

# Is a bottom in sight?

Answer: A bottom? *Yes!*

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## ***The Four Horsemen: Avoiding the Apocalypse***

Making bottoms in markets are a process and often entail contributions from many different sources. We have been looking to get more constructive on the spread banks based in part on the belief that a confluence of forces would come together to support housing and the capital markets at this critical juncture. Specifically, we have been looking to “four horsemen” to pull us out of this quagmire of a housing/credit bust. ***The four horsemen are:***

1. ***The Federal Reserve Board***, which has become increasingly creative in its various liquidity injection programs. Their role is largely to buy time to allow markets to clear in a more orderly, elongated fashion. At the center of these liquidity pools are the TAF auctions, the TSFL and the primary dealer credit facility, not to mention the discount window.
2. ***The U.S. Congress***, which we felt (particularly in an election year) would pass various housing support programs (using the ***FHA***, the ***GSEs*** and the ***FHLBs*** as their lead steers) to help stabilize the housing market. Toward that end the partisanship and swiftness with which housing bills (see below) are passing through the various levels of Congress says there is motivation toward this end.
3. ***The SEC and/or FASB***, which we felt would water down or bend the various fair value or mark-to-market accounting conventions. Toward that end, we note last Thursday’s (3/27/08) letter from the SEC which emphasized that assets did not need to be written down to market prices if those prices were the result of “*a forced liquidation or a distressed sale.*” Given that this wording already existed in the language of the original FAS 157/159 documents, it is curious that the SEC sought to harp on this one phrase in its recent letter. ***Yes, the fix is in.***
4. ***The Treasury Department***, which is consolidating power in an effort to coordinate rescue efforts. One of the keys to gaining market stability, we believe, will be to stabilize the U.S. dollar. Thus, a coordinated global intervention in the foreign exchange markets is likely. Given the coupling of currencies through the carry trade with commodities, we expect any dollar rally might be accompanied by a commodity correction. These two potential moves might do wonders to alleviate the inflationary fears that have been building over the past year.

***We believe that three of the four horsemen have taken form and that it is only a matter of time before the fourth emerges.*** It is with these support structures in place:

- That we believe the housing market will stabilize (albeit at depressed levels),
- That we will pull ourselves out of the existing recession,
- That the spread widening and risk-averse trades in the fixed income markets will reverse, and
- That a rally in financial stocks will develop.

# Housing – Volume Precedes Price

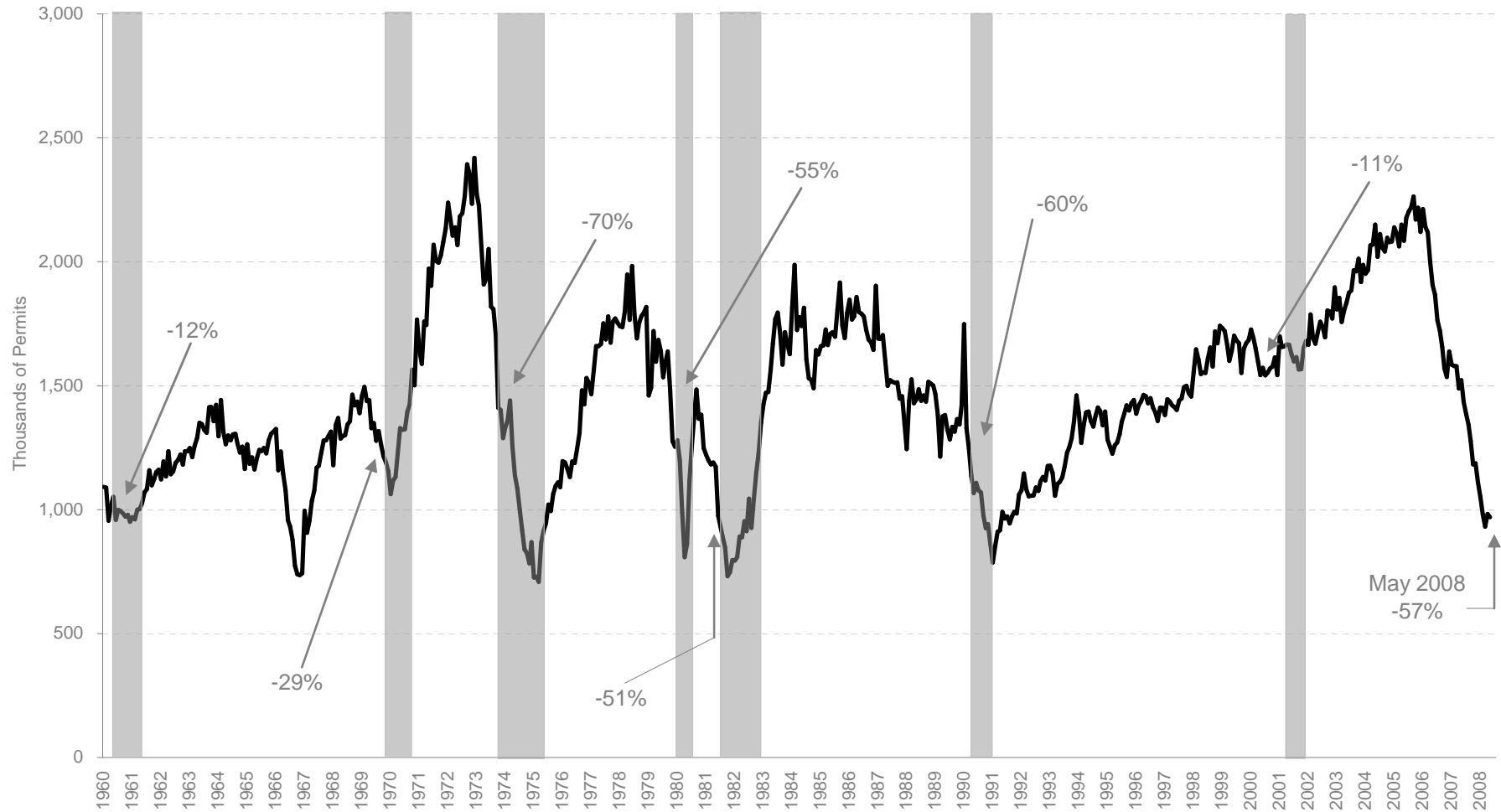
A bottom must be found before a sustained rally in financials can resume.

Two Bottoms:

- 1) A deflating asset on an over-leveraged balance sheet  
(collateral driven losses)
- 2) An inability to cover debt service requirements  
(cash flow driven losses)

### New Building Permits

Annualized; Seasonally Adjusted; Recessionary Years Highlighted

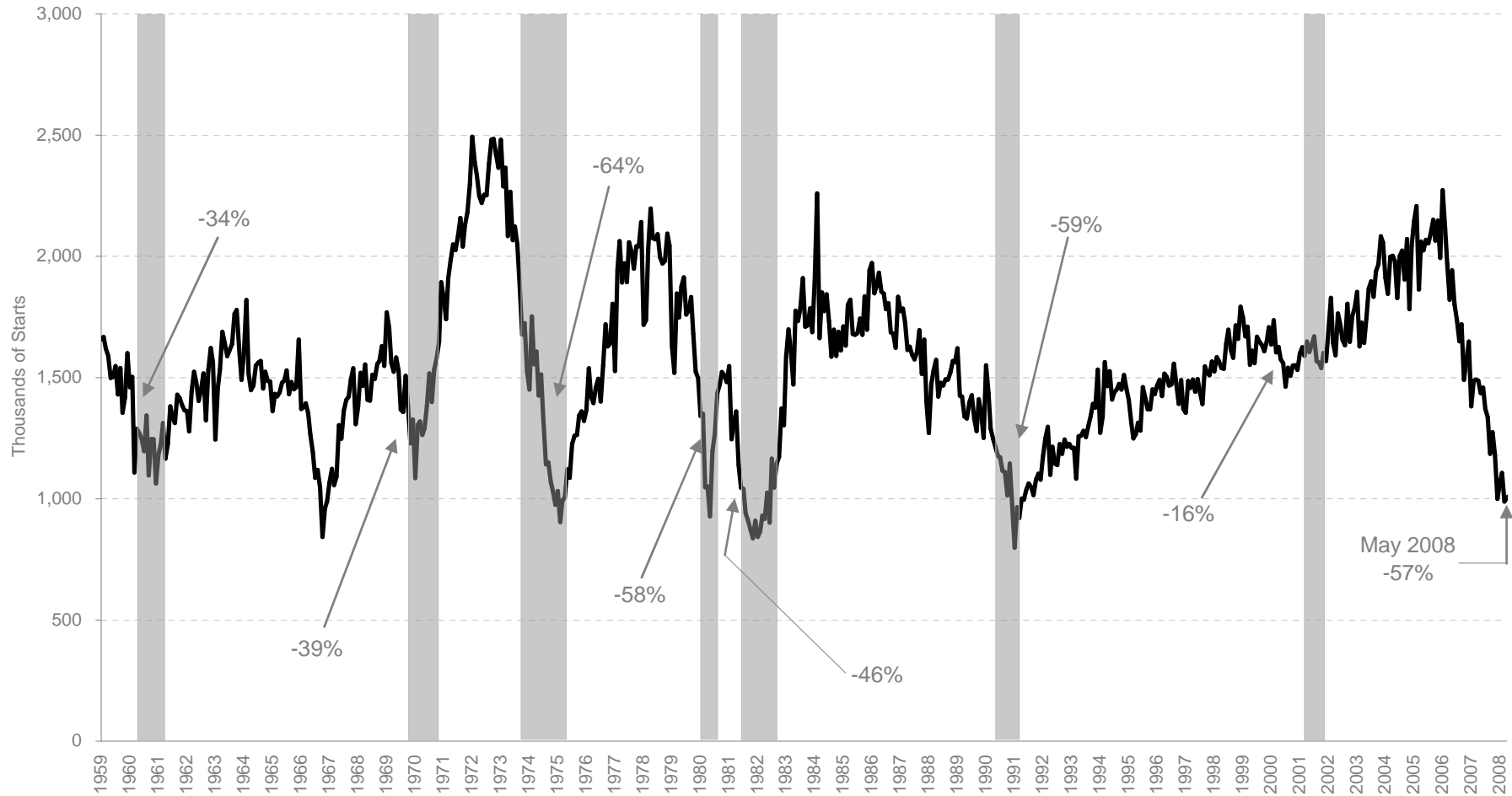


Seasonally adjusted building permits peaked in September 2005, and have now declined 57% through May 2008. The current drop is now in line with historical averages, but expect this housing recession to eventually rival that of the mid-70s.

Source: US Census Bureau, Portales Partners

### Monthly New Privately Owned Housing Units Started

Annualized; Seasonally Adjusted; Recessionary Years Highlighted

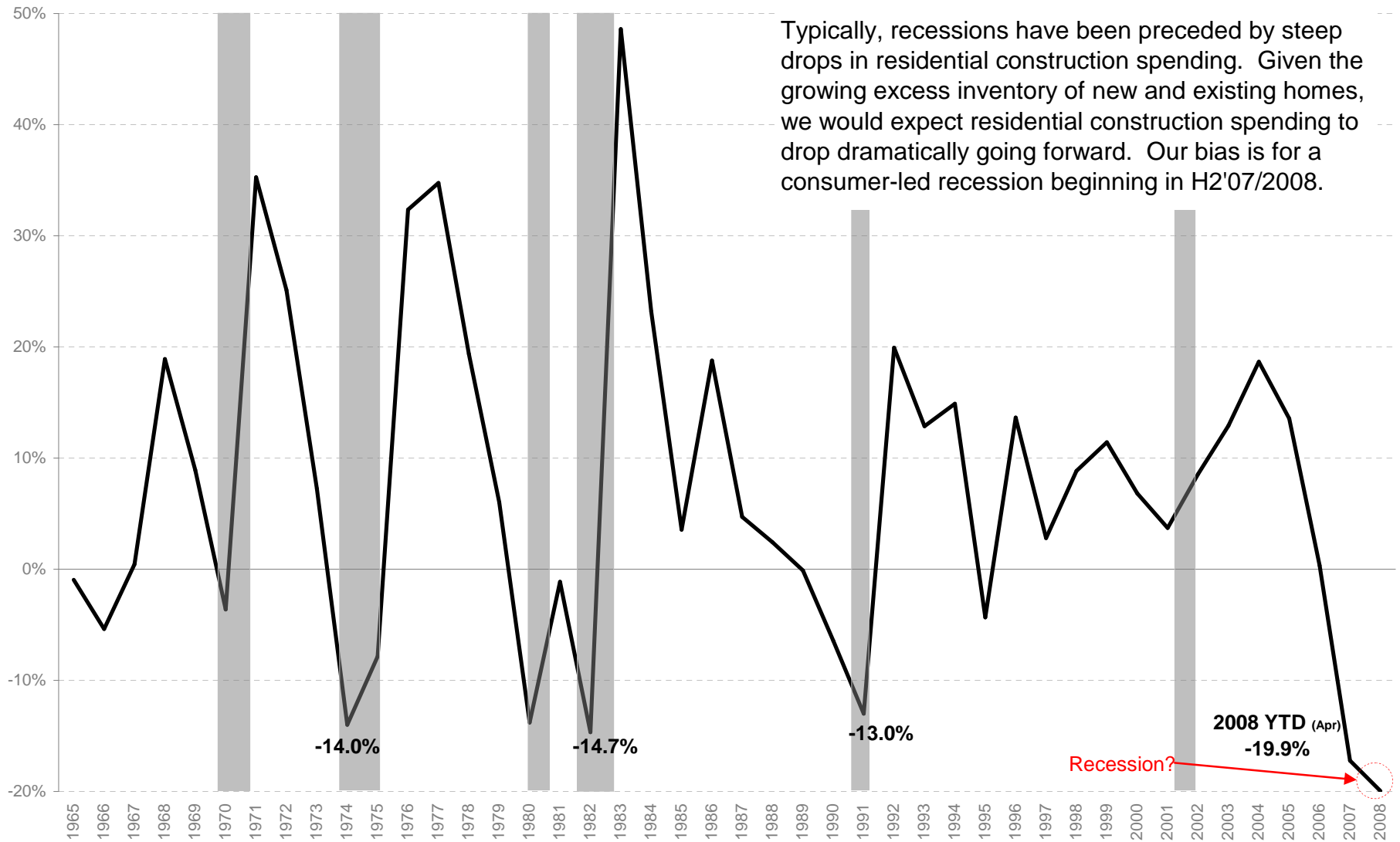


Since 1959, monthly housing starts have declined an average of 45% from peak to trough ahead of the recessions. Seasonally adjusted housing starts peaked in January 2006, and have now declined 57% through May 2008. This indicator is signaling a recession.

Source: US Census Bureau, Portales Partners

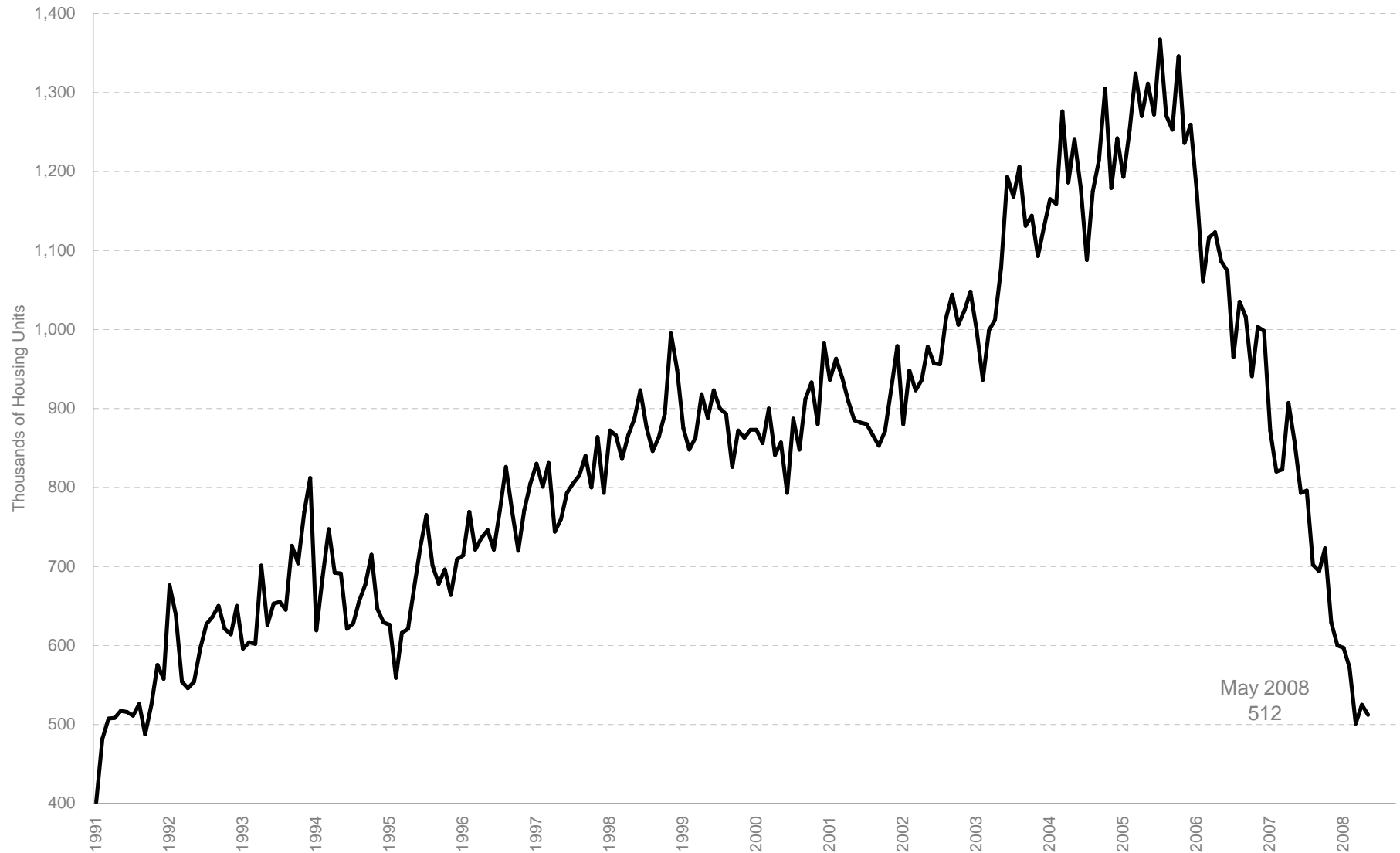
### Annual Change in Private Residential Construction (%)

Not Seasonally Adjusted; Recessionary Years Highlighted



Source: US Census Bureau, Portales Partners

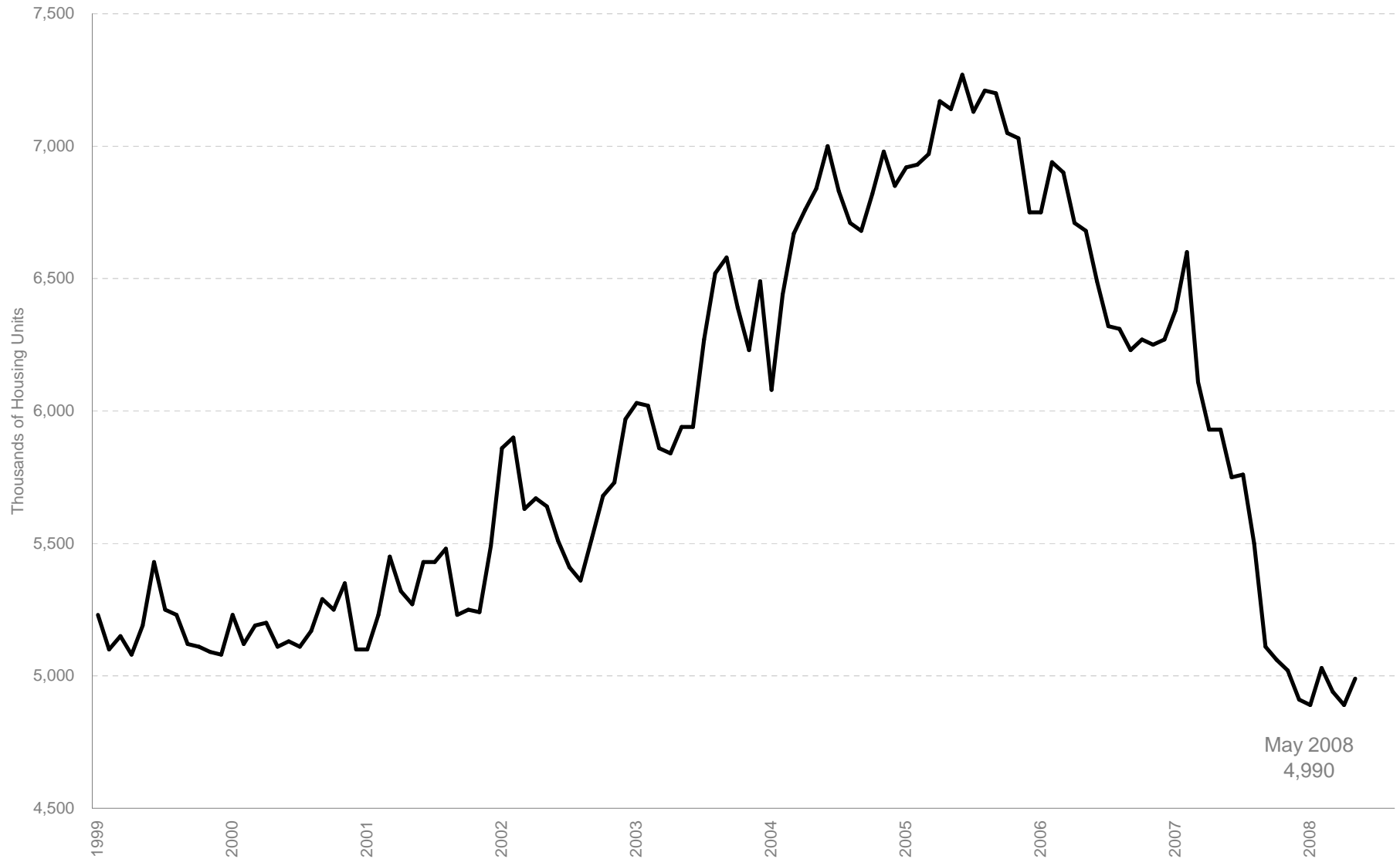
# NEW HOME SALES



Unit volume sales have clearly turned South. Sales have fallen below our earlier prediction of normalized levels of 750,000 to 900,000.

Source: US Census Bureau, Portales Partners

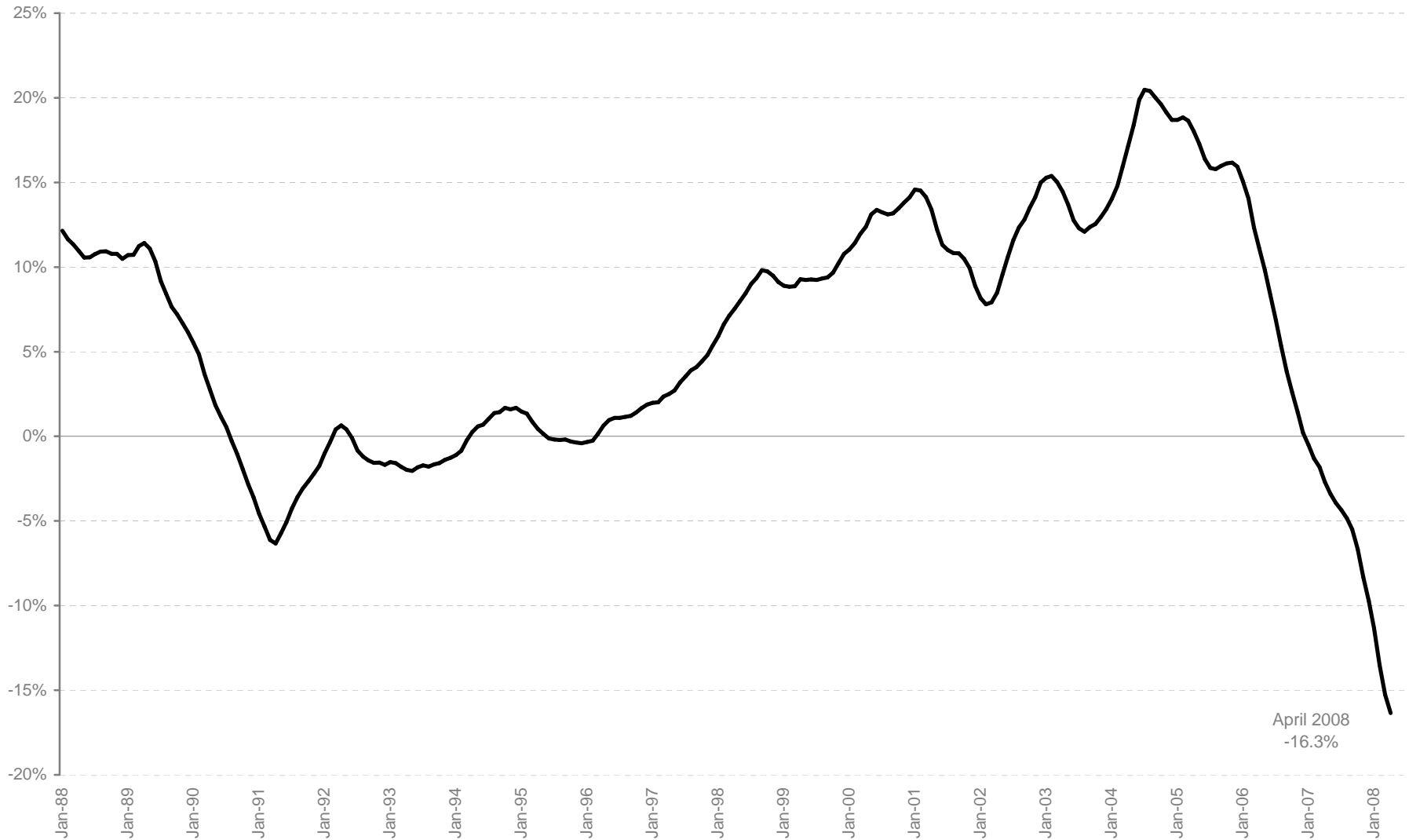
# EXISTING HOME SALES



Declines in unit volume sales should be followed by annual declines in prices, possibly on a national scale (something our nation has not experienced since the 1930s).

Source: US Census Bureau, Portales Partners

### S&P/Case-Shiller Home Price Index Composite-10, Δ% YoY



Source: Standard & Poor's, Portales Partners

Eventual home price declines could be in the 25-30% range, in real terms. Probably halfway there, as of today.

## S&P/Case-Shiller Home Price Indices

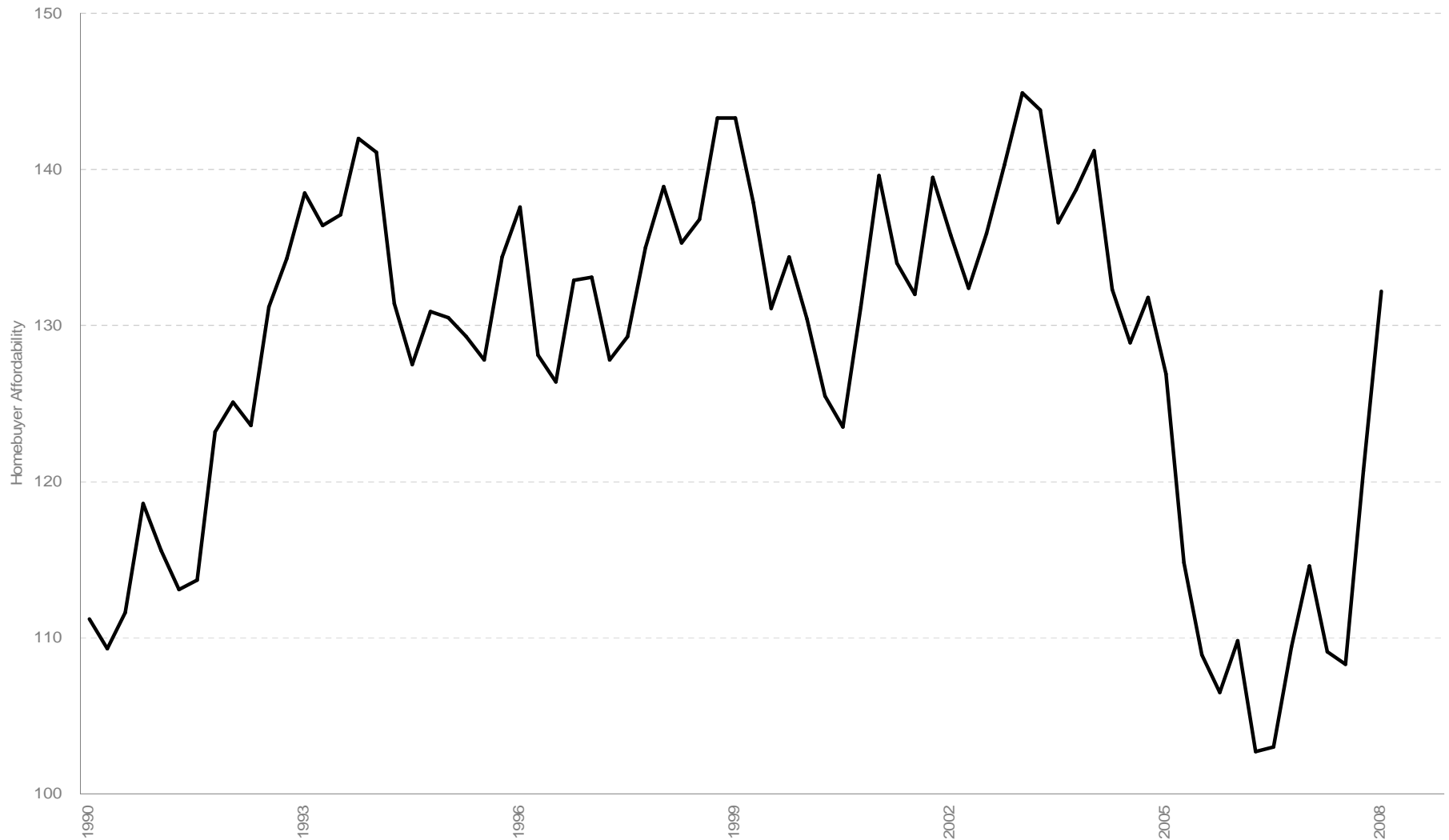
April 2008

	MoM	YoY	From Peak
Las Vegas	-2.0%	-26.8%	-29.3%
Phoenix	-3.4%	-25.0%	-29.1%
Miami	-4.1%	-26.7%	-28.6%
San Diego	-2.6%	-22.4%	-27.9%
Detroit	-1.9%	-18.0%	-26.2%
Los Angeles	-2.2%	-23.1%	-26.1%
Tampa	-2.1%	-20.4%	-25.0%
San Francisco	-2.2%	-22.1%	-24.6%
Washington DC	-1.0%	-14.8%	-19.9%
Minneapolis	-2.2%	-15.5%	-18.7%
Boston	<b>0.1%</b>	-6.4%	-13.0%
Cleveland	<b>2.9%</b>	-6.8%	-11.3%
Chicago	<b>0.1%</b>	-9.3%	-10.8%
New York	-1.3%	-8.4%	-10.1%
Atlanta	-0.1%	-7.5%	-9.0%
Denver	<b>0.8%</b>	-4.7%	-8.4%
Seattle	<b>0.7%</b>	-4.9%	-6.6%
Portland	<b>0.3%</b>	-4.7%	-6.2%
Dallas	<b>1.1%</b>	-3.4%	-4.8%
Charlotte	<b>0.2%</b>	-0.1%	-3.0%
Composite-10	-1.6%	-16.3%	-19.1%
Composite-20	-1.4%	-15.3%	-17.8%

Source: Standard & Poor's, Portales Partners

Deflation of an overleveraged asset has been broad-based.

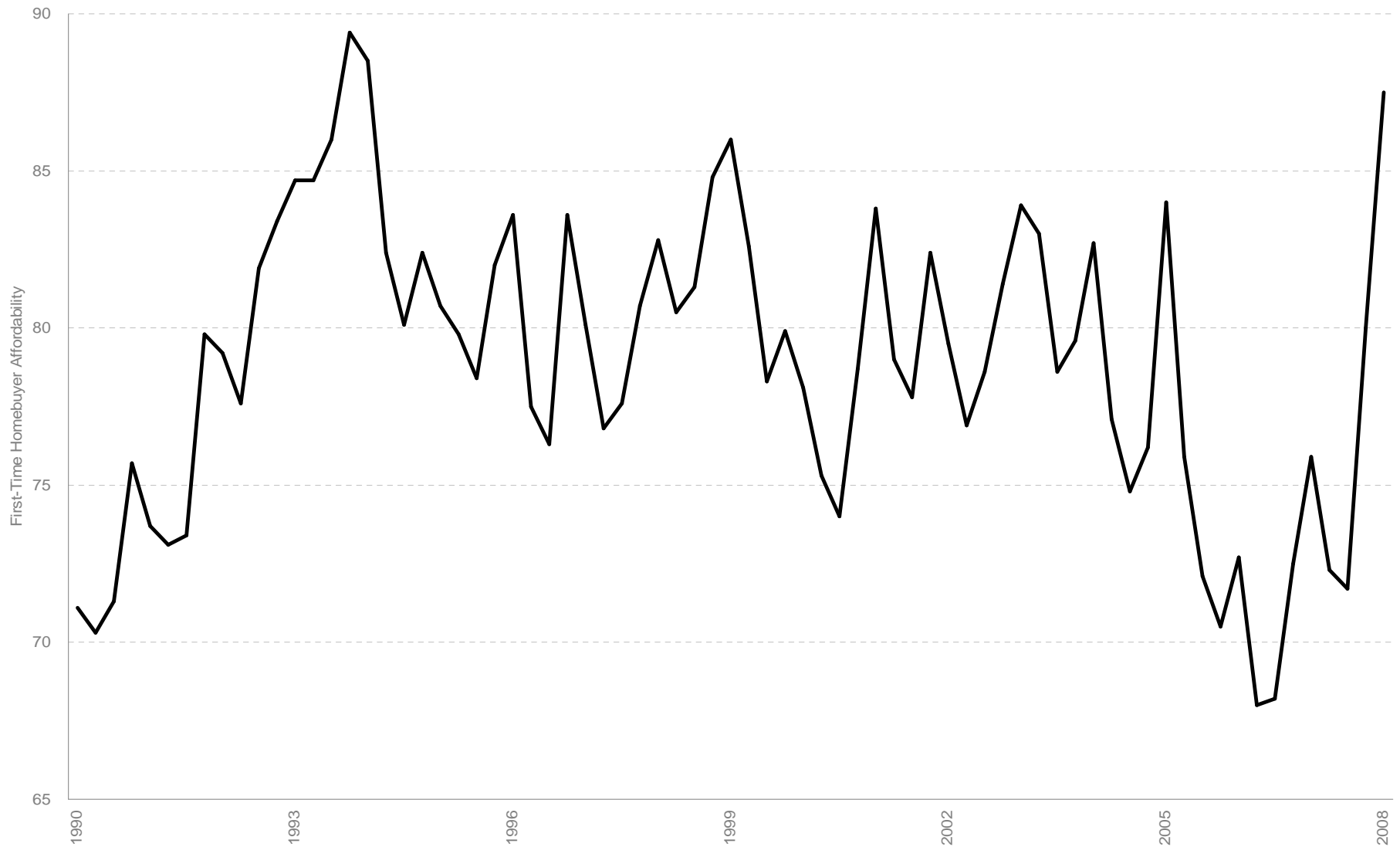
# HOME BUYER AFFORDABILITY



Source: Bloomberg, Portales Partners

With home prices dropping and financing costs coming down, affordability has probably improved dramatically...

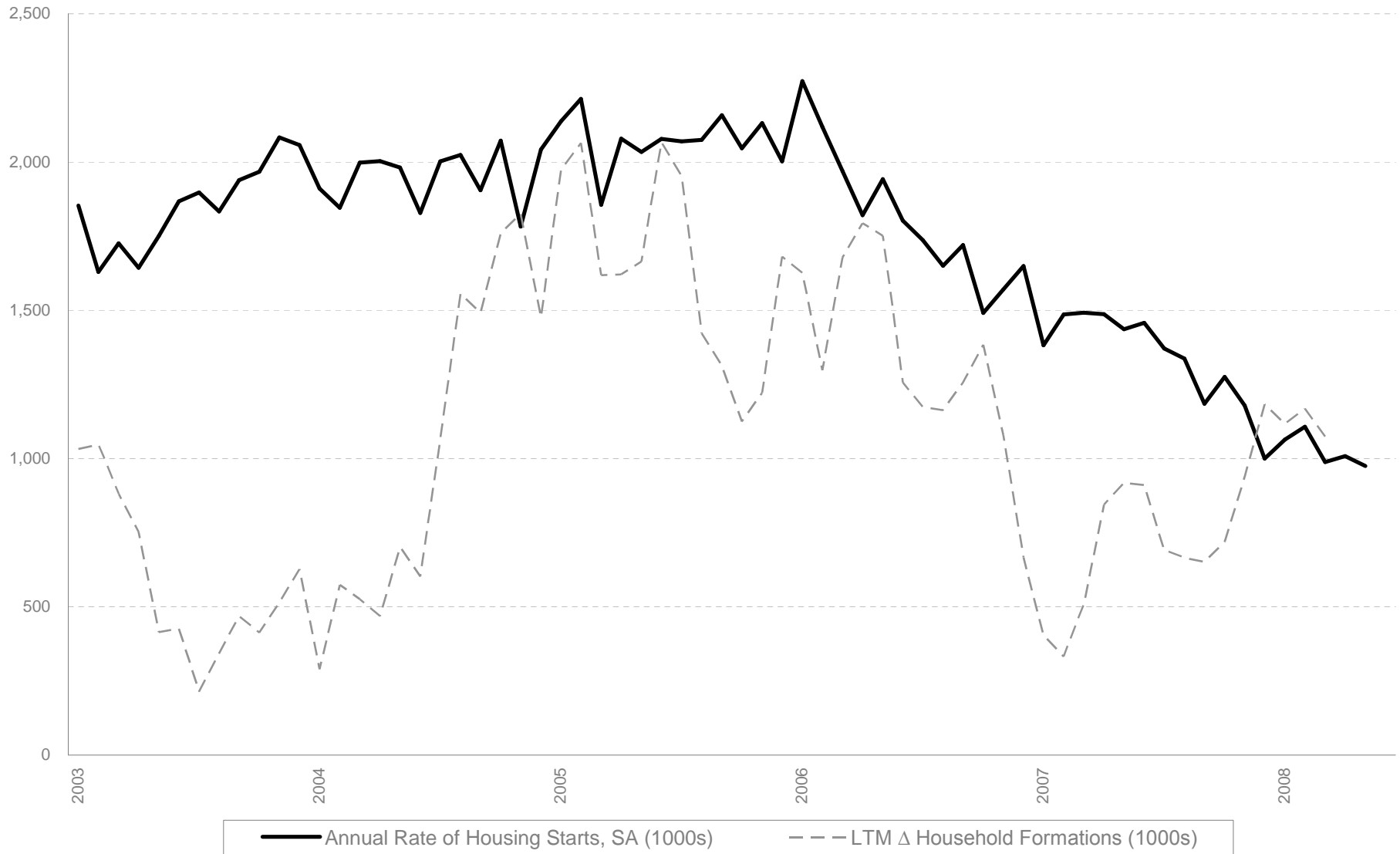
# 1<sup>ST</sup>-TIME HOMEBUYER AFFORDABILITY



Source: Bloomberg, Portales Partners

...And the 1st-time homebuyer may re-emerge this summer.

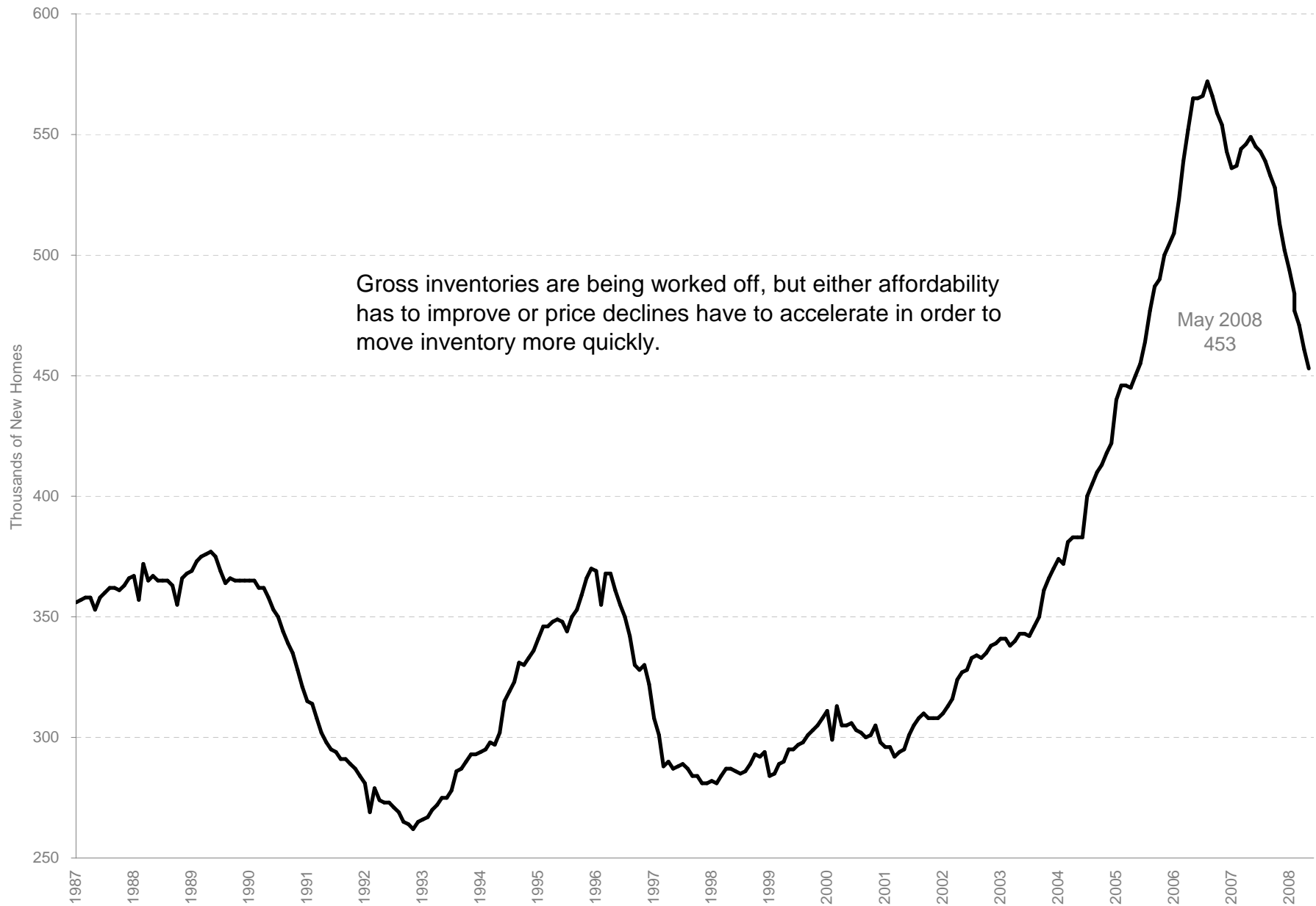
# HOUSING STARTS VS. HOUSEHOLD FORMATIONS



Housing starts have now fallen below the band of household formation changes that have occurred over the past two decades.

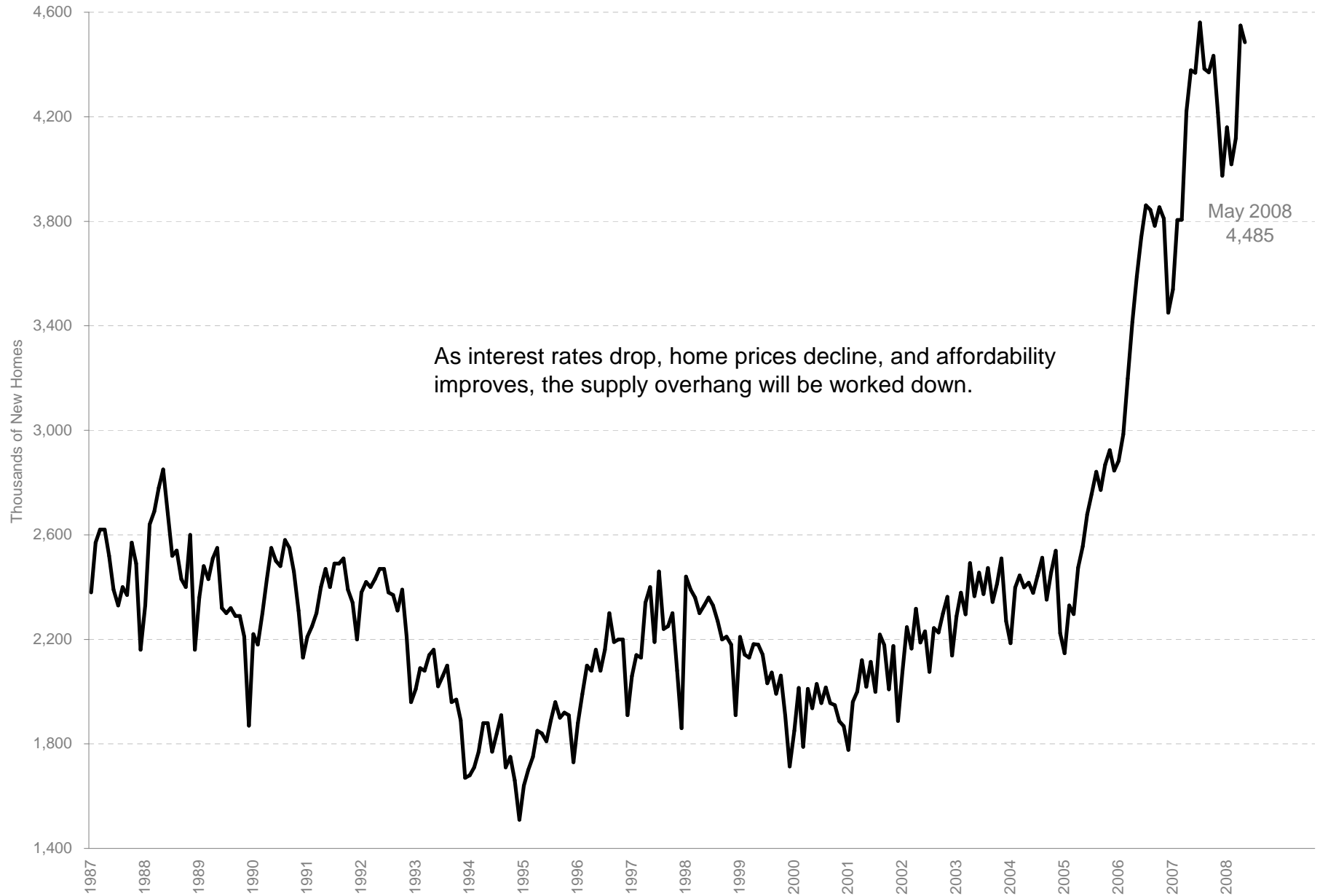
Source: US Census Bureau, Portales Partners

# SUPPLY OF NEW HOMES FOR SALE



Source: US Census Bureau, Portales Partners

# SUPPLY OF EXISTING HOMES FOR SALE



Source: US Census Bureau, Portales Partners

California...

...A Key Swing State

## California Housing Market at a Glance

California Housing Market Indicators	Reporting Period	Current Period	Last Period	Year Ago	MoM Change from Last Period	YoY Change from Year Ago
Existing Home Sales (SAAR)	March 2008	318,830	340,580	422,300	-6.4%	-24.5%
Median Home Price	March 2008	\$413,980	\$419,640	\$582,930	-1.3%	-29.0%
Unsold Inventory Index (Months)	March 2008	11.6	14.4	7.6	-19.4%	52.6%
Median Time on Market (Days)	March 2008	56.7	69.8	52.9	-18.8%	7.2%
First-Time Buyer Housing Affordability Index	Q4 2007	33%	24%	25%	9.0%	8.0%
30-Year Fixed-Rate Mortgage	March 2008	5.97%	5.92%	6.16%	0.05%	-0.19%

Source: California Association of Realtors, Freddie Mac, Portales Partners

## Regional Sales & Price Activity

Not Seasonally Adjusted

Region	Median Home Price			Home Sales	
	March 2008	Δ% MoM	Δ% YoY	Δ% MoM	Δ% YoY
California – Single-Family, Detached	\$413,980	-1.3%	-29.0%	-6.4%	-24.5%
California – Condominium	\$361,760	-1.6%	-17.8%	26.6%	-45.5%
High Desert	\$210,660	-4.4%	-34.3%	34.9%	-12.6%
Los Angeles	\$431,950	-9.6%	-25.6%	27.6%	-37.6%
Monterey Region	\$554,820	-10.5%	-23.8%	6.1%	-38.4%
Monterey County	\$430,000	-14.0%	-35.7%	7.5%	-28.1%
Santa Cruz County	\$645,620	-5.7%	-14.0%	4.1%	-49.3%
Northern California	\$356,950	2.7%	-8.8%	14.7%	-24.9%
Northern Wine Country	\$458,210	2.1%	-23.8%	39.6%	-32.4%
Orange County	\$591,460	-0.8%	-16.3%	12.5%	-36.6%
Palm Springs/Lower Desert	\$311,540	-7.0%	-20.1%	16.5%	-27.1%
Riverside/San Bernardino	\$276,630	-4.5%	-29.8%	45.5%	-3.9%
Sacramento	\$258,460	-0.1%	-28.8%	23.0%	4.7%
San Diego	\$447,500	-0.7%	-26.1%	15.5%	-29.9%
San Francisco Bay	\$704,580	-0.3%	-10.2%	34.5%	-33.3%
San Luis Obispo	\$467,310	-0.9%	-15.1%	44.4%	-25.1%
Santa Barbara County	\$576,090	19.2%	-34.2%	12.8%	-22.4%
Santa Barbara Southern Coast	\$1,140,000	-12.0%	-5.0%	26.4%	-33.7%
Northern Santa Barbara County	\$327,080	-2.1%	-19.7%	0.0%	-5.8%
Santa Clara	\$810,000	3.8%	-2.4%	36.3%	-35.0%
Ventura	\$504,210	-3.1%	-25.0%	15.7%	-38.5%

Source: California Association of Realtors, Portales Partners

## 2007 First-Time Buyer Housing Affordability Index

	Q1 '07	Q2 '07	Q3 '07	Q4 '07
California	25	24	24	33
California – Condominium	38	36	38	42
United States	63	62	62	65
<b><u>Region</u></b>				
Central Valley	41	42	n/a	n/a
High Desert	44	45	48	54
Los Angeles County	20	20	20	27
Monterey Region	19	17	16	20
Northern California	37	37	38	42
Northern Wine Country	24	23	24	33
Orange County	25	23	24	28
Palm Springs/Lower Desert	32	31	33	38
Riverside/San Bernardino	36	37	39	46
Sacramento County	43	44	46	53
San Diego County	23	23	24	31
San Francisco Bay	24	18	18	23
San Luis Obispo County	21	19	20	28
Santa Barbara Area	12	12	11	21
Santa Clara County	27	21	21	24
Southern California	25	23	24	33
Ventura County	26	25	25	30
<b><u>County</u></b>				
Alameda	25	23	23	27
Contra Costa	19	16	16	22
Fresno	44	44	44	47
Marin	21	19	20	22
Merced	46	46	48	51
Riverside	35	35	36	42
San Bernardino	39	40	44	46
San Francisco	18	15	15	20
San Joaquin	38	39	n/a	n/a
San Mateo	19	18	17	19
Santa Cruz	20	18	17	22
Sonoma	26	24	25	36
Stanislaus	40	41	n/a	n/a

Source: California Association of Realtors, Portales Partners

### Example Area - Lompoc/Santa Maria

<b>Peak Purchase Price</b>	=	\$500,000	
<b><u>Recent Auction Price</u></b>	=	<u>\$250,000</u>	(down 50%)
<b>Mortgage Interest Cost</b>	=	\$ 15,000	(at 6% rate)
<b>Taxes</b>	=	\$2,500	
<b><u>Insurance &amp; Misc. Costs</u></b>	=	<u>\$2,500</u>	
<b>Total Payments</b>	=	\$ 20,000	
<b>Two Income Family - Gross Wages</b>	=	\$80,000	
<b>Payments as % of Gross Income</b>		25%	
<b>House Price as % of Gross Income</b>		3.1x	
<b>House Rental Rates</b>		\$1,500-\$2,000	(per month)
<b>Competing Interest Rates (MMDAs, Savings, etc.)</b>	=	1%-2%	
		(i.e., no big positive carry necessary to compete)	

Source: Portales Partners

## Rent Ratio Declines

(Purchase Price of a Typical House Divided by the Annual Rent of That House)

MSA	Peak	Q1'08	Δ%
New Orleans	19.1	11.5	-40%
Sacramento	28.0	17.6	-37%
San Diego	28.3	19.0	-33%
Riverside - San Bernardino	23.9	16.1	-33%
Las Vegas	24.0	17.1	-29%
West Palm Beach	31.4	23.4	-25%
Orange County	29.7	22.2	-25%
San Francisco	34.5	26.1	-24%
Los Angeles	31.5	24.1	-23%
Phoenix	22.5	17.3	-23%
Memphis	15.6	12.1	-22%
Washington	21.4	16.8	-21%
Fort Lauderdale	26.7	21.0	-21%
Miami	28.2	22.4	-21%
Minneapolis	19.1	15.3	-20%
Boston	27.5	22.2	-19%
Tampa	21.4	17.5	-18%
Chicago	17.7	14.5	-18%
New York*	26.8	22.2	-17%
Orlando	26.3	21.9	-17%
Columbus, OH	13.6	11.4	-16%
Dallas	15.2	12.8	-16%
St. Louis	15.3	12.9	-16%

MSA	Peak	Q1'08	Δ%
Denver	17.4	14.7	-16%
Atlanta	18.6	16.2	-13%
Cincinnati	15.1	13.2	-13%
Indianapolis	13.6	11.9	-13%
Kansas City	14.4	12.7	-12%
Oklahoma City	15.7	13.9	-11%
Jacksonville	18.9	16.9	-11%
San Jose	34.3	30.7	-10%
Nassau/Suffolk	23.0	21.1	-8%
Milwaukee	17.6	16.4	-7%
Baltimore	18.8	17.6	-6%
Portland	17.7	16.8	-5%
Hartford	18.2	17.4	-4%
Houston	16.1	15.4	-4%
Philadelphia	16.3	15.6	-4%
Charlotte	18.8	18.0	-4%
Oakland	22.9	22.2	-3%
Pittsburgh	13.9	13.6	-2%
Raleigh	18.4	18.1	-2%
Austin	15.3	15.3	0%
Salt Lake City	16.0	16.0	0%
San Antonio	17.8	17.8	0%
Seattle	17.9	17.9	0%

\* = Includes Westchester County and Northern New Jersey

Source: Moody's Economy.com, NY Times, Portales Partners

# Government Support

Given the importance of housing to our economy, we have always felt that the government would intervene, thereby prohibiting the true market-clearing mechanisms to work. Thus, a Japanese-styled elongated economic malaise is likely. No immediate catharsis.

# Government Support

## **Implemented**

- Economic Stimulus Plan
  - Tax Rebate Checks
  - Accelerated Depreciation for Business
  - Tax Write-Offs for Capital Investments
  - Infrastructure Projects
  - Food Stamps
- FHA & GSE programs
  - Raise Loan Limits
  - Lower GSE Capital Requirements
- HOPE NOW Initiative
  - Mortgage Servicer Outreach Effort to Distressed Homeowners
  - Fed Fund Cuts

## **Being Considered**

- Extend Loan Workout Period Before Foreclosing
- Temporarily Freezing Mortgage Rates
- Loan Contract Renegotiations Through Bankruptcy Courts
- FHA Refinance of Loans Whose Principal Has Been Reduced by Lenders at Risk to Foreclosure
- Eased FHA Lending Standards