RADAR LOGIC OPINION

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BEWARE THE SHADOW

The data firm CoreLogic announced today that the number of homeowners who owe more than their houses are worth fell for the third straight quarter this summer. About 10.8 million households, or 22.5 percent of all mortgaged homes, were underwater in the July-September quarter, compared to 11 million households in the second quarter. But according to CoreLogic the decline came about because more homes had fallen into foreclosure, and not because home prices had increased. CoreLogic went on to say that the ranks of underwater borrowers will remain high and will likely rise in coming months as home prices decline.

We at Radar Logic agree with this assessment, and believe that there is a risk that without a combination of renewed demand and foreclosure abatement, this phenomenon will likely get worse. Even a modest decline in home prices could drive many more Americans underwater in their mortgage loans. The homes of underwater borrowers are not counted in most analysts' numbers regarding housing inventory, and estimates of "visible" inventory already suggest a heavy imbalance between supply and demand. There is little doubt that one of the impediments to buying a home today is the expectation that there will be more for sale tomorrow.

According to research by CoreLogic, borrowers become more likely to default the further underwater they become in their mortgages. Thus, falling home prices could increase defaults, foreclosures and, as a result, the inventory of bank-owned properties. Based on our analysis, homes sold by financial firms sold for 38 percent less, on average, than homes sold by other sellers as of September 30, 2010. As such, foreclosed homes represent a low-priced alternative to homes for sale by owner/occupants, and as sales of foreclosed homes become a larger percentage of total sales, owner/occupants face increasing pressure to reduce their asking prices in order to compete. So falling prices could create a self-perpetuating cycle of negative equity, foreclosures, and further price declines.

Composite Home Prices, Expressed as Price Per Square Foot, for 25 Metropolitan Areas

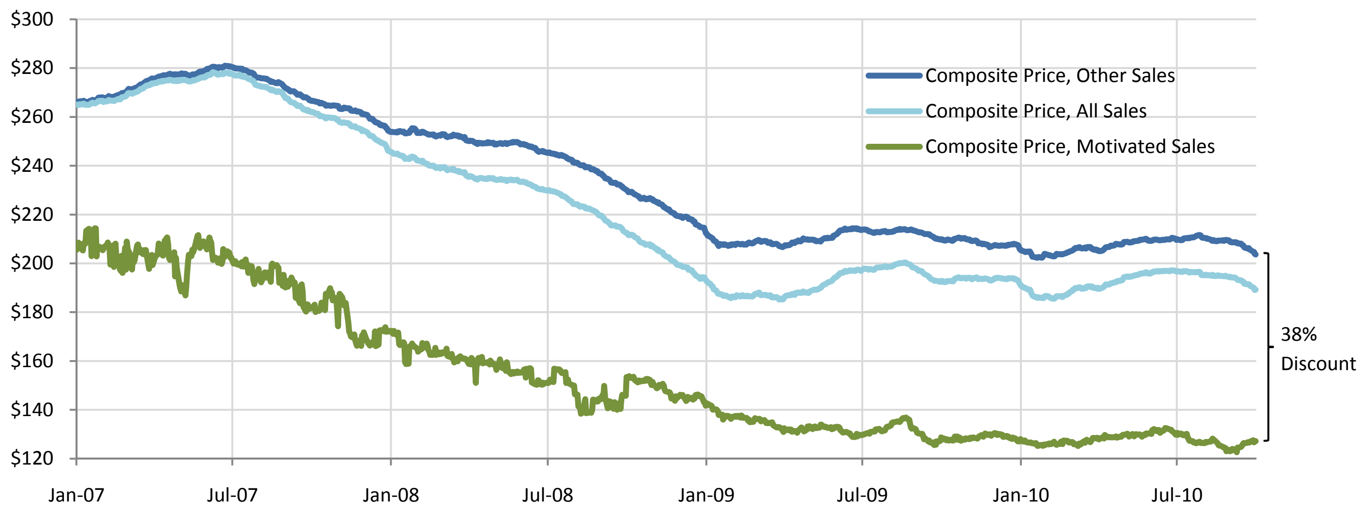

Figure 1: This chart shows historical values for the 25-MSA RPX Composite price along with composite prices for motivated sales and other sales. Motivated sales are sales of foreclosed homes by financial firms and at foreclosure auctions. Other sales are all sales not considered to be motivated sales.

We are just beginning to see the transaction results for the fall. Normal seasonality would suggest some softness through the winter, with a rebound in the spring. As we warned previously, the imbalance between supply, both visible and shadow, and real demand seems to be the most prominent factor in the direction of home prices. As we enter the spring, and assuming mortgage credit is available on manageable terms, one hopes the market will stabilize or even recover. But, beware the shadow. It will matter.