Profitis Capital Services LLC

Market Commentary

December 10, 2010

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Flow of Funds: December Report

The Fed's "Flow of Funds Accounts of the United States" report was released yesterday. This is one of the most comprehensive Fed releases, comprising household, corporate and governmental asset and liability positions. Although equity market returns helped to boost household wealth, the Fed's calculation of home values took a dramatic plunge.

As of 9/30/10, the value of real estate held by households stood at $16.552 trillion. This level stands 3.77% below the tally for the second quarter. It also marks the lowest quarterly value since the first quarter of 2009.

Household mortgage debt fell to $10.1 trillion at the end of the third quarter. As a result, *owner's equity fell to just 39%*. Owner's equity averaged 57% from 1990 – 2009. It is difficult to arrive at a compelling explanation for such a shift. The decision to borrow funds requires an assessment of not only the return prospects of the acquired asset, but one's ability to service the debt (in this case, household income). It should be clear that households considered gains on the asset itself as a supplement to their ability to service the debt. The collapse of home values and a still struggling labor market have greatly disturbed this anticipated intertemporal balance.

Of course, owner's equity is a function of two variables: value and mortgage balance. The below scenarios chart a few possible courses for home values and a corresponding level of mortgage debt that would bring owner's equity back to the historical average of 57%.

Change in Home Value	Change in Mortgage Debt to Reach Target
-10%	-36.6%
-5%	-33.0%
0%	-29.5%
5%	-26.0%
10%	-22.5%

Table 1: Owner's Equity
The figures for 2010 are year-end forecasts, based on the most recent report.

Source: FRB Z1 Release

Year End	**Home Value** (Billions of USD)	**Mortgage Debt** (Billions of USD)	**Owner's Equity**
1990	$6,805.3	$2,488.8	63.43%
1991	$6,975.5	$2,667.0	61.77%
1992	$7,258.9	$2,840.0	60.88%
1993	$7,500.7	$2,998.7	60.02%
1994	$7,772.7	$3,165.3	59.28%
1995	$8,054.8	$3,318.9	58.80%
1996	$8,431.0	$3,523.8	58.20%
1997	$8,864.7	$3,739.3	57.82%
1998	$9,694.2	$4,040.6	58.32%
1999	$10,644.9	$4,416.3	58.51%
2000	$12,202.8	$4,798.4	60.68%
2001	$13,576.8	$5,305.4	60.92%
2002	$14,849.3	$6,009.9	59.53%
2003	$16,446.0	$6,894.4	58.08%
2004	$18,948.9	$7,835.3	58.65%
2005	$22,026.2	$8,874.3	59.71%
2006	$22,692.8	$9,865.0	56.53%
2007	$20,879.0	$10,539.5	49.52%
2008	$17,446.1	$10,497.9	39.83%
2009	$17,038.4	$10,336.7	39.33%
2010	*$16,393.0*	*$10,024.2*	*38.85%*

Mortgage debt can be reduced in several ways:

- Households pre pay mortgage principal
- Loan restructuring
- Charge-offs by mortgage holders

From the perspective of the mortgage holders, there are obviously preferred outcomes. However, losses aside, it will be difficult for the revenues of financial institutions to resume their trajectory in such a (still) over-indebted environment.

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