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Greg Brooks, editor | 303 845 4880

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COMPLIMENTARY

THISMONTH
IN CONSTRUCTION SUPPLY

AUG 2011

PRETTIEST HORSE IN THE GLUE FACTORY

By Greg Brooks. You'd get laughed at if you tried to sell this script to Hollywood. After posturing for three months over whether it was willing to pay for purchases it had already made, Congress cobbled together a last-minute agreement to raise the debt ceiling. The deal will also reduce government spending by $2.4 trillion over the next decade.

Impressed? The government was slated to spend $46.055 trillion during those ten years, according to CBO. Now it'll spend a mere $43.655 trillion.

The deal didn't prevent the U.S. from losing its AAA credit rating with Standard & Poor's, but S&P never questioned our ability to pay. It was 100% about our government (or lack thereof): "The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."

If S&P previously believed Congress was stable, effective, and predictable, that explains why they gave AAA ratings to all those subprime mortgage-backed bonds.

Recent turmoil in the stock market has more to do with Europe than S&P's downgrade, but there's no denying the psychological effect. Politicians are now serious about appearing to be serious about reducing our national debt.

If the downgrade could have had a direct impact on anything, it would've been the bond market. It did — for about five minutes. Then it dawned on investors that there is still no safer place on the planet to park your money than with the government of the United States.

As a result, real yield curve rates on 5-, 7-, and 10-year Treasury securities were all negative as of August 12. Investors are literally paying us to borrow their money.

Imagine taking a deal like that to your board: "Our bank wants to give us a loan and will pay us interest on whatever we borrow. What do you think?"

We all want to reduce the debt, but you have to admit the timing is less than fortuitous. Sort of like starting your diet the day before Thanksgiving.

S&P is right, though: Gridlock in Congress probably isn't going away anytime soon. That means Keynesians won't get the stimulus they want and Friedmanites won't get the spending cuts they want. Whether that's good or bad is another question.

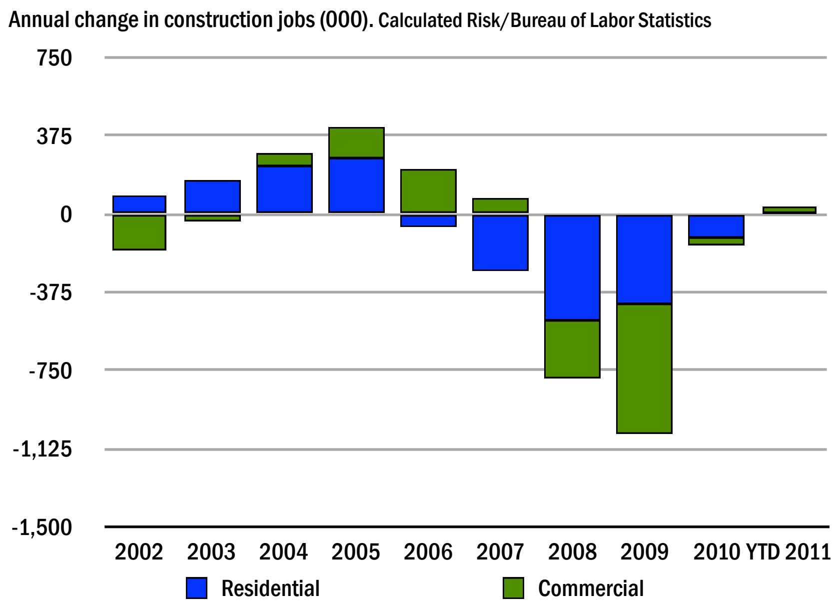
But one thing everyone seems to agree on is that a little action in the housing market would go a long way toward jumpstarting the rest of the economy.

It's no secret that foreclosures are preventing a housing recovery. But the lack of a recovery is also fueling foreclosures.

Construction accounted for over 2,000,000 jobs in 2005. If we put even half of those people back to work, mortgage defaults would drop dramatically, which would help bring lending standards back to normal. In turn, that would boost investment and create even more jobs that would boost investment further.

Instead, we're caught in a classic vicious cycle. Some believe there's nothing to be done except let it run its course. Maybe not. But an old idea that could help break the cycle is getting legs again.

In the early days of the crash, the government tried to encourage loan modifications and fell flat on its face. Modifications were a non-starter from the beginning. If you lost your job or were so far under-water that the house would never be worth as much as the mortgage, no



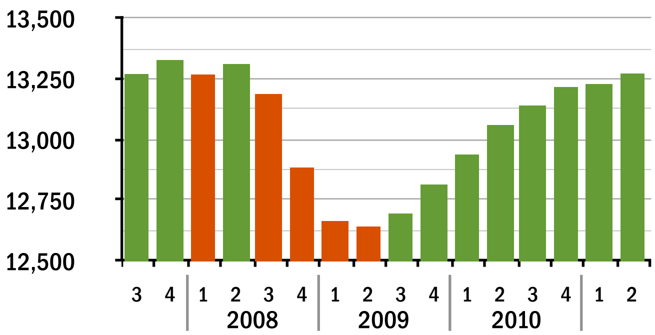
giveaway was big enough to motivate you to stay put.

Nor were banks trying very hard. Because the home equity loans on their books were subordinate to the first mortgages sold into the bond market, they thought they'd lose less by foreclosing than by modifying loans.

Early on, someone came up with the idea of requiring banks to rent the homes they foreclosed back to their former owners. On one level, it had merit: Lenders would get an income stream, someone would be on site to mow the lawn mowed and keep van-

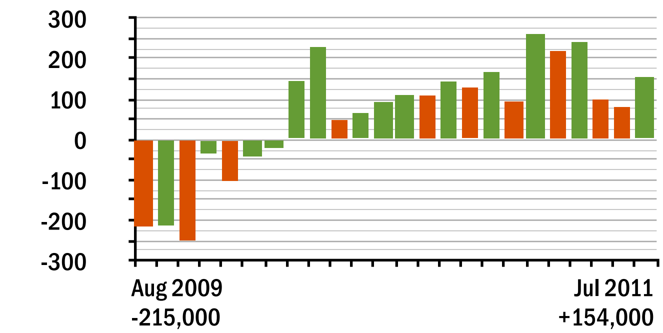
VITAL STATISTICS: U.S. ECONOMY

REAL GROSS DOMESTIC PRODUCT ($ BIL)

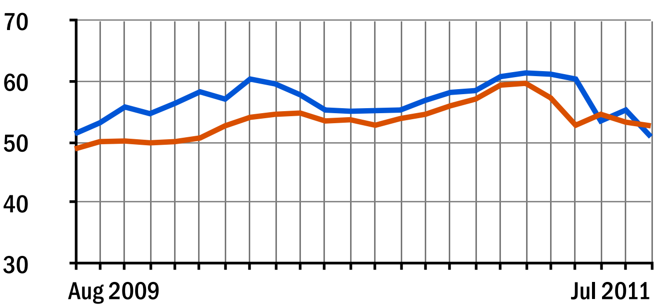


3Q 07: $13,269.8   2Q 2011: $13,270.1

CHANGE, PRIVATE-SECTOR EMPLOYMENT (000)



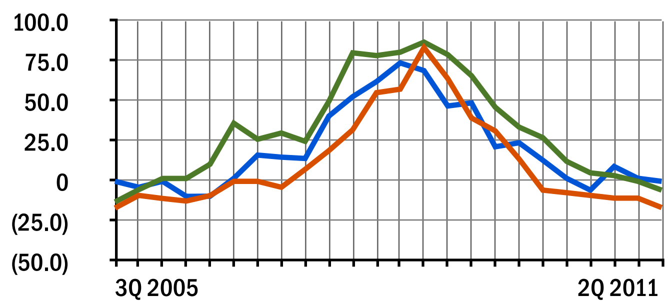
ISM PURCHASING MANAGERS' INDEX



Manufacturing: 50.9   Non-manufacturing: 52.7

Over 50 = expansion, under 50 = contraction

% OF BANKS TIGHTENING LENDING STANDARDS



Commercial/industrial loans: -16.4%
Commercial real estate loans: +5.5%
Residential mortgage loans: 0.0%

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Institute for Supply Management

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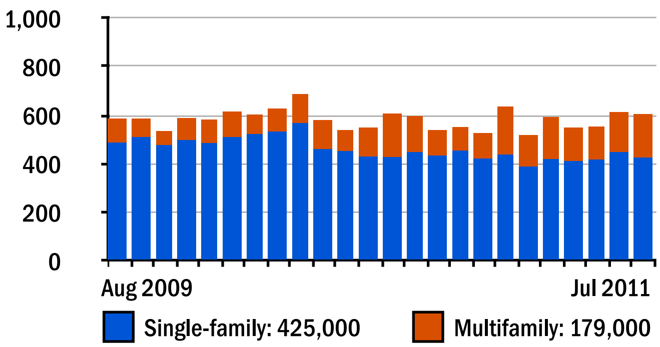
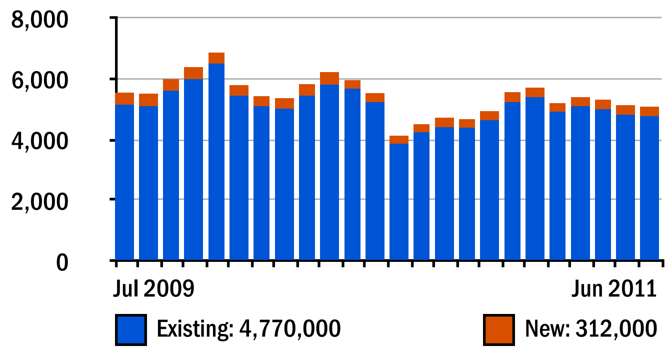
VITAL STATISTICS: HOUSING

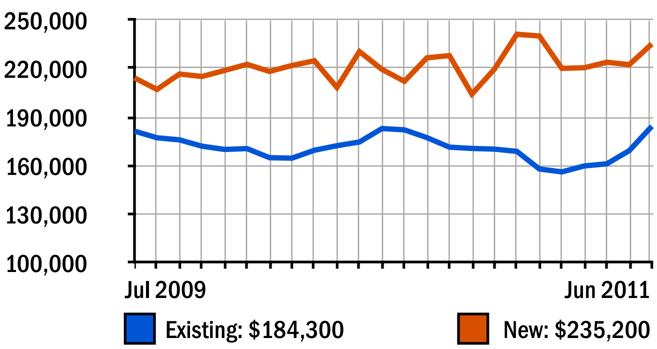
ANNUALIZED HOUSING STARTS (000)



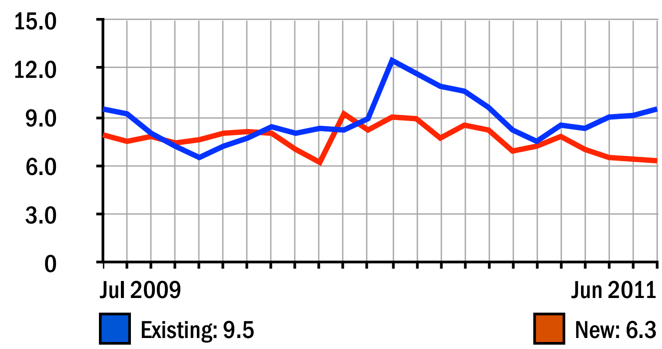
ANNUALIZED HOME SALES (000)



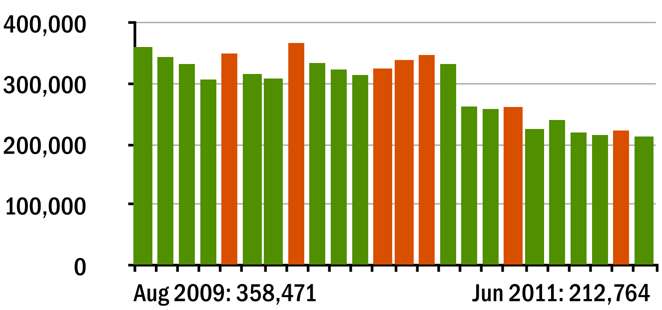
MEDIAN HOME PRICES



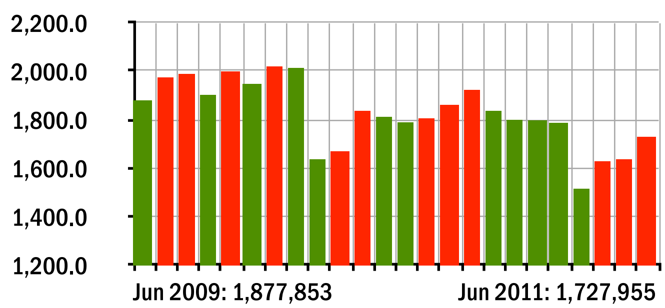
UNSOLD INVENTORY (MONTHS)



FORECLOSURES (000)



30-DAY DELINQUENCIES (000)



[Download current Econo-Matrix spreadsheet at CS24.us](CS24.us)

Sources: U.S. Census Bureau, National Association of Realtors, Freddie Mac, RealtyTrac, LPS Applied Analytics. EconoMatrix data compiled by:

LBMRESEARCH

dals from ripping out the plumbing and wiring, and fewer vacant homes would help preserve the value of surrounding homes. The idea never got past the fantasy stage because banks didn't want to be in the property management business.

That's where Fannie Mae and Freddie Mac come in. Fannie-bashers blame the two for the housing crisis on the premise that, by buying subprime mortgage bonds (rated AAA by Standard and Poor's), they encouraged lending to people who shouldn't have been able to borrow.

Actually everyone was doing that; the problem with Fannie and Freddie is that they were late to the party.

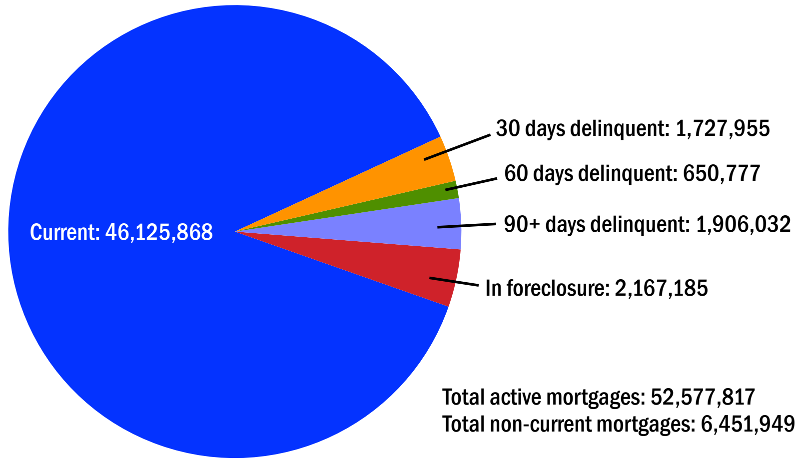
Fannie and Freddie have historically dominated the securitization market. As home prices approached their peak, so-called "affordable" mortgages became the rule rather than the exception. Fannie and Freddie historically dominated the securitization market, but from 2003 to 2006, their market share fell from 70% to 40% because they *weren't* buying enough low-quality loans.

Finally they jumped in — just as the private sector was jumping out. What happened to Fannie and Freddie was what always happens to the last guy who buys into a Ponzi scheme.

The upshot is that between them, Fannie, Freddie, and FHA [own roughly 1,100,000 homes] either in foreclosure or that have been repossessed.

So far the REO market has been dominated by individuals and small investor groups who typically buy a few homes and flip them as fast as possible. The new idea is to sell

Mortgage market status, June 2011. LPS Applied Analytics



[government-owned REOs in bulk] — hundreds or even thousands at a time — to big investment groups that would rehab them and then rent them for a specified period of time.

If it happens, it'd take half the current and soon-to-be REO inventory off the market all at once, which would help stabilize home prices. If those homes get rehabbed, it'd put people to work and reduce the delinquency rate.

One possible downside is that the government would have to offer steep discounts to attract investors. But [Fannie and Freddie have already cost taxpayers a bundle]. We may be money ahead getting our REOs off the books fast, even at fire sale prices.

There are plenty of details yet to be worked out and the Obama administration is only soliciting feedback at this point. But the idea apparently has [broad bipartisan support].

Who knows whether it'll work? But as Albert Einstein said, "The best way to have a good idea is to have a lot of ideas." **TM**

Greg Brooks, editor of THIS MONTH, is a 43-year veteran of the construction supply business with 20 years' experience in the field. Brooks is a former editor of ProSales, a steering committee member at the Harvard Joint Center for Housing Studies, and author of Scope of the LBM Industry, published by the National Lumber & Building Material Dealers Association.

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