Seer Capital Management LP
489 Fifth Avenue, 17th Floor
New York, NY 10017
212-850-9000
www.seercap.com

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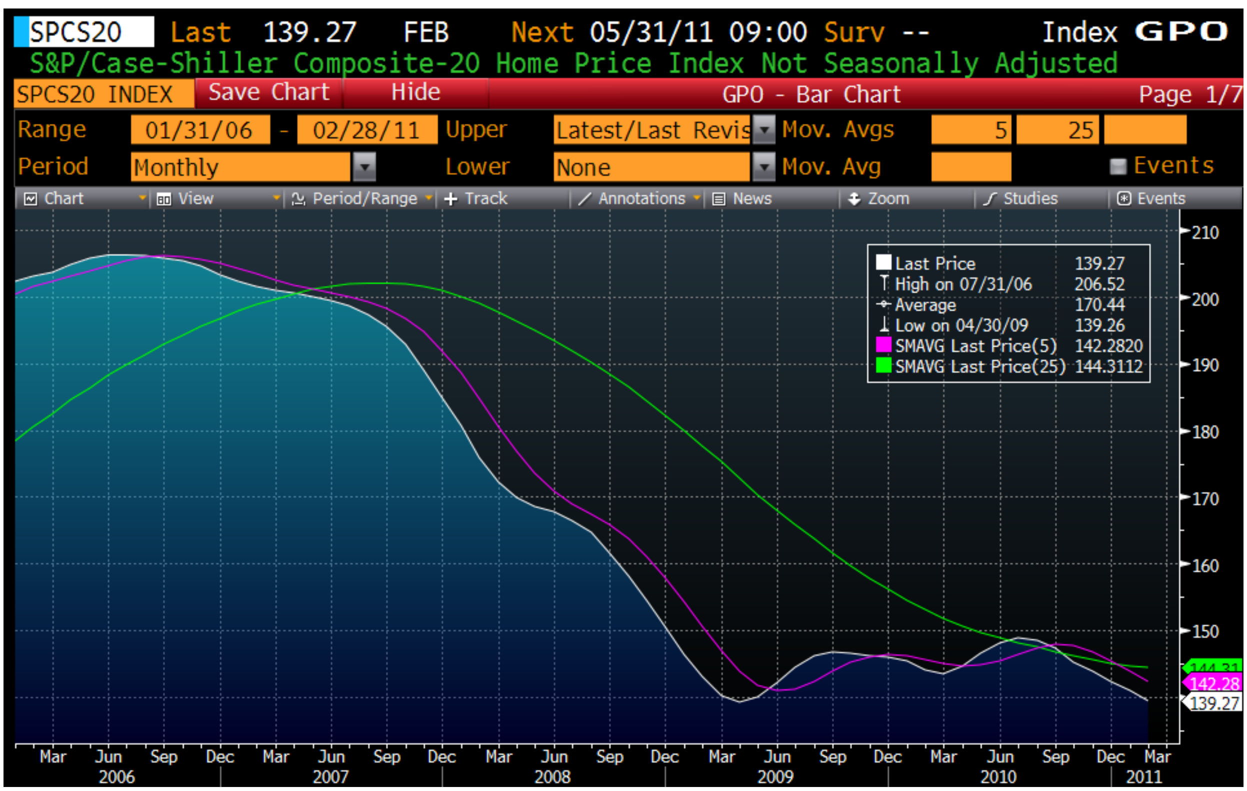
Commentary: Thoughts on the Recent U.S. Housing Price Data

It may be spring outside your window, but in the housing market, as measured by the popular Case-Shiller 20-city index, it is still February, and the housing market is still cold and windy. The latest Case-Shiller 20-city ("CS20") index release, which covers activity through February, was just published. The CS20, a composite index for the top 20 U.S. housing markets, fell 1.1% month-over-month, bringing the year-over-year decline to 3.3%. Importantly, February is a seasonally slow month for housing, and with seasonal adjustments the month over month decline was more benign, registering only a 0.2% decline. (see chart below)



Source: S&P/Case-Shiller, Bloomberg

Recent Case-Shiller Data

Putting the CS20 in context, the aughts, 2000-2010, are now officially the "lost decade" for housing values. In real terms, adjusting by CPI ex-shelter, the CS20 has reverted to 2000 levels. Nominally, prices have dropped 31.4% from their peak. Of course, we always champion the importance of granularity in discussing housing markets, and once again we see that markets are quite heterogeneous. Within the CS indices, only one market was up in February -- Detroit, at +1% month-over-month. And one market is up year-over-year – Washington, DC is +2.7%. Taking a longer term view, prices in Atlanta, Cleveland, Las Vegas and Detroit, are below 2000 levels, while prices in New York and Los Angeles remain more than 65% above 2000 levels. Once again, evidence shows that one's focus must be highly granular when analyzing housing markets. In fact, we continue to divide the market into 4,000 submarkets for purposes of modeling and evaluating MBS investments.

Outlook for HPI

While many analysts have adjusted their home price forecasts downward in response to recent CS prints, the index results are in line with our expectations, and our outlook is largely unchanged. Expressed as a nationwide figure, our forecast equates to a further 10% decline from current levels. Our bias is that it should not be worse than another 10% and that it could be better, especially if employment rebounds while mortgage rates stay at their current lows (approximately 4.8% for 30yr fixed rate 80% LTV mortgages).

It bears noting that the housing market correction will continue to be a protracted process. We need to adjust our time frames for this unique asset, which, for better or worse, does not equilibrate as quickly as financial markets might. For example, consider two of the issues that currently plague housing: excess supply and distressed borrowers.

"Excess supply" is a somewhat subjective term. But it includes excess housing units related to currently vacant homes, unsold spec-built housing, and households doubling up and vacating units. Estimates are that current excess supply is somewhere between

2.25 million and 3.25 millions units. How is excess supply resolved? Less building is one component. Household formations are another. Household formations are suppressed in economic downturns, but history suggests that, at some point, pent-up formations are unleashed and the result is demand for additional housing units (for our purposes, whether the demand is for rental or to own is less relevant). But household formations do not rise in a trading day, they move slowly. At the current rate of household formations, about 420,000 per year, it would take many years to work through excess supply. Of course, household formations are running at only a third of their long run average, and we assume that formations will pick up as the recovery holds. Even so, a doubling of formations would only bring us to about 800,000. Annual formations of 800,000 would still mean it could take four years to clear excess inventory.

The other pox on the housing market is distressed borrowers. As is well reported, we are at an all-time high on foreclosure filings, with the year 2010 posting 2.9 million new foreclosures, closing in on 3% of all households. Various attempts by the government to encourage modifications as an alternative to foreclosures, in addition to the temporary halt in foreclosures self-imposed by the industry in response to criticisms, have slowed down the resolution of mortgage loans. At current liquidation rates, it could easily take 3-4 years to resolve the foreclosure backlog. Even at normalized (higher) liquidation rates, it will take 2-3 years.

This is not to suggest that home prices are destined to overcorrect for 3-4 years as these two key areas are resolved; we are not that grim. Rather, some positive momentum, some progress in the right direction, is needed to start the recovery process. In essence, the market does not need to wait for every last vacant home and foreclosure to be resolved for it to begin to heal. The sense that more foreclosures are behind us than in front of us, for example, should start to stabilize prices. With delinquencies starting to trend down, and our expectation that the pace of completed foreclosures will pick up this summer, we think that the housing market should begin to approach a bottom within the next 12-18 months.

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Seeds of Housing Optimism

There is some "good news" in housing that we also need to bear in mind. First, as a generalization, home prices are now much better aligned with fundamentals. While that does not mean they won't become *cheap* to fundamentals, it is still worth noting and should provide some comfort. For example, on an affordability basis, housing is historically fair to cheap, while on a rent vs. buy basis, housing is just moderately cheaper than historic norms.

Another possible harbinger of a bottom in some markets is the dichotomy we have seen in distressed sales versus non-distressed sales. Simply stated, a distressed sale occurs as part of a foreclosure or a short sale (i.e. where the mortgage lender agrees to allow the property to be sold for less than the amount owed). Recent home price data shows that prices for distressed properties have posted flat to very moderate declines while non-distressed property prices have fallen more significantly. This is interesting for two reasons. One, investor outcomes in MBS are driven by the prices realized in distressed sales, since that is directly relevant to the cash flows received. Second, a bottoming in distressed sale prices may portend an overall bottoming, at least as the prices for both types of sales continue to converge.

While credit continues to be "tight", if we continue to refer back to the aggressive lending environment from the peak, the downside risk to demand appears to be very limited. GSE reform, securitization reform, and higher servicing costs all contribute to higher borrowing costs. And higher down payments and more stringent documentation requirements continue to freeze out some potential first time buyers and many potential move-up buyers. These factors, though, seem to have all been priced in. And, interestingly, investors have begun voting with their checkbook. Estimates are that currently 35-40% of all home sales may be investor purchases. Investors' involvement is a good sign because investors currently tend to be all-cash buyers who should be able to withstand some further weakening of prices, in contrast to the 100%-leverage short term "investors" during the boom.

The Attorneys General Mortgage Industry Settlement Talks

Overshadowing all of this are the machinations of various states attorneys general, now joined by the OCC, OTS, FDIC and the Federal Reserve, in trying to forge a settlement over the "foreclosuregate" scandal. There are three elements under discussion as part of the settlement: fines, servicing guidelines, and loan modification programs. As to fines, numbers as high as $20 billion have been bandied about. Of course, these fines do not affect MBS cash flows, which as MBS investors are our main concern.

As to mortgage loan servicing procedures, we do observe widely different servicing practices, most notably for modifications, foreclosure timelines and advancing. These differences absolutely offer compelling trading opportunities. However, the servicing protocols addressed by the settlement are largely superficial, including such things as better tracking of documents and providing a single point of contact for the borrower, none of which should affect MBS values significantly.

Our primary interest in the settlement is in possible modification programs and any other policy that impacts timelines in the resolution of loans. For example, one proposal disallows "dual tracking" a borrower. Dual tracking refers to pursuing a foreclosure even as you modify a borrower and give them time to reperform. This dual tracking is done so that the foreclosure is "teed up" in the event that the modification fails. It is a prudent practice, given the high failure rate of modifications and the protracted nature of foreclosure processes (especially in certain states). Yet, to some, the practice may seem "unfair" to the borrower.

For the purpose of evaluating MBS investments, assuming longer timelines to resolve loans than what is currently observed is appropriate. It varies based on the location of the property, but, in some cases taking as long as three years to resolve a delinquent loan is a reasonable forecast. For investments purchased at a substantial discount, which applies to most outstanding non-agency mortgage securities, sooner loan resolution leads to higher yields.

With regard to loan modifications, the government has already had a couple bites of that apple, and their programs have "rescued" only a small fraction of troubled borrowers. For example, under HAMP, they have only met 15% of their goal of helping

4 million borrowers. It is worth noting that, to date, the government has encouraged loan modifications by establishing guidelines, by offering GSE takeout financing (very limited) and by making small payments to lenders, servicers and even borrowers to help defray the costs and frictions that might preclude more loan modifications. The government has not mandated modifications per se. The question is, now that the various states attorneys general have the industry "in their crosshairs", with the industry "proven guilty" of something (if only sloppy paperwork), how might they exploit that opportunity? In the interest of seeking some vision of justice or meting out punishment or currying favor with voters, might the settlement include some draconian requirements for more loan modifications?

At the federal level, we do not see support for any dramatic new loan modification programs. The administration and the various regulators involved fully appreciate the risks of offering modifications too generously and giving borrowers perverse incentives. We think they also appreciate the deleterious impact of forever drawing the problem out, and they have further made it clear that they do not believe there are many undeserved foreclosures consummated. As a result, while we continue to monitor developments in the settlement discussion, we believe conservative timeline assumptions will protect MBS investors from the political vagaries of settlement talks.

Karen Weaver, CFA

Head of Strategy and Research
Seer Capital Management LP