WEALTH MANAGEMENT MONITOR

THE PROVIDENT BANK | Wealth Management Group

Volume 2 Edition 9 | September 21, 2010

Economic Theme:

The Housing Market – Insights and Implications

Heading the list of potential drags on the US economy would be jobs, or lack thereof, and the housing market. To the extent that one or both of the feared "Ds", Deflation and Double-Dip, materialize, the housing market would likely play a major role. Our base case anticipates disinflation, or a reduction in the rate of inflation as opposed to deflation, which is a sustained decline in consumer prices. We are also forecasting slow real growth but not a double-dip recession. However, recent insights gained in analyzing the housing market suggest that the risks of both deflation and a double-dip recession have increased.

A key piece of the housing puzzle is the outlook for prices. The Great Recession that dates from December 2007 to June 2009 is widely attributable to a housing price bubble that began around 1997. As measured by the Case-Shiller Composite Index of 20 cities, housing prices increased 35% between July 2003 and July 2005, the period of most rapid advance. The rate of gain decelerated sharply in 2006, and prices began their year-over-year decline in 1Q07, culminating in a 30% drop from the 2006 peak.

While there are several variables that influence the direction of housing prices, we have found that existing home sales are a good leading indicator. Existing homes currently constitute about 90% of total sales with new home sales representing the rest. The sales trend apparently influences price expectations in subsequent periods. The accompanying chart shows the correlation between the Case-Shiller Composite and existing home sales a year earlier from 1Q2001 to 2Q2010. Existing home sales explained 77% of changes in housing prices during the period. Existing home sales have risen year-over-year between July 2009 and July 2010, resulting in a modest uptick in housing prices. However, sales fell 25.5% in July, no doubt attributable in part to expiration of the home buyer tax credit. We believe that in the absence of government support, the large and growing inventory of unsold homes and foreclosures, and the psychology of deflation gripping prospective buyers, home sales will remain under pressure during the second half of this year. As a result, the Case-Shiller Composite could be about 10% lower a year from now.

Inflation Implications. If, as suggested above, home prices resume their downtrend, the potential risk of deflation cannot be minimized. The core CPI, which excludes food and energy, has risen by only 0.9% year-over-year the past five months. The biggest component in the core index is shelter costs at 40% of the total. Housing prices are not measured directly as with the Case-Shiller Composite. Rather, the Bureau of Labor Statistics calculates Owner's Equivalent Rent (OER) or the cost of renting a house equivalent to your own. OER represents about 80% of shelter costs with regular rents paid by tenants responsible for the remainder. OER has dropped by 0.2%-0.3% in recent months. Given shelter's large share of the core index, a further 10% slide in housing prices could push core inflation dangerously close

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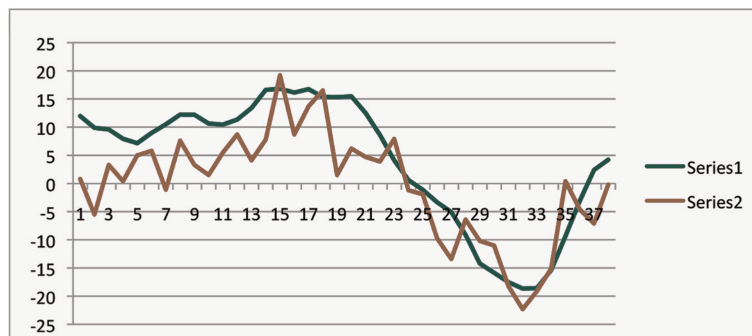
to zero. In addition, the psychology of deflation could spread to other big-ticket items.

Growth Implications. In a study titled, "Household expenditure cycles and economic cycles, 1920 – 2010", Steven Gjerstad and Vernon L. Smith of Chapman University's Economic Science Institute, demonstrate that the Great Depression, most post-war recessions, and the recent Great Recession "originate in a pronounced downturn in expenditures on new single-family and multi-family housing units". These housing expenditures, which have averaged only 3% of GDP since 1947, are very volatile and have declined before ten of eleven post-was recessions and the Great Depression. In short, housing expenditures are a good leading indicator of recession as well as a good predictor of the depth and duration of recessions. We would add a few thoughts based on our examination and analysis of the data. First, housing expenditures typically show extremely large gains coming out of recessions. This has not yet been evident in the recent recession with expenditures up only 6% in 2Q2010 following declines of 13% in 1Q2010, 42% in 2009, 35% in 2008, and 25% in 2007. Second, we correlated housing expenditures with real GDP for the 1967 to 2009 period and found expenditures to be a statistically relevant predictor of

HOUSING PRICES AND EXISTING HOME SALES



Series 1 - Case Shiller Composite Series 2 - Existing Home Sales (1 Year Lag) Period 1Q2001 to 2Q2010 Y-O-Y % Changes

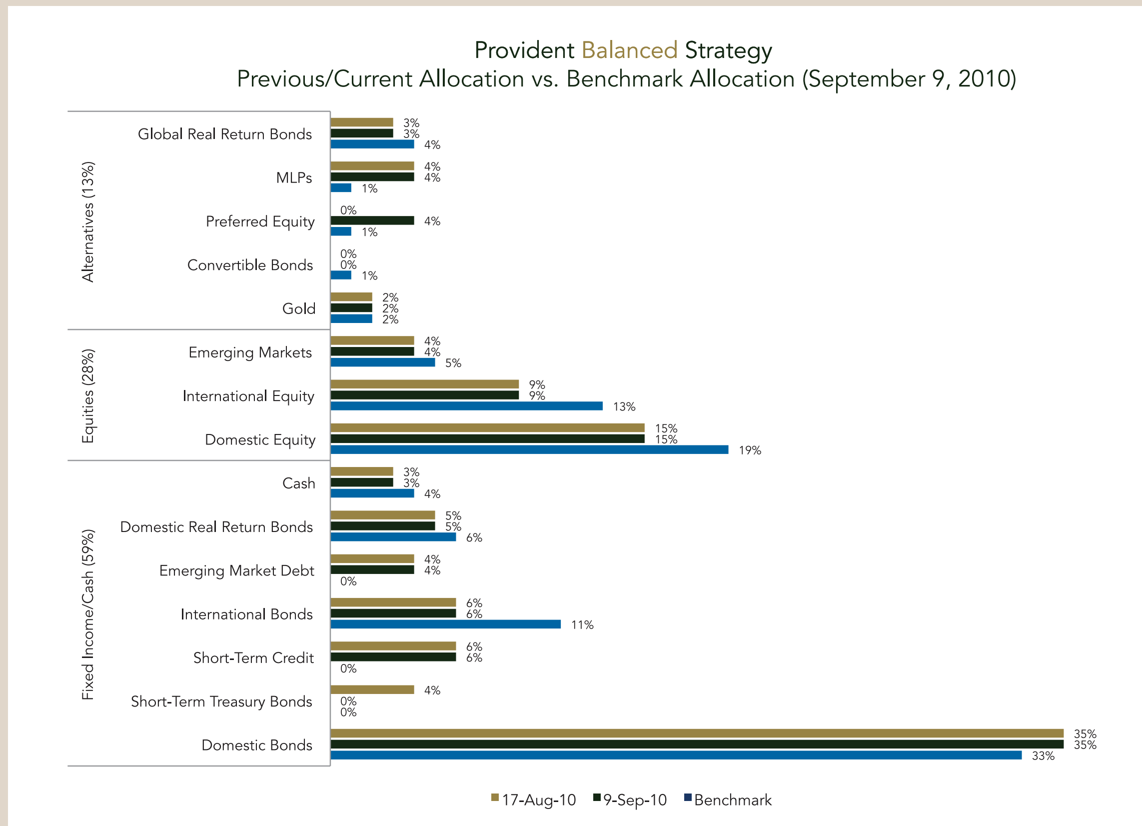
Sources: Case-Shiller; National Association of Realtors.

growth. Third, the tepid recovery in housing expenditures suggests a real growth outlook of about 2% during the near-term. Along with existing home sales, housing expenditures will be a critical variable to monitor relative to deflation and growth prospects.

Investment Implications. An increasing probability of deflation and a double-dip recession could result from a prolonged housing crisis. In those circumstances, we would expect risk-averse asset classes to perform relatively better than riskier asset classes. As such, we would favor government bonds, corporate credits, emerging market debt and preferred equity. We would deemphasize equities and commodities.

ASSET ALLOCATION RECOMMENDATION

During September, we established a 4% position in Preferred Equity (PFF), using Short-Term Treasury Bonds (SHY) as a source of funds. PFF is viewed as a partial hedge against our underweight equity exposure, offering a considerable yield cushion of 7%.



MARKET CLOSES

S&P 500 Index: 1,142.71	**Dow Jones Industrial Average**: 10,753.62	**10-Year Treasury Yield**: 2.70%

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