AER

Atlantic Equity Research
Independent Research

State of the U.S. housing market **May 31 ST, 2006**

Exactly how the current housing sector slow down will affect consumer spending and what is the nature of the slow down today as it stands are two issues that will greatly affect the U.S economy moving forward because of its contribution for spending and employment. The current status of the housing market has many of the characteristics you would expect of a falling market, but hasn't fallen of a cliff because of the still extremely lax lending environment. Almost every public home builder that reported results for the first quarter had approximately 5 to 15 % less new orders than the year before, and lowered their guidance for the second quarter and the year. Many also experienced huge jumps in cancellations. Centex, for example, had 30 % cancellation rates and Ryland Group had 27% cancellation rates. The level of speculative building seems to be high and the amount of sales made by the public home builders with little or no money down seems to be high as well. And there have been estimates by different organizations that track the housing market that between 25 to 50 % of the sales over the last few years have been to investors. We are also now starting to see the home builders use the type of tricks many technology companies used in '01, as home builders are now starting to write - off inventory. Toll Brothers wrote down $12 million in inventory in the first quarter compared to only $200,000 last year. There was also an inference on its recent conference call that Toll Brothers will now experience greatly increased margins for the sales made in communities in which the inventory has been written down, similar to what some technology firms did in '01, when they increased margins by selling off inventory that had previously been written down. Selling inventory that has been written down reduces the cost of goods sold so that revenues drop right to the bottom line. It is also important to note that Toll Brothers had a higher than expected $13 million contribution from a joint venture. It expected only $6 million from the joint venture, and its contribution from its other income category was $11 million, $5.5 million higher than it expected. These are the types of gains from non – operating items that are used when a growth company is stretched to meet growth expectations.

The situation in the housing market today is one in which there simply isn't enough buyers willing to borrow the money to absorb the skyrocketing inventory across the country. But, the banks will still give buyers the money if they want it. For the market to completely fall banks would have to pull back from making the risky loans that they have been very willing to make. This, I believe, will happen when the results of the risky loans that have been made come to fruition. The results of the risky loans made are starting to come in now, and will accelerate next year as many adjustable mortgages made between '02 and '04 reset. Realty Trac, a company that tracks foreclosures, claims that mortgage defaults between January and March of this year numbered 323,102 versus 188,122 during the same time period last year. Most of the appreciation in home prices on the coasts, and in Arizona and Las Vegas depended upon exotic mortgages such as adjustable, interest only or negative amortization loans to drive home prices between '03 and '05. These types of loans have never been sold to the degree that they have been sold over the last three years, so the banks that have made these loans, and the investors that have purchased the packages securities made up of these types of loans, do not know what will happen once the adjustable periods reset.

We are currently in the first leg of the slow down which is characterized by significantly rising inventories, and slowing sales. Prices are falling in some areas of the country, and the increase in pricing growth has slowed significantly everywhere. According to the National Association of Realtors the median house price for existing homes were $223 K in April up from $214 K in April last year, and existing home sales were 5.7% lower this year than last April, at 6.76 million units versus 7.17 million. New home sales were also down 5.7% from last year. Inventory for existing homes was up 900,000 to 3.38 million, a 36 % increase, and inventory for new home sales was up to 565,000 from 445,000 a year ago, a 26% increase.

A very important statistic to consider is the number of homes sold over the last 15 years because the statistics completely contradict the “bulls” argument that population growth has driven the housing market, and that home builders have not over - built. The Exhibit below, see Exhibit 1, shows the number of single family and condominium sales in April from ’91 through ’06 in Massachusetts. There were a combination of 2,385 single family homes and condominiums sales in ’91, 4,323 sales in ’97 and 4,954 sales in ’06. Massachusetts has actually lost population over the last few years, yet sales were up from 4,323 to 5,508 between ’97 and ’05. And sales in ’05 were approximately 2.5 times what they were in ’91. This shows that population growth is not what has driven the housing market over the last 15 years, but rather a massive financing scheme combined with a marketing blitz. Nation wide, new home sales went from 790k in ’96 to approximately 1.2 million in ’05. Existing home sales ranged between from 5 to 5.2 million in the years between ’99 and ’02, and then jumped to over 7 million in ’05. These huge growth increases in the turn - over of homes has nothing to do with population growth. What has happened is a wild speculative frenzy in which Americans have traded up to more expensive homes or started to invest in homes themselves.

Exhibit 1

April homes Sales

Massachusetts –’91-‘06

Massachusetts Association of Realtors

April Sales	Single	Condo
06	3,268	1,686
05	3,628	1,880
04	4,046	1,663
03	3,318	1,189
02	3,609	1,231
01	3,212	1,024
00	3,421	1,051
99	4,216	1,120
98	4,139	905
97	3,521	802
96	3,385	681
95	1,931	388
94	3,180	554
93	2,675	463
92	2,885	440
91	2,107	282

I believe that the high inventory levels and sales slow downs combined with the increasing foreclosures will eventually bring the housing market to the next stage, which will be the stage in which the banks are forced to stop giving out the exotic, risky mortgages that have driven this market. The increase in foreclosures will now accelerate as the adjustable mortgages reset. Right now, we are still at the stage in which prices are hanging near peak levels. The higher interest rates the U.S. is now experiencing will adversely affect people with adjustable mortgages when their mortgages reset. It should also be considered that the employment situation will be hurt as a significant portion of the employment growth from the economic bottom in'02 through today has come from the real estate industry. As home prices fall, because consumers have so heavily depended upon equity extraction for spending, consumer spending will fall as well. With wage growth lower than inflation over the last five years, and savings rates fluctuating between negative and zeros, many consumers will have nothing to fall back on when they no longer have equity to tap into.