Agincourt Capital Management, LLC

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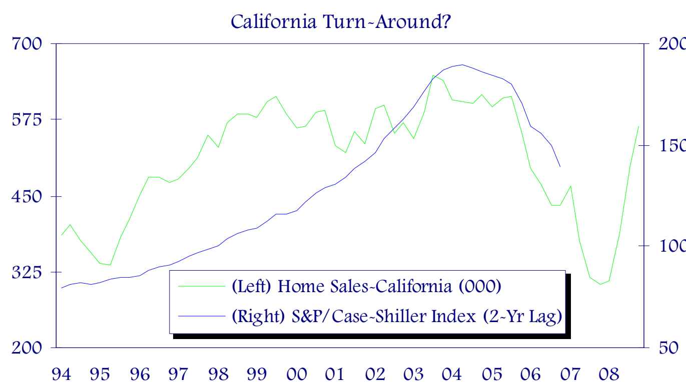
INVESTMENT UPDATE

The Wall Street Journal's main story for its February 14-15 "Weekend Edition" showed just how close to home the housing crisis has come for Fed Chairman Ben Bernanke. A tidy, single-story ranch-style house that just changed hands in a foreclosure sale in Dillon, South Carolina was the boyhood home of Dr. Bernanke.

Now, the Bernanke family has no personal culpability here; they sold the house more than a decade ago. But this house, as unremarkable as it is, is emblematic of what has been happening all over America over the past few months—a house that seemed affordable a couple of years ago when prices were zooming and financing was easy became a financial burden too heavy for the new owners to bear. This house was purchased by the previous owners in 2006; less than two years later they "mailed in the keys."



While Dillon, South Carolina (home of the Interstate 95 tourist trap "South of the Border") is typical in many ways, it has been harder hit than most small towns in the current economic downturn. The auction price of the Bernanke house was 32% below its 2006 selling price, a much bigger drop over this period than most towns and cities in the Southeast. Dillon has been impacted by the closing or scaling back of local manufacturing facilities (including Mohawk, Smurfit-Stone and Wix) who've been laying off workers at a rapid clip. With the county's unemployment at 14.2%, it's no surprise that the local housing market is suffering.

The couple that defaulted on the Bernanke house reportedly couldn't keep up with payments due to their job situation—the wife was laid off, the husband had his hours cut back; they separated (in part due to money problems) and the husband, suddenly the sole occupant, fell further and further behind.

Clearly, the labor market and the housing market are highly correlated. Yet there is a chicken and egg aspect to this relationship; while rising unemployment is now driving home prices lower, skyrocketing real estate prices in the boom years were a huge job generator, not just for home construction, but for real estate agents, furniture, appliance and home furnishing manufacturers, and yes—banks and brokerage firms. The bursting of the housing bubble removed a huge source of wealth for homeowners who had used their homes as virtual ATMs, extracting equity to pay for discretionary items. Even those who didn't cash in during the housing boom borrowed and spent with abandon, taking comfort in the mistaken notion that their homes would provide a rock-solid backstop. Now that backstop has been shown to be full of holes and consumers are cutting back, saving more, and reducing aggregate demand for goods and services. Businesses are seeing demand fall and are cutting production and laying off workers. The cycle has powerful negative feedback implications, especially in small industrial towns like Dillon.

One thing is clear: There will be no end to the downward cycle without some stability in home prices. And while the news has been consistently negative for months on end, we are beginning to see the first glimmer of hope in the housing market. It is coming from the other side of the country from South Carolina, a place that's become known as "ground zero" for the mortgage crisis, the home of the "option ARM," the "interest-only" loan and the "Pick-a-Pay" mortgage—California.

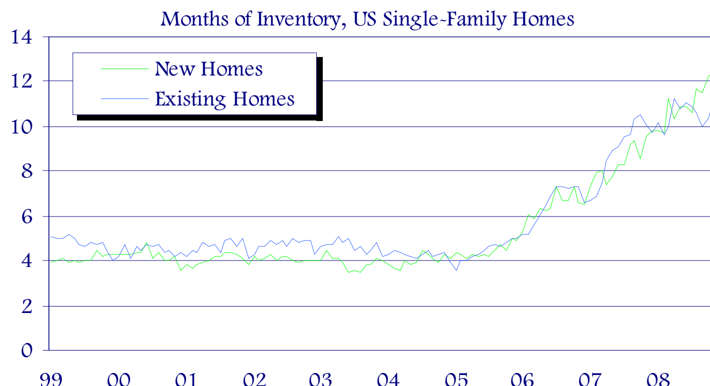
California's home prices exploded like no other region of the country in the decade from 1995-2005. In the San Francisco region, as measured by the S&P/Case-Shiller surveys, home prices more than tripled over that ten-year period, rising by nearly 12.5% per year compared to the national average of less than 9% over the same period. Rapidly rising prices spurred even more building, so when the boom turned to bust, few places suffered more than California.

As the chart on this page shows, California monthly home sales volume peaked in mid-2003 at just below 650,000 units before falling by more than 50% over the next four years. In both California and nationally, prices continued to climb for roughly two years after the peak in sales volume. In other words, sales trends are leading price trends by approximately two years. In the chart, we lag the price data (the S&P/Case-Shiller USA Price Index, represented

by the blue line) in order to show the data as contemporaneous and to provide some insight as to the probable future direction of home prices. This may be especially timely, as the volume of home sales has been rising in California (although not yet nationally) for the better part of the last year.

There are a couple of ways of interpreting the sales trend. We could conclude that California real estate, after inflating wildly in the boom years, has now fallen so low that it's a compelling buy, attracting bottom-fishers. We might surmise that this bounce is a function of increased foreclosures and simply reflects the number of bank auctions taking place in California. We could conclude that California is a special case, driven by special factors, and that there's no reason to expect a similar uptick in sales for the other 49 states.

All of these have some truth, but the fact remains: Sales are up in California and are bottoming nationally, and that's very good news for the economy, for homeowners, for builders (though they've got a ways to go yet), and especially for bond holders. The chart to the right shows how the oversupply of existing homes nationwide has been falling in recent months. Reducing the overhang of available housing will go a long way towards easing the downward pressure on home prices. For months, potential homebuyers have had an unusual degree of flexibility in picking and choosing what kind of house they want to buy, and sellers have been forced to sell at rock-bottom prices for fear of losing that one buyer who may not come around again for a while. With marginally fewer homes to choose from, sellers can have a little more confidence and don't have to adopt a stringent "price-taker" posture. The chart also indicates that despite the fact that new construction is at its lowest level in three decades, the supply of new homes coming on the market is still in excess of new homes being sold nationally.



As mentioned above, stability of home prices is the first step to turning around the US (and by extension, the world's) economy, and is a main focus of US policymakers right now. In the past few days, the Obama administration has released details of how $75 billion will be allocated to directly support the housing market. Without going into all the details, and while also attempting to refrain from editorializing, we can say with some confidence that the steps that have been announced are a strong, albeit expensive, step in the right direction. There will be monetary incentives for lenders to work with homeowners with shaky finances rather than to simply foreclose on them (which is often the most expeditious path currently for lenders). For borrowers who fall into a "sweet spot" on the debt-to-income scale, there will be subsidies to help them make their monthly payments and stay in their homes during this economic trough. In addition, Fannie Mae and Freddie Mac will cut fees and ease requirements for homeowners who are trying to refinance mortgages with loan-to-value ratios of 80% to 105%. At the same time Fannie and Freddie's balance sheets will be expanded, which will lower fixed rates and make refinancing more attractive for borrowers with adjustable rate mortgages.

If we are to believe the President, this plan "will help between seven and nine million families restructure or refinance their mortgages so they can avoid foreclosure." Along with a separate plan that includes a credit for first-time home buyers (or those who haven't owned in at least three years) of up to $8,000, this two-pronged approach should help to further correct the supply-demand housing imbalance, a necessary and vital step to shoring up home prices.

There is no magic bullet; the problems in the US housing market are profound and deep, but from our perspective as bond investors the government is moving in the right direction. While there is little that can (or should) be done for the holders of low-quality mortgage securities that offered risk-loving investors wide yields and a speculative future, we do think it's important to avoid a complete meltdown in the entire non-Agency mortgage market. Bonds that are backed by loans made to credit-worthy borrowers have been under attack for months now, as investors fear that even good borrowers will walk away from their mortgages if houses in their neighborhood sell for a fraction of the price they paid themselves just two or three years ago. As much as we favor free and unfettered markets, allowing home prices to simply spiral down unchecked adds fuel to the deflationary fire and risks a much longer, deeper and broader global recession.

We're not out of the woods yet, not by a long shot. But if current events play out as we believe, by the end of 2009 we will begin to see broad improvement in the US real estate market, from Dillon, South Carolina to Del Mar, California.