M Hanson Advisors – Real Estate & Finance

***The Mortgage Pages** - May 19th 2010*

- **New & Existing Home Sales…Near-Term Trouble**
- **The Builders…YoY Near-Term Volume & Pricing Power Trouble**
- **House Prices…Lots of Gravity for Remainder of Year**
- **Updated Builder NOD through Foreclosure Activity (Put-Back Exposure)**

Our mission is to provide our clients a significant edge. This is done by turning the daily, market-moving real estate and mortgage news flow and events into old news by the time it makes headlines. - *Mark Hanson*

It's that time of the month again with **new and existing house sales** reports on tap. Despite the reports being of stimulus-juiced April, I think there will be some surprises surrounding the results, which on average have dropped 1% and risen 10% MoM respectively over the past five-years.

But taking it out a little further, the next four months -- specifically the months of May and June for new home sales and July and August for existing (both reported one month lagged) -- will usher in a confluence of events that will make for a string of housing-related surprises I haven't seen detailed as of yet.

The following report highlights the near and mid-term risks to new and existing sales, prices, and the builders.

1) Seasonal Adjustments to Work Against Housing for a Change

At the macro, the tax-credit sunset will be amplified by negative seasonal adjustment factors, leading to potential volume disappointments.

The tax-credit stimulus effect of funneling sales into specific months, which may not have been historically strong, has wreaked havoc with the Voodoo seasonal adjustments, in some cases making the macro look much stronger than it really is when measured on a not-seasonally adjusted basis. A perfect example of this was the q409 "record high" seasonally-adjusted, annualized existing home sales reports that got the press and markets all hot and bothered.

The confusion was caused by sales increasing going into the original Nov 30th tax-credit sunset and the seasonal adjustments adding sales because Oct and Nov are historically weak months.

The knife cuts both ways.

This time around, with the last of the tax-credit effects ending going into peak season, the seasonal adjustments will work against sales during the summer months when volume is should drop YoY due to the stim-driven pulled-forward demand. And this comes at a time when last year sales were spiking due to Fed QE, lower prices, and a relatively large amount of distressed inventory available.

Bottom Line: Unless new and existing sales can maintain an upward trajectory ex-stimulus their respective tax-credit effect sunsets in the historically busier months of April and June, for new and existing sales respectively, should create a situation in which **significant YoY negative comps will be recorded.**

At this point, I do not think the market has factored this sort of disappointment in yet, especially across new home sales and the builders.

2) New Home Sales & the Builders - Near-Term Trouble

Since the heavy-handed housing stimulus began a year ago existing home sales, led by distress sales, have outperformed new home sales by a large clip. During the first few months of 2010, new home sales as a pct of total sales has never been lower. Because of this, consensus is that it can't get much worse.

For new home sales, the drop-dead-date for tax stimulus effects was April 30th. April's sales results released in a week and a half will continue to show strength, but based upon my national sampling, perhaps not a huge step up from March. It is always challenging deducing national numbers from limited regional sampling especially with stimulus on, but from what I can deduce from this month's sampling, April sales were probably only flat to slightly up from March, taking into account seasonality.

But **with respect to May new home sales reported in June, any MoM ex-stimulus weakness will be amplified by the seasonal adjustments**, which subtract from sales due to May being historically a stronger sales month. Ex-stimulus weakness was significant at the end of original 2009 tax credit, but because Nov is a slow month, sales were added through seasonal adjustments, which smoothed it out somewhat.

The builders have run nicely on the stimulus pump. Their stocks are 95% pair wise correlated, so if there is a leg down in the group they should all trade together.

That being said based upon this particular catalyst I am identifying, **the large volume builders** (DHI, LEN, PHM, etc) have benefited the most from the recent rally so they may have the most to lose from a general reversal of trends.

The high credit risk names (BZH, SPF, HOV, etc) have also run quite hard this year; however, that has as much to do with debt spreads coming in as new home sales.

Lastly, **they should all suffer from ex-stimulus pricing power, which we saw last year**. And a notable difference is this year supporting prices was the relentless gorilla marketing to all of America to "get in before the end of the tax credit" and "buy before rates shoot up after the Fed quits supporting the mortgage market", was much greater.

3) Existing Home Sales - Near-to-Mid Term Trouble

The same dynamic will occur for **existing sales**, but because they are counted at closing and not application, stimulus-driven sales will continue to be reflected in the monthly sales reports through June 30th, reported in the third week of July.

Therefore, unless sales increase into July -- as they the past two years but this year it's reasonable to assume they won't due to a year of stimulus-driven pulled forward demand -- then **July existing sales (reported in August) should have a seasonally-adjusted headline amplified to the downside.** In fact, I would not be surprised to see sales weak enough to see the phenomenon begin with June sales (reported in July).

It is very important to note that **July 2009 was the strongest month of the year, so the YoY miss could be substantial.** And because the August reporting of July sales is so far after the published April 30th tax sunset much of the market's correlation forgiveness allowance will have dissipated.

4) Prices - Remainder of the Year Trouble

Prices for new and existing houses have many negative forces to combat in the near-to-mid term. For existing sales, it is a case of 'what comes around goes around'.

In large part, reported median and average house prices have benefited from the artificial lack of distressed inventory causing the distress/organic sales mix to shift over the past four quarters while demand has been boosted by tax credit and interest rate stimuli.

But, suddenly over the past couple of months Foreclosures have reached record highs, as the stimulus sunsets, and short sales are surging. As more Foreclosures resell into a slower overall market, it will cause the distress/organic ratio to once again begin to grow adding statistical pressure on the median and average house prices.

In addition, both **new and existing sales will be negatively impacted from the loss of the sense of urgency and big coupon** in buyer's hands, which makes over-paying in order to 'get in now' more palatable especially given the artificial lack of distressed inventory.

Moreover, the lack of armies of builder reps and mortgage loan officers proactively marketing every qualified and unqualified human being in America to "get in before the end of the tax credit" and "buy before rates shoot up after the Fed quits supporting the mortgage market", will add to the sudden void in activity further impacting prices.

5) Builder Put-Back Exposure - Updated Reports

Sudden record Foreclosures, surging short sales, and the stimulus sunset are all resounding negatives for the builders over the near, mid and long term.

But in addition to these risks, the builders that operated in-house mortgage banking operations during the bubble years face potentially heavy legacy loan put-back exposure that I have highlighted on numerous occasions.

We know for certain that the GSE's and FHA are aggressively auditing billions in loans looking for recourse level deficiencies and are sticking it to the banks. It stands to reason, as the builder's stock prices are doing well and they have not been this liquid in years, they are also targets. Quite simply, those builders with the heaviest default and foreclosure activity are at the greatest risk

Most builder mortgage divisions were the worst of the worst. In fact, during the bubble Realtors would often re-direct their clients, who could not qualify for a loan to buy an existing home for whatever reason, to a new home because in-house builder mortgages always went through.

As part of my prop database, I can track the legacy and new vintage loan performance of most builders. The **timing of their default and foreclosure activity is notable because their trends do not follow the macro.** While the macro saw the Subprime NOD surge begin in back-half 2007, the builders as a whole did not see the same ramp until back-half 2008.

It is as if when they saw the market falling apart in 2007 they went out and made as many bad loans as possible in a short period of time right before the outright collapse. .

Put-Backs

In terms of builder put-backs, disclosures are bad since the mortgage divisions are small and usually only account for less than 10% of profits. If the put-back amount isn't material they probably won't even break it out.

There have been a few quarters here and there where they will break out decent losses (e.g. DR Horton had one in late 2009). But even among these, nothing has really made investor heads turn yet because they have been booked along with much larger land impairments (i.e. builder reports $15 mm fin serv provision, but also reports $200 mm land loss).

At this stage -- with land impairments falling -- if provisions began to rise sharply folks would be blind sided. And with several of the builders near the **BILLION dollar Notice-of-Default mark (for states I cover in this granular of detail) in 2009 alone**, the exposure is not trivial.

Perhaps the time has come when every piece of trash loan they made in order to shove everybody with a heartbeat into a new cracker box with a 50x20 backyard originated from 2003-2007 is on its way back. This possibility can't be shelved.

Of the more liquid public builders I track DHI, KBH, LEN and legacy Centex are the most exposed. For its size, HOV has moderate risk while BZH, MTH, PHM (ex-Centex), and RYL look to have insignificant risk.

My standard real-time builder NPA report shows Notices-of-Default, Notices-of-Trustee Sales and Foreclosures broken out by builder name, counts and original deed-of-trust amounts. Keep in mind that the actual amount owed on each note is approx 15-20% higher than I show here due to missed payments, interest, penalties etc.

The data has not changed much from when I sent it out last in April covering NOD's, NTS's, Foreclosures and Cancelled Foreclosures through March. Since then, builder Default and Foreclosure activity has tracked closely the macro with NOD's down and Foreclosures and Cancelled Foreclosures both at-or-near record highs.

The pdf report is large in size so I did not include in this email. If you would like a copy, please let me know and I will email under separate cover.

Best Regards,

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