



AKROS CAPITAL, LLC

It's Still About Housing

March 1, 2010

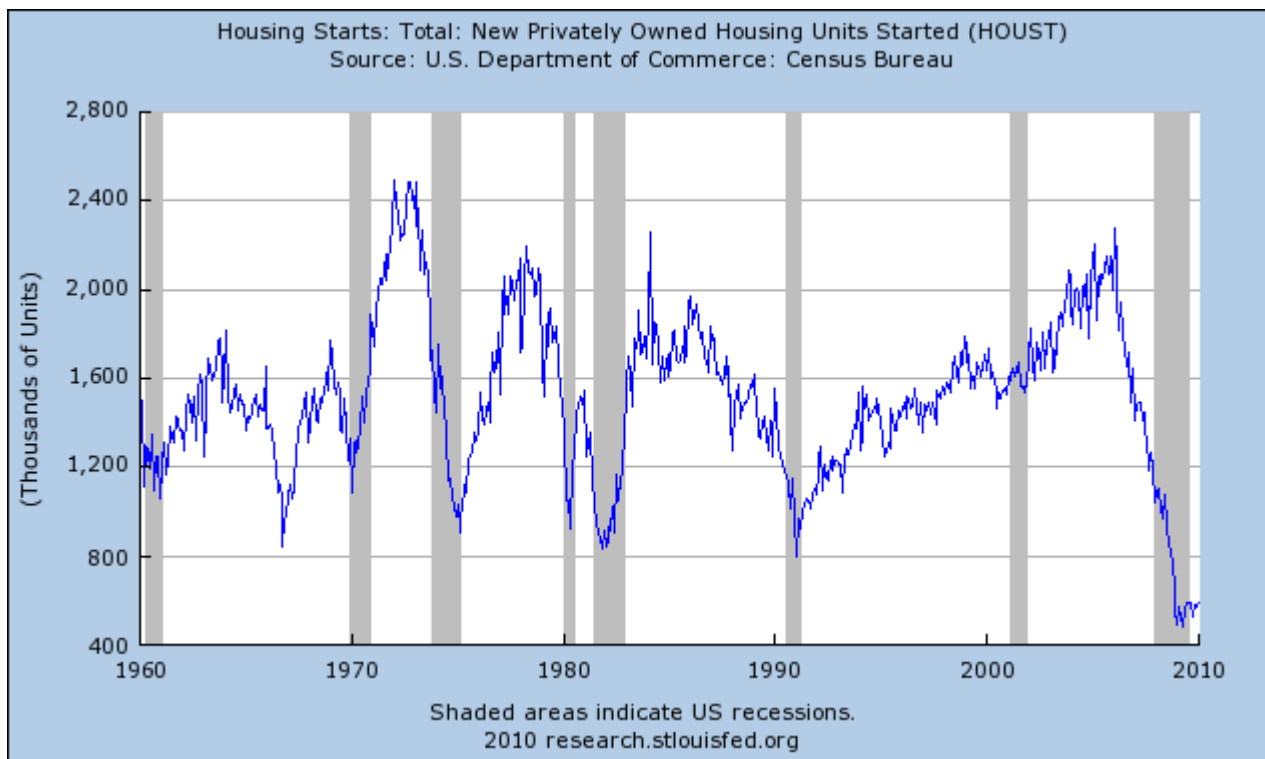
“There's a lot of underlying weakness in the world economy and national economy. That's not the general economic environment in which people decide to go out and spend \$200,000 on a house.”

– Bill Weaver, Real Estate Professor, University of Central Florida

Of all the various measures used to predict the future course of employment and the economy, housing has been and continues to be the best leading indicator. Despite government efforts to prop up the housing market and stimulate demand, the outlook is poor and has shown little improvement in recent months.

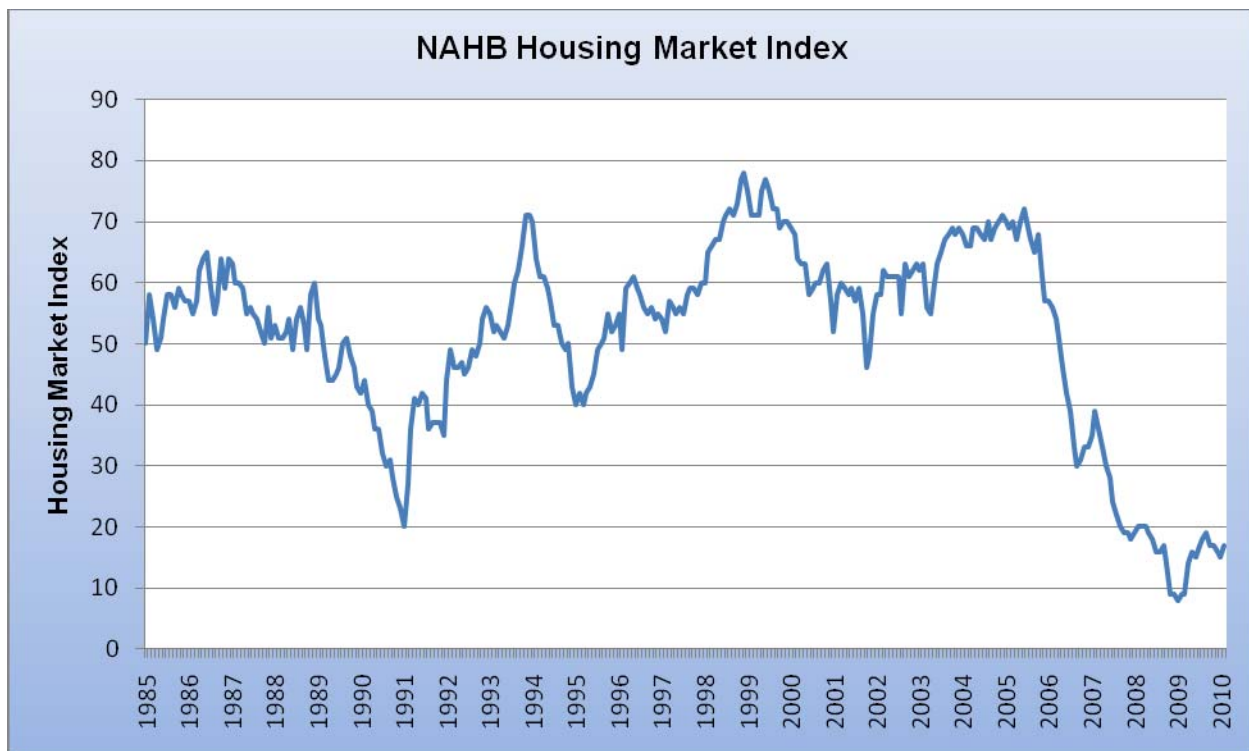
Housing Starts Remain Slow

The Census Bureau reported last month that total housing starts were running at a seasonally adjusted annual rate of 591,000 units in January, up 2.8% from December and up 21% from January 2009. The graph below shows these increases came off very depressed levels and the current pace of housing starts remains slow by historical standards.



Although January housing starts were up 23% from the all-time low of 479,000 recorded in April 2009, they were down slightly from 593,000 last July. Despite some early signs of stabilization, there has been no sustained rebound. Moreover, the large number of available excess housing units suggests the situation will not improve in the near future.

Accordingly, builder confidence remains extremely low. The National Association of Home Builders Housing Market Index increased to 17 in February from a reading of 15 in January, up from the record low of 8 in January 2009. Any reading below 50 indicates more builders view conditions as poor than good. As the next graph illustrates, the HMI has been stuck in the 14-19 range since April 2009 and shows no signs of recovery.



Home Sales Remain Weak

Last Friday the National Association of Realtors reported sales of existing homes fell in January to their lowest level since June. January's seasonally adjusted annual rate of 5.05 million was down 7.2% from 5.44 million in December, but 11.5% above the 4.53 million-unit pace in January 2009. The decline in sales from December reflects weakness both in employment and in consumer confidence, especially in view of the extended and expanded government tax credits for home buyers. That said, sales of existing homes are not a particularly good leading indicator. Except for generating real-estate commissions, they neither contribute to GDP nor create jobs.

New-home sales are a better indicator, and the most recent report was a disaster. The Census Bureau reported last Wednesday that new-home sales plunged 11.2% in January to a seasonally adjusted annual sales pace of 309,000 units, which was the lowest on record. The

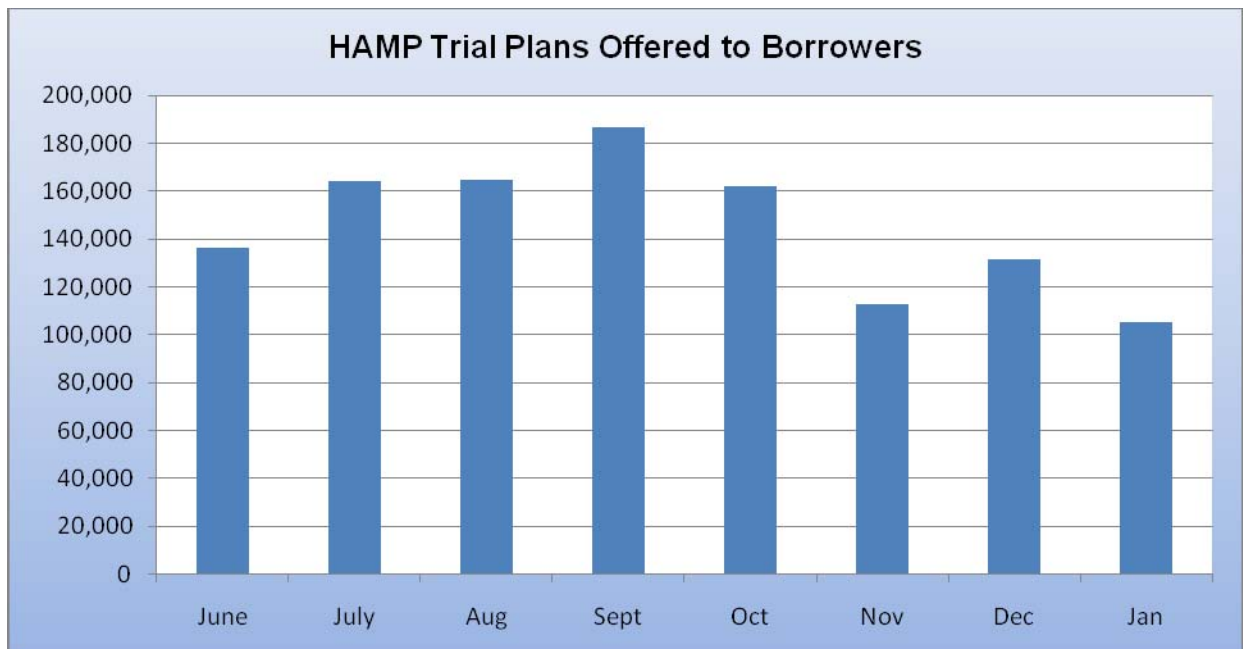
dismal report came the same day the Mortgage Bankers Association's Weekly Application Survey revealed mortgage-purchase applications were down 7.3% from the previous week and are at their lowest level since May 1997. With the Federal Reserve's \$1.25 trillion program of mortgage-backed securities purchases set to end March 31 and the home-buyer tax credits scheduled to expire at the end of April, there is little reason to expect improvement once these stimulus measures are withdrawn.

More Foreclosures Ahead

Caution on the part of buyers is understandable given that today's potential home buyer is tomorrow's potential underwater borrower. According to First American CoreLogic's Q4 2009 report, the number of residential properties in negative equity rose to 11.3 million and 24% of all borrowers at the end of the fourth quarter of 2009, up from 10.7 million and 23% in Q3.

More troubling was the report's finding that negative equity is a major factor in changing homeowners' default behavior. In particular, once negative equity exceeds 25%, or the mortgage balance is \$70,000 higher than current property values, owners begin to default with the same propensity as investors. Up to that point investors default at much higher rates. Apparently, 25% or \$70,000 is the "tipping point" at which the owner-occupant realizes it would be faster and less costly to default and repair damaged credit than to wait for and ride out a potential recovery in prices that may never come.

Meanwhile, the centerpiece of government efforts to prevent foreclosures, the Treasury's Home Affordable Modification Program (HAMP), has resulted in only 116,297 permanent modifications through the end of January 2010. An additional 76,000 permanent modifications have been approved by servicers and are pending borrower acceptance. The graph below indicates that despite the program's limited success it already may be reaching the saturation point of qualified borrowers, as the number of trial plans offered per month appears to have peaked.



The government is obviously concerned that, in an epidemic of lucid thinking and rationality, the nation's tens of millions of underwater borrowers may decide to walk away from their homes rather than remain saddled with excess debt. Consequently, the Federal Deposit Insurance Corporation is developing a program to test whether cutting the mortgage balances of underwater borrowers can successfully reduce the number of walk-aways.

“We're thinking about it in terms of earned principal forgiveness. If you stay current on your mortgage, you would earn a principal reduction. It would only be for loans significantly underwater.”

– *Sheila C. Bair, Chairman, FDIC*

Though the program supposedly is designed for “distressed” borrowers, the Chairman’s comments reveal the principal reductions are intended solely as enticements for borrowers who already can afford to pay. Otherwise, what would be the point of making the recipient “earn” the forgiveness by continuing to make timely payments?

Until government subsidies are withdrawn and housing prices adjust to sustainable levels of household income, weak demand for houses will weigh on employment growth and the U.S. economy. And until that process runs its course, underwater borrowers will have an incentive to walk away from their homes rather than to continue making payments valued significantly in excess of what their homes are worth.

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