

Housing is a Buyer's Market

This May Not Be the Bottom, but it Might Be the Beginning of the Bottom

Home sales have increased, but this seems to be the result of sellers accepting lower bids rather than a broad-based increase in demand and buyer confidence.

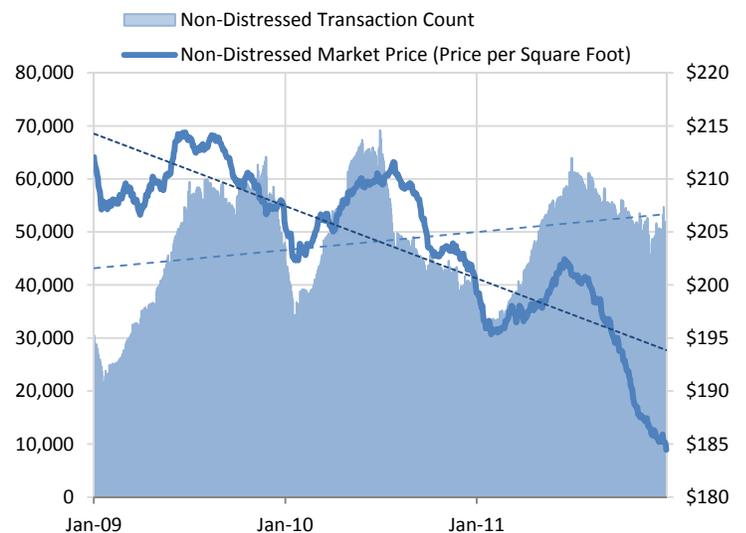
The price and sales trends observed in 2011 are consistent with sellers dropping their prices to meet bids from bargain-hunting buyers. Sales in the non-distressed market increased in 2011, but the increase in sales was accompanied by declining prices.

Insofar as sellers are willing to accept lower offers, housing is currently a buyer's market. Unfortunately, difficulty in accessing financing and concerns over inventory are preventing buyers from entering the market in force. Would-be buyers are still experiencing difficulty accessing mortgage financing. While rates remain near record lows, lenders remain risk averse and underwriting standards remain extremely strict.

Moreover, buyers remain apprehensive of purchasing new homes given their perception of a large inventory overhang that will weigh on home prices well into the future.

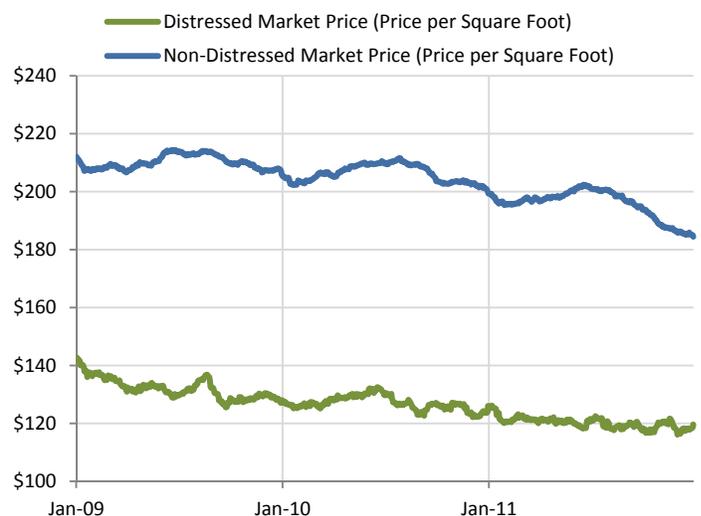
Prices in distressed sales declined slightly in 2011, but less than prices in non-distressed sales. As a result, the price spread between distressed and non-distressed sales tightened.

25-MSA Composite -Non-Distressed Market Price and Transaction Count



Source: Radar Logic

25-MSA Composite -Distressed and Non-Distressed Market Prices



Source: Radar Logic

The inventory of homes for sale is declining, but potential supply remains huge by historical standards.

The National Association of Realtors reported an inventory of 2.31 million existing homes for sale in January. At the rate of sales at the time, that inventory would amount to a 6.1 months' supply, the lowest such figure since 2006. Both inventory and months' supply declined from December 2010 to December 2011, with inventory dropping 23% and months' supply dropping 21%.

However, these inventory figures do not include vacant homes held off the market, homes securing delinquent mortgages and in the foreclosure process, or homes with underwater mortgages. When these homes are taken into consideration, the potential supply of homes, including homes on the market and on their way to market, remains large in historical perspective despite the recent declines.

Homes with underwater mortgages are at increased risk of falling into foreclosure, so given the huge number of such homes, some 11.1 million according to CoreLogic, it seems likely that the number of underwater borrowers who strategically default will be measured in millions, particularly if housing prices continue to fall. The vast majority of the 2.1 million homes in the foreclosure process will enter the market via REO sales, and as the rate at which loans 90+ days delinquent transition into the foreclosure process remains very high, it is likely that the bulk of the 1.8 million loans in this category will eventually enter REO inventories and be put up for sale as well. It is also likely that, when prices eventually firm and start to recover, a considerable number of the 3.6 million vacant homes held off the market will be put up for sale. Thus, given the number of homes in each of these categories of potential inventory, the figure of 2.31 million existing homes for sale probably understates the current supply overhang by millions of homes.

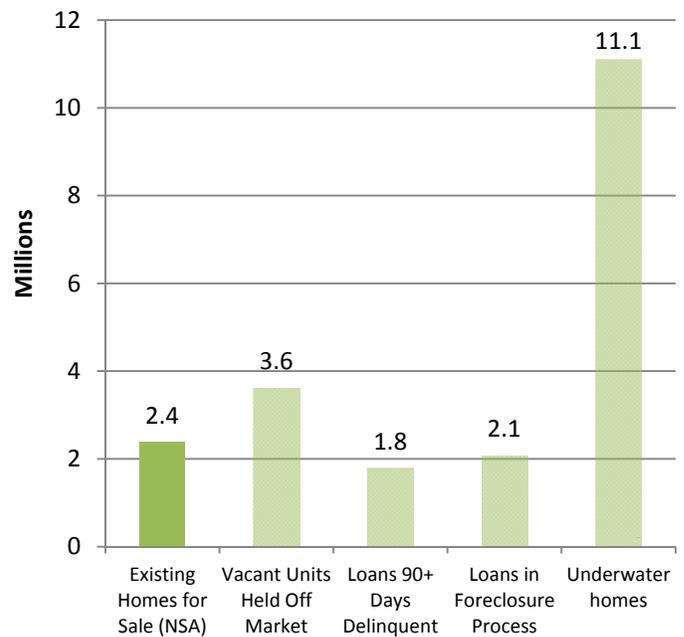
It is important to note that the large potential housing inventory does not need to be put up for sale in order to weigh on home prices. The mere perception of a large supply overhang reduces buyer confidence that home values will rise in the near future, and feeds fears of further declines.

Existing-Home Inventory and Months' Supply, 2007-2011



Source: National Association of Realtors

2011 Year End Inventory Figures



Sources: Existing homes for sale from the National Association of Realtors, vacant units held off market from the Census Bureau, loans 90+ days delinquent and loans in foreclosure from LPS Applied Analytics and underwater homes from CoreLogic

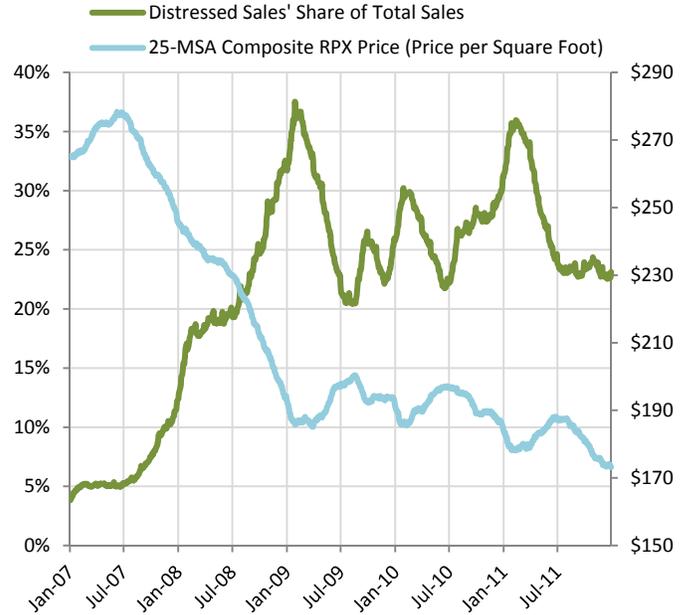
When housing markets finally start to recover, declines in distressed sales will amplify improvements in RPX prices.

Distressed sales as a percentage of total sales are inversely correlated to RPX daily prices. The reason is simple: homes sold in distressed sales are priced at roughly a 36 percent discount, on average, to homes sold in non-distressed sales. As distressed sales with heavy discounts increase as a percentage of total sales, the RPX price, which measures the price that one is most likely to observe in a given market, will decrease. And conversely, as distressed sales decrease as a percentage of total, the most likely observed price in a metropolitan housing market will increase.

As such, changes in the ratio of distressed sales to total sales will cause RPX prices to change, even if values of individual homes remain constant. This has important implications for how the RPX indices will react when housing markets finally move into a sustained recovery.

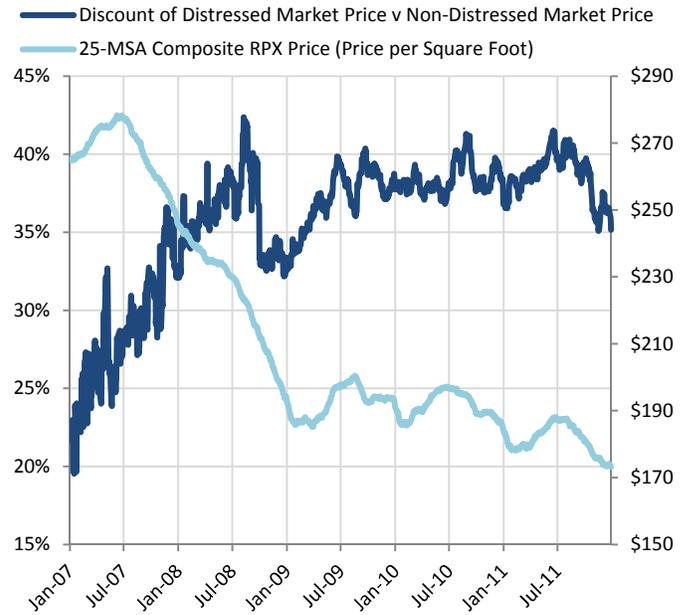
When housing markets recover, prices of non-distressed properties will start to increase, foreclosures will become less common, inventories of distressed homes will start to return to normal levels, and sales of REO likely will decline. The decline in distressed sales will cause the market price for homes, as measured by the RPX, to increase. This increase will be independent of changes in the values of individual homes, which presumably will also increase as demand increases and supply returns to historical norms. Thus, market-wide prices will increase more quickly than the prices of individual homes. The result could be a more rapid than expected increase in RPX values off the trough of the current boom-bust cycle.

25-MSA Composite - Distressed Sales as % of Total Sales



Source: Radar Logic

25-MSA Composite - Price Discount, Distressed Sales Vs. Non-Distressed Sales



Source: Radar Logic

Bernanke - No economic recovery without improvement in the housing sector

On February 10, Fed Chairman Ben Bernanke gave a speech at the National Association of Home Builders International Builders' Show in Orlando, Florida. Bernanke concluded his speech by noting that the housing sector has been a key impediment to recovery in the broader economy:

In sum, the economic recovery has been disappointing in part because U.S. housing markets remain out of balance. Many local markets have an overhang of empty and foreclosed homes, and many potentially creditworthy homebuyers cannot obtain mortgages. The weak housing market also impairs homeowners' financial health and diminishes the quality and stability of neighborhoods and communities. For these reasons, and because the troubled housing market depresses construction activity and employment, we need to continue to develop and implement policies that will help the housing sector get back on its feet. No single solution will be sufficient. But sustained efforts to address the many interlocking factors holding back the housing market will pay dividends in the long run.

We are pleased to hear the Chairman acknowledge that recovery of the US economy will be contingent upon stability in the housing sector. We at Radar Logic have held this view for years now, and hope that the renewed focus of the Fed and the administration will lead to pro-active and innovative programs to address the housing crisis. We agree that the key challenge facing the housing market is excess supply relative to demand and will watch closely to see how this imbalance evolves. This will be the key to a housing recovery.