

# CIRIOS TRENDS

IN SEARCH OF REAL ESTATE OPPORTUNITIES.



## The State of the Markets

For 12 months now, the Case Shiller Home Price Index - the most widely watched home price indicator - has been hinting that the housing market has at the very least stopped getting worse. In February's *Cirios Trends*, we examined housing's relationship to the stock market and how last April's nadir coincided with lows in equities. (For more on home prices and stocks, flip to the charts in the back of this month's issue for some interesting graphical analysis.)

But back to the data. This month we also received two more signs that the economy, at least on paper, is doing a bit better. First, last week's employment report showed a meaningful jump in non-farm payrolls for the first time since the recession began. Second, that same Case Shiller Index registered a year-over-year change of nil, the first time prices didn't slip from the previous year in more than four years.

And looking to the right at the state of office vacancies, despite hitting the highest level since the 1990s, the rate at which office space is going dark appears to be slowing.

So is that it, are we out of the woods? Not exactly.

Data is easily manipulated and subject to bias, even when its collectors have the best intentions. Let's look at Case Shiller and dig into just what the data tell us.

Case Shiller looks at paired sales to determine home price changes. In other words, researchers compare sale prices of individual homes in a given month to the last time that house sold. Add in a bit of statistical wizardry and you have a pretty good metric for home price changes over time.

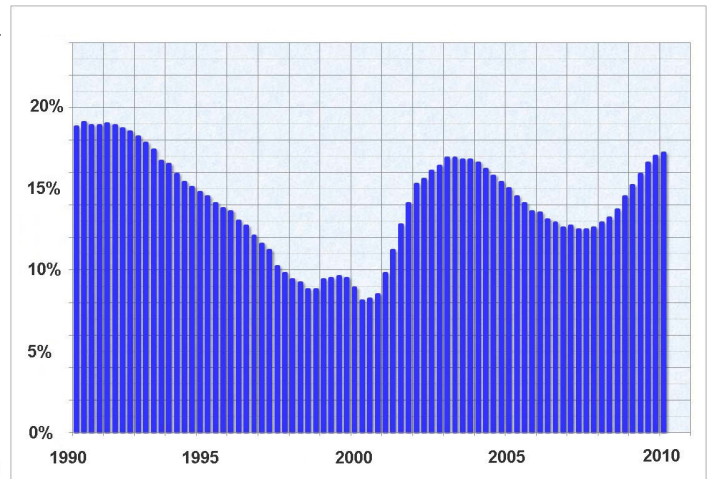
Case Shiller is also considered a value-weighted measure, as it weighs more expensive homes more heavily than cheaper ones. This makes some sense, since otherwise the relatively small number of high priced sales would get lost in the mix.

The implications of this is that an increase in the Case Shiller Home Price Index could either indicate true appreciation, or a shift in data where if more higher priced homes started selling, prices would look like they were rising when in fact, it was something else entirely.

Case in point: Livermore, CA - one of the cities we highlight in this month's Talking Charts. By measuring price per square foot, which we use as a broad proxy of value, it appears that prices have flat lined for the past 12 months or so. Meanwhile, looking at median prices (a metric commonly used by the National Association of Realtors), prices are up 13.4% in the past 12 months. Quite a difference.

As we edge forward, keep in mind that there is more going on underneath the data than it appears. Always look at trends on as defined a level as possible. Look at cities not countries, zip codes not cities, neighborhoods not cities. Only by drilling deep into the data will it truly help you make better real estate decisions.

Chart of the Month:  
US Office Vacancies



Source: [CalculatedRiskBlog.com](http://CalculatedRiskBlog.com)

**“Are we out of the woods? Not exactly.”**

### Housing Data Walks a Thin Line Between Love and Hate

- DEC. CASE-SHILLER HOME PRICE INDEX: +0.0% Y/Y | -0.2% M/M
- JANUARY EXISTING HOME SALES: +7.0% Y/Y | -0.6% M/M
- FEBRUARY NEW HOME SALES: -2.2% M/M
- MARCH HOME BUILDER SENTIMENT INDEX: 15 (DOWN FROM 17)

### Inside This Issue

<b>THE STATE OF THE MARKETS:</b>	1
APRIL 5, 2010	
<b>FEATURE: HAFA - DOUBLE</b>	2
EDGE SWORDS ABOUND	
<b>AROUND THE BAY:</b>	4
LOCAL NEWS BITES	
<b>ZIP CODE SPOTLIGHT: SAN JOSE - A TALE OF TWO CITIES</b>	5-6
<b>TALKING CHARTS: LOCAL MARKET ANALYSIS</b>	7-10

“Will the program be effective?”

## Feature: HAFA - Double Edge Swords Abound

Every six months or so, Washington's political will seems to coalesce in support of the only issue where there is true agreement across party lines: The housing market is still broken. Sadly, in our view, the Treasury Department's Home Affordable Foreclosure Alternatives Program, or "HAFA," is simply the latest in a series of flawed legislation aimed more at pacifying popular outrage rather than offering real, tangible solutions to the challenges facing the US housing market.

On April 5th, HAFA will become law, representing the Federal government's latest assault against the depressed residential housing market. HAFA aims to provide options for homeowners unable to qualify for loan modifications through the Home Affordable Modification Program, or "HAMP," which was the last government-backed foreclosure prevention initiative.

Indeed, the foreclosure epidemic in this country remains a pressing issue, as recent data indicate that more than five million households are behind on their mortgage payments, with almost three million households 90 days or more delinquent but not yet in foreclosure.

HAFA attempts to step in where permanent modification via HAMP is not a viable option, offering incentives to lenders, servicers and distressed homeowners in the hopes that foreclosures can be cut off at the pass. The primary mechanisms HAFA promotes are short sales, where the lender allows the homeowner to sell his or her home for less than the mortgage amount, and deeds-in-lieu of foreclosure, or "DILs," where the homeowner hands the lender the keys cooperatively in exchange for the lender agreeing not to pursue back payments. These alternatives are believed to be less damaging to a homeowner's credit.

While some homeowners will be assisted by HAFA, each group affected by the legislation could see unintended consequences that mitigate the program's good intentions.

### 1. Distressed Homeowners

HAFA's primary goal is to help distressed homeowners. Noble enough, but will the program be effective? First, to incentivize homeowners to cooperate in short sales, Uncle Sam (read: taxpayers) is offering a \$1,500 payment for "relocation assistance." This payment is on top of cash assistance lenders often provide short selling homeowners.



From our experience, however, the decision to short sell is not typically one that is easily swayed by \$1,500. If the government wants to help homeowners start over, every little bit helps, but if the aim is to encourage more short sales, this amount of money is but a drop in the bucket and successes will be few and far between.

Second, and almost more important, it's not even clear short selling truly benefits the homeowner in all cases. Even though the IRS revised rules which previously treated the forgiven loan as taxable income, many states are behind the ball. For example, in California, if a homeowner short sells his home for \$400,000 with a \$500,000 mortgage outstanding, at year end he could face \$100,000 in additional taxable income. A proposed amendment to this law is in limbo because Governor Schwarzenegger has threatened to veto due to an unrelated provision in the bill. For those seeking to enter a short sale, tread lightly and seek tax counseling before agreeing to anything.

### 2. Lenders / Mortgage Servicers

HAFA also tries to further incentivize lenders and mortgage servicers (who collect payments and administer modification and/or foreclosure proceedings on behalf of lenders) to avoid foreclosure. Lenders and servicers receive a \$1,000 bonus for each short sale and Uncle Sam (read: taxpayers) will cough up \$1,000 to second lien holders in order to get them to play ball. Second lien holders can gum up short sales by demanding payoffs first lien holders aren't willing to make. Washington hopes this token payment will encourage second lien holders to cooperate, but in reality a mere \$1,000 may not be enough to coax second lien holders' to take their lumps.

In addition to making short sales more palatable, HAFA makes the foreclosure process even more

## Feature: HAFA - Double Edge Swords Abound (cont.)

**“The NAR continues to demonstrate its lobbying prowess.”**

onerous than it already is. Additional notification to borrowers, a required HAMP review of each file and other hurdles to completing foreclosure aim to push more lenders in the direction of short sales or DILs.

### 3. Non-Distressed Homeowners

Some of HAFA’s major impacts, to the extent it is successful of course, will be felt by homeowners seemingly untouched by the legislation: Non-distressed homeowners.

While the government wants to delay foreclosures, short sales flooding the market could put downward pressure on home prices. For each successful short sale or DIL, that is one additional home dumped onto the market. Currently short sales are viewed by many buyers as not worth the hassle and that they should not be treated as true supply. If word gets out, however, that lenders are actually cooperating, short sales may lose their negative stigma and start to more strongly impact prices.

Mortgage-paying homeowners could see their property values continue to fall thanks to government efforts to speed short sales to market.

### 4. Once Again, Taxpayer Loss is Realtor Gain

No analysis of HAFA would be complete without mention of the National Association of Realtors, or NAR, which continues to demonstrate it’s lobbying prowess.

In addition to supporting the legislation because more short sales means more transactions and more commissions for Realtors, the NAR lobbied aggressively for the inclusion of a provision preventing lenders from lowering a Realtor’s commission in a short sale below 6% of the sales price. In distressed transactions, a 5% commission has become the defacto rule, a trend which, much to the NAR’s chagrin, is causing commission compression across even non-distressed housing markets.

Thus, HAFA hands lenders, servicers and homeowners taxpayer dollars, even as it mandates that real estate agents earn more money on each transaction.

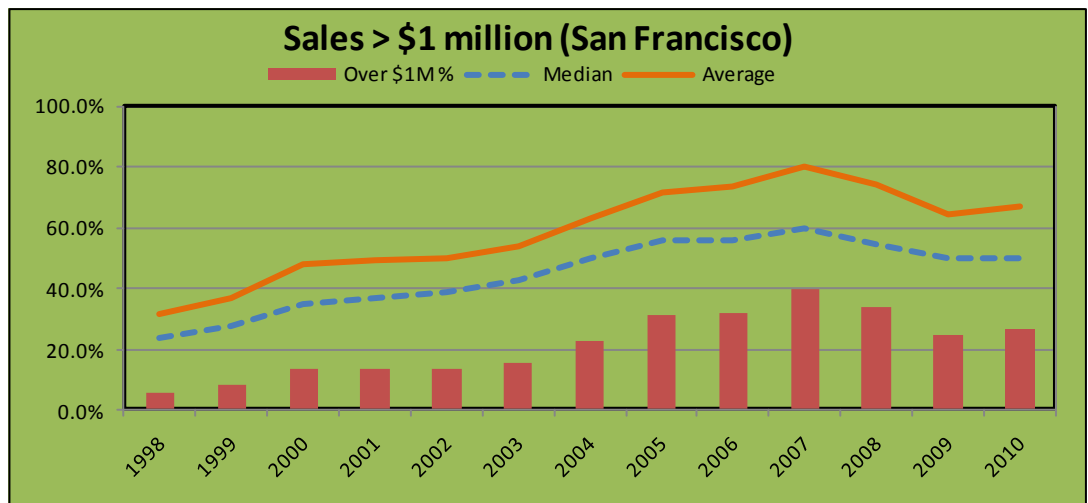
So how will it all end? Ultimately, the aforementioned effects will only be felt to the extent the program is an actual success. Will small handouts across many transactions cause actual change?

Will HAFA promote Washington’s stated policy of propping up home prices? Will flooding the market with new short sales add to the backlog of distressed homes working their way through the system or fail and further delay the inevitable normalization of the market?

Time of course will be the true arbiter of the debate, but we’ll be monitoring the program’s successes ... and failures.

### Did You Know?

Single Family Homes are highly sought after within the city of San Francisco. A look at the chart below helps explain the relationship between average/median home prices and the distribution of high priced sales vs. low priced sales. Median and Average price data is heavily influenced by sales mix, so always make sure you understand what’s going on beneath the trends.



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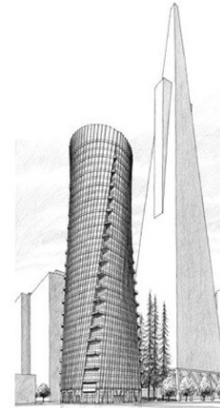
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## Around the Bay: Local News Bites

### Tower in Pyramid Shadow One Step Closer (San Francisco Business Times)

Liberty Hill Development, the developer working on a controversial project to build a 248-unit condo tower adjacent to San Francisco's Transamerica Pyramid received good news last month, as the San Francisco Planning Commission approved the Environmental Impact Report for the project. While far from a done deal, the project is one step closer to getting the final seal of approval from the city. While development of the 400-foot tower would use private funds to expand Redwood Park and deed the area to the city at no cost, neighbors fear the shadow and traffic implications more than warrant stiff opposition to the project. Plus, does the city really need more luxury condos?

(Read more here: <http://tinyurl.com/cirios Trendsapril1>)



### “Champagne Space at Beer Prices” (Silicon Valley Business Journal)

At least someone is taking advantage of the abysmal state of Silicon Valley commercial real estate. As frequenters of Highway 101 are well aware, the two towers next to the freeway which used to don the Yahoo! moniker have been a constant reminder of the market's woes since the Internet firm vacated almost a year ago. Lease rates have tumbled, and McAfee, a leading provider of anti-virus software, reportedly snatched up 241,000 square feet, or the entire tower located at 2821 Mission College Blvd in Santa Clara, for a song. According to brokerage Cornish & Carey, rental rates in Santa Clara have tumbled to \$2.02 per square foot from \$3.21 a year ago as vacancies have edged up to almost 20%.

(Read more here: <http://tinyurl.com/cirios Trendsapril3>)



### San Francisco Unemployment Hits New High (San Francisco Business Times)

Despite an easing in the national unemployment outlook this month, unemployment in San Francisco hit 10.3%, the highest level since the Great Depression. Looking underneath the data, shopping, parking and hotel occupancy remain weak, as home sales slipped and rents kept falling. As dire as that headline sounds, however, the data is from January, and by most metrics the employment outlook has brightened somewhat since that time. The report, issued by the Controller's Office, also indicated that declines were less severe than earlier in the recession.

(Read more here: <http://tinyurl.com/cirios Trendsapril3>)



### Fans Mull Ellison as Warriors' Savior (San Jose Mercury News)

The state of Bay Area sports is, in a word, abysmal. The 49ers are hoping youthful energy can make up for their play on the field, the Giants can't hit their way out of a wet paper bag and the Raiders and A's make their cross-bay rivals look championship-bound by comparison. The only bright spot is the Sharks - wait, they still play hockey in this country? Oh, and then there's the Warriors. With the team up for sale (finally), fans are crossing their fingers Oracle founder Larry Ellison will save the team from its legendary mediocrity. Now, with an America's Cup crown under his belt, Ellison just may set his sight's on Your Golden State Warriors.

(Read more here: <http://tinyurl.com/cirios Trendsapril4> )



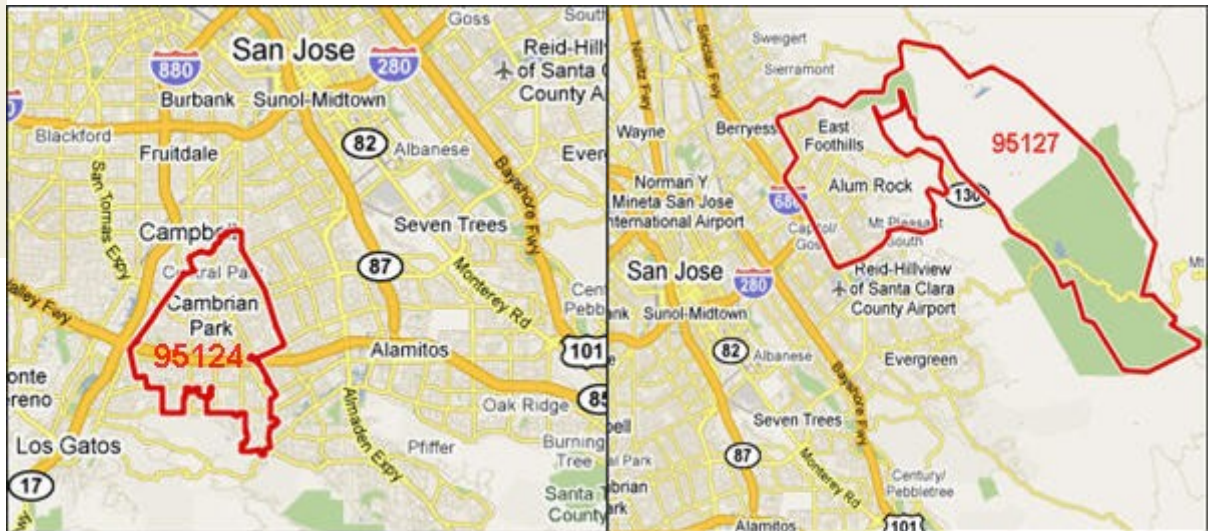
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## Zip Code Spotlight - San Jose: A Tale of Two Cities

San Jose is a vast city, encompassing many varied neighborhoods. This month, the zip code spotlight falls on two zip codes within the city of San Jose: 95124 (Cambrian Park) and 95127 (Alum Rock). While these zip codes vary somewhat in price (average current listing in 95124 is \$655,000 and 95127 is \$528,000), they have experienced markedly different market behavior in the past few years.

**“95127 experienced the biggest spike in supply we’ve ever seen.”**



Looking at the market activity graphs below, one dramatic aspect immediately jumps out at you. 95127, the less expensive of the two, experienced a huge spike in supply (the biggest we’ve ever seen) during the economic crisis of 2008. Home sales in the area came to a virtual standstill and average prices fell almost 60% in around a year.

By contrast, 95124, the “nicer” of the two neighborhoods experienced “mild” price declines, falling only 30%. While this decline likely felt anything but mild to those living in the area, it’s decline was middle of the road by California standards.

So what made the difference? The answer lies in the nature of the now-burst housing bubble and provides an interesting insight into the future of the real estate market.

As you can see in the graphs, 95127 experienced a huge run UP in prices as the real estate market peaked in 2007. In contrast, 95124 saw prices flatten out in 2007, showing the market was more reflective of economic reality - namely that the gig in housing was up. 95127 saw far more new homes constructed during the boom than did 95124, and as such, homebuilders lubricating the local market with generous incentives lured in many aspirational buyers who felt that negative news surrounding the housing market would soon blow over. This liquidity of buyers enabled owners who bought early to cash in, and when the music stopped and the bubble pricked, those new buyers in 95127 were left without a chair.

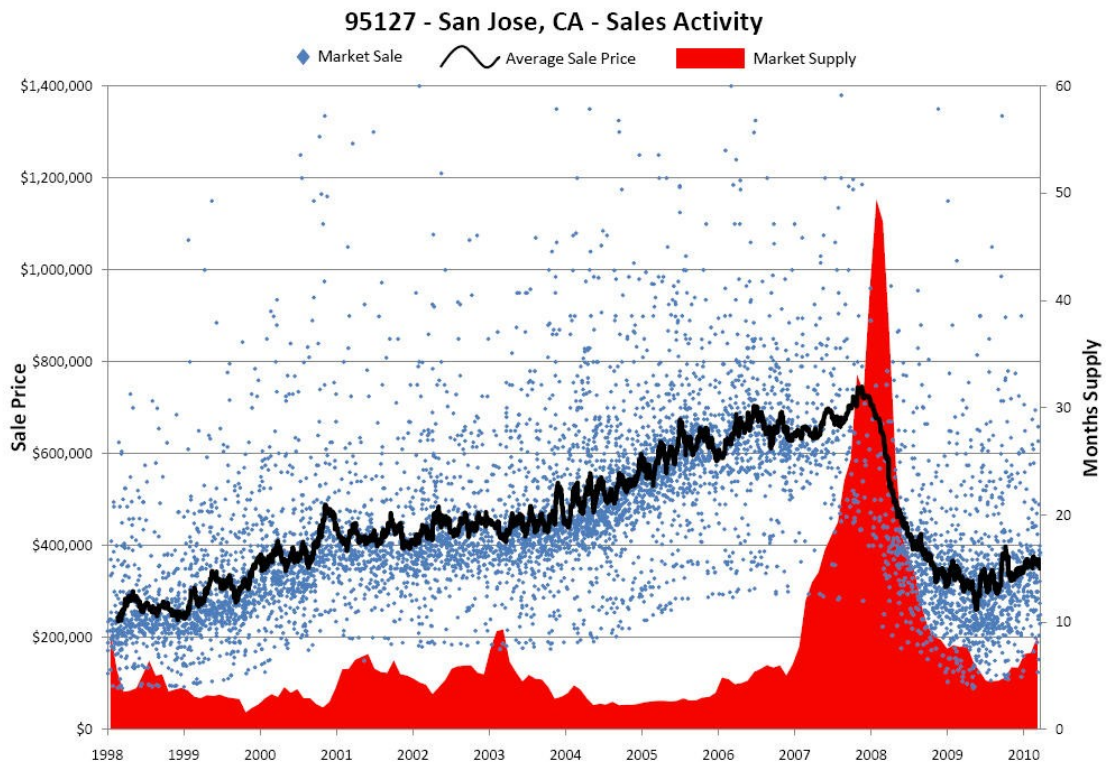
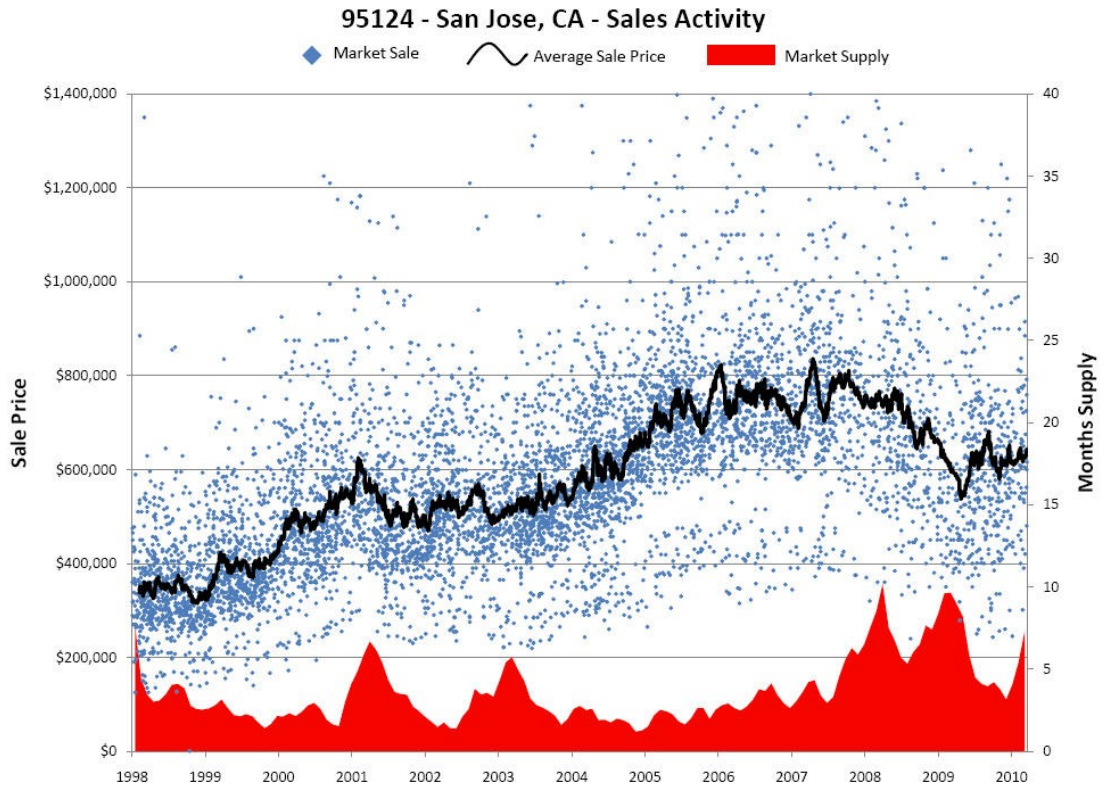
Meanwhile back in 95124, frenetic buying was a bit more muted. An established neighborhood with good schools and a strong community, prices had been rising not just due to boom-time forces pushing up prices (easy lending, a mania of skyrocketing prices area-wide, etc), but also due to more traditional, fundamental factors.

The moral of this story is to not just look at charts and graphs, but to examine the fundamentals behind home price movements. We at Cirios spend a lot of time carefully monitoring market trends and are intensely interested in the factors underlying value. Why do people want to live in this area? Will they still want to live here in 5 years, 10 years, 20 years? Asking questions about the fundamentals of real estate value can help make sure that you too don’t get pricked by the next bubble.

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## Zip Code Spotlight - San Jose: A Tale of Two Cities (cont.)

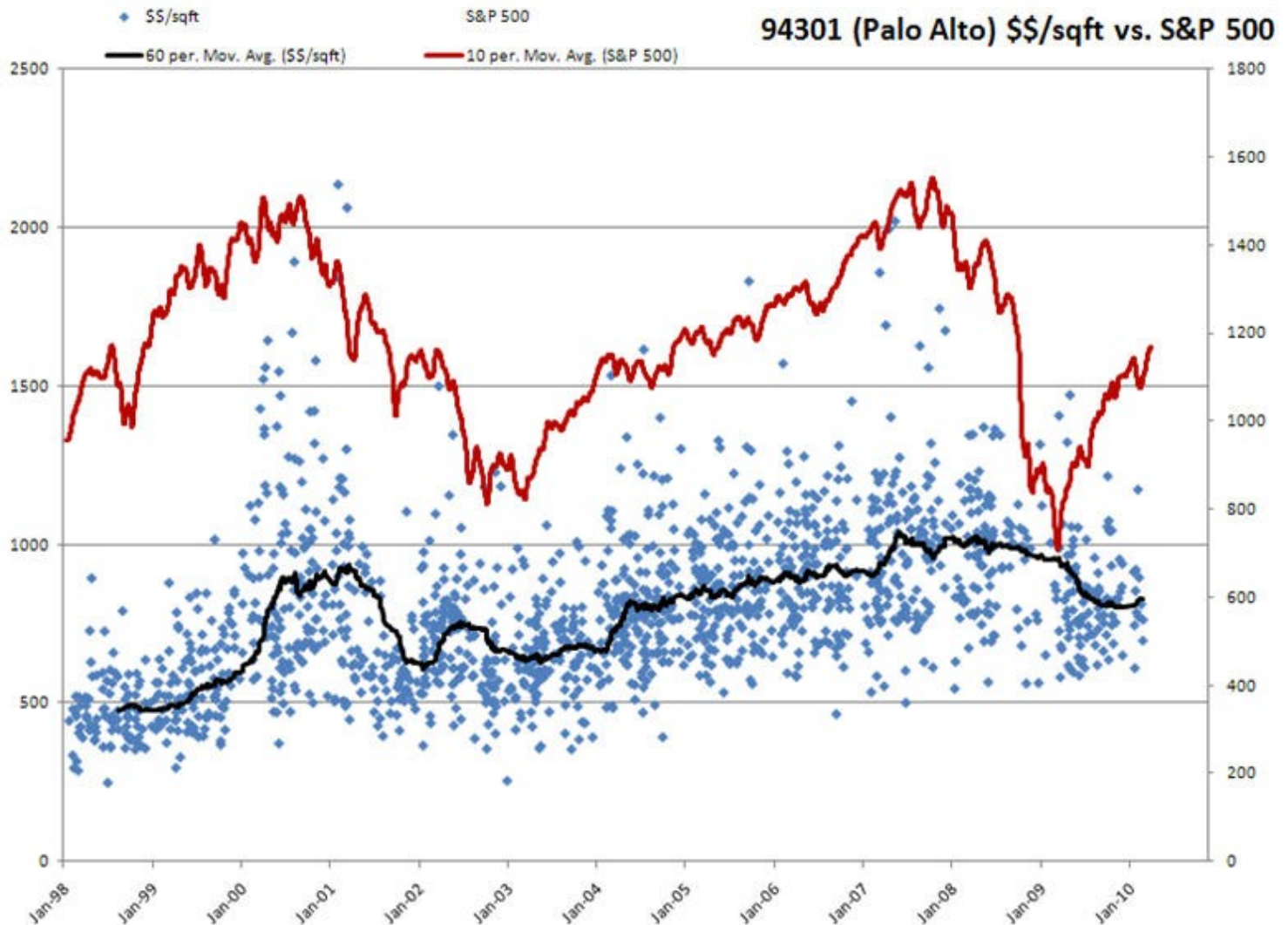


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## Talking Charts - Fundamentals Matter: Palo Alto

As long time readers of this newsletter know, we at Cirios rail against the concept that “it’s a great time to buy,” irrespective of market condition. There is just too much that goes into the homebuying decision to make this sort of blanket statement. We urge clients and non-clients alike to be wary of Realtors bearing such oversimplifications, as if with some fancy chart or graphic they can assess the whole of the real estate market and the collective whims of all buyers therein. So, without further ado here are some charts and fancy graphics from which we will attempt to extrapolate the condition of the whole of the housing market.

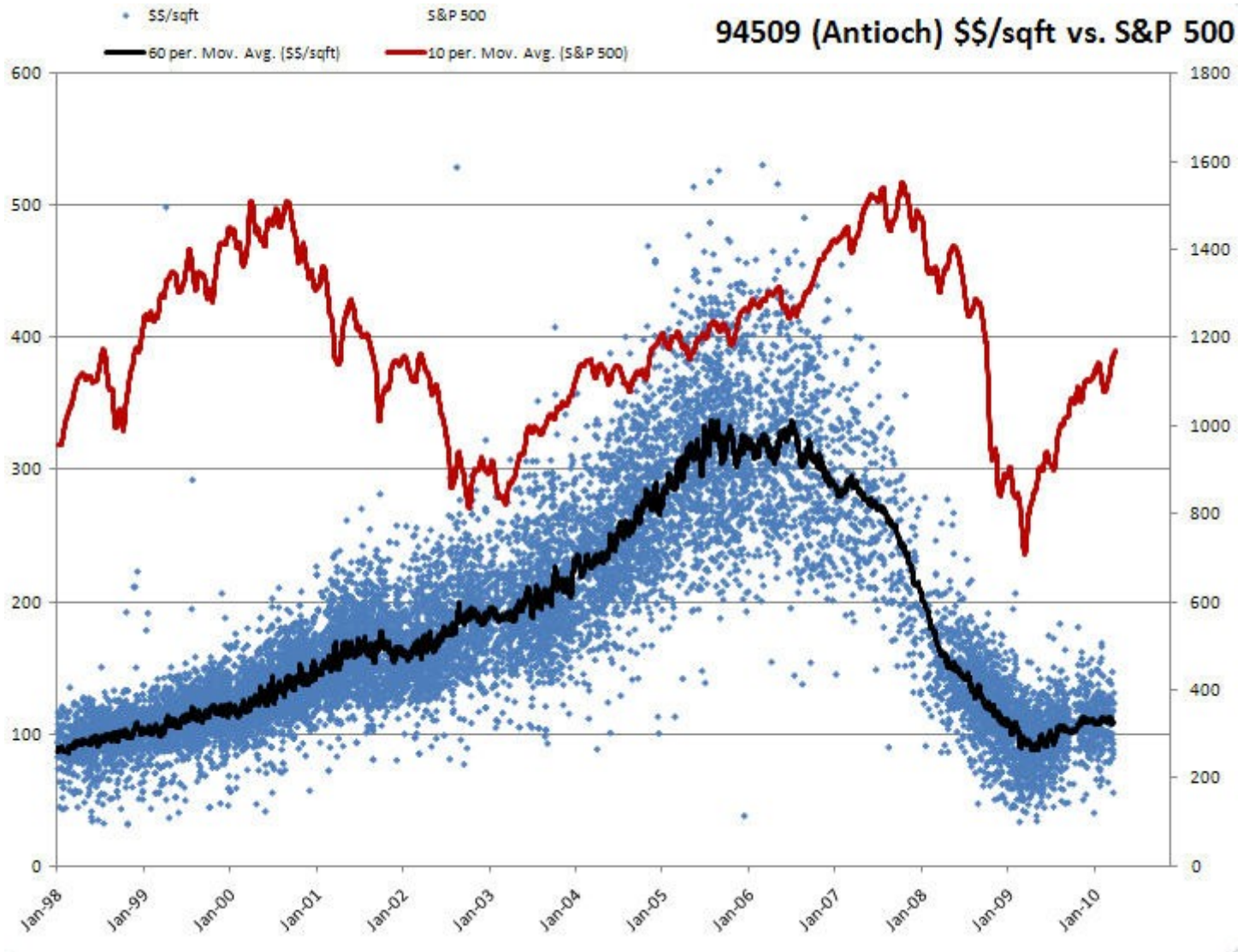


In this month’s Zip Code Spotlight, we examined two areas of San Jose and tried to explain why neighborhoods with similar price points could have witnessed such divergent price trends. It all comes down to fundamentals, understanding why buyers are buying and why sellers are selling. The following two graphs attempt to break out one of those fundamental demand factors: The stock market. The stock market is most certainly **not** a rising tide that lifts all boats. First consider 94301, the well-to-do enclave of Palo Alto where Silicon Valley’s wealthy move to raise their children. Top notch schools and neighbors like Steve Jobs and Steve Young draw executives from around the Bay Area to settle in and settle down. It’s safe to say that the so-called “wealth effect” of rising (or falling) stock prices is strong in Palo Alto. The data above concur, as a home price spike in 2000-2001 matched the peak of the dotcom mania. Further, as stocks made all-time highs in 2007 even as the broader housing market had begun to roll over, 94301 home prices rose seemingly without worry.

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## Talking Charts - Fundamentals Matter: Antioch

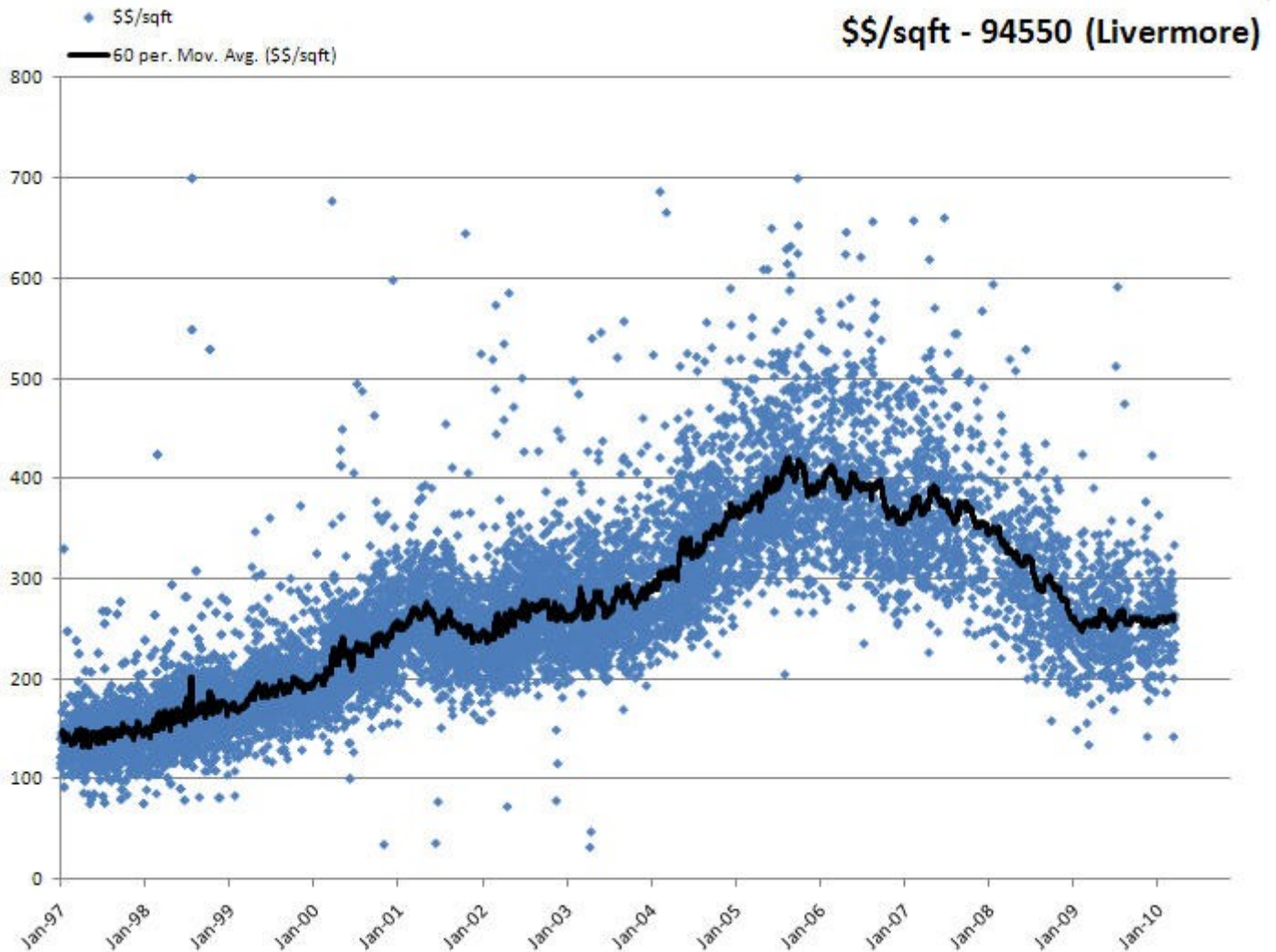


So now that we know rising stock prices are a reasonable determinant of rising home prices, let's apply the analysis to a very different part of the Bay Area. Antioch, a small suburban community an hour east of San Francisco, is hanging onto the Bay Area at the fringe, just beyond the reaches of BART. Formerly an agricultural and industrial community, Antioch is known to be frequented by gangs and homebuilders alike. A quick glance at the chart above, tracking the same time period and movement in equity prices shows how important fundamentals are to understanding home price trends. To have bought a home in Antioch in 1996 with the expectation of price gains due to stock market gains would have shown a lack of understanding of what moved home prices in the area. As can be seen, all it took to move prices up was a bubble of a different kind.

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## Talking Charts - The Flatline Cometh: Livermore

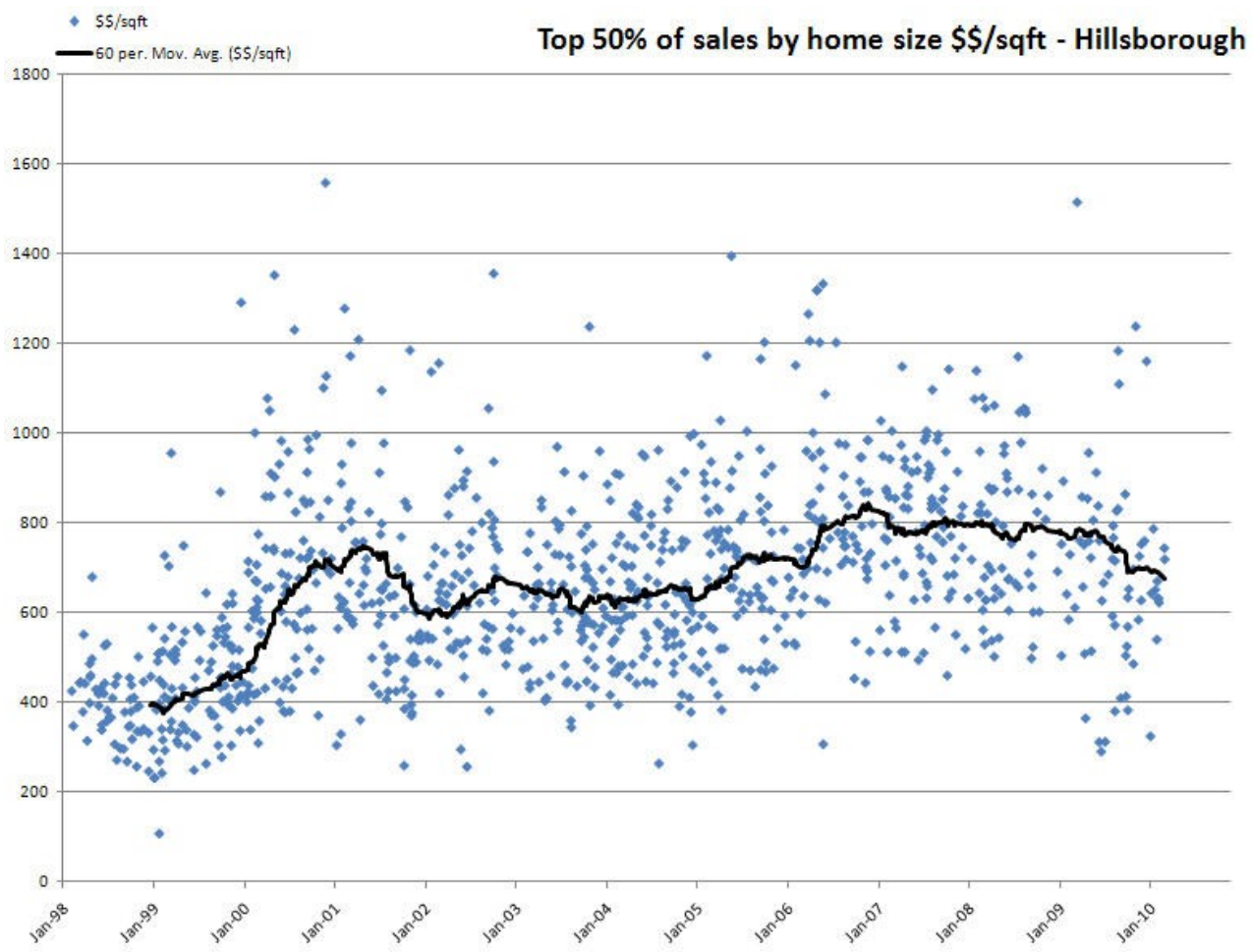


As the housing market began to roll over in 2006, the most frothy, speculative markets were the first to be hit: Phoenix, Vegas, Florida and the California Central Valley were the first to fall. Then last year, as government-backed foreclosure prevention initiatives began to squeeze inventories, some of those same distressed markets began to stabilize. But true stabilization and any eventual rebound will depend not on government programs, but underlying economic factors that support strong buying demand. By both looking at the data and examining actual transactions, it is becoming clear that cities further away from job centers are starting to falter. In fringe markets like Livermore, where economies were hit harder with layoffs, buying demand is starting to wane. Looking above, while prices stopped falling last year, gains are yet to materialize. In Fairfield, Livermore, Petaluma, Gilroy, and other far out suburbs we are starting to see cracks in the recovery. And as foreclosures are kicked down the road and more short sellers enter the market, expect more local market trends to start to mirror the one above — a long march sideways, at best.

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## Talking Charts - Is Bigger Better in Hillsborough?



Hillsborough is one of the Bay Area's most exclusive communities. With grand estates nestled in the hills, the wealthy and reclusive flock to this unique town. Here, despite the allure of hobnobbing with the elite, buying demand remains weak. In particular, the area's largest homes appear to be in least demand. Even as affordable neighbors such as South San Francisco and Daly City see tight markets and strong demand, there is a dearth of buying activity in Hillsborough's high end. In looking at the top 50% of sales as measured by home size, prices are still slipping. In particular, look at how many sales are happening below the trend line - a precursor of lower prices to come.



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