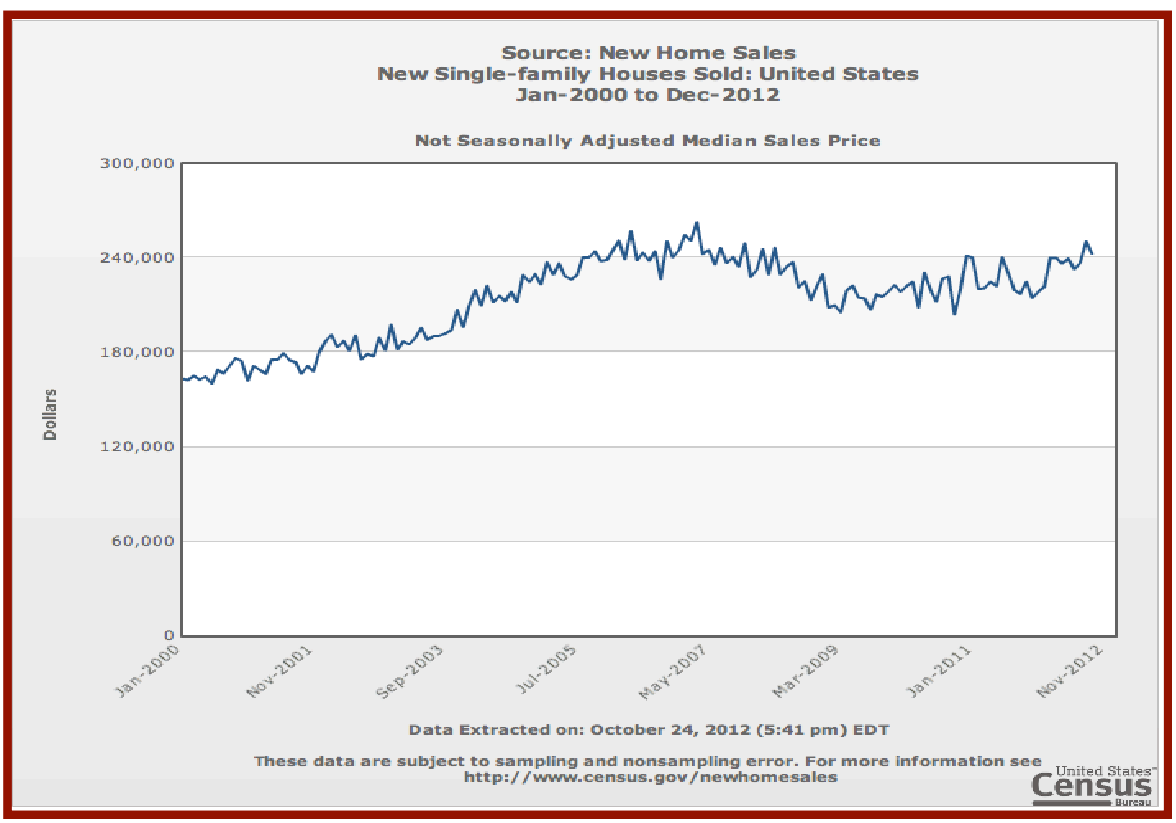


Does this mean housing starts will move substantially higher in coming months? Well, if demand for new homes continues to climb, it will certainly encourage construction greater than the modest 603,000 annual pace of last month. However, lots of factors influence demand for homes, including employment conditions, access to bank credit, and the ability to sell one's current residence.

Let's briefly look at each. The job market has improved despite all the political rhetoric arguing otherwise. Total nonfarm payrolls grew in the third quarter twice as fast as the previous quarter and that is good news, though everyone prefers to see hiring accelerate even faster. (If we can get past the danger of the fiscal cliff fall, then the employment outlook should continue to brighten.) In terms of getting mortgage financing, the Federal Reserve in its weekly report on commercial bank assets and liabilities shows that lenders have proceeded to ramp up loans to homebuyers. Americans are also finding it easier to sell their existing homes and use the profits to purchase their next residence. Nationally, distressed sales on existing homes accounted for just 24% of September sales, down from 30% a year ago.

The improvement in housing fundamentals has boosted homebuilder confidence to a 6-yr high, says the National Association of Homebuilders. (Buyer traffic into showrooms in October turned out to be the busiest since April 2006.) No wonder permits to break ground for new single-family homes jumped in September to the most in more than four years.

Home values are also firming. The median price of single family homes



averaged more than $243,000 in the last three months, a level we haven't seen since early 2007, nearly a year before the recession began. Prices have firmed in large part because fewer people are now forced to sell their homes under distressed conditions.

A third interesting data point we found in today's new home sales report deals with lots sold. This measure (described as "new houses sold but not yet started") is an excellent leading indicator of housing market trends. There has been a marked increase in home lots sold this year (up 56% above 2011). This should not only encourage builders to hire more construction workers but also push real estate firms to buy more land for future development.

Finally, mortgage rates are likely to remain near record lows, thanks to actions by the Federal Reserve. Later today, the FOMC is expected to reaffirm its commitment to purchase $40 billion every month in mortgage back securities for the foreseeable future. This will keep mortgage rates at record low levels (30-yr. fixed rates are still below 3.5%!!). Indeed, these low rates along with the multi-year drop in home prices have kept the "home affordability index" at or near all-time highs this year, according to the National Association of Realtors.

So, can we say the housing recovery is now firmly entrenched? It is certainly tempting. The problem is there still are quite a few hurdles out there that can trip up future progress. Here are dangers that loom largest.

(1) Obviously all bets are off if Washington policymakers fail to agree on a budget-reduction plan and end up shoving the economy off the fiscal cliff. The recession that follows will slash home sales and construction.

(2) If Bernanke steps down as Federal Reserve Chairman in 2014, market interest rates (and thus mortgage rates) could move markedly higher even sooner to reflect investor concerns the next Fed chief will tighten monetary policy.

(3) A barrage of new lending rules comes into force next year that could make it harder for homebuyers to obtain a mortgage. The rules were set up to prevent the sort of abuses in mortgage finance that occurred in the middle of the last decade and triggered the worst financial crisis since the Great Depression. Clearly lenders and borrowers will have to adjust to the new regulatory climate and this may temporarily tighten credit availability and depress home sales.

(4) A geopolitical eruption that disrupts oil supplies, such as a military clash with Iran, could quickly drive WTI oil prices toward $200 a barrel, and that would choke off economic activity and kill the housing recovery.

None of the risks above can be dismissed as remote at this time. Yet we believe the odds still remain fairly high that housing will continue rebound and resume its critical role as a vital contributor to jobs and GDP growth.

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