U.S. HOUSING MARKET VULNERABLE TO 'SECOND WAVE' OF FORECLOSURES: TD ECONOMICS

Boston, Philadelphia and New York City in better position to avoid the flood of defaults

APRIL 23 – The incentive to buy a home has improved markedly across all regions, but is not yet at price levels that can entice sufficient buyers to offset new supply coming onto the market according to a report published today by TD Economics (www.td.com/economics). TD Economics provides insight and analysis on the economy and financial markets on behalf of clients and customers of TD Bank Financial Group.

Typically home price declines spur demand and curtail new construction and listings, helping to move a market in excess supply toward balance. However, home price declines have been driving foreclosures – creating a second source of supply. This puts a "twist" on the conventional economic law of supply and demand, and is complicating the housing market recovery.

The report warns, if prices decline by 6 to 10 percent in the next year, there is a chance that a second wave of foreclosures could hit the American economy. That's because many homeowners will find their mortgage payments exceed the value of their home, often referred to as "underwater" mortgages. There are six to 11 million mortgages had turned underwater by February 2009, which represents up to 33 percent of all new mortgages taken out over the last five years.

"Combined with a forecast of a double digit unemployment rate, some homeowners will be left with no other option but to foreclose, thereby exacerbating the supply glut of homes already in existence," write Beata Caranci and Richard Kelly, the authors of U.S. Housing Market – Fishing For The Bottom. "Lower home prices will continue to be a bane for current homeowners, but it may be a necessary evil to improve affordability and draw in new buyers."

The report examined critical measures of demand and the likely path of foreclosures across the four broad markets - West, South, Northeast, and Midwest. This release focuses on two notable regions: the Northeast and the West.

On higher ground: Northeast

Newly underwater mortgages may grow faster in the Northeast than anywhere else in the U.S. as home prices continue to fall. If home prices retreat by 10 percent, the report estimates that the stock of underwater mortgages would nearly double, but still leave it well below levels in other regions.

The region, which includes the major housing markets of Boston, Philadelphia and New York City, has seen much less underwater mortgages to date, so it's rising from a small base. The authors argue the region is in a better position to avoid the devastating effects of a second wave foreclosures because, for instance, the pace of decline in home prices has been less rapid than the other major regions and, relative to the rest of the nation, fewer Northeastern homeowners put downpayments in the high-risk grouping of less than 20 percent.

As a result, less than 10 percent of newly sold homes over the last five years were at risk of being underwater as of February, 2009. Even if the absolute number of underwater mortgages doubles, as a share of newly-sold homes over the last five years, it would only amount to 15 percent, which is just one-third the national average. The issue of underwater mortgages may increase in importance over the next year, but it does not appear to be overwhelming.

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Of greater concern, the report notes, is the potential for a substantial decline in house prices. There are three factors behind this: first, there remains a glut of current supply of new homes relative to other regions. Second, affordability is poor relative to other regions, suggesting that prices need to fall considerably to pull in more demand. Third, given existing mortgages in the Northeast are less price sensitive, home prices can fall farther and faster than other regions, if needed, in order to increase affordability and bring more buyers into the market.

Rising to the surface: the West

There are signs that conditions are ripening for a recovery in the West. Not only would this bode well for the region, but also the entire country. Since the West was the first region to be submersed by the housing crisis, it follows that it will be the first to rise to the surface, an early sign of recovery for the overall economy.

The risks – the accumulation of underwater mortgages and rising unemployment – were "frontloaded" in the West, which explains why it has led the pace of foreclosures to date. The report estimates that one-third of mortgages on newly-purchased homes were underwater as of February, 2009.

The Western market is now the least price sensitive of any region in accumulating new underwater mortgages. A further 10 percent decline in home prices has the potential to increase the stock of underwater mortgages by 26 percent, half the national average

"Our analysis shows that in the West where price declines have been the steepest and foreclosure activity has been among the greatest, the peak impact from underwater mortgages appears to have passed," according to the TD Economics report.

Stemming the tide of foreclosures

The good news is a number of actions have been taken to help stem the tide spilling from at-risk underwater mortgages to actual foreclosures. Notably, President Obama's Home Affordable Refinancing Program helps current homeowners with a solid payment history and, at most, are five percent underwater in their mortgage, to refinance. And the Home Affordable Modification Program provides borrowers who are already delinquent or at risk of default, with the ability to refinance their mortgage with lower interest rates and subsidies. Government incentives are also paid to borrowers and lenders for modifying loans and staying current.

"Recent government assistance initiatives are helpful, but may not go far enough in breaking the negative feedback loop between falling prices and new foreclosure. The bottom line is that prices need to fall further across the United States," the report concludes. "Even though this risks dumping more supply into the market from foreclosure activity, the West offers an example that the impact from underwater mortgages does eventually peak and further price declines have a waning impact on supply."

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