Atlantic Equity Research
Independent Research

November 29, 2006

Foreclosures, is this the beginning of the end or the end of the beginning?

Exhibit 1

Notice of defaults/ California
'92 – Q -3 -2006
Source – DataQuick
In thousands

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
	101	121	123	136	163	141	122	101	89	81	78.7	66.1	52.5	54.4	66.1
in thousands															

06 - 3 qtr's

Former Federal Reserve chief Alan Greenspan has recently claimed we are near a bottom for the decline in home sales and prices. Home sales are down a fair amount in the U.S. so far and inventory has increased dramatically over the past six months. Prices have come down significantly in some areas of the country, but, overall have just started to come down nationwide in the single digits, in year – over - year comparisons over the last few months. Home prices in Massachusetts, New York, Virginia, Florida, Arizona, Nevada and California have at least doubled between 1997 and 2005. The above exhibit uses data from Data Quick, a company that tracks the foreclosure market. The exhibit shows the number of notice of defaults issued in California between '92 and the third quarter of '06. **Notice how small the number for notice of defaults issued over the last five years is compared to the mid - nineties.** The number of notice of defaults issued in the years '04 and '05 were less than half of every year in the nineties. And notice how there has been just 66K notice of defaults issued though the first nine months of this year. These numbers show we are at the very beginning stages for foreclosures, and all recent data shows the growth rate for foreclosures all over the U.S. has increased dramatically over the last six months. And, one must keep in mind that in the U.S. new home sales went from 790K in 1996 to 1.25 million in '05 and existing home sales went from 5 million in '99 to 7 million in '05. In my opinion given the recent growth in the rate of foreclosures and the growth in the absolute number homes sold over the last few years California will easily surpass the record of 163 K notices of default issued in 1996 within the next few years. And the huge foreclosure growth rate increases over the last six months have not just affected the so called "bubble" states or the rust belt states. Colorado, Georgia, Texas and Utah were all in the top ten in the recent third quarter for foreclosures per population according to Realtytrac, a company that follows the foreclosure market.

Home ownership rates have gone from about 65% of the population to approximately 70% over the last 10 to 20 years. Almost everybody is in agreement that lending practices by banks in the U.S. have been extremely aggressive over the last five years. If there has been 50 to 75% more new and existing homes sold over the last few years compared to ten years ago, and prices have at least doubled in California, and wages have been less than inflation in four of the last five years, how could this be the end of the housing market decline if the number of notices of default are still less than half of what they were ten years ago? The housing correction ending declaration by Greenspan doesn't make any sense to me.

The reason why notices of default are still so low is that price declines are just starting to accelerate. People through the first half of this year could get about the same price for their house as they received a year earlier. This is now changing hence notices of defaults are really starting to accelerate. Notices of default were up 111.8% in California in the third quarter in year – over – year comparisons, and were up 28.3 % sequentially from the second quarter. The third quarter represented over 40 % of the notices of default for the first three quarters of the year, and October had 13.6 K notices of default, which was about half of the entire third quarter amount. But, as mentioned, it is important to remember this year will still represent about 40 % less notice of defaults than the height in '96 when there were much less houses being sold. And, notices of default only go out after 90 days of delinquency. Actual foreclosures usually take 6 to 9 months before the homeowners are removed from their houses. In my opinion the lag on when the foreclosure data hits the market has made the so called "soft landing" in the housing market seem not so bad. It is also estimated by several sources that over a trillion worth of adjustable loans will reset in '07, while in '06 less than $500 billion of adjustable mortgages reset. I believe that all of these data points show that we are just at the very beginning of the housing market correction. The housing market in my opinion will not really start to correct until the results of the creative mortgages offered over recent years start to be filtered through the market. Once the adjustable mortgages start to reset in force next year defaults and foreclosures will really start to accelerate. And then once the market for mortgage backed securities starts to absorb the fact that defaults and foreclosures are skyrocketing, interest rates and the current easy lending standards will change. This is when we will have a housing market correction. It is important to remember that right now people can still get no-document, adjustable loans even if they have poor credit. Credit standards are still easier than they ever have been. How can we be at the bottom of the housing market correction when lending practices just have not changed and the obscene lending practices have just begun to be absorbed by the credit markets?

According to Realtytrac there have been over a million filings of foreclosures so far this year, up 27% from last year. The flings include notices of default, notices of auctions and notices of property being taken over by financial institutions. Realtytrac data showed that in the third quarter there were 318.5K filings of foreclosure, up 43 % from last year, and up 17% sequentially. Places, such as Florida, have experienced close to 100% increases in foreclosure notices in year – over - year comparisons.

Many people I have spoken to are surprised that foreclosure rates until recently have actually been quite low when you consider the easy lending standards and the increase of home prices. I believe that this can be explained by the fact that as mentioned prices are now just starting to fall, and the fact that banks are loath to put someone into default. According to my research banks are much more willing to give someone a moratorium on mortgage payments for several months, stretch payments over a longer time period or to lower interest payments than they were 10 to 20 years ago. It is very costly and resource intensive to put some one through the foreclosure process. Plus it looks terrible to investors if there are high rates of foreclosure. What would all those banks in China and Japan think that buy Fannie Mae and Freddie Mac bonds if there were suddenly huge defaults and foreclosure rates?

Exhibit 1 also shows an extremely interesting phenomenon. The technology bubble crashed in 2000. California was affected as much as any state in the country by the technology bubble crashing. California experienced massive job losses. But if you look at data in the exhibit, in 2000, notices of default started to come down precipitously, the exact time job losses accelerated in California. This phenomenon shows how the current housing bubble between the years 2000 to 2005 is different than any other in history in my opinion. During much of this period there were job declines or flat job growth, yet home sales and prices skyrocketed. Historically there has been a strong correlation between the job market for a local economy and the strength of the local housing market. Not this time. But who cares about having a job when you have no document loans in which you do not have to show W -2 forms. This is why it interesting when recently a few CEO's of the public home builders said they were surprised given the current strong economy that home sales are falling. How come they weren't surprised in '02 and '03 when there was a jobless recovery and yet home prices were going up high single digits in many areas of the country? I believe Exhibit 1 shows we are in the about the second inning of the housing correction. I wonder what Asian banks will think about Fannie Mae bonds when there are over 200,000 notices of default issued in California per year. And that can very easily happen, as, don't forget there were 163 K notices of default given out in '96 when bankers would have called you crazy for suggesting to give people no – document , no money down, adjustable loans.