TD Bank Financial Group

Special Report

March 23, 2010

TD Economics
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HIGHLIGHTS

- **Thus far in the recovery, the Northeastern economy has developed an edge over the rest of the nation.**
- **In three key areas – employment, residential real estate and commercial real estate – the Northeast held up better than the rest of the U.S. during the recession, and thus has less ground to recover.**
- **This raises the prospect that the Northeast economy faces less downside risks and is well positioned to recover at a faster rate than the rest of the nation.**
- **Although this notion diverges from recent experiences where the Northeastern economy typically lags economic recoveries due to its more mature market and older demographics, we must emphasize that the starting point matters.**

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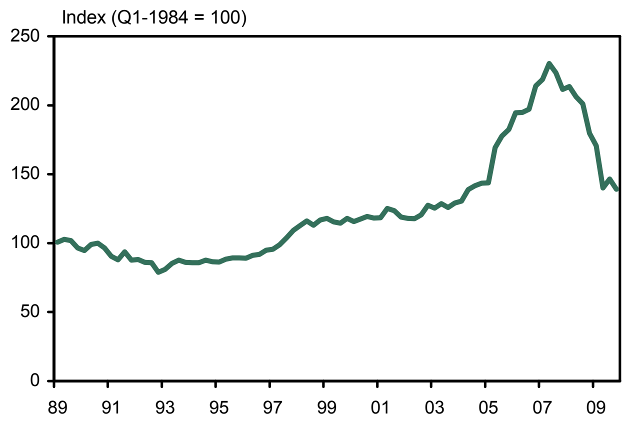
U.S. NORTHEAST ECONOMY BECOMES THE FRONTRUNNER

Economic recoveries are not created equal, and there are a number of features in this recovery cycle that shows the northeastern economy to have a few advantages over its counterparts in the West, South and Midwest. This became apparent when we investigated some of the lingering downside risks to the economic recovery due to the weak job market, slumping commercial real estate market and high delinquency rates in housing markets. When it comes to all three of these issues, the Northeast is the fairest of them all. However, we must bear in mind that all regions remain highly vulnerable to these risks, and the Northeast is currently the queen amidst a troubled kingdom.

Commercial Real Estate – atop of the heap

The commercial real estate (CRE) market is in a deep funk. By the end of 2009, commercial real estate prices had fallen 40% from the peak, more than the price decline experienced in the residential market. The CRE troubles mirrored the residential market, in the sense that lax underwriting standards were exposed and exacerbated when the economic environment deteriorated and credit conditions tightened. The Congressional Oversight Panel of Tarp estimated that more than 60% of commercial mortgage backed securities (CMBS) were interest-only loans in 2007, up from 6-9% in the late 1990s. If you include partial interest-only loans, that ratio for 2007 rises to about 90%. Sound familiar? Little wonder that against a backdrop of falling prices and difficult refinancing conditions, delinquency rates have soared from an average of 0.7% over the 2001-2008 period to 5.4% at the start of this year.

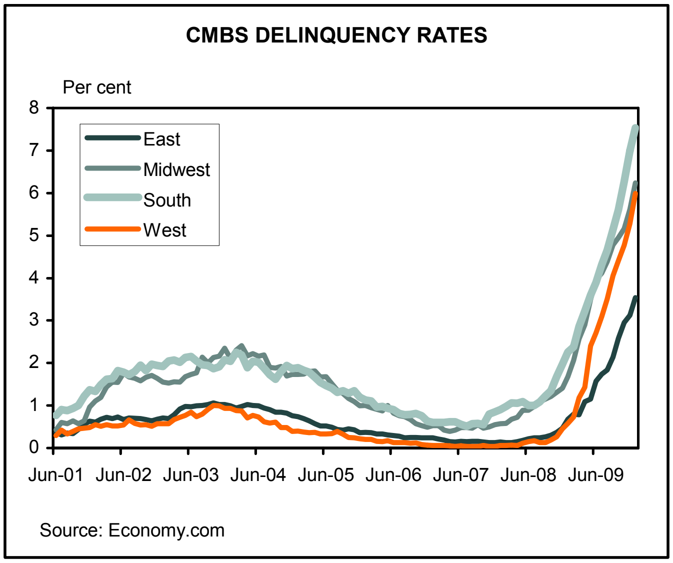
COMMERCIAL REAL ESTATE PRICE INDEX



Source: MIT Center for Real Estate

The combination of falling prices, high vacancy rates and soaring delinquency rates reined in the risk appetite of investors and financial institutions resulting in weak new securitization activity and construction spending. Where new securitization and refinancing initiatives are being met, research by Standard & Poor's indicates that much larger amounts of equity are required, in many cases more than 50%.

We know the problem in the CRE market is big and will drag on through 2010,



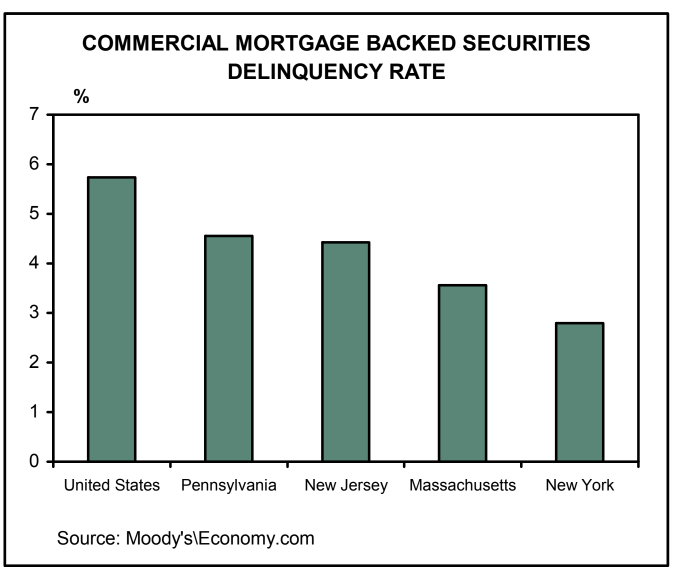
and this was discussed in detail in a November 13, 2009 TD Economics report entitled "U.S. Commercial Real Estate is a Speed Bump, But Not a Road Block To Recovery". The question we're now asking is whether the Northeastern economy will be disproportionately impacted by the CRE troubles relative to the rest of the nation. At first brush, the answer would appear to be 'yes' given the high concentration of CMBS in the region, but this could be misleading. The nine Northeastern states do account for slightly more than one-quarter of the CMBS market, with New York alone accounting for just over 15%. New York is second only to California (17%) in CMBS holdings. Massachusetts, New Jersey and Pennsylvania make up the bulk of the remaining Northeastern share of the CMBS market.

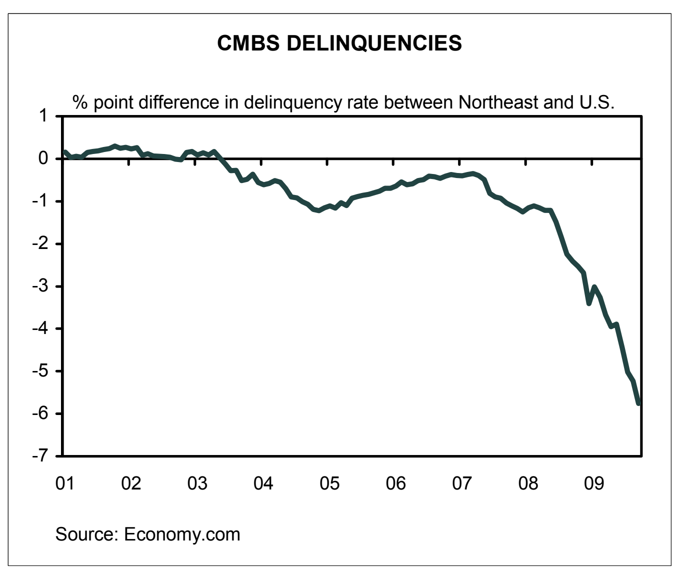
This handful of states in the Northeast may have high exposure to the CMBS market relative to their economic weight, but the quality of loans appears to be better than the nation, because delinquency rates are much lower. Now this is a bit of a game of who gets to stand on top of a rotting heap, because delinquency rates are unquestionably high across the board. However, the Northeast had a delinquency rate of 3.6% in February compared to over 8% in the West and more than 6% in the Midwest and West regions. In particular, New York's high concentration of loans has produced a delinquency rate of just 2.7%, with Massachusetts at an even lower 2.4%. The states on the higher side are New Jersey and Pennsylvania. However, their delinquency rates are only high relative to their own region, not relative to the national rate, where both states still have delinquency rates below that of the nation. The two main CMBS markets impacting New Jersey are:

1. The hospitality industry, where 20 states have delinquency rates in excess of 20%, including New Jersey. Pennsylvania is also feeling hardship in the hospitality industry, where the delinquency rate stood at 8% in March.
2. The industrial sector, where Moody's reported that in March, of the newly delinquent industrial loans in the broad Eastern region, nearly two-thirds were located in New Jersey.

To show the outperformance of the Northeast relative to the nation, the graph below reflects the difference between the delinquency rates. The downtrend deep into negative territory captures the widening gap being forged between the national delinquency rate, which is not only substantially higher, but also rising at a faster pace than the Northeastern region.

Refinancing risk for commercial real estate loans will





remain a dark cloud hovering over the CMBS market for several more years because rolling maturities will amount to $1.3 trillion by 2013. However, as the economy continues to gain momentum, it's possible (and even likely) that risk aversion among investors will lessen, facilitating greater credit flow to the sector and tempering the rate at which some of the higher quality CMBS fall into delinquency. Even if this doesn't occur to any great extent, if the CMBS market in the Northeast continues to outperform the nation, it will at least be in better standing to weather the storm to come.

Residential – a cut above

With the housing market at the center of the recession and a key determinant to the speed and sustainability of the recovery, the Northeastern residential market looks to be a cut above its regional counterparts. There are a number of reasons to believe this.

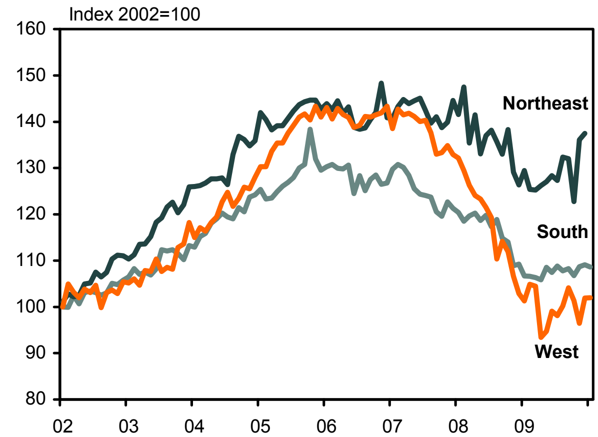
First, home prices in the Northeast never deteriorated as much as the rest of the country, resulting in fewer underwater mortgages, less contraction in wealth and, subsequently, fewer mortgage delinquencies. The average homeowner in the West is living with median home prices that are 29% below the peak, while those in the South and Midwest face prices that are 16-17% below the peak. In the Northeast, however, existing home prices are only 7% off peak levels.

Second, although inventories remain elevated across all regions, the Northeast has less buildup than the others, especially relative to the South and Midwest. Less inventory overhang means less downward pressure on prices.

Third, the potential for inventories to rise due to homes in the foreclosure pipeline is less in the Northeast because the region has a lower representation of delinquent mortgages. On average, almost 10% of mortgage loans were delinquent in the rest of the U.S. at the end of last year, compared to 8.6% in the Northeast. Both figures are high, but the Northeast has slightly more breathing room in terms of the number of loans in the pipeline that could turn into possible foreclosures, which would dump more supply onto the market and constrain improvements in prices. As with the CMBS delinquency graph shown earlier, the same pattern emerges when we compare residential delinquency rates with that of the nation, in which the spread not only shows the better position of the Northeast, but also that the pattern is a-typical of past recession cycles.

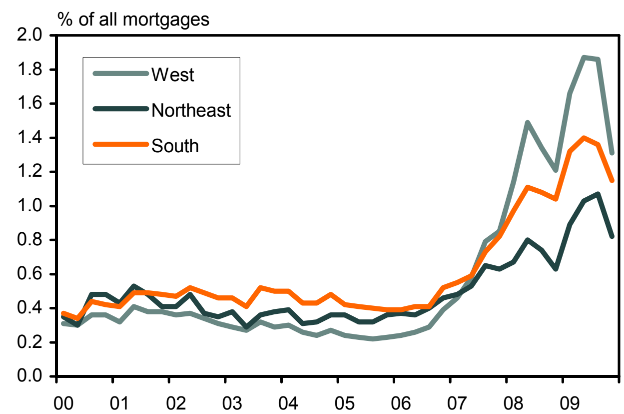
The one caveat on the Northeastern residential market is that because prices did not decline to a greater degree, affordability in the region did not improve as much as the other U.S. regions. One metric of affordability looks at the ratio of home prices to household incomes. This ratio

U.S. EXISTING HOME PRICES



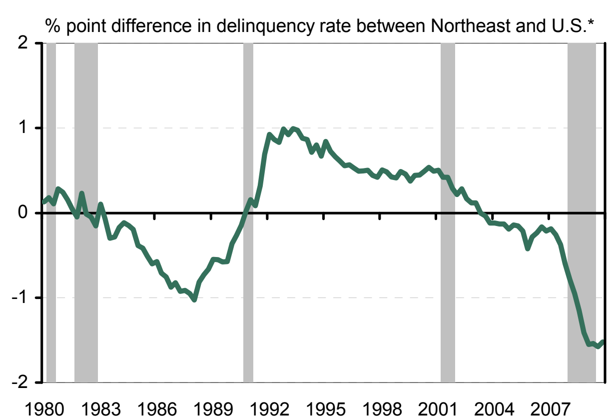
Source: Moody's\Economy.com

FORECLOSURES STARTED IN THE QUARTER



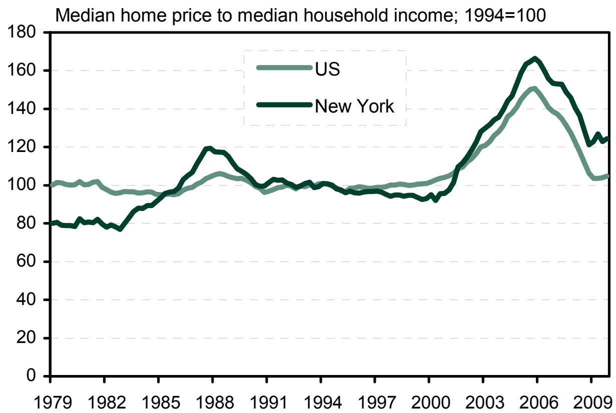
Source: Moody's\Economy.com

SERIOUSLY DELINQUENT MORTGAGES



*Excluding Northeast. Mortgages delinquent 90 days or in foreclosure
Source: Mortgage Bankers Association, Economy.com

HOME PRICE TO INCOME RATIO INDEX



Source: National Association of Realtors, U.S. Census Bureau, Moody's Economy.com

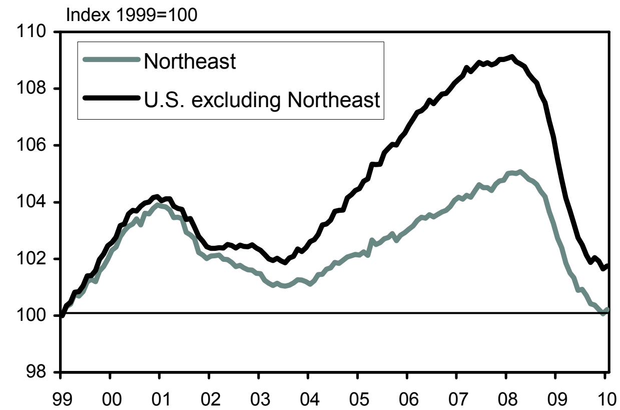
for Massachusetts has recently started to diverge above the national ratio, while the remaining states in the New England region have risen moderately over the national ratio. However, the greater concern is that New York and New Jersey appear to be considerably over-priced. The ratio for both states is not only higher than that of the U.S. average, but it is also higher than each state's own historical trend. Both factors suggest affordability will have to improve further to support stronger demand and price stability. However, this can occur in more than one way. For instance, the improvement in affordability can occur because prices fall, or it can improve because incomes rise at a faster rate than prices. The discussion on the employment and wages prospects in the next section suggests great possibility for the latter scenario.

Employment – recovery well embedded

The labor market is showing definite signs of stabilizing, enough so for the Federal Reserve to make note of it in its most recent policy communication statement. The stabilization is occurring across the nation, but the Northeastern economy is in a slightly more advantageous position. Northeastern workers faced a shallower job recession than the rest of the country. From peak levels, the labor market has contracted by 4%, which is half of the employment contraction experienced by the West and also well below the percentage decline experienced in the other two regions of the country. This may seem counterintuitive considering that the financial sector was at the center of the recession. However, the Northeast had a job-buffer in the form of a higher-than-average concentration of workers in the health and education fields, as these counter-cyclical sectors added to payrolls throughout the recession. In addition, the region also had lower exposure in construction jobs, which bore the brunt of the recession and contracted by a whopping 27% nationally from the peak. (For additional details see September 28, 2009 – Northeast Job Market is a Cut Above).

It's not all good news for the Northeast. The job market in the region had a much slower recovery following the 2001 recession, which did not return to pre-recession levels until the end of 2006 – two years after the rest of the nation. As such, although the recent job losses in the Northeast are considerably less than the rest of the nation as a share of the labor market, the total number of workers employed is sitting at 1999 levels. Perhaps it's this leaner starting position that helped the Northeast avoid the more dramatic losses in this recession.

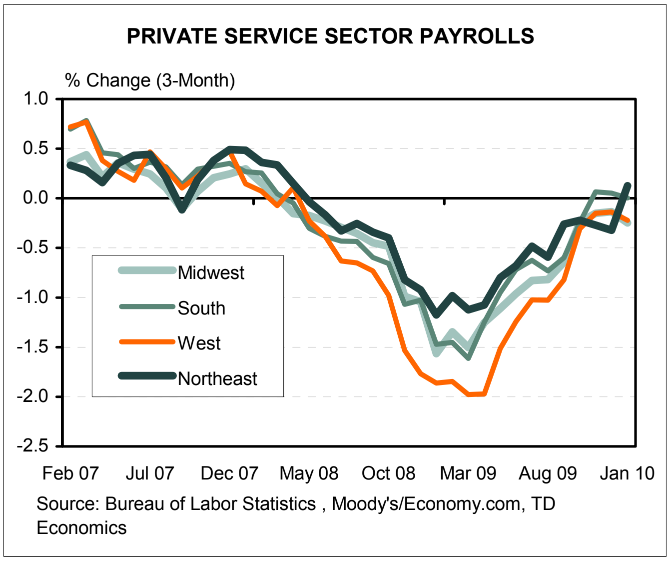
NON-FARM PAYROLLS

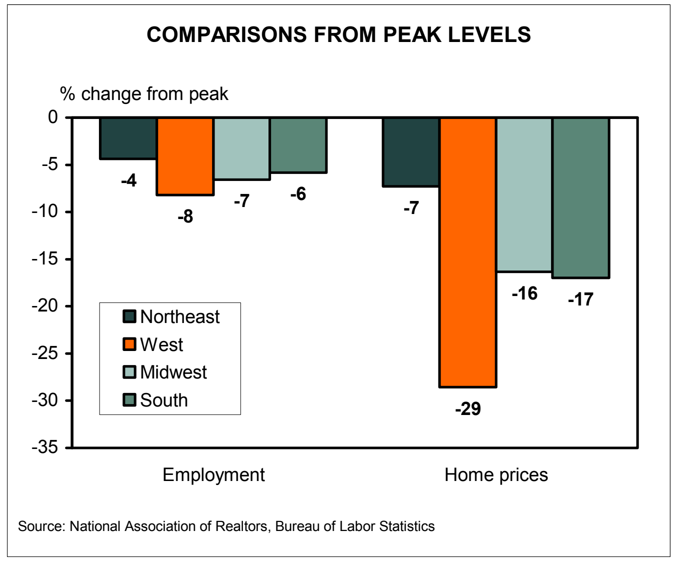


Source: Moody's\Economy.com

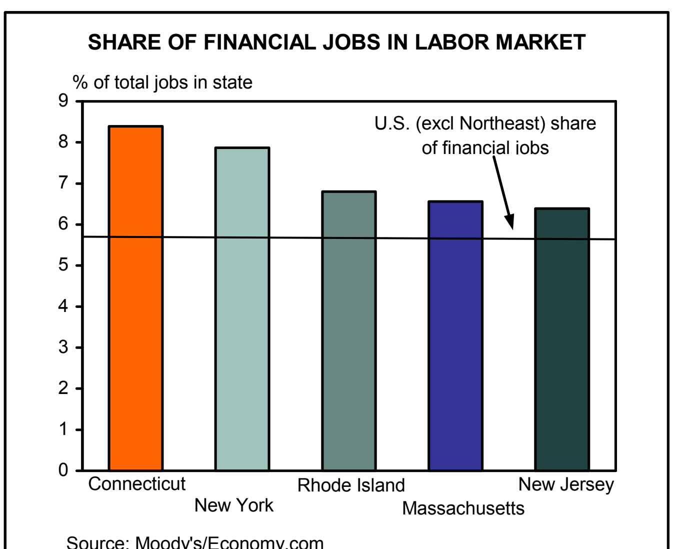
It does not look like history of a lagging job cycle in the Northeast is repeating in this recovery cycle. The Northeastern economy posted job gains in January, along with the Midwest and West regions. In particular, Northeastern service jobs in the private sector rose by 60,000 in the month, led by growth in retail, leisure and health and education sectors. In fact, on a three-month trend basis, private sector service jobs edged into positive territory, while the rest of the nation did not. This is an important development for the Northeastern economy, where private sector service jobs make up a higher share of the labor market, at 73%, compared to being in the 67-68% range elsewhere in the country. A recovery in professional service employment is linked most closely to the recoveries in large metro areas.

Wages and salaries are also making a swift comeback in the region. Although the regional data here is more limited, extending only to the third quarter of 2009, it is plain as day





that the Northeastern economy was already leading in wage gains. In the third quarter, wages were up 3% relative to the start of the year, while they remained in the red for the rest of the nation. The financial sector provided the kick, where wages have surged 19%, about four times more than financial sector wages of the other three regions. However, it behooves us to note that financial sector wages remain deeply rooted in negative territory relative to peak levels for the Northeastern economy, which has a skewed reliance on the high incomes generated by this sector. Having said that, many of the largest banks have made a swift recovery back to profitability, which will correspond with stronger income growth in the region. Although bonus payouts will not exceed the 2006-2007 record year, they are expected to be higher in 2010 relative to 2009. In fact, this could result in a significant divergence of Northeast incomes with the rest of the country, as Moody's/Economy.com predicts wage and salary growth in the Northeast to be nearly 7% on an annualized basis in the first quarter of 2010 compared with about 1% for the rest of the nation. The recovery of jobs in the financial sector is key to the health of the broader Northeastern economy due to its higher-than-average exposure to the sector and the positive feedback loop it creates with the housing market, government income tax revenues and consumption in general.



Conclusion

The Northeastern economy typically lags economic recoveries because of its more mature market and older demographics. And, the concentration of the financial industry in the Northeast amidst a recession defined as a financial crisis might have some arguing in favour of this dynamic this time around. It's possible that the data will conform to tradition and start to lag the rest of the nation in the months to come. Mathematically, this isn't a hard feat considering that the other economies will be bouncing up from very depressed levels (i.e. a low bar). However, we cannot gloss over the fact that the Northeastern market held up better than its counterparts during the recession. It simply has less ground to recover. Letting the data speak for itself, the Northeastern economy has developed an edge over the rest of the nation in three areas that make critical foundations to a broad and sustainable economic recovery – employment, residential real estate and commercial real estate. This suggests that the Northeast economy faces less downside risks and is well positioned to recover at a faster rate than the rest of the nation. The starting point matters, and in that area, the Northeast is the frontrunner.

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