Profitis Capital Services LLC

HOUSING MARKET HANDBOOK: IS THE BOTTOM IN SIGHT?

JUNE 18, 2011

Executive Summary

This brief presentation is designed for a single purpose: illustrating how far the housing market is from equilibrium. Since this presentation's first publication (September, 2010), home prices have continued to decline. However, price discovery is still hampered by shadow inventory and the nonexistence of the private label MBS market.

The market' s disequilibrium is structural in nature. As such, this is not a condition monetary policy (not even "QE2") can rectify. A dramatic equity devaluation (resulting from markdowns of loan values) on behalf of financial intermediaries would be the only solution for alleviating the credit logjam. At that point, normalized underwriting would assist the market in creating a price bottom. The Resolution Trust Corporation model would serve as a template for the necessary restructuring.

Based on current trends, it is unlikely that the housing market will see bottom in 2011. Monetary and fiscal policies are simply delaying the inevitable: 15% - 18% drop in home prices from current levels. Early 2012 is our estimate for the nadir.

The Path of Home Prices

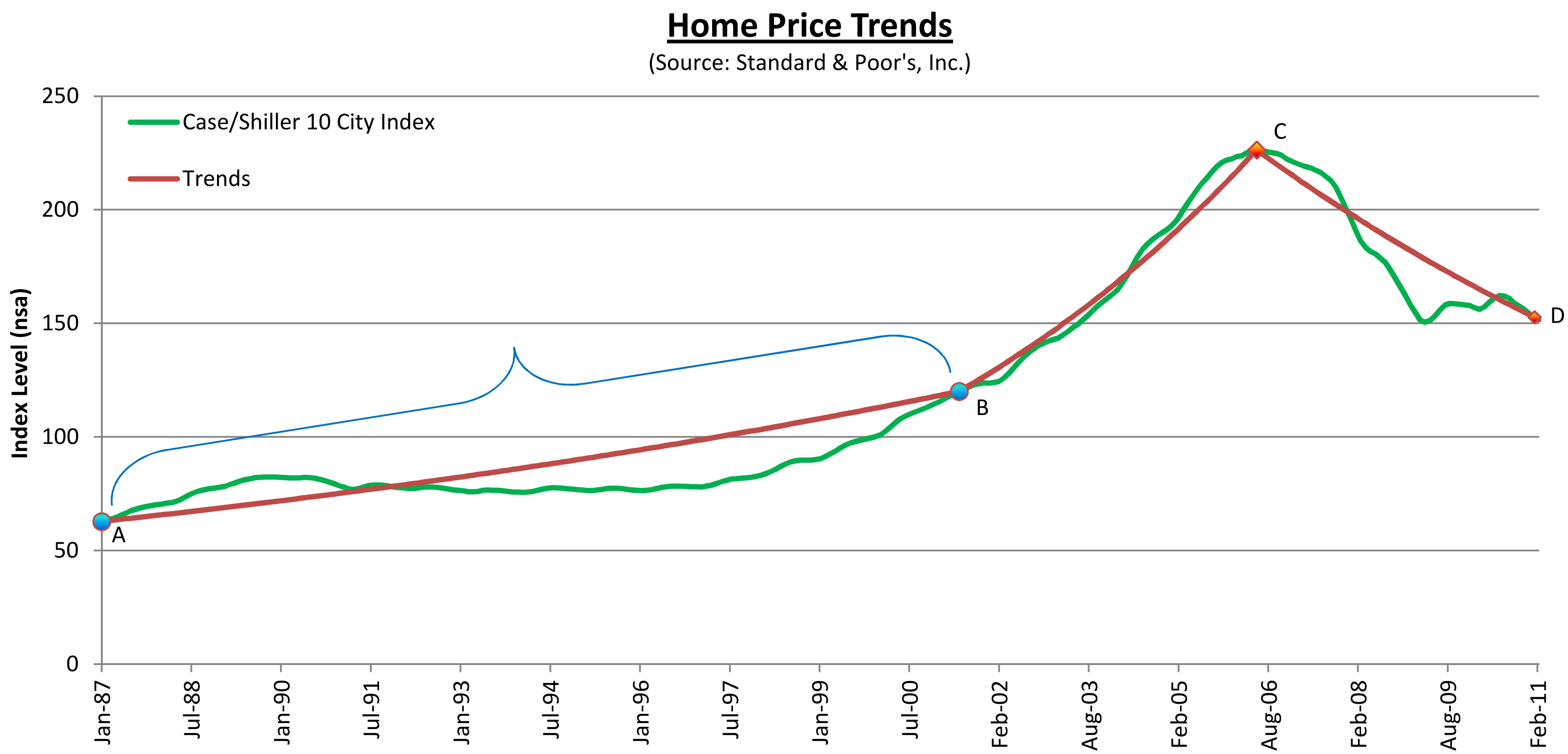
The following three slides track the movement of the Case/Shiller 10 City Composite Home Price Index. The price path is broken down into three trends that highlight the distinct phases of growth that have taken place over the last 20+ years.

Phase 1: 4.59% annualized growth over 14+ years

Phase 2: 13.52% annualized growth over 5 years

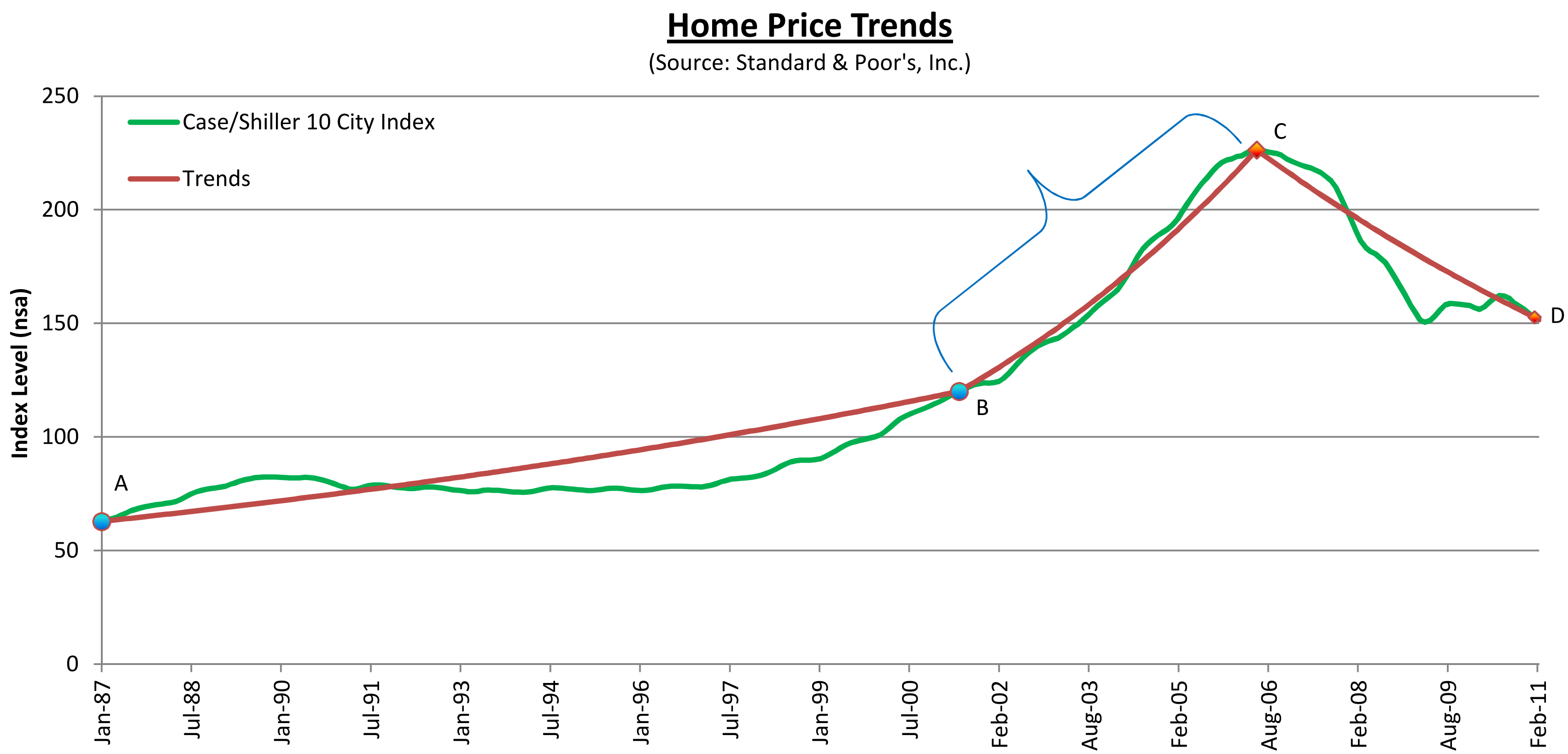
Phase 3: -8.08% annualized growth over the last 4+ years

Home Prices Over The Last 20+ Years I



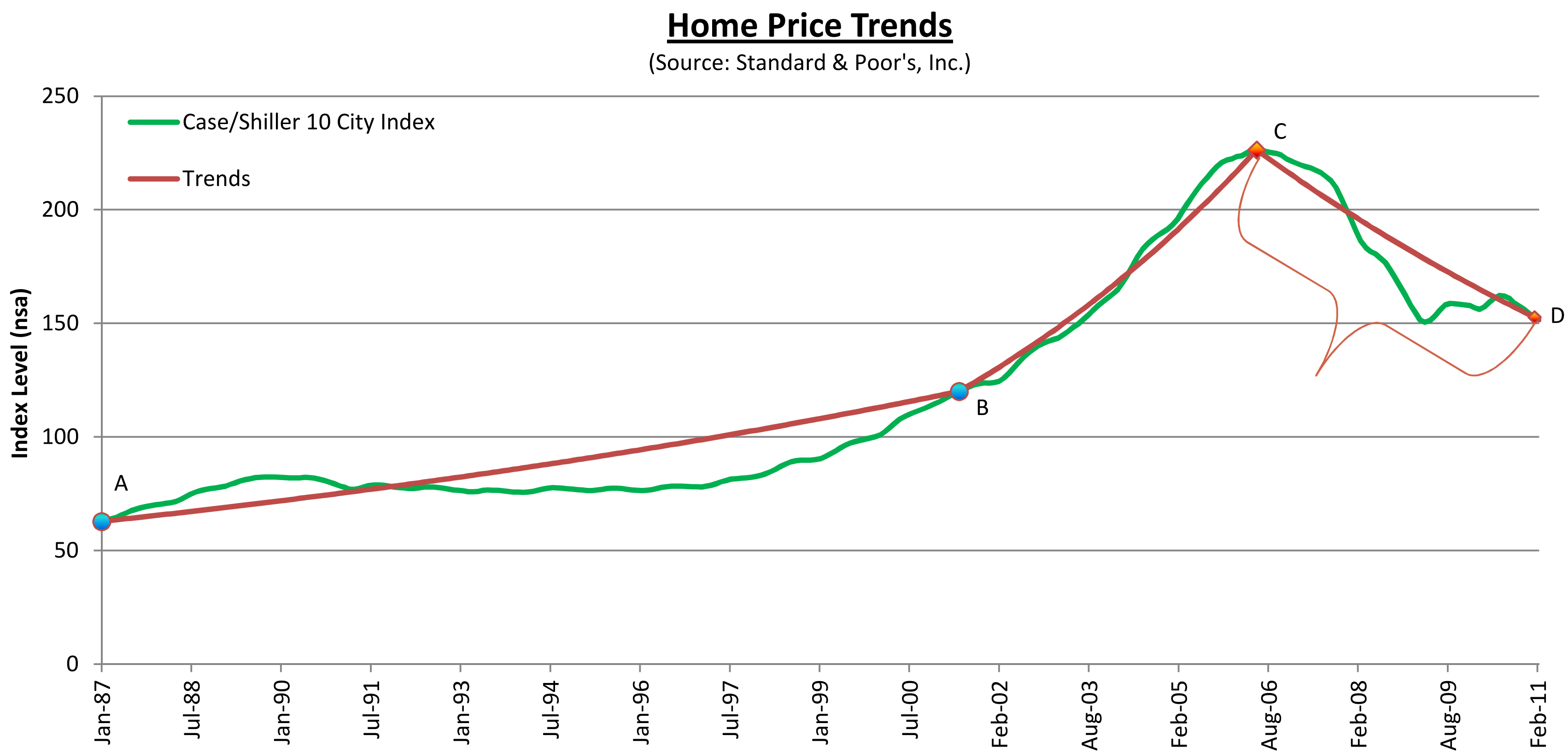
Points	Date Range	Index Level	Index Change	Trend Horizon	Annualized Change
A	Jan-87	62.82	91.1%	14 years 5 months	4.59%
B	Jun-01	120.03			

Home Prices Over The Last 20+ Years II



Points	Date Range	Index Level	Index Change	Trend Horizon	Annualized Change
B	Jun-01	120.03	88.5%	5 years	13.52%
C	Jun-06	226.29			

Home Prices Over The Last 20+ Years III



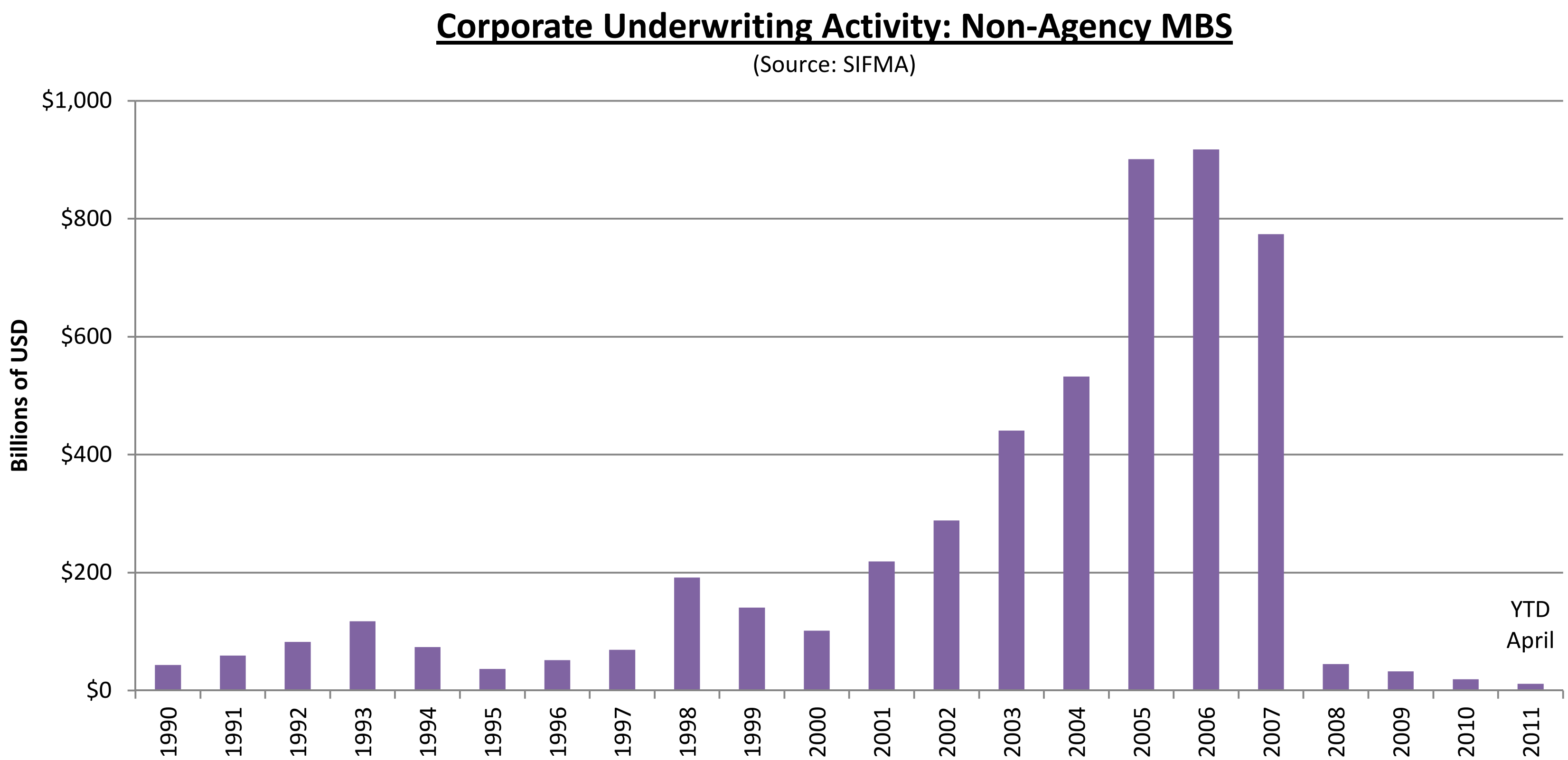
Points	Date Range	Index Level	Index Change	Trend Horizon	Annualized Change
C	Jun-06	226.29	-33.0%	4 years 9 months	-8.08%
D	Mar-11	151.66			

...So How Did "Phase 2" Come About?

The evolution of the mortgage market and institutionalized moral hazard propelled home price gains during the early 2000s. Investment banks, government sponsored enterprises (GSEs) and regulatory bodies all promoted risk taking behavior that eventually became the responsibility of the U.S. citizenry.

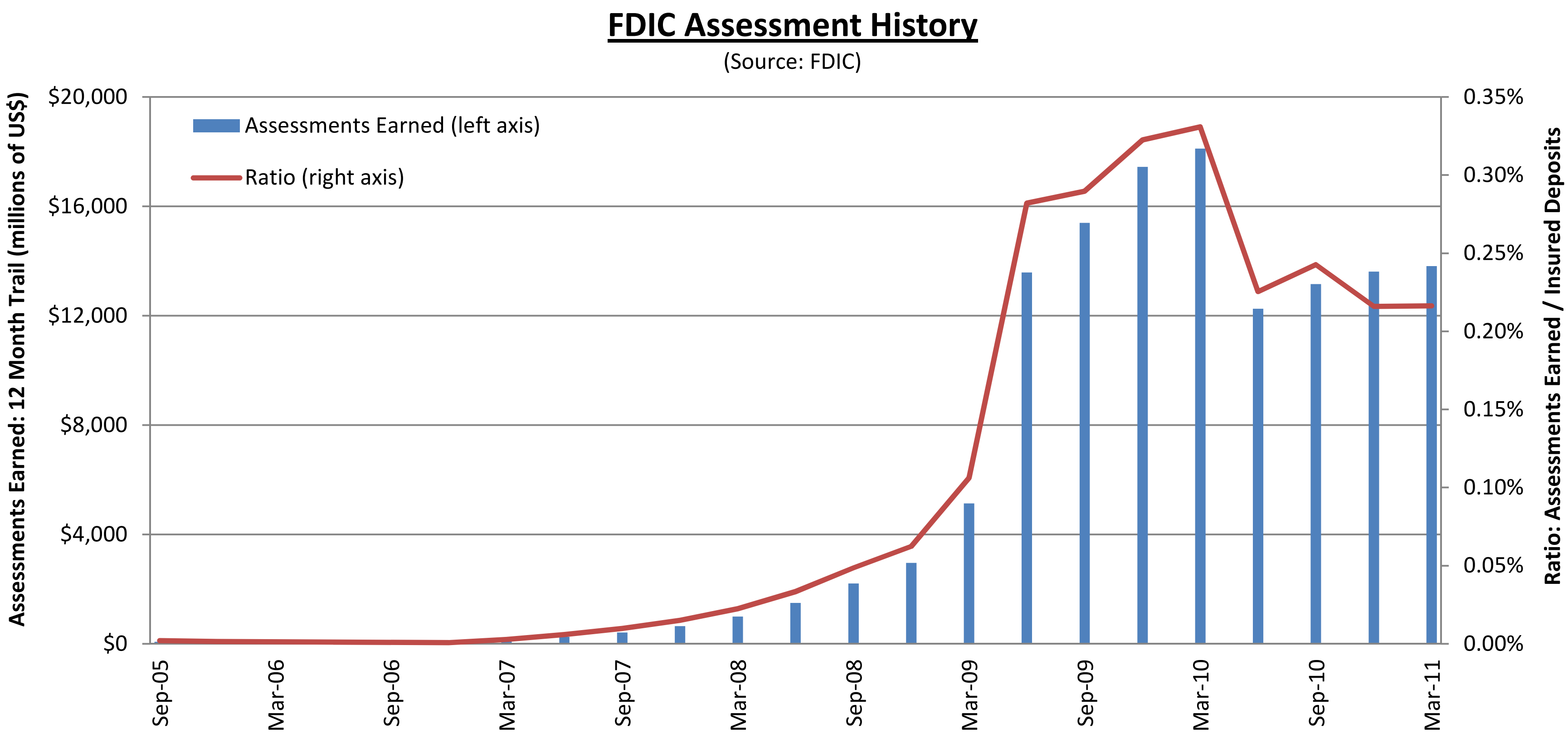
The following slides provide an overview of financial market developments that contributed to the dramatic increase in mortgage debt outstanding.

Land of Misfit Toys



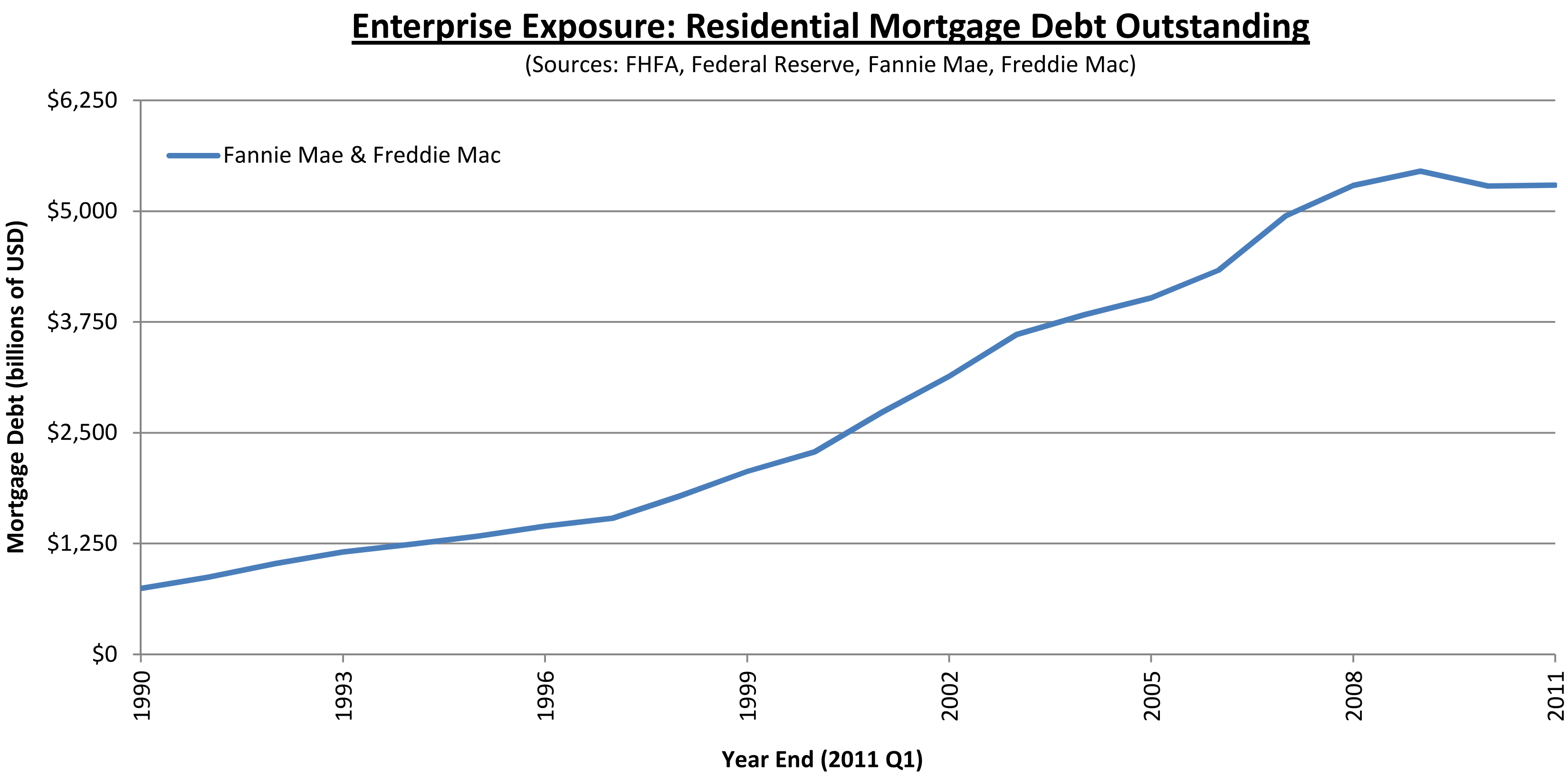
Loans that did not conform to GSE securitization standards found a home in "private label" securitizations. This market has yet to rebound in the aftermath of the financial crisis.

Free Insurance



Financial institutions were essentially unencumbered with deposit insurance premiums during the early 2000s. Mispriced insurance promotes risk taking behavior.

Mortgage Market Friend or Foe?



The role of GSEs expanded dramatically over the last 20 years. From 1990 – 2010, the combined exposure of Fannie Mae & Freddie Mac grew at an annualized rate of 10.3%.

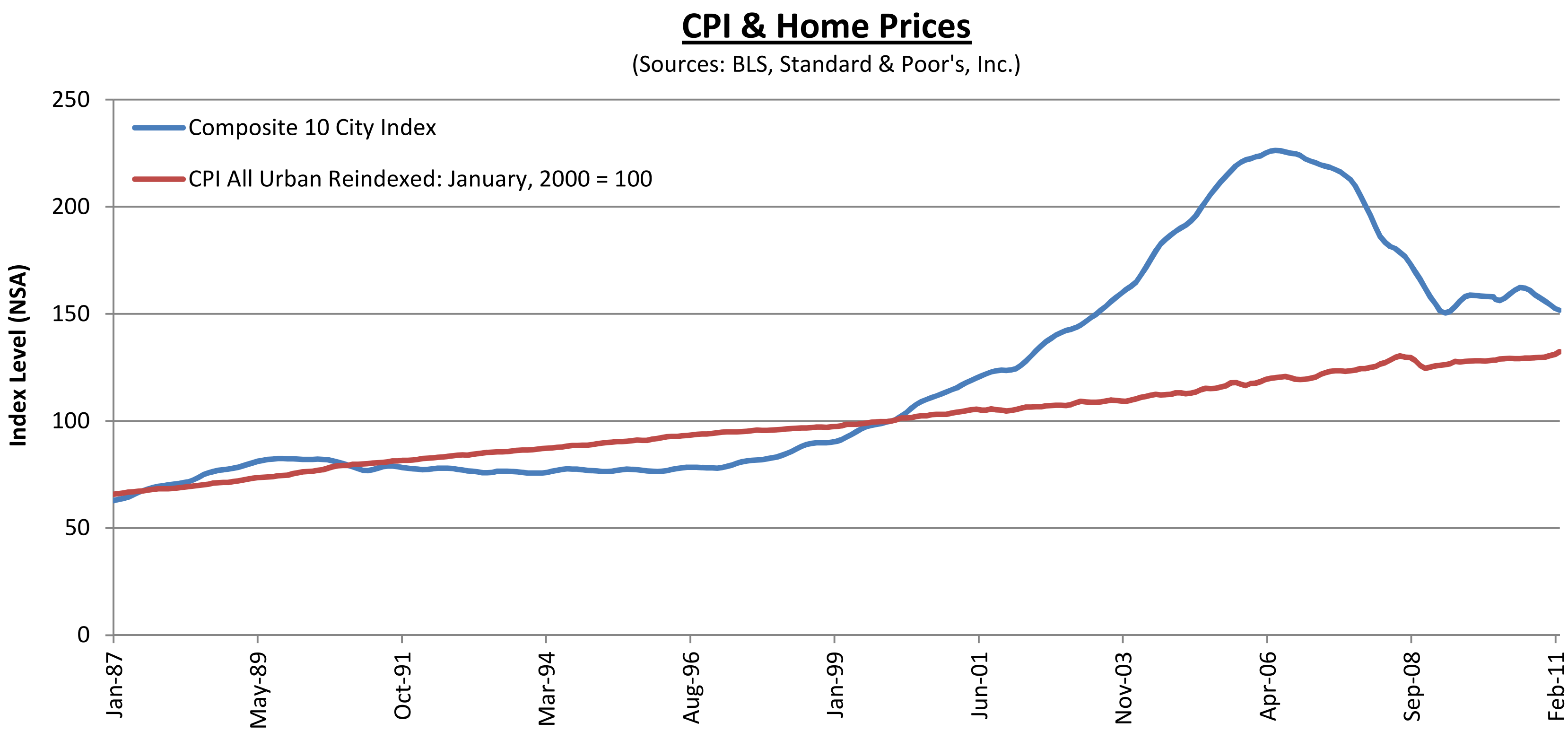
How Big Did The Bubble Get?

- Home price growth versus movements in the general price level

- Housing Inventory compared to the change in the number of households

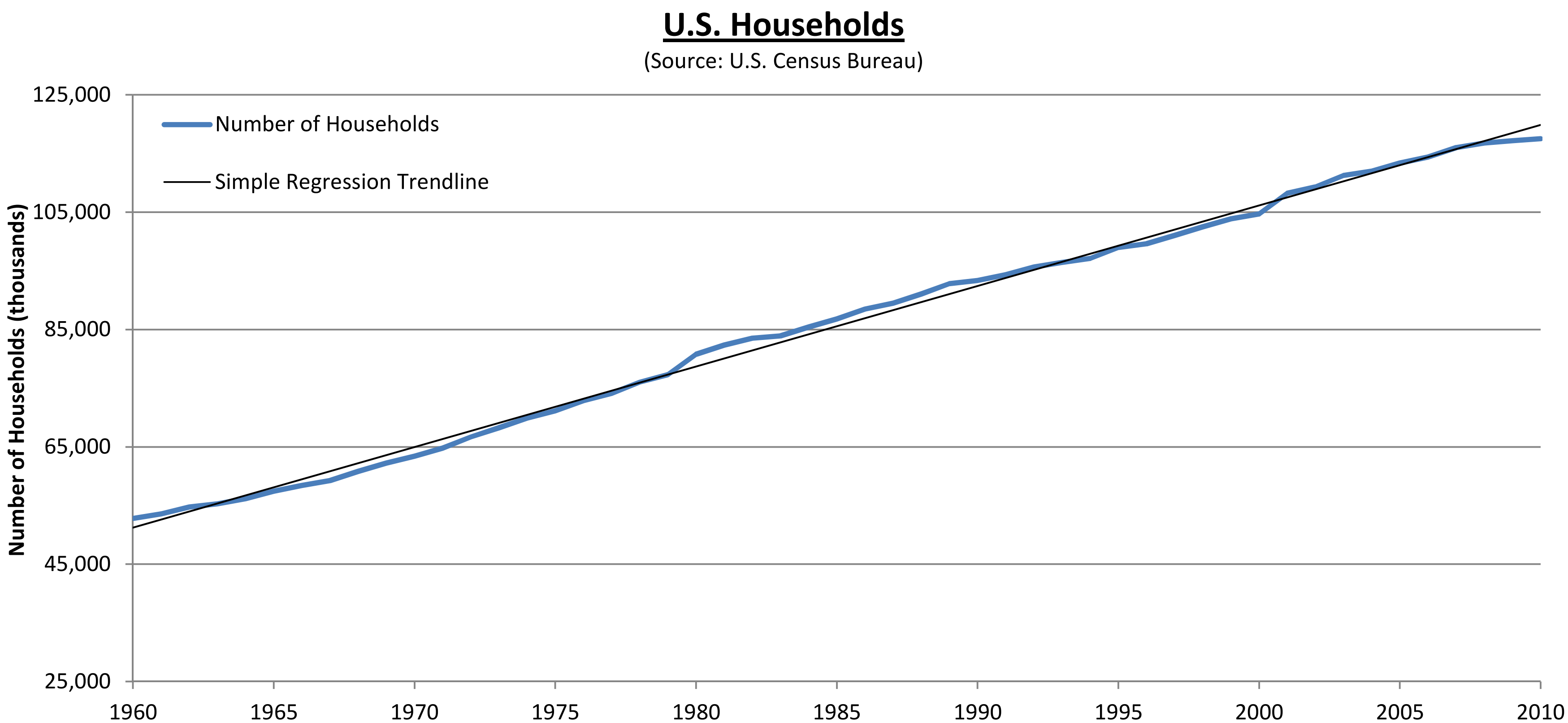
- Measures of outstanding mortgage debt

Home Prices vs. General Price Level



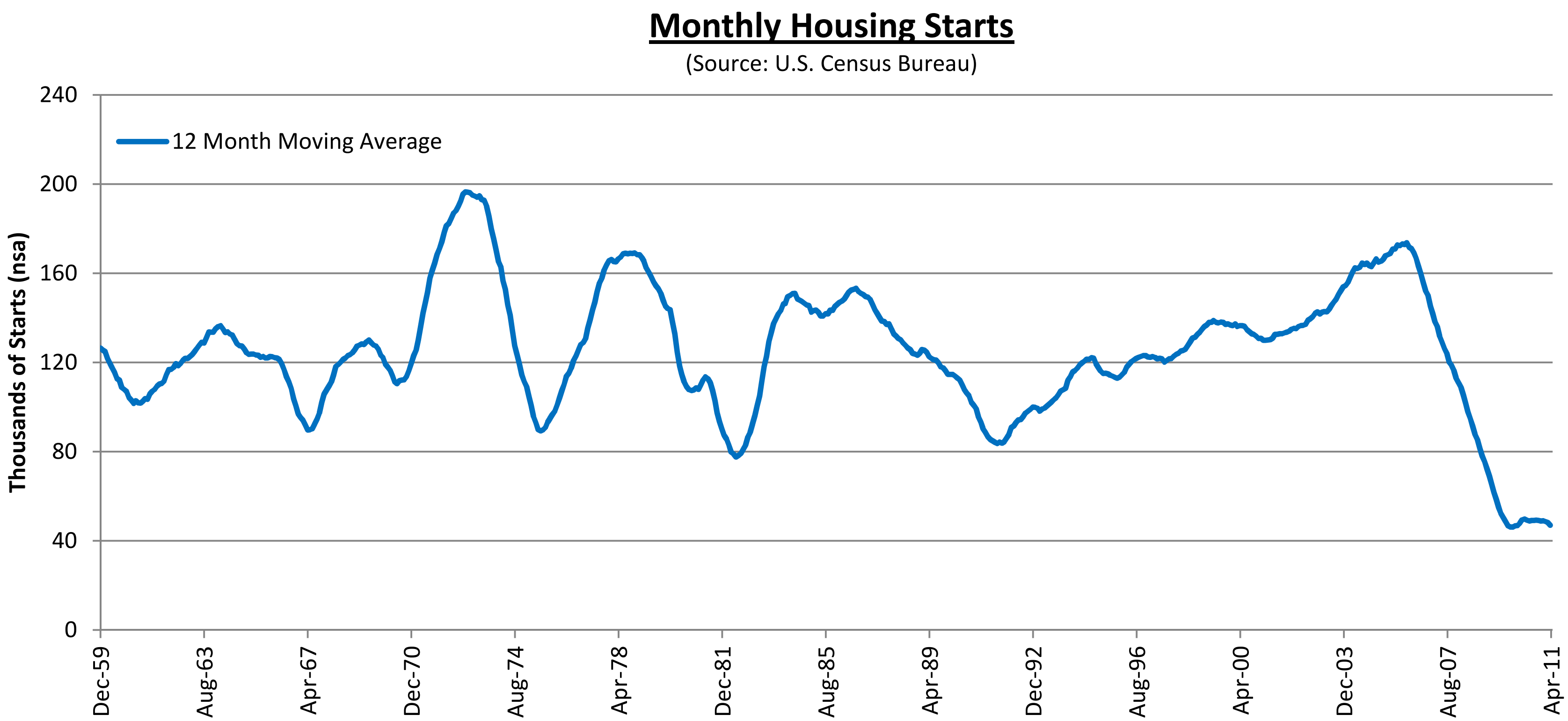
The increase in home prices far outstripped the increase in the general price level from 2000-2006. A home is a depreciating asset, an amalgam of raw materials and replaceable goods.

How Many Homes Are Needed? I



The last 50 years of household growth has been remarkably consistent. Ultimately, a house is not an asset that can be "carried." If it is unoccupied, it generates no income or utility.

How Many Homes Are Needed? II



Housing starts began an impressive, 14 year run in 1991. Does the subsequent drop in starts imply that speculation was responsible for the previous trend?

Mortgage Equity/Debt I

Year End	Home Value (Billions of USD)	Mortgage Debt (Billions of USD)	Owner's Equity
1990	$6,799.9	$2,488.8	63.40%
1991	$6,973.1	$2,667.0	61.75%
1992	$7,258.9	$2,840.0	60.88%
1993	$7,501.0	$2,998.7	60.02%
1994	$7,773.4	$3,165.3	59.28%
1995	$8,054.8	$3,318.9	58.80%
1996	$8,431.1	$3,523.8	58.20%
1997	$8,864.8	$3,739.3	57.82%
1998	$9,694.3	$4,040.6	58.32%
1999	$10,645.0	$4,416.3	58.51%
2000	$12,201.3	$4,798.4	60.67%
2001	$13,575.5	$5,305.4	60.92%
2002	$14,853.2	$6,009.9	59.54%
2003	$16,453.8	$6,894.5	58.10%
2004	$18,955.1	$7,838.2	58.65%
2005	$22,051.1	$8,877.3	59.74%
2006	$22,732.5	$9,866.5	56.60%
2007	$20,895.0	$10,540.2	49.56%
2008	$17,516.0	$10,495.7	40.08%
2009	$17,114.9	$10,342.1	39.57%
2010	$16,450.6	$10,055.4	38.88%
2011q1	$16,111.8	$9,987.9	38.01%

- 21 year average (1990-2010): 56.1% Owner's Equity
- Source: FRB Z.1

Mortgage Equity/Debt II

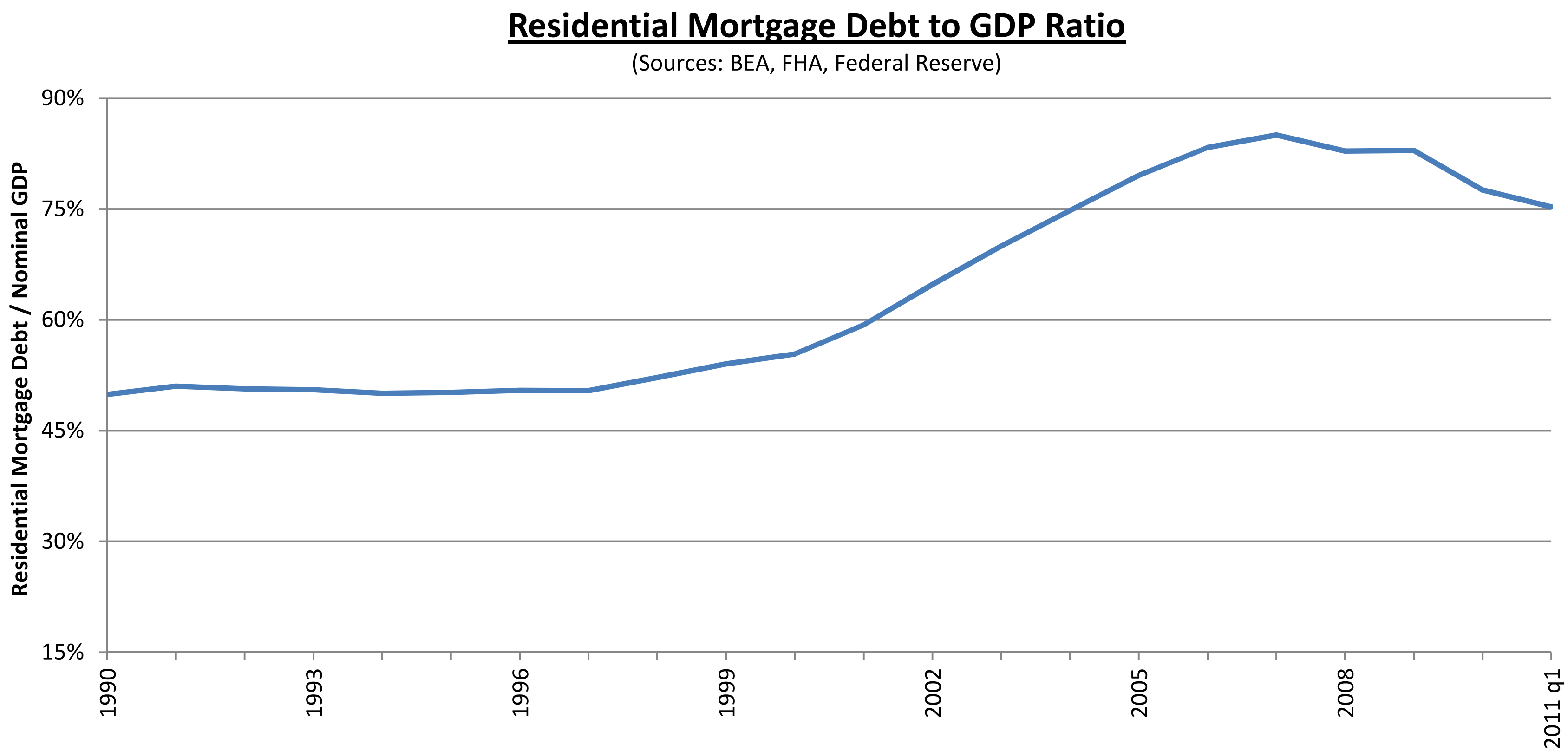
Year End	Home Value (Billions of USD)	Mortgage Debt (Billions of USD)	Owner's Equity
2011 q1	$16,111.8	$9,987.9	38.01%

-Scenarios:

Change in Home Value	Change in Mortgage Debt to Reach Target
-10%	-36.3%
-5%	-32.8%
0%	-29.3%
5%	-25.7%
10%	-22.2%

The above scenarios reflect the proposition "If home value changes by a given amount, how much would mortgage debt have to decline by to reach the 21 year average of owner's equity?"

No More Room For Debt?



Growth in mortgage debt outstanding outpaced gains in the size of the overall economy. Absent sufficient economic growth, how can debt be serviced?

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