

The Campbell Real Estate Timing Letter

Separating likely probabilities from whims and pure hope

The only real estate timing advisory for Southern California investors

January 15, 2010

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2010 Housing Outlook: Lower Prices on the Horizon

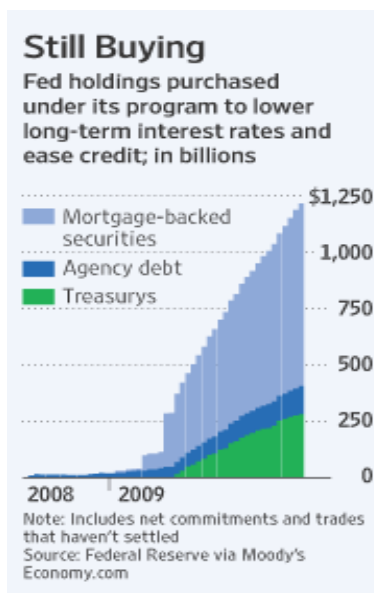
“There is nothing more elusive than an obvious fact.”
– Sherlock Holmes

With the upturn in housing prices that began in April 2009, there has been a lot of bullish commentary on the housing market. But as my readers know, I believe the housing market is fundamentally in bad shape and that's why my view differs from that of many other analysts. Frankly, even though housing prices as measured by Case-Shiller have rebounded nicely off the market bottom low, I suspect the growing optimism that is now taking hold will eventually fade away into obscurity as everyone starts to realize that (1) this is no ordinary recession we're in; and (2) there is no fundamental basis to support a self-sustaining housing recovery.

For one thing, could the upturn in prices simply be the result of seasonal forces at play? If you go back to 1987 and look at the raw Case-Shiller numbers on a month-to-month basis, you'll see that prices tend to rise in the spring and summer months, and tend to fall in the fall and winter months. While these seasonal price changes are usually modest, they occur for the simple reason that they are highly correlated with the same seasonal ebbs and flows in home buying activity (demand).

There has been a tremendous amount of government effort that has gone into stopping the fall in prices. The government has given an \$8,000 tax credit to first time homebuyers to encourage them to buy more homes. To keep mortgage rates artificially low, the chart to the right shows that the Federal has purchased more than \$1 trillion of mortgage-backed securities since February 2009.

So when you add the government stimulus to the seasonal forces already at work, this kind of one-two punch was bound to have a positive effect on home prices. Yet with all that, the Case-Shiller 20-City Home Price Index – after four straight months of gains – was unchanged in October 2009. And just seven of the 20 cities recorded gains from a month earlier – which included San Francisco (+1.2%), San Diego (+0.4%) and Los Angeles (+0.3%).



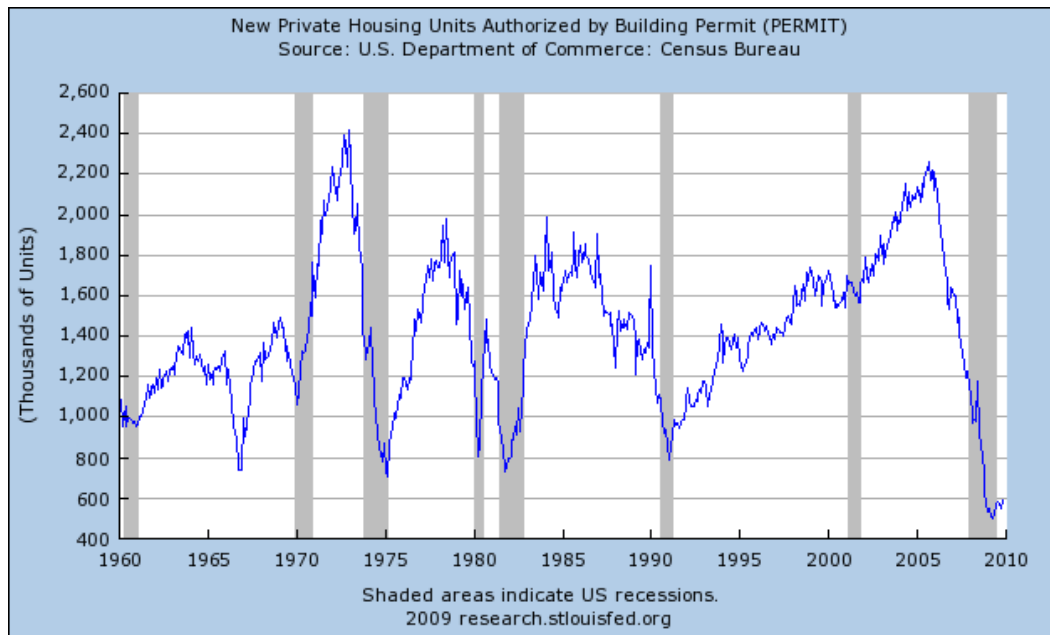
That said, the turnaround in home prices we saw in the spring and summer could be ending. If that's the case, I would view this current uptrend as nothing more than a dead-cat bounce – which occurred because the U.S. housing prices became so severely depressed that they sparked an onslaught of speculative buying. Because prices were far lower than they were just a couple of years ago, people have been rushed in and frantically bought what they perceive to be good deals.

Whenever this dead-cat bounce ends, I expect homes prices to embark on their 2nd leg down – taking the pendulum from very expensive in 2006 to very cheap before the downturn is over.

Let's now see why the recent rise in housing prices does not reflect the underlying fundamentals.

New Home Building Permits – No Signs of a Recovery Yet

Historically, a recovery in building permits occurs before housing prices start rising, usually by a year or more. That's why this is one of the five Vital Sign indicators in my real estate timing model – it tends to lead the housing market both up and down with respect to trend (and price) changes.



As you look at the above chart, you'll see that U.S. building permit activity is still near the lowest level we've seen in 50 years. Do homebuilders see a housing recovery on the horizon? Apparently not.

In my past two Timing Letters, I talked at great length about the multitude of negative market forces – rising unemployment, wages falling the most in 80 years, record high mortgage delinquencies and foreclosures, a 2nd wave of mortgage resets, and shadow inventory – all of which show what I believe to be clear evidence the housing crisis isn't over.

So here's a new reason for my skepticism that we are in an emerging bull market for housing. If in fact we were embarking on a genuine recovery in housing – a recovery that would be able to overcome the weight of all these negative market forces in the coming years, I would have expected to see the number of new home building permits rise strongly in 2009. That just didn't happen.

Could it be different this time? Sure, but I wouldn't risk much money in the hope that it will.

Negative Equity – The #1 Catalyst for Default and Foreclosure

Going forward, I believe that negative equity – which occurs when the value of a home falls below the outstanding balance of the mortgage – is one of the biggest obstacles to a sustainable housing recovery.

According to the Wall Street Journal, the number of Americans in August 2009 that owed more on their mortgages than their homes were worth totaled 10.7 million – or about 23 percent of all U.S. mortgage holders. About 40 percent of Americans that took out a mortgage at the peak of the housing bubble in 2006 are now underwater. In Nevada alone, 46 percent of all mortgage holders have negative equity on their homes.

But the worst is still to come, predicts Deutsche Bank. In an August 2009 report, Deutsche said the U.S. housing market would not have a full recovery anytime soon – and about half of all U.S. mortgages could be underwater by 2011.

According to the report, some of the housing markets that appreciated the most during the 2002 to 2006 housing bubble – such as California, Florida, and Nevada – may ultimately find that 90% of all borrowers end up underwater.

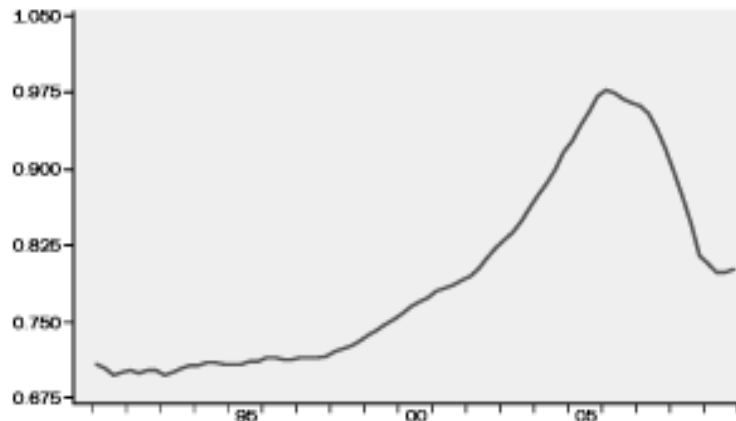
This market outlook is supported by the chart to the right – courtesy of Gluskin Sheff – that shows the collapse in housing prices has yet to fully mean revert toward rental rates. To do so would require another 10-15% drop in residential housing prices.

According to David Rosenberg of Gluskin Sheff, “a decline of this magnitude would take the number of households who are underwater on their mortgage for 15 million (25% of the mortgage population) to 30 million (half).”

Not only are the number of mortgage holders with negative equity expected to rise, but the Mortgage Bankers Association Delinquency Survey for Q3 2009 shows that 14.1% of borrowers are not making their mortgage payments. This means that 7.9 million homeowners did not pay their mortgage in Q3 2009 – a massive increase from several years ago.

CHART 1: HOME PRICE TO RENT RATIO HAS YET TO MEAN REVERT

United States: FHFA House Price Index Relative to CPI Rent (ratio)



Source: Haver Analytics, Gluskin Sheff

Why do I mention the rising trend in delinquent mortgages? Because when borrowers miss a mortgage payment for any reason – and then re-evaluate their financial situation as to what to do next – the default rates are high and the cure rates are low when borrowers have negative equity in their home. In research from Amherst Securities, a company that specializes in trading mortgage backed securities, it was found that even if delinquent borrowers are financially able to bring the mortgage current again, most will decide to walk away if they are significantly underwater (meaning their home has a loan-to-value between 120% to 150%, depending on the loan type).

Many people have argued that unemployment – not negative equity – is the primary reason for default and then foreclosure. Amherst Securities showed this argument was not supported by the evidence. “First, the increase in delinquencies for subprime, Alt-A, and pay option ARM mortgages began to accelerate in Q2 2007. By contrast, we did not begin to see large increases in unemployment until Q3 2008.”

When highlighting the risks for 2010, and because negative equity is the primary catalyst for default and foreclosure, this is one of the reasons this housing crisis still is not over.

But what about HAMP – the Home Affordability Mortgage Program? Wasn't this Treasury program designed to lower payments for underwater borrowers to prevent foreclosures?

Sure, but HAMP isn't working out as everyone had hoped. Even though monthly payments are being lowered, there are no principal balance reductions. In other words, the borrowers who do qualify for a loan modification are still underwater. Borrowers know this and are simply using the lengthy HAMP loan approval process as a way of staying in their homes rent free for a longer period of time.

And we're talking about a lot of houses here. Since the HAMP program was initiated in March 2009, there are currently close to 750,000 homes that are under what are called "trial modifications" – and only a small fraction of them (30,000 or so) have actually converted into a permanent loan modification. The bottom line is this: the vast majority of these HAMP loan modifications currently in process will fail.

Little known to most people, HAMP's high failure rate will ultimately cause a new wave of distressed homes to hit the market this coming spring and summer. This will be the result of a Supplemental Directive to HAMP that requires all loan servicers who participate in HAMP to offer expedited procedures for short sales and even "deed in lieu" programs to those borrowers who do not qualify for a modification – or to those who do not make it through their trial modification.

According to the directive: "Both of these foreclosure alternatives reduce the need for potentially lengthy and expensive foreclosure proceedings. The options help preserve the condition and value of the property by minimizing the time a property is vacant and subject to vandalism and deterioration. In addition, these options generally provide a substantially better outcome than a foreclosure sale for borrowers, investors, and communities."

There you have it folks. With a flood of inventory (close to 750,000 homes) poised to hit the market as short sales and "deed in lieu" sales in April 2010, it seems that the Treasury is finally starting to get serious about clearing the market of homes that are owned by defaulting borrowers that cannot afford them. This is actually a good thing. This "extend and pretend" game can only go on for so long before we have to face the fact that houses are still too high and have to come down to more normalized levels that are based on sustainable income and rental metrics.

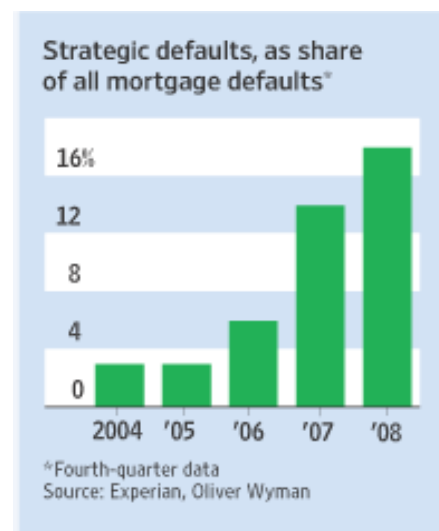
A nasty consequence of a new leg down in the housing market could be the fact that it would swiftly push hundreds of thousands of 2009's crop of "first time" home buyers deeply underwater on their low-down FHA loans. Even worse, these underwater borrowers cannot simply default and walk away because they will have to pay back the \$8,000 tax-credit they were given by the government as an incentive to buy a home. Knowing that it's unlikely most of these home buyers can pay the \$8,000 back to the government means they will be stuck in these underwater homes for at least 3 years. Welcome to the new American Nightmare!

Tracking a 5 Stage Real Estate Collapse – Revisited

In the July 2009 issue, I said I expected this real estate collapse to evolve in a 5 stage process. To review, **Stage 1** was driven by speculators, people who let their properties go back to the bank because prices started falling. **Stage 2** was driven by sub-prime borrowers, most of whom stayed in their homes only until the low-introductory teaser rate on their mortgages reset in 2 years to a significantly higher payment. **Stage 3** would be driven by rising unemployment and that's a big part of what we're seeing today – when you lose your job, you lose your house to foreclosure.

As discussed in the November 2009, **Stage 4** would start in earnest in 2010 – and for two years would be driven by the Alt-A and Option ARM resets. I figured that **Stage 5** market capitulation – the final washout that would ultimately identify the market low – would be that point in time when underwater homeowners with high credit scores and good jobs will bail out of their mortgages in mass with none of the expected warning signs, such as non-payments on other debt.

These Stage 5 "strategic defaulters", however, may be walking away sooner than I originally expected. Researchers have found the number of strategic defaults is far greater than most industry estimates - especially in California, Arizona, Florida, and Nevada, where home prices have fallen the most. The most current data shows that there were 588,000 nationwide during 2008, more than double the total in 2007. As seen on the chart to the right, this total represents 18% of all 2008 mortgage defaults – and this percentage has risen steadily every year since 2005.



Be clear about this: these upside down homeowners are walking away from debt not out of necessity because they can't afford to make the payments, but because they believe it's in their financial best interests to do so. In other words, why throw good money after bad?

In fact, taking a cue from underwater homeowners, Morgan Stanley, the giant Wall Street securities firm, is planning to give 5 properties it bought in San Francisco back to its lender, Barclay Capital. This would be a strategic default on a loan of \$2 billion.

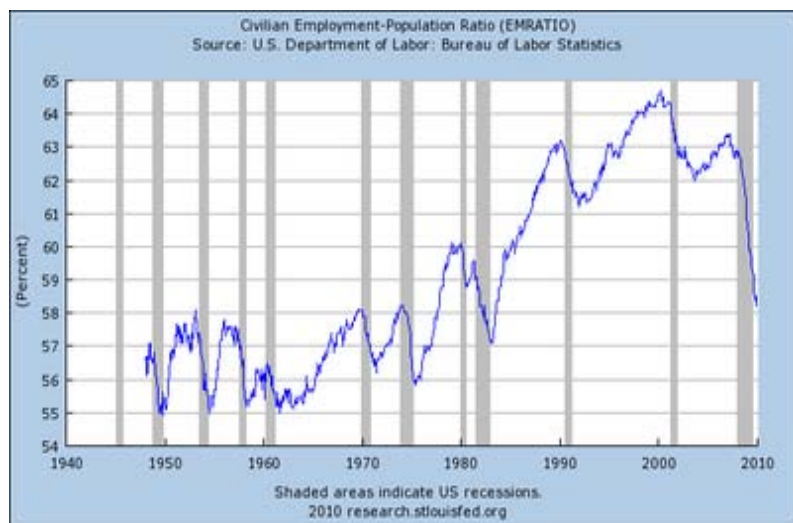
After Morgan Stanley bought these properties at the peak of the commercial real estate market in 2007, values declined as much as 50%. And while the company is current on its debt and has the money to keep making payments, the move represents a purely financial decision. Good business has always dictated that you know when to cut your losses.

While many people don't feel right about strategic default, and there is not yet a stampede of underwater borrowers tossing their keys over to lenders, I suspect we'll start seeing a lot more of it in 2010 – especially if the housing market starts turning down again. With more and more underwater borrowers starting to ask themselves “should I stay or should I go,” I think Morgan Stanley's actions could legitimize this decision and remove the stigma for a lot of people. After all, if Morgan Stanley cuts its losses and walks away from a losing real estate investment, why shouldn't we?

The Dismal State of the U.S. Job Market

I now want to look at employment trends. The chart below shows the ratio of employed people compared to the population. For the 25 years prior to the year 2000, this ratio has clearly been in a rising long-term trend characterized by higher highs and lower lows. But since 2000, this up trend turned into a down trend – and in 2007 the ratio went into a cliff dive that we haven't seen in almost 70 years.

The Bureau of Labor Statistics reports there has been zero net job growth in the last 10 years – making this a lost decade for American workers. While the U.S. population has increased from 282 million in 2000 to roughly 307 million in 2009, the total number of jobs has remained constant. This can only be classified as horrible. If you go back to the 1940s, in no previous decade was job growth less than 20% - with an average well above that. With 15.3 Americans currently out of work, the Labor Department recently reported that job seekers outnumber job openings by more than six to one.



What's the best solution for creating economic growth and more jobs?

For starters, we need lower housing prices. The U.S. economy cannot recover without consumers. Yet American consumers, who constitute 70% of the U.S. economy, are facing mounting job losses as well as pay cuts.

With all the stimulants the government is supplying to support the housing market, we're on the wrong path in trying to keep housing prices high.

The bottom line is that housing prices must drop to save the U.S. consumer and revive the economy. Households

should only be spending 30% of their income on housing costs, not the 45-50% (or oftentimes way more) that is currently allowed with the current FHA underwriting standards. As I showed you in the November 2009 issue, real “inflation adjusted” U.S. housing prices have only fallen back to August 2003 levels. That's not far enough because the housing prices are still roughly 20-25% too high relative to historic norms for incomes and rents.

Undermining today's housing prices even more is the fact that incomes are currently falling at an annual rate we haven't seen in 80 years, and rents are seeing the largest annual decline in 30 years. Thus, the “norm” is falling too, and has become a downward moving target. How low will incomes and rents go is anyone's guess. However, since the housing market has always reverted back to the mean over time, this suggests housing values will have to revert to pre-2000 price levels in order to return back to historic norms.

Current Housing Trends for 14 Major U.S. Cities

The table below shows data through October 2009. Here's how to read the data and determine what it is telling you. If housing prices are likely to rise in any of the 14 cities, the Market Momentum reading for October 2009 will be a positive number – and if prices are likely to fall, the October Market Momentum reading will be a negative number. This tells you whether the primary trend of the market is up or down – and whether you should be invested in the market for potential price appreciation, or out of the market for capital preservation.

It is also valuable to know whether a housing market is getting stronger or weaker relative to the primary trend. This can be determined by comparing the latest Market Momentum reading (October 2009) to the Market Momentum reading from four months ago (July 2009). If the reading has become more positive compared to four months ago, it tells you the market is improving relative to the primary trend. If it has become more negative compared to four months ago, it tells you the market is getting worse.

City	Sell Signal	Price Change in Last 12 Months	Price Change from Peak Values	Market Momentum Reading: <u>July 2009</u>	Market Momentum Reading: <u>October 2009</u>	Primary Trend
Phoenix	Jan 07	- 18.1%	- 51.3%	- 28.5	- 18.1	Down
Denver	Jan 07	- 0.1%	- 2.8%	- 2.9	- 0.1	Down
Washington DC	Oct 06	- 2.7%	- 28.4%	- 9.7	- 2.7	Down
Miami	Apr 07	- 16.9%	- 46.9%	- 21.2	- 14.0	Down
Tampa	Feb 07	- 15.2%	- 41.1%	- 18.4	- 15.2	Down
Atlanta	Oct 07	- 8.1%	- 19.1%	- 11.7	- 8.1	Down
Chicago	May 07	- 11.9%	- 21.3%	- 14.2	- 10.1	Down
Boston	Apr 06	- 2.8%	- 10.0%	- 5.0	- 2.8	Down
Detroit	May 06	- 15.1%	- 42.5%	-24.6	- 15.1	Down
Las Vegas	Mar 07	- 26.6%	- 55.4%	- 31.4	- 26.6	Down
New York	Feb 07	- 7.7%	- 18.9%	- 10.2	- 7.7	Down
Cleveland	Sept 06	- 3.4%	- 15.0%	-1.3	- 3.5	Down
Dallas	Oct 07	- 0.1%	- 5.2%	- 1.6	- 0.6	Down
Seattle	Jan 08	- 12.4%	- 22.3%	- 15.3	- 12.3	Down

As you can see, the October 2009 Market Momentum (MM) readings for the 14 cities tracked are all negative. This means that each of these housing markets is in a primary downtrend and that prices are likely to keep falling during the next 3 to 6 months. In 13 of the 14 cities, the MM readings were more positive in October as compared to July, which tells us that 13 housing markets have strengthened in the last 4 months. Only the city of Cleveland got weaker.

Denver is the city closest to a buy signal, with an October 2009 MM reading of – 0.1. The next two strongest cities are Dallas (-0.6) and Washington DC (-2.7).

Las Vegas is the city farthest away from a buy signal, with an October 2009 MM reading of – 26.6. The next two weakest cities are Phoenix (-18.1) and Detroit (-15.1).

If you calculate the change in the MM readings for the last 4 months (October 2009 vs. July 2009), the three cities that are currently strengthening at the fastest rate are Phoenix (+10.4), Detroit (+9.5) and Miami (+7.2)

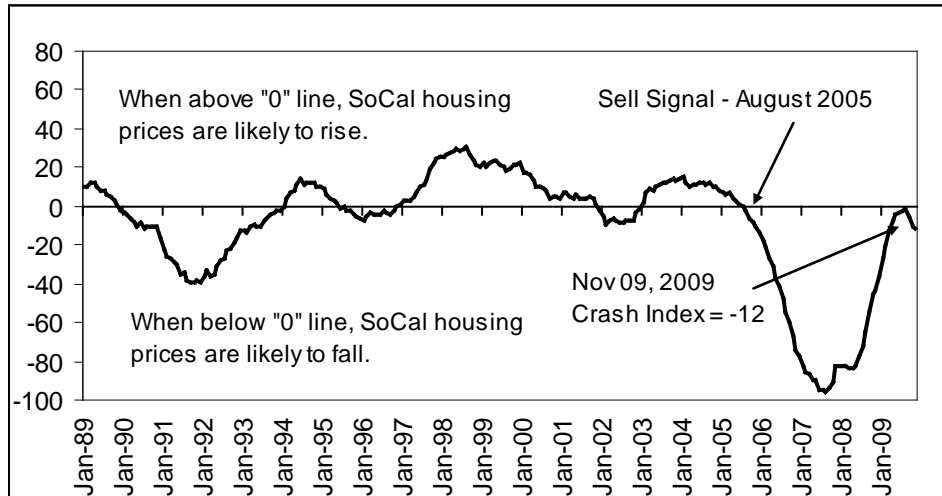
While my timing model shows the broad U.S. housing market is still in a primary downtrend – these current MM statistics confirm that housing is now showing signs of price improvement. For most cities, we are now starting to see small price rises above the 2009 market lows.

Let's now take a look at the Southern California real estate market, and find out what the key data is telling us about where housing prices are likely to go.

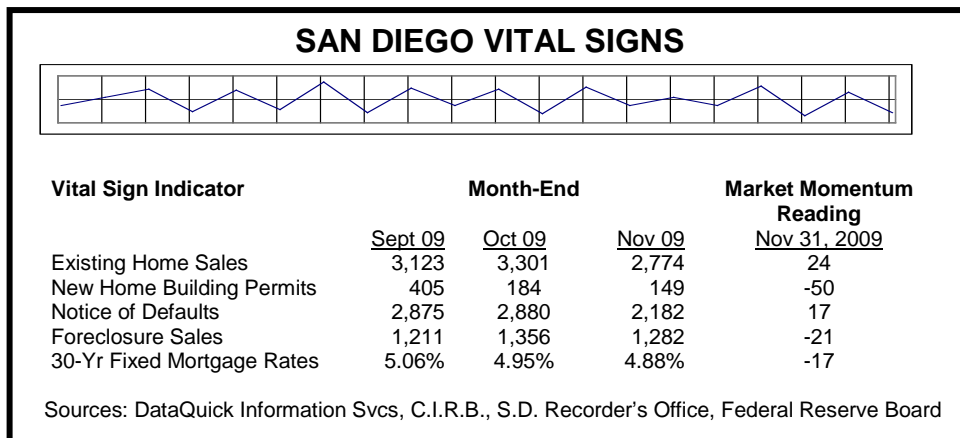
Real Estate Crash Index

The Real Estate Crash Index gave us a - 5 reading as of Sept 30, 2009. This forward looking indicator is telling us that Southern California housing prices are likely to fall for the next 3 to 6 months. A “sell signal” was flashed in August 2005, when the “0” line was crossed to the downside.

Currently, three Vital Sign indicators are in trends that are friendly to price appreciation (Existing Home Sales, Foreclosure Sales, and Interest Rates), and two are in trends that are unfriendly to price appreciation (New Home Building Permits and Notice of Defaults)

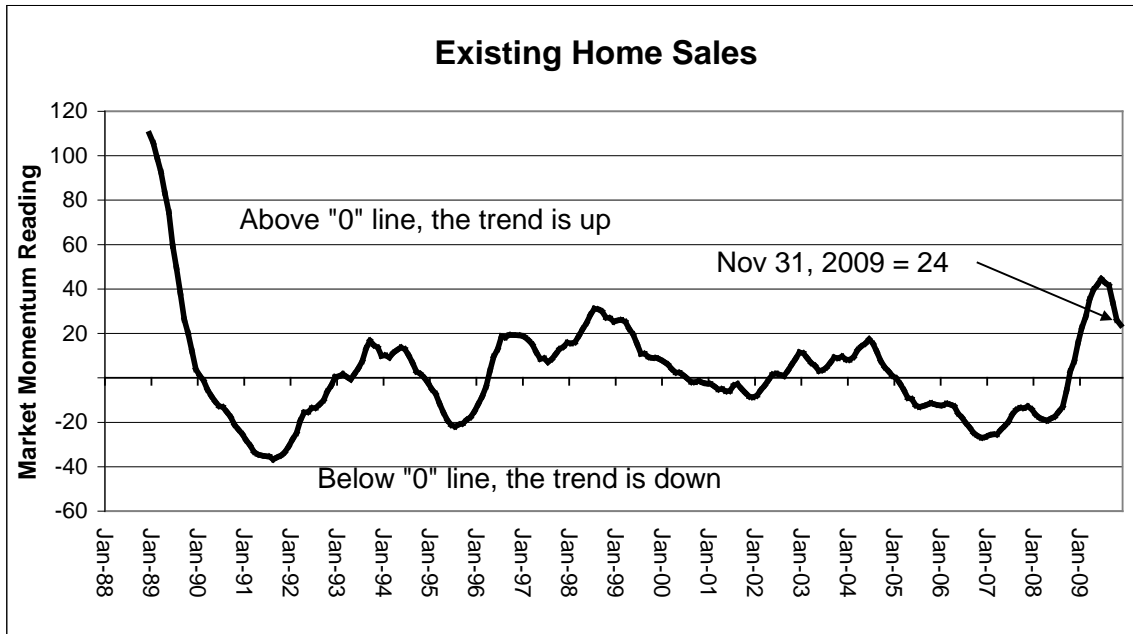


Vital Sign Readings



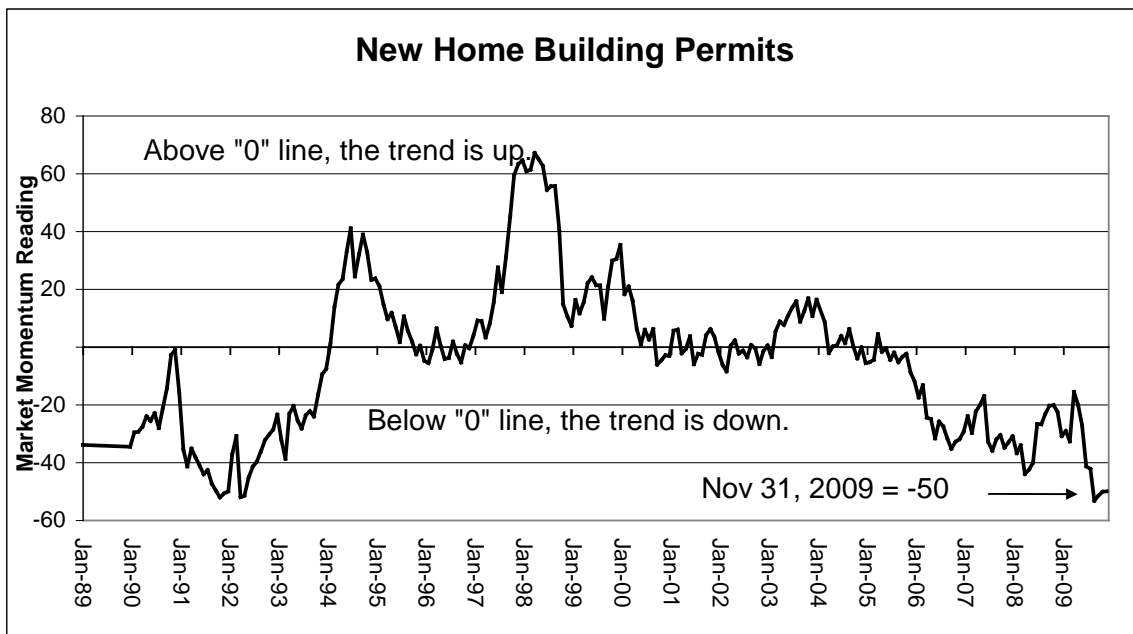
IMPORTANT NOTE: While my trend indicators are based solely on statistical data derived from the San Diego real estate market, the trend signals they send have historically worked with equally good accuracy for the Los Angeles, Orange County, and many other California real estate markets. Thus, please be aware that I often use the words “Southern California” and “California real estate markets” interchangeably.

Vital Sign #1: Existing Home Sales



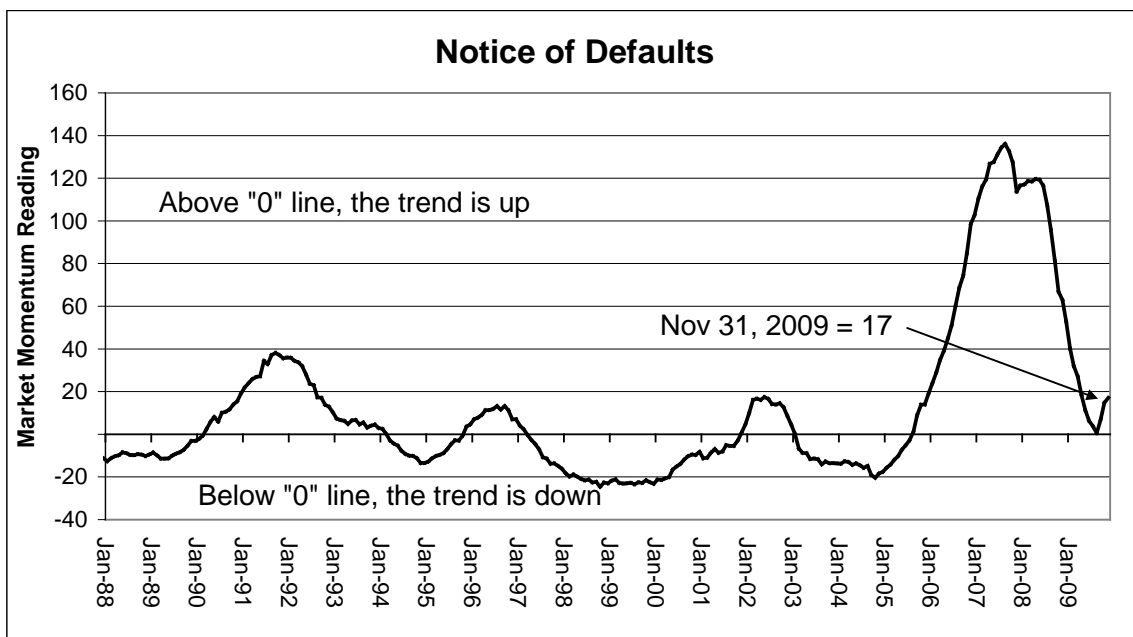
There were 2,774 Existing Homes Sales in Oct 2009, giving us a trend reading of + 24. This means the trend is up. It has been statistically proven that Existing Home Sales are a good leading indicator for predicting the future direction of housing prices. The 12-month moving average (MA) was 2,998 in October 2009, which represents a 38 month high. During the last housing market upcycle, the peak reading for the 12-month MA was 4,221 in June 2004.

Vital Sign #2: New Home Building Permits



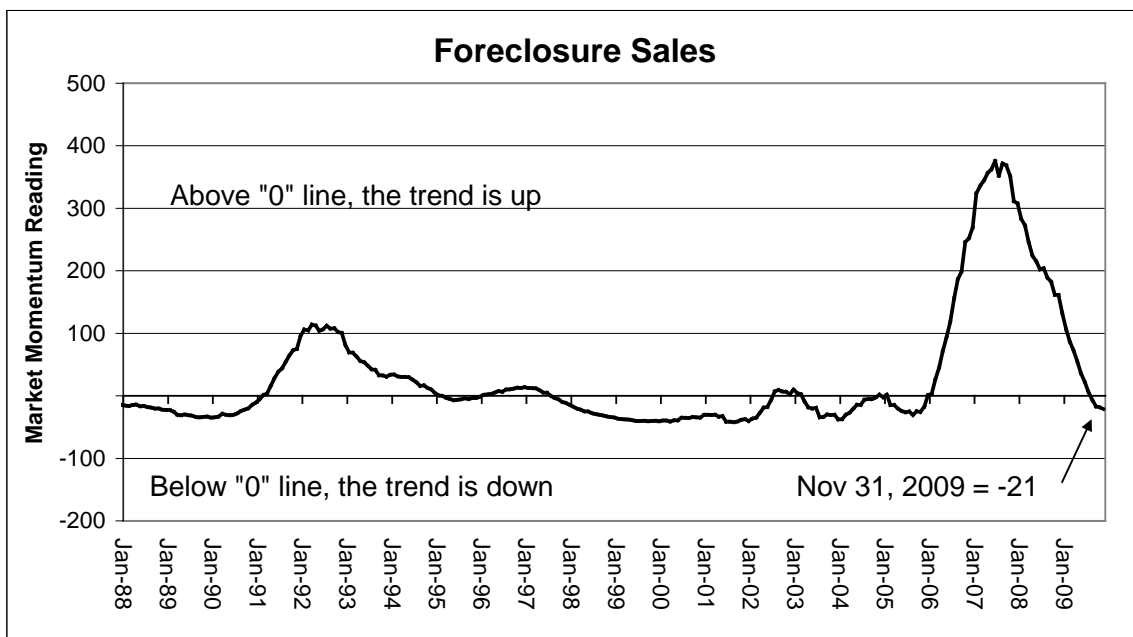
There were only 149 New Home Building Permits pulled in October 2009. This produced a Market Momentum reading of - 50, the lowest since 1992. New home building activity is still decelerating, a negative trend for housing prices and a good leading indicator as to what will be the future strength of the SoCal economy. The 12-month moving average (MA) was 237 in October 2009, the lowest reading since 1988, which is as far back as my data goes. The October 2009 MA is currently an incredible 85% lower than its most recent peak reading of January 2004 (1,556) – which was when the SoCal real estate market was booming

Vital Sign #3: Notices of Default



There were 2,182 Notice of Defaults in October 2009, producing a Market Momentum reading of +17. This tells us that mortgage defaults continue to be in an uptrend, which is a negative sign for both the San Diego economy and its housing market. The 12-month moving average was 3,283 in October 2009. Since I started collecting data in 1982, this is the highest 12-month moving average reading ever. It surpasses the prior peak of November 1993 (1,044) by an amazing 214%.

Vital Sign #4: Foreclosure Sales

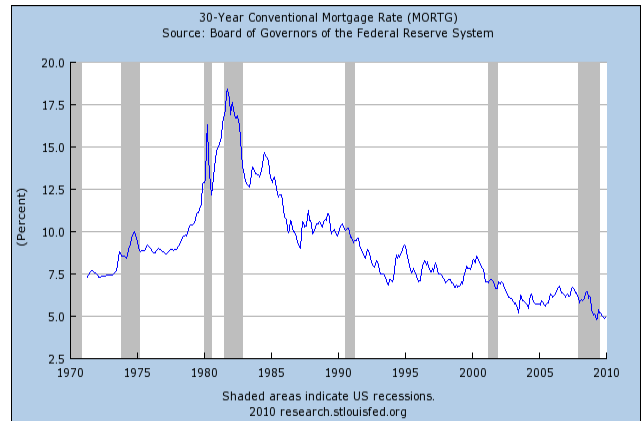


There were 1,128 Foreclosure Sales in October 2009, producing a Market Momentum reading of -21, signaling that this key indicator has now been in a downtrend for 4 straight months. The 12-month moving average was 1,282 in October 2009 – the 2nd lowest reading since June 2008.

Vital Sign #5: Interest Rates

Mortgage rates fell to 4.71% in early December, which was an all-time low since Freddie Mac started tracking the numbers in 1971. After hitting that record low, rates went up for the next four straight weeks – reaching 5.14% by year-end. Even more importantly for the housing market, that rise in rates could be a glimpse of what we are going to see in 2010.

The Federal Reserve has taken aggressive steps during 2009 to drive mortgage rates down in order to encourage more people to buy homes and revive the market. However, the Fed plans to start winding that program down by the end of March. Experts estimate this withdrawal could increase rates by 0.5 to 1.0%.



With federal deficits running in the trillions of dollars, there is another reason interest rates could rise. To finance these deficits, the government's issuance of U.S. treasury debt is expected to hit \$2.55 trillion in 2010, a \$700 billion increase from 2009, which in turn was a \$1.1 trillion increase from 2008. These numbers are clearly monstrous. Says Richard Russell of Dow Theory Letters, "Whether all this debt can be successfully rolled over is doubtful, but one thing is clear – interest rates will go up. This will have an immediate impact on housing."

Final Words

"The housing bust is over" say any number of housing market pundits. "Houses are selling at their fastest clip in nearly three years and prices have started to rise again. So what's holding you back?"

As explained in this and previous Timing Letters, there are plenty of reasons why this current recovery will peter out – and therefore you should remain cautious. To me, this is merely a short-lived sugar high that is the result of massive government support. That's why I think people are fooling themselves if they think this recent bullish market activity is self-sustaining.

Know that the widely followed Case-Shiller (CS) home price index is already losing strength. After registering large gains of over 1% per month in July and August, it has slowed to an average gain of only +0.25% in the past two months. Because the CS number is a three-month moving average, it's possible that the renewed price declines that I expect to see may already be occurring.

That's not to say you can't make money in this market with the right strategy. I'd suggest buying "fix and flips" – where you can profit from forced appreciation in a short-period of time – as I am currently doing. Longer-term investors, however, should still stay on the sidelines until we work (or see) our way through all the fundamental problems that lie ahead. Only then will it be clear what the true risks are.

To all my valued readers, best wishes until next issue.

Robert M. Campbell
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PS: If you did not attend my July 18, 2009 real estate timing seminar – "How to Make Money in Real Estate during the Next Bull Market" – you can order the 4-hour CD with PowerPoint presentation for \$65.00. Please note, however, that this CD is free if you re-subscribe for another year. I'll also include a free special bonus that I know you're sure to like – I promise.

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How to read the Vital Sign charts: All charts use the statistical tool called "momentum analysis" to determine trend changes in the marketplace. Trend changes are signaled when the "0" line is crossed. When the market momentum reading is above the "0" line, it means the trend is upward. When the market momentum reading is below the "0" line, it means the trend is downward. Consult the book *Timing the Real Estate Market* for a complete understanding of these charts, how to construct them, and how to interpret them.