

# CIRIOS TRENDS

FINDING REAL ESTATE OPPORTUNITIES.



## The State of the Markets

In a financial landscape marred with uncertainty, there is one constant, one thing that "everyone" knows: Housing is in trouble. And while the bears certainly have ammunition to support their pessimistic case, history tells us that when everyone is looking one way, smart investors should be looking the other.

The federal government's determination to prop up housing at all costs is creating pockets of opportunity, even as data point to an increasingly bleak picture. We've heard the story for months: Tax credit expiration, weak employment outlook, looming shadow inventory, tight lending environment, etc. And it's all true.

Meanwhile, billions of dollars continue to be thrown at the housing market, in the desperate hope that home prices can be kept from falling (again).

This flood of money is keeping mortgage rates low, which benefits not just hard hit markets, but all markets, including those poised for fundamental growth. Buyers in markets that don't need government support, those that are strengthening because they are becoming more popular with wealthier buyers, are benefitting from stimulus pouring in to help distressed markets.

Recently, on the same day the financial media was obsessed with existing home sales data that painted a stark picture for the future of housing, we checked on a house in Bernal Heights, a neighborhood on the outskirts of San Francisco, that had gone under contract in just a few days. The transaction had closed, well above list, with a note that there had been 13 offers.

Apparently, Bernal Heights didn't get the memo that housing is dead.

Bernal Heights isn't unique, despite being one of the strongest real estate markets in the Bay Area. It is one of the last affordable neighborhoods in San Francisco (on a relative basis of course), it has a growing main drag and is well-poised to benefit from large scale redevelopment plans already underway (see last month's Cirios Trends that discussed the Hunters Point redevelopment project).

All over the country, there are similar pockets of fundamental growth. Neighborhoods are changing, jobs are being created, people are moving who need places to live. Meanwhile, the vast majority of housing markets remain weak, plagued by oversupply, anemic job markets and a limited pool of prospective buyers.

These struggling communities are the focus of the trillions of dollars in housing stimulus that have driven interest rates to historic lows and kept distressed inventory off the market. These unsustainable policies have, unwittingly, doomed most distressed markets to stagnation for years, if not decades, by preventing the legitimate price discovery required to find a sustainable bottom. On the flip side, this massive injection of cheap funding is accelerating demographic shifts already underway.

So while housing bears look at national data and proudly remind us how right they have been about the double dip in housing, they risk throwing the baby out with the proverbial bathwater. There continue to be opportunities out there, as long as you know where to look.

Chart of the Month:  
30-year Fixed Mortgage Rates



Source: Freddie Mac

### Housing Data Gets Ugly (Again)

- JUNE CASE-SHILLER HOME PRICE INDEX: +4.2% Y/Y | +0.3% M/M
- JULY EXISTING HOME SALES: -25.5% Y/Y | -27.2% M/M
- JULY NEW HOME SALES: -32.4% Y/Y | -12.4% M/M
- AUGUST HOMEBUILDER SENTIMENT INDEX: 13 (DOWN FROM 14, 17-MONTH LOW)

**“Bernal Heights didn't get the memo that housing is dead.”**

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**“The GSEs bought more than 70% of mortgages issued last year.”**

## Feature: What To Do With Fannie and Freddie?

Every couple months, the trials and tribulations of Fannie Mae and Freddie Mac (collectively known as the Government Sponsored Enterprises, or GSEs), appear on the national radar. This typically happens around earnings season, when staggering loss numbers are announced.

Once hailed as critical components to a robust housing market and easy access to mortgages for low income Americans, the growing sentiment of many inside housing finance is that the two mortgage giants should be fitted with toe tags.

Maybe its because policy makers aren't sure what to do with the troubled companies, whether they should be publicly or privately owned. Perhaps its due to the staggering amount of money they're losing: the GSEs are beyond broke, burning through \$150 billion in taxpayer money to remain solvent. Last month, Freddie requested billions more after reporting its 12<sup>th</sup> straight quarterly loss.

Before delving into the quagmire that is “what to do about the GSEs?” a brief history lesson is in order. Fannie Mae was established by the federal government in 1938 to create a liquid secondary mortgage market that would allow loan originators to focus on creating more loans. Essentially, Fannie bought mortgages from lenders so that lenders could use the cash for new loans (sounds like the foundation of a bubble, or at least inflation, doesn't it?).

By 1968, the federal government released Fannie into the wild when it morphed into a private, shareholder-owned corporation. By 1970, Fannie was authorized to purchase private mortgages in addition to federally insured mortgages, such as FHA and VA mortgages. That same year, Freddie Mac was created to provide some “free market” competition for Fannie. Importantly, while they were technically outside the government umbrella, the GSEs carried an implicit guarantee from the US government. That is, investors in Fannie and Freddie debt were led to believe that any repayment problems would be cleaned up by the federal government.

Though both were publicly traded companies, the federal government routinely passed regulations specifically directing their actions. In 1989 the government passed the Financial Institutions Reform, Recovery and Enforcement Act, subjecting both to oversight by HUD (the U.S. Department of Housing and Urban Development).

In 1995, **more than ten years prior to the peak of the housing bubble**, Congress granted the GSEs affordable housing credits to encourage the purchase of subprime mortgage securities.

By September of 2008, as the housing market was in the throes of collapse, the GSEs were placed into conservatorship under the Federal Housing Finance Agency and have since been kept alive by regular injections of taxpayer money.



So why are the GSEs even necessary? Why not just shut them down? Perhaps its because of how important a role they currently play in the financing (read: propping up of) the US housing market: Fannie and Freddie were the buyers of more than 70% of mortgages issued last year.

Essentially, the GSEs buy loans from mortgage originators, paying in cash or exchanging the mortgage for a mortgage-backed security comprising those mortgages. By doing this, Fannie and Freddie enable lenders to quickly sell their loans and use the money to make new loans.

The GSEs will also issue guarantees that mortgages will be repaid, which act as insurance against borrower defaults. Both companies also issue mortgage backed securities that come with a guarantee that the principal and interest payments will be paid on time to the investor.

The GSEs earn income from the interest rate spreads between what they pay investors to buy their securities and the interest collected on mortgages underlying them, as well as from fees for guaranteeing loans and assuming the aforementioned risks related to defaults.

The latter is why the GSEs were crushed when the housing market fell apart. When borrowers default on loans guaranteed by Fannie or Freddie, the GSEs owe the entire balance of the loan or guaranteed security. Now, explicitly not just implicitly, US taxpayers are on the hook for GSE losses resulting from mortgage defaults and home price declines.

Calls for reforming Fannie and Freddie are growing ever louder. However, despite these calls no right solution seems to exist. Moreover, it seems unlikely that any real resolution to problems with Fannie and Freddie will take place before November. Treasury Secretary Timothy Geithner has promised to deliver a proposal for housing finance reform to Congress by January 2011. Conveniently after the midterm elections in November.

As long as it is politically unacceptable to tackle this gaping hole in housing reform, the only thing that can save the GSEs is the return of private securitization. Which, as it turns out, may not be as far off as most “experts” think.

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## Around the Bay: Local News Bites

### Is Google Getting Long Real Estate? (Silicon Valley Business Journal)

Google, the web behemoth, appears to be stepping further outside its sweet spot of Internet search. The company is investing \$19 million in a senior housing development in nearby Sunnyvale, aiming to support building low cost affordable housing in California. Also, making a couple bucks doesn't hurt. Google is investing in Low-Income Tax Credits, facilitated by Union Bank. Developers use tax credit investors to generate early-stage operating cash by selling cash credits to investors at a discount. Upon completion of the project, the credits mature and investors, in this case Google, earn the difference between where they bought them and the full value of the credits.

(Read more here: <http://tinyurl.com/cirios Trendssept1>)

### Sunpower Gets Pop from Stimulus (Silicon Valley Business Journal)

San Jose based Sunpower Corp., a solar power integrator, announced plans to install solar power systems on a host of US government properties, which the company said could generate around 1,000 new jobs in the Bay Area. In particular, the bulk of the new jobs will be focused in the construction sector, an industry badly hurt by the anemic home building environment of the past three years. This isn't the first government gig Sunpower has won, as the company started working on government contracts as early as 1999. And while 1,000 jobs is a drop in the bucket compared to the broad economic outlook, it is certainly a welcome influx of work.

(Read more here: <http://tinyurl.com/cirios Trendssept2>)

### Still Ugly, San Francisco Economy Outperforms Peers (San Francisco Business Times)

The nationwide employment outlook may not be getting better, and may have even started to deteriorate again, but at least its no longer in free fall. And although San Francisco's 9.7% unemployment rate is nothing to write home about, it's better than most other large cities in the country, and is certainly the strongest in California. According to Ted Egan, chief economist for the city, between mid 2008 and the end of 2009, jobs in software, internet publishing, intellectual property transactions, directory publishers, translation services and performing arts and management all grew at least 20%. These are not the nations largest industries, but many are centered right here in the Bay Area.

(Read more here: <http://tinyurl.com/cirios Trendssept3>)

### Local Investor Diversifies into Apartment Buildings (The Registry SF)

900,000 square feet of office space is coming to market, according to CB Richard Ellis, the real estate brokerage tasked with marketing the properties. The Sobrato Organization, a family-owned real estate investment group, is selling a 12-building Silicon Valley portfolio. The company's stated reason for selling is its ongoing diversification away from office towards multifamily properties and equities. As noted in the RegistrySF.com, a local real estate website, the flood of foreclosed commercial properties never came, so demand for the Sobrato portfolio should be healthy.

(Read more here: <http://tinyurl.com/cirios Trendssept4>)



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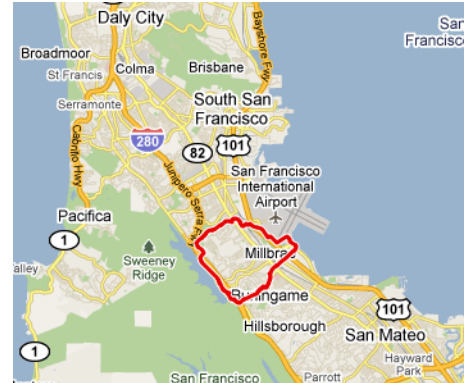
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## Zip Code Spotlight - Millbrae (94030)

**“These ideal conditions do not come without a price.”**

This month's zip code spotlight falls on 94030, Millbrae, CA. A mid-peninsula locale providing a happy medium between ease of city access and warmer, quieter climates of the lower peninsula, Millbrae has excellent schools and is an all-around good choice for desirable peninsula living. BART and Caltrain provide quick public options for getting to San Francisco and SFO is literally right at your doorstep. The weather is consistently 5-10 degrees warmer than northern peninsula cities like Daly City.

As with almost all things Peninsula, these ideal conditions do not come without a price. As can be seen in the graph below, current average prices in the area are above the \$800,000 mark.

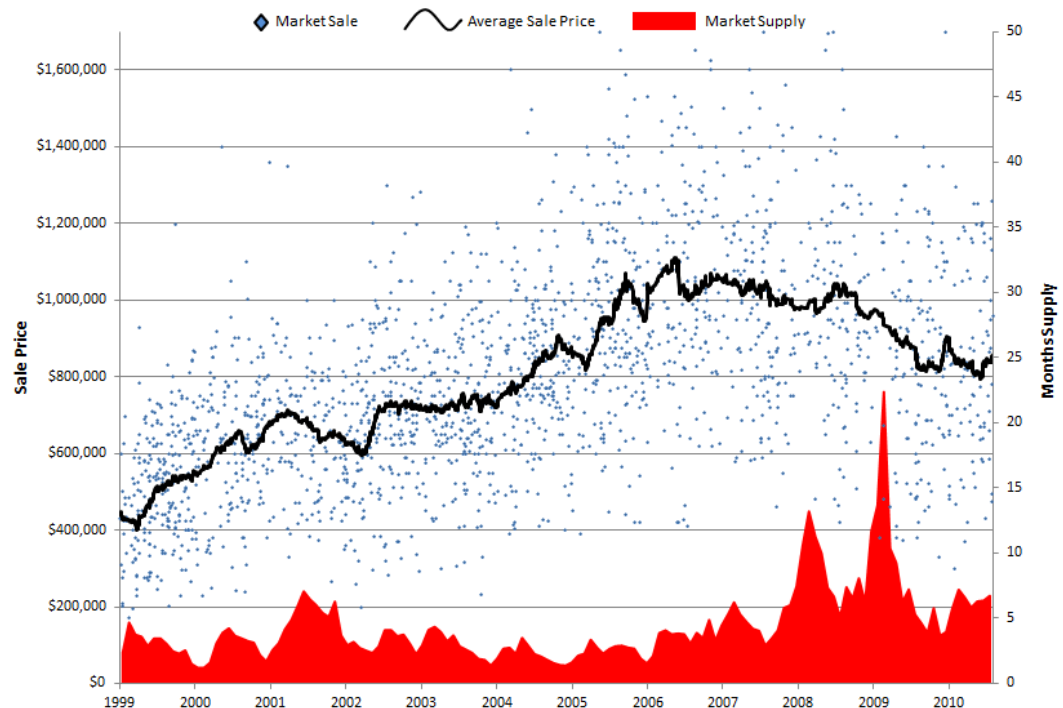


Homes in Millbrae sell in a wide range, from \$400,000 to over \$1,200,000. The strongest deciding factor of price within this zip is location relative to the 101 Freeway. Homes closer to the freeway tend to be smaller and less expensive, even on a price per square foot basis. In contrast, homes up the hill to the West of 101 sell at a premium. However, even homes at the high end of the zip's range are still relatively cheap by lower peninsula standards, another reason Millbrae is often on most Peninsula buyers' shopping list.

Looking more closely at the time series data below shows us the characteristic sharp run up of prices in the early 2000's, over a 100% increase from 1999 to the peak of the market in 2006-2007. Prices have "only" fallen 20% since the market collapse of 2008, and while this is a painful drop to most homeowners, it's a pattern we see often in higher end markets on the peninsula that have held value relative to other, outlying areas of the Bay Area.

Finally, prices have been essentially flat in this zip for the last year. The question, as always, is which direction they will go next. As can be seen in the graph, supply remains elevated over traditional levels for the area and looks to be trending upwards in the last 4 months. This fact argues caution in the near future. However, another drop in prices in this area could provide an excellent opportunity for a home investment. Cirios watches these developments closely and is always available to discuss how we can help make the right housing decision.

Sales Activity – 94030 – Millbrae, CA



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**“Current lending standards are as tight as they have ever been.”**

## Cirios Opportunities - High Fico Second Liens

Pay-Option ARMs, No Documentation Loans, 100% financing, 2/28 ARMS with stated income, High Fico second liens ...

These are just some of the numerous mortgage products that have essentially gone the way of the dinosaurs and boxing. Similar to the Komodo dragon and Manny Paciao. however, there might still be a place in society for one of these products.

If you ask any mortgage banker who was around to participate in the housing boom, they will tell you that current loan underwriting standards are as tight as they have ever been. In many parts of the country, the only loan in town is the FHA 3.5% down loan. While a mortgage originator might look at this loan and call it conservative due to the government guarantee, it is anything but riskless. Many FHA transactions include a closing cost credit of 3% or more, which effectively means the borrower puts little or no money down.

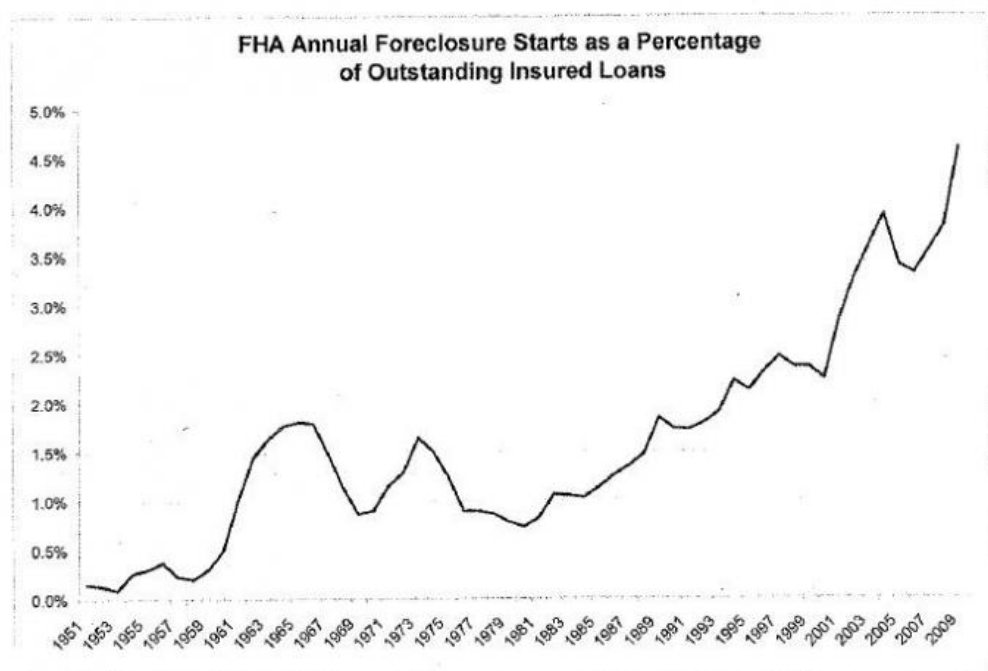
So, of all the exotic mortgage products mentioned above, the survivor of the housing market's crash has been 100% financing. Based on recent default rates (see below) for these government (read: taxpayer) backed FHA loans, we at Cirios believe the wrong product was kept around while another one might have been eliminated without good cause.

The High FICO second lien was originally created to give well qualified home buyers the option to finance some of their down payment. In many parts of the Bay Area, buyers need to put down more than \$150,000 to buy a home. If given the choice, many of these buyers would welcome the opportunity to cut that down payment in half so they could put the money to use in other worthwhile investments.

Is a buyer with the means to put down 20% and a credit score over 770 significantly more likely to default on their mortgage because they put down 10% rather than 20%? We believe the answer is No.

When underwritten correctly, the borrower has the opportunity to allocate capital to other investments and the lender gets to take advantage of a mortgage with 2%+ more yield with dramatically less default risk than many FHA first liens.

As with any mortgage product there are risks, but if you were a lender, wouldn't you sleep better at night knowing you lent money to a well-qualified buyer in Noe Valley who put down 10% to buy a restored Victorian than an FHA buyer in Vallejo who put down 3.5% and received \$5,000 back at closing to buy a falling apart 20-year old deteriorating Lennar tract home?



Sources: FDIC, MBA, and Edward Pinto

# Cirios Trends

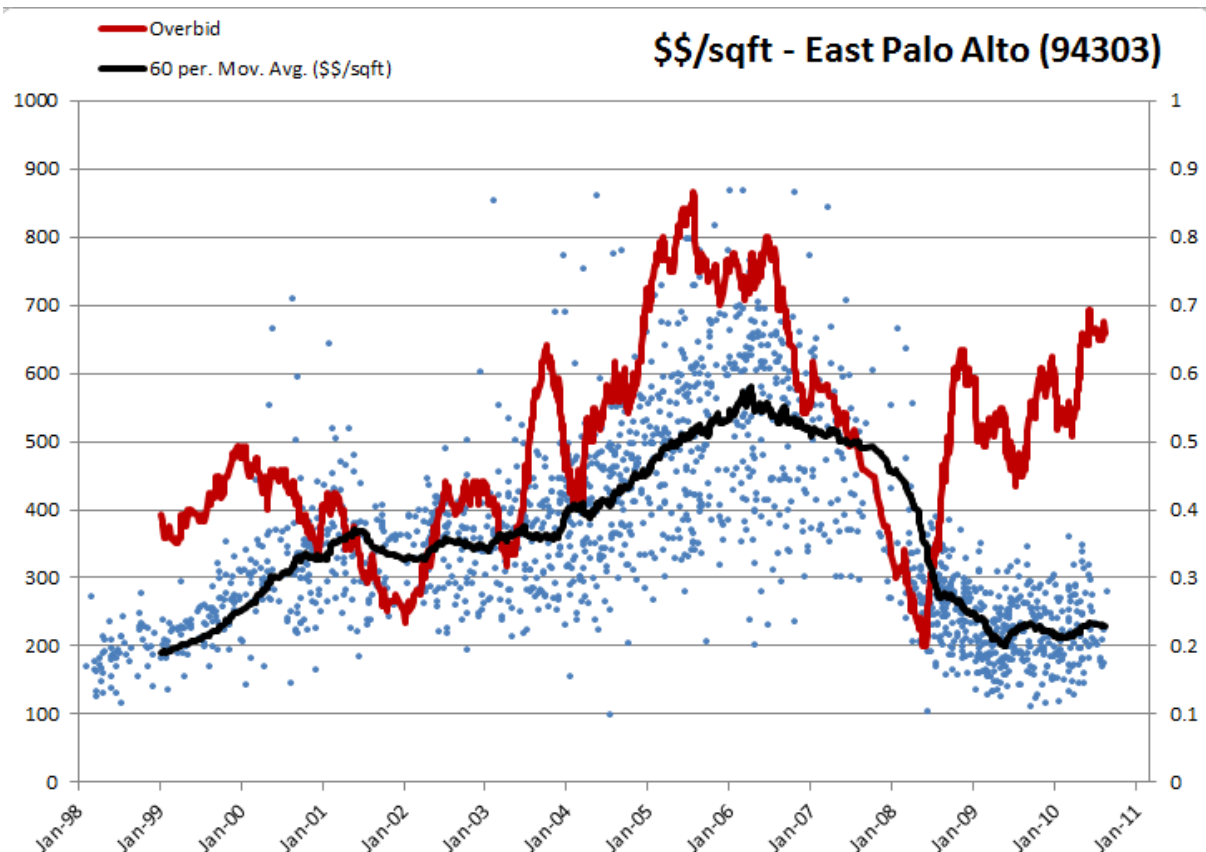
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## Talking Charts - Sentiment Rules - East Palo Alto (94303)

One of the chief challenges in trying to be experts in home price trends is that you are constantly challenged. So, one of the most common questions we receive is “how can you predict what direction housing prices will go?” The short answer, that we cannot, is the simplest and most accurate. However, there are certain home price metrics that are predictive — that is, can help forecast the direction of prices. One of those, which we discuss often, is Inventory. Rising supply often portends lower prices, as buyers begin to gain the upper hand in negotiations. Another metric, one we developed here at Cirios, we call “The Overbid Indicator.”

This metric tries to approximate buyer sentiment, which provides insight into how many buyers there are relative to sellers and how excited those buyers are to buy. We assign a value of 1 to any sale above the list price, a value 0.5 to a sale exactly list, and a value of 0 to any sale below list. These values are arbitrary (you could just as easily use 2, 1.5 and 1, etc) but when the ratio is looked at over time, it can show what portion of sales occur above list. The more sales above list, the more scarce well-priced properties are, and the more listing agents are counting on bidding wars indicative of periods when demand overwhelms supply. We have found that this metric is highly predictive, particularly at cusps, where sharp trend shifts can push home prices in one direction or another.

One final point on this metric is that tends to be highly seasonal. That is, during the spring and summer buyers are by nature more excited, and typically more inclined to make offers above list. The opposite is true during the winter, especially around the holidays. The next iteration of this metric will attempt to factor in these seasonal aspects for a smoother, more realistic representation of sentiment.

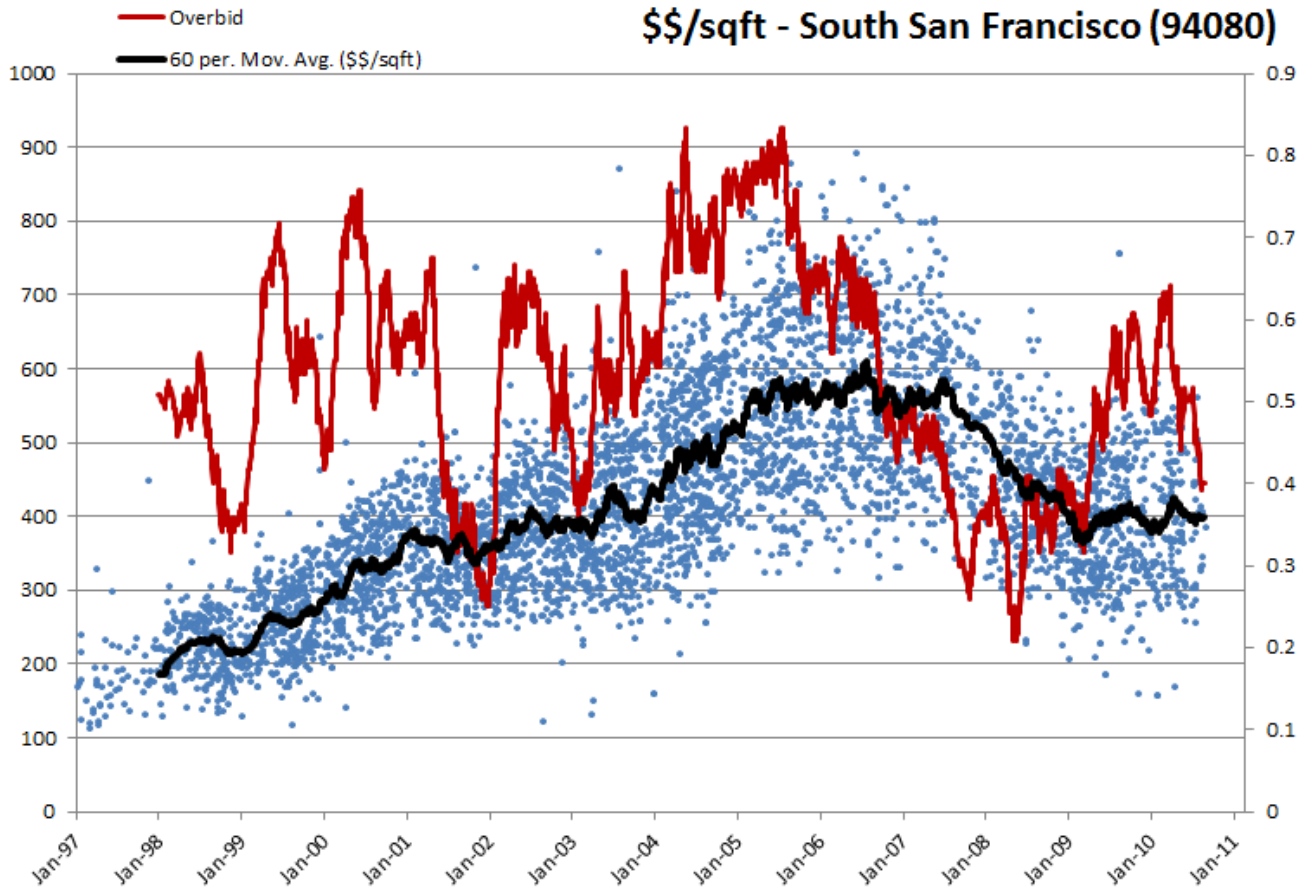


It wouldn't be an issue of Cirios Trends without some mention of East Palo Alto, our poster child for a pocket of affordable housing smashed in between some of the most expensive real estate in the country. Looking at the overbid indicator above, demand overwhelmed supply during the boom, shown by a rising red line. The indicator peaked in early 2005, a full year before prices peaked in 2006. On the other side, sentiment, as measured by this metric, bottomed in early 2008, also around 12 months prior to a trend shift. Of course, two data points are far from conclusive in saying that the Overbid Indicator is a 12-month leading indicator of home prices, but it certainly can help warn market participants that the winds of change are afoot. Currently, despite a leveling of prices, demand remains strong in East Palo Alto, and has not slumped nearly as deeply as other markets (see next page).

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## Talking Charts - Sentiment Rules - South San Francisco (94080)

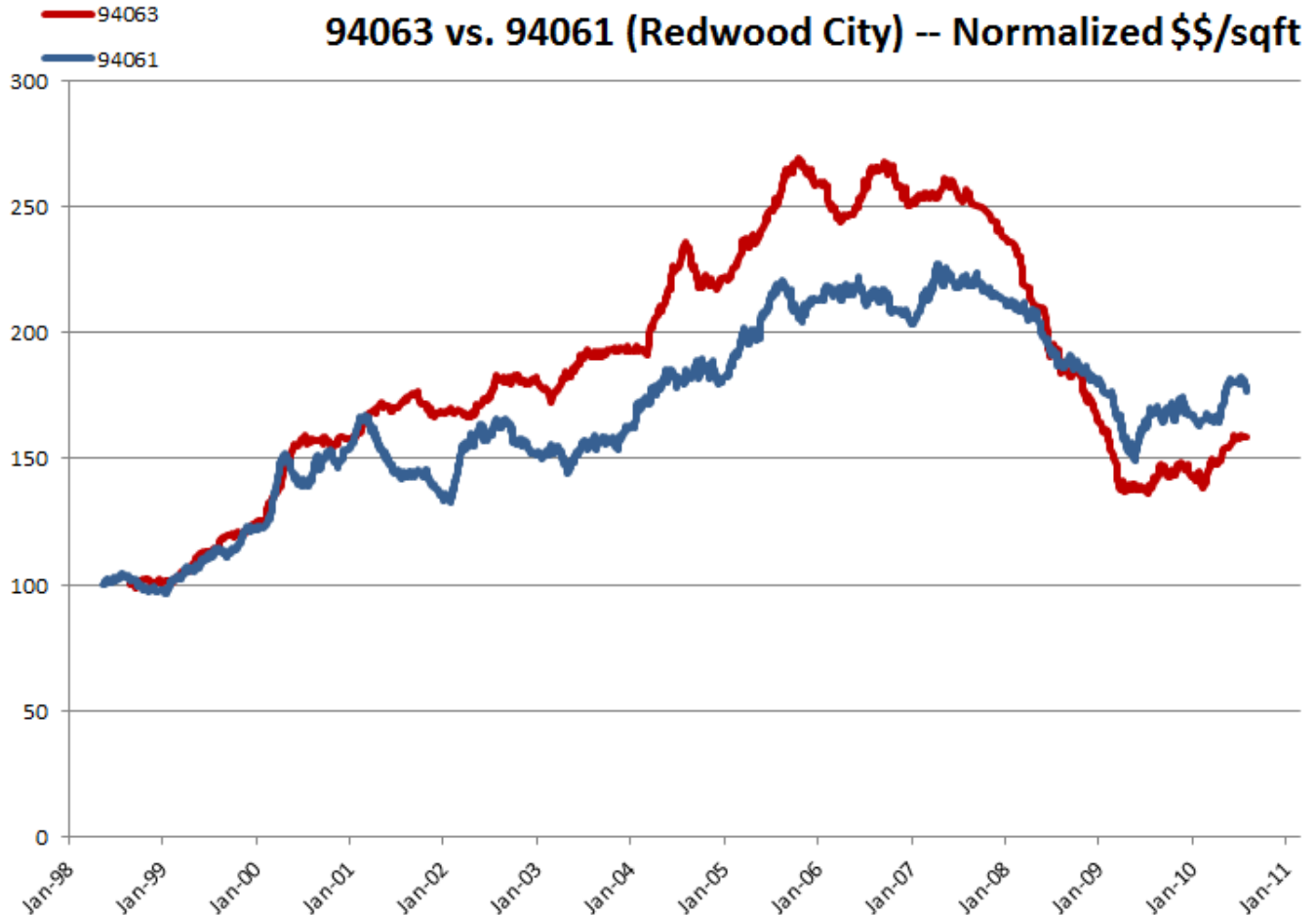


Much like East Palo Alto on the previous page, the Overbid Indicator for South San Francisco peaked well before home prices did. And, similarly, sentiment bottomed out well before prices. One distinct difference between the two cities is recent activity. Recall that East Palo Alto has seen sentiment remain steady, while looking above you can see that the Overbid Indicator started falling in South San Francisco at the beginning of 2010. One likely reason for this is that East Palo Alto is a more foreclosure-driven market, and bank owned inventory has been slow to seep out into the market this year. This has kept inventory levels low, while all cash investors have been eagerly looking for low priced homes. South San Francisco, on the other hand, is driven by short sales and regular sales, which have seen a steady increase in the past 6-8 months. While it would be premature to predict a dramatic drop in South San Francisco home prices, we are cautious, given that buyers in that area have turned more cautious as well.

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## Talking Charts - A Tale of Two (Redwood) Cities: 94063 vs. 94061

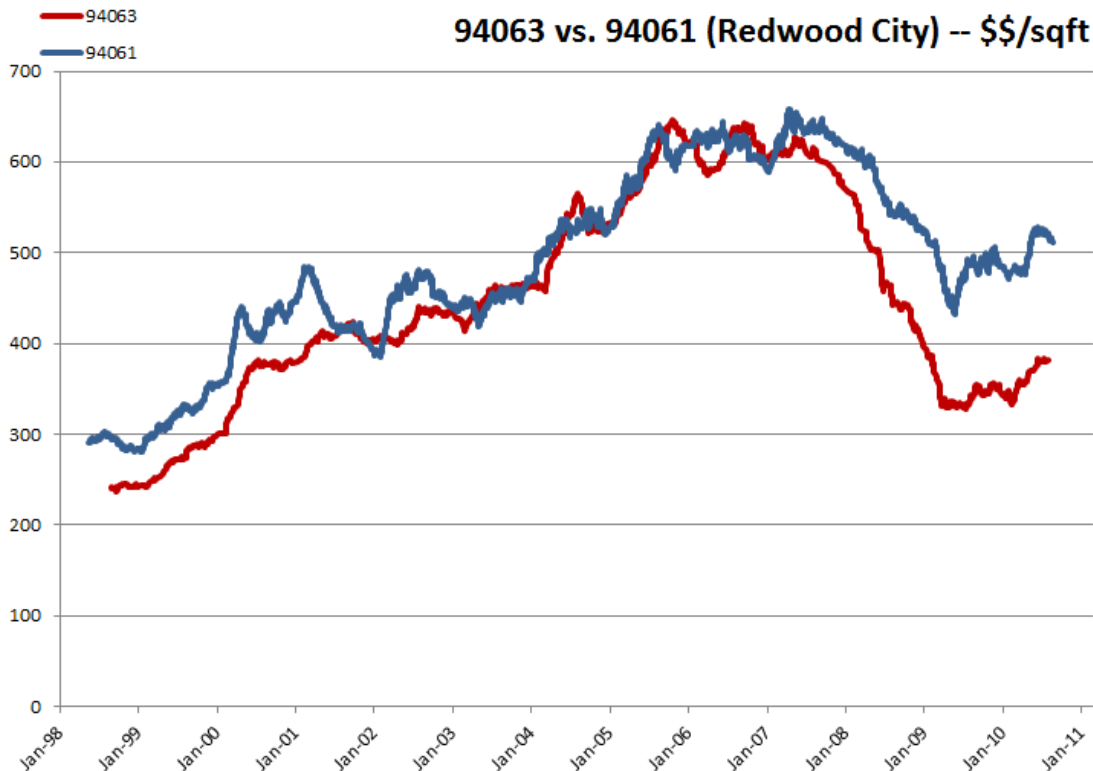


As we often discuss, home price trends are becoming increasingly local, as structural factors affecting prices begin to be supplanted by fundamentals. This is a positive sign, not necessarily for prices themselves, but rather for restoring health to markets, and eventually providing support for sustainable, renewed appreciation. In this graph, we compare two distinct zip codes within Redwood City and look at how important it is to understand divisions within cities. 94063 is located on the east side of El Camino Real, consisting of generally lower income neighborhoods. 94061 on the other hand, is made up of quiet, tree lined streets and abuts Atherton, one of the wealthiest communities in the country. Unsurprisingly, the effects of the housing boom and bust were felt more strongly in 94063, where peak to trough declines nearly hit 50%, while 94061 experienced declines of “just” 34.4%. Looking at this chart, one could glean that if you had purchased two identical homes in 94063 and 94061 in our base year of 1998, you would have been only slightly better off on the 94061 home. This shows that while it is typically “safer” to buy in a more established neighborhood, you are still exposed to price declines. Meanwhile, buying in the less established, more gritty area certainly poses risks, but there is more potential upside as demographic changes can bring more wealthy buyers into the area.

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## Talking Charts - A Tale of Two (Redwood) Cities: 94063 vs. 94061 (cont.)



Anyone who tries to paint the entire picture of an area with a single home price metric is missing the point, and probably has an agenda. We saw on the previous page that over the past decade or so, buyers in 94063 did almost as well as 94061. The graph above paints a different picture. Or rather, helps glean how a buyer may fare if they were to buy now in either area. Back in 1998, homes in 94061 sold at around a \$50/sqft premium to those in 94063. This spread held through the dotcom boom, but as the housing bubble began to inflate in 2002, loose lending standards evened the playing field, values converged and homes in the two zip codes sold at a similar price per square foot. (It is important to note, however, that during this time, the average size of a sold home in 94063 was 1133 sqft vs. 1551 sqft in 94061. All else being equal, smaller homes sell at a higher price per square foot than larger ones, so these relative values should be taken with a grain of salt). As prices collapsed, the spread between these two areas has grown, now standing at well over \$100/sqft, the widest in recent memory. This can be viewed in two ways. First, prices in 94063 have crashed further, as high foreclosure rates in the area reflect a homeowner population that could not afford bubble prices. Second, and more interesting, we would argue that on a relative basis, homes in 94063 are selling at a steep discount to those in 94061. If that spread reverts to the mean, then buying in 94063 now could in fact be a better investment than buying in 94061.



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