

# CIRIOS TRENDS

SPECIAL EDITION: MID-YEAR REVIEW -- WILL HOUSING SLIDE AGAIN?



## The State of the Markets - Will Housing Slide Again?

According to Gallup's annual survey on home buying attitudes, more than 75% of Americans believe the housing market has bottomed. Talk about a huge red flag.

Humans are emotional animals, and as a result you often see peek social mood coincide with market tops. When things seem like they just couldn't get any better, they likely can't. And conversely, just when you think the downward spiral will never end, it often does.

A cursory glance at the chart below shows just how tied consumer confidence has been to the stock market over the past five years. Indeed, this relationship has been remarkably close since they started keeping track of such things.

So here we are halfway through 2010 and confidence has been badly shaken. The steep drop in June reflects a growing concern that our tentative economic recovery is showing signs of petering out. Employment data is weakening, concerns over sovereign debt defaults persist and the housing market's recovery is looking more transitory every day.

Supply levels are climbing, buyers in many markets seem to have disappeared after the expiration of the home buyer tax credit and fears of looming shadow inventory haunt the market. And with the job market sputtering, it's little mystery why some of the most prominent economists, pundits and housing experts are asserting that the long-predicted double dip in housing is here.

This really isn't news, and readers of this newsletter know that while we are constructive on certain real estate opportunities, we

Remain cautious. In March, we wrote that "A backlog of eager sellers is one of a host of factors that looms on the horizon." Three months later, San Francisco inventory reached an all time high for mid-June.

The question above, "Will Housing Slide Again?" is a bit of a misnomer: Housing *is* sliding again. That is, the broad housing market has been slipping for months, as you will see by reading further in this month's special Mid-Year Review. The important question, however, is what to do with this information.

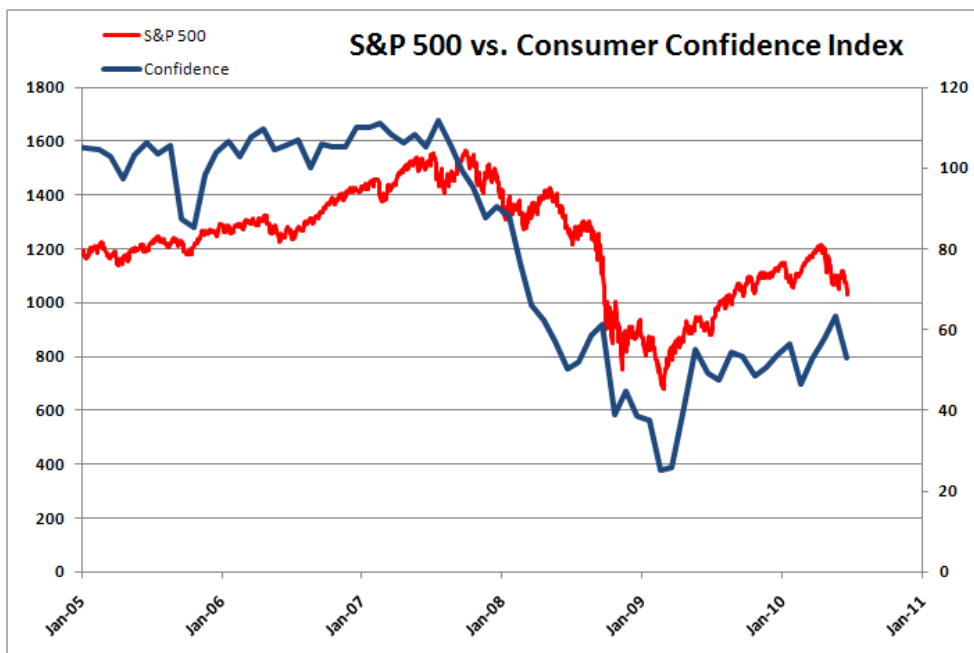
For buyers, caution and patience remain the most important traits for making good decisions. For sellers, being realistic and eliminating hope from your selling decision will ensure that you don't spend the next 12 months (or more) chasing the market down.

Broad declines in home prices are likely to drag down banking stocks, as large portfolios of housing-related assets will drop in kind.

The above conclusions are not new, nor have we just imparted some sort of unique wisdom; it's really just common sense.

But housing's imminent, indeed renewed, slide isn't all bad. Real estate investors who jumped into the market late will be the first to be flushed back out as assumptions of continued appreciation prove wrong. This will reduce demand for distressed properties, and even though the resale environment is already more challenging than just months ago, wider spreads for investments means better opportunities for those who know where to look.

Cirios Real Estate, as it happens, knows exactly where to look.



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“Social mood drives events, and specifically our reaction to those events.”

## Why Are Home Prices Falling Again?

Ask any housing expert worth his (or her) salt why home prices are falling again and you'll likely hear a litany of reasons, all of which sound completely plausible: Tax credit expiration, weak job market, high inventory levels, shadow supply, strategic defaults, negative equity and a tight lending environment.

This sort of analysis isn't wrong, per se, but all too often discussions about home prices and the real estate market ignore the most fundamental of all economic indicators: Confidence.

As we showed on the previous page, shifts in confidence are closely tied to movements in the stock market. And, as we have written previously, the stock market is the most widely used barometer for the country's economic health. It stands to reason then that the relationship between stocks and home prices could be similarly close.

In fact, they are. Below is an updated graph we showed earlier in the year, where you can see how home prices and stocks tumbled in tandem throughout 2008, only to both find support at almost exactly the same time last spring.

Similarly, as stocks have swooned in recent months, so too have home prices begun to slip. And while it's easy to point to the above factor as reasons for the fall, it only tells part of the story.

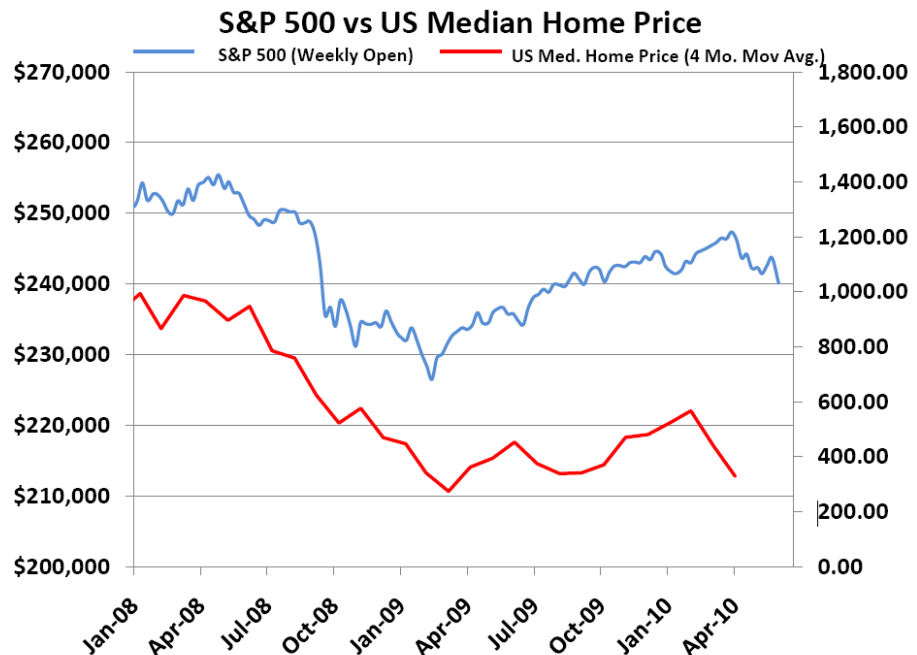
At its core, buying a home remains a highly emotionally decision. For as much as we at Cirios preach that our clients should focus on making a sound economic decision, it's impossible to leave emotions out of the picture.

When people read headlines about crushing debt loads in Europe, rising unemployment, bankrupt states and the Gulf filling up with oil, it naturally affects the way they make economic decisions. Interestingly, however, this relationship may not be as straightforward as we may think.

Conventional wisdom favors the idea that events drive social mood - that is, we react to what's around us. Logical enough, but there is another school of thought: Socionomics, which counters that social mood drives events, and specifically our reactions to those events.

In other words, just because there is an oil spill, or because California is broke, people won't necessarily get skittish and stop taking risk. Instead, prevailing social mood provides a context in which decisions are made. And depending on that mood, the whims of millions of unique minds, reactions to similar events will vary over time.

The theory isn't yet mainstream, but as new media increasingly captures humanities real time pulse, this isn't the last time you'll hear Socionomics and social mood uttered in the same breath.



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**“Those are precisely the times that bold buyers can step in and reap huge profits.”**

## Is Housing Policy Working?

From WhiteHouse.gov: *“President Obama’s programs to prevent foreclosures will help bolster home prices.”*

Reams have been written, and will continue to be, about the wisdom of our country’s current housing policy, and whether unintended consequences of these efforts will ultimately do more harm than good. This is not a partisan discussion, as Obama’s housing policy is a continuation of the Bush Administration’s loan modification and foreclosure prevention efforts.

For now, we’ll leave the debate over effective policy to those more concerned with rhetoric than us. Rather, let’s examine whether these policies, however flawed (or not flawed), have achieved their stated goal of propping up home prices.

Despite the historic declines of the past four years, US median home prices have retraced to almost exactly the long term trend. Looking at the graph below, you can see that as prices started to recover last year, they hugged the trend like a stranded sailor to a life raft.

Indeed, recent declines have pushed back through the trend, but on the surface it appears that government efforts have largely achieved the goal of staunching the bleeding. When we last showed this graph in March 2008, prices were in freefall. It seemed like no one was buying, everyone was selling and the market would never stop unraveling.

But as we learned at the beginning of this

newsletter, those are precisely the times that bold buyers can step in and reap huge profits.

As we discussed last year, government housing relief programs have tried to generate a “soft landing,” preventing the market from over-correcting and going down so far it would take years to recover.

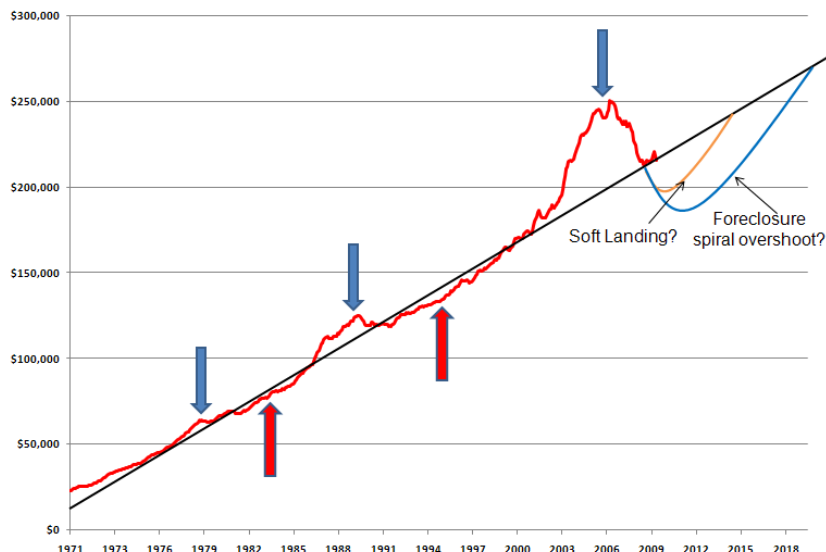
Now, as a second round of price declines is underway, there continue to be concerns about a policy that may have simply delayed the inevitable.

Another aspect of housing policy with more mixed results has been foreclosure mitigation efforts. Loan modifications have been, until recently, the centerpiece of programs aimed at limiting repossessions. Success has been muted, as default levels continue to be higher than expected and lenders remain reticent to grant meaningful principal reductions.

The Administration has now turned to short sales (selling a home for less than is owed on the mortgage) as the latest strategy to keep struggling homeowners in their homes. And while short sales on paper sound like a win-win for everyone, in reality they are messy, red-tape laden transactions.

The housing market is central to the President’s belief that through policy, government can coax the economy back to health. To success of these programs, not their relative merit on a philosophical level, is what really matters to those who want to make good real estate decisions.

US Median Home Prices



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**“Looking at broad home price indices is a great way to miss opportunities.”**

## Picking Winners in the Next Housing Cycle

The next leg down in the housing market is going to take a lot of people by surprise. Make no mistake, the downturn is underway and data is beginning to verify what has been known at the ground level for months; namely that demand is drying up and supply is increasing.

The surprise is going to be the nature of this next down cycle, not the slide in prices itself.

From 2007-2009, US property values fell across the board. Severity varied by region, city, neighborhood and even street, but correlations went to one: Everything was going down.

To assume that during the next downturn depreciation will be similarly uniform is a mistake. But don't take our word for it, let's look at the raw numbers.

The graph below compares three parts of the Bay Area. The red line is the prestigious Silver Creek Valley part of San Jose, where large homes and exclusive communities dot rolling hills just steps from Silicon Valley. The blue line is Morgan Hill, a suburb of San Jose which is a desirable town but still a decent commute from job centers. Lastly, the black line is Hunter's Point, San Francisco's roughest neighborhood, near Candlestick park.

As the market crumbled, all three areas fell - albeit at different rates. Each one actually found support around the same time, Spring 2009, but since have taken decidedly different paths.

Silver Creek has steadily rebounded, as stock

market gains lined the pockets of Silicon Valley executives. With prices off more than 25%, buyers took advantage of what was perceived to be a great buying opportunity to move up into one of San Jose's most exclusive neighborhoods.

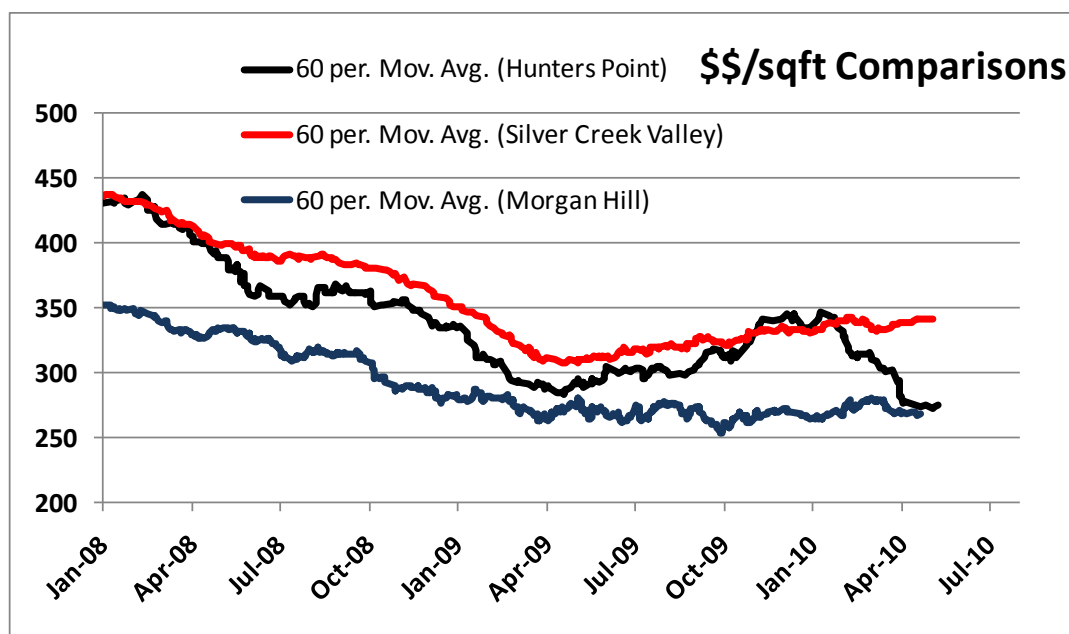
Morgan Hill, on the other hand, has meandered along, as aspirational buyers were forced into short sale and foreclosure, dragging down prices. Demand remains strong, but overhanging supply looms, keeping appreciation in check.

Hunter's Point on the other hand, saw a ramp up in prices as investors moved in, anticipating a new 49ers' stadium and the approval of redevelopment plans. When it became clear that Santa Clara would be the likely new home for the team, a lack of fundamental homebuyer demand has pushed prices back down to new lows.

What is described above is known as "differentiation," the process by which markets recover in a healthy manner. Specifically, when you begin to see market segments detach from the broader trends and begin to move based on underlying fundamentals, this is a sign that natural market forces are slowly returning after a downturn.

This is a concept often used to identify buying opportunities for stocks, as price movements begin to move independently from the broad market.

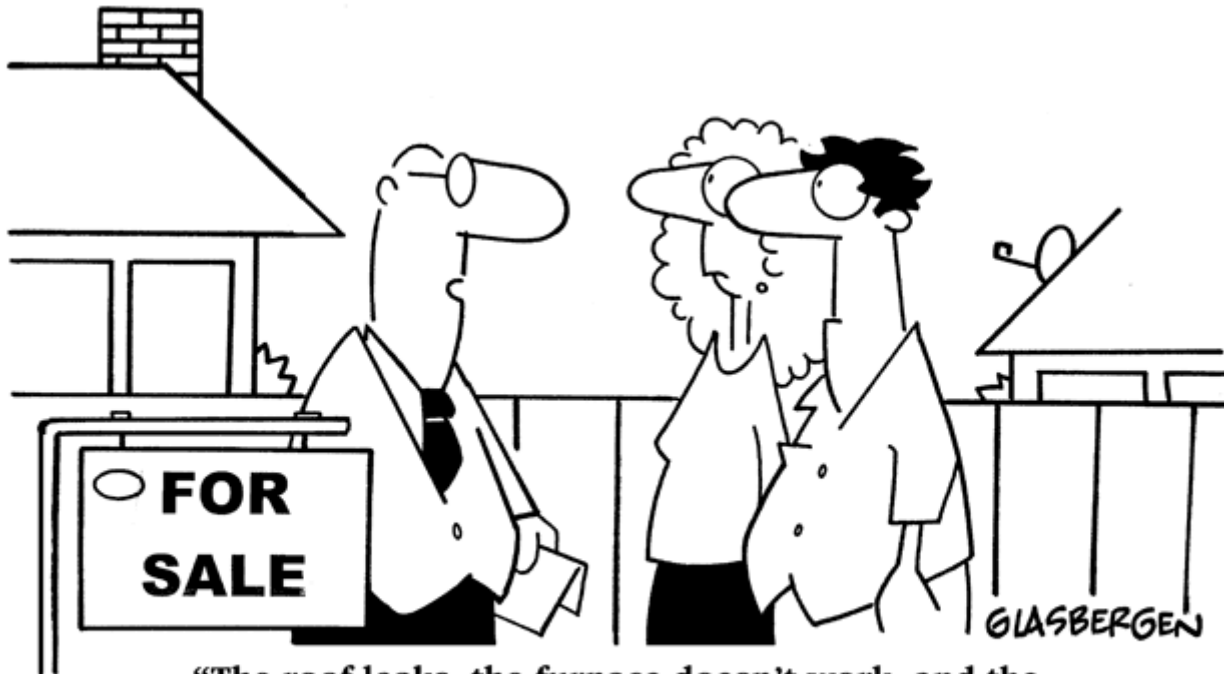
The message here is clear: Looking at broad home price indices is a great way to miss opportunities.



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... in real estate, there is always a silver lining ...



**“The roof leaks, the furnace doesn’t work, and the plumbing needs repair...but it’s located on the greatest planet in the universe!”**



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