

April 25, 2011

Securitized Credit

Global

Housing Market Insights

Home Prices: Distressed or Not Distressed?

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We continue to believe that distressed home prices are outperforming non-distressed prices and will continue to do so. Specific index-related issues may cause measurement discrepancies, but we support our view with three different measures of price changes. *(To avoid confusion, distressed vs. non-distressed refers to the type of sale, not a particular location or region.)*

We believe distressed home prices are cheap on a cap rate basis when compared to other real estate assets given the strong rent environment. Equivalent cap rates on distressed single-family homes suggest that prices have room to improve.

We continue to view the relative stability in distressed home prices to be favorable for recovery values in non-agency mortgage pools – particularly subprime and alt-a collateral. While servicer advancing and expenses could add to severities, we believe recovery values should generally be flat to higher going forward.

Recent developments in issues such as GSE reform, Dodd-Frank securitization rules, and foreclosure settlement issues suggest a tighter and more expensive environment for mortgage credit. We believe a lower level of mortgage credit availability is, and will, contribute to weakness in the housing market.

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Home Prices: Distressed or Not Distressed?

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Home prices are back in the spotlight. All major aggregate measures of home prices are again in decline. Not just monthly non-seasonally adjusted decline, but year-over-year decline, and those declines are accelerating. Undoubtedly, some of those declines can be attributed to base issues (there was a tax credit in place a year ago), and others can be due to shifts-in-mix (distressed sales are again making up an increased share of total sales). But in our opinion, some of it must be coming from actual price declines. There's also been some disagreement over whether distressed or non-distressed prices are outperforming the other, and what part, if any, of the housing market is improving. In addition, home sales activity remains weak – perhaps not unexpected given our observation that mortgage-dependent buying is declining (see [Housing Market Insights: Cash For Closing](#), March 21, 2011). Finally, as we begin to get clarity on issues surrounding housing finance, including GSE reform, Dodd-Frank rules, and foreclosure settlements, it is increasingly clear to us that the future environment for residential mortgages is one of higher rates and lower availability. Evaluating all of these developments, we come to the following conclusions:

- We are lowering our forecast for national home prices. We now project 6-11% declines in major home price indices from Q4 2010 levels – this is lower than our previous projection of 6-11% declines from Q3 2010 levels as the index declined nearly 4% from Q3 to Q4. This increases projected peak-to-trough declines by roughly 3%.
- We continue to believe that distressed home prices are outperforming non-distressed prices and will continue to do so. Specific index-related issues may cause measurement discrepancies, but we support our view with three different measures of price changes.
- We believe distressed home prices are cheap on a cap rate basis when compared to other real estate assets given the strong rent environment. Equivalent cap rates on distressed single-family homes suggest that prices have room to improve.
- We continue to view the relative stability in distressed home prices to be favorable for recovery values in non-agency

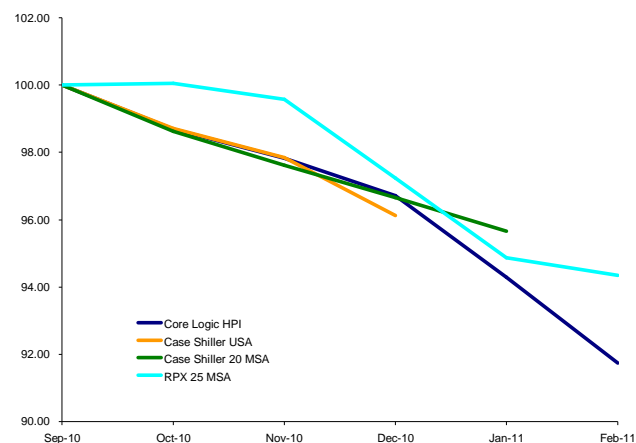
mortgage pools – particularly subprime and alt-a collateral. While servicer advancing and expenses could add to severities, we believe recovery values should generally be flat to higher going forward.

- Recent developments in issues such as GSE reform, Dodd-Frank securitization rules, and foreclosure settlement issues suggest a tighter and more expensive environment for mortgage credit. We believe a lower level of mortgage credit availability is, and will, contribute to weakness in the housing market.

What Happened?

Before we present our new home price projections, we will start by reviewing our last projection, and discussing the events that have occurred in housing since that time. As a quick refresher, in Exhibit 1 we show the path of home prices for a variety of home price indices since our last forecast published on December 8, 2010.

Exhibit 1
**Home Price Indices Since September 2010
(Normalized)**



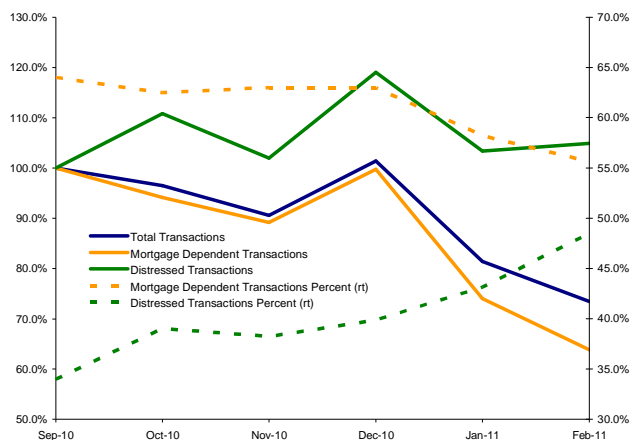
Source: CoreLogic, S&P, Radar Logic, Morgan Stanley Research

As we can see, home prices by any of the measures in Exhibit 1 have declined. But declining home prices are not the only negative occurrence in the housing market since our last

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forecast. In Exhibit 2, we show internally calculated transaction counts across the 25 MSAs that we have tracked previously (also the same 25 MSAs that comprise the RPX 25-MSA index). This data represents actual counts, not survey-based estimates, and are not seasonally adjusted; however, the headline housing numbers which are seasonally adjusted show similar patterns for total sales. In addition to the total number of transactions, we also show the changes in key components such as mortgage-dependent transactions and distressed transactions.

Exhibit 2
All-Cash Transactions Vary by Sale Type



Source: DataQuick, Morgan Stanley Research

From this data, we can see that the major drivers of both actual home prices and home price indices have declined since Q3 2010.

Where Do We Go From Here?

Given the continued weakening in most parts of the housing market, combined with other factors such as securitization and GSE reform that we believe will continue to restrain mortgage lending and therefore housing demand (we will discuss these further later in this report), we are lowering our projection for major home price indices. We point out that given our view that distressed pricing has generally stabilized while non-distressed prices will continue to fall, we believe that the entirety of our projected declines will come from two sources: 1. the continued decline of non-distressed prices, and 2. the shift-in-mix toward distressed sales that we believe will continue to climb (when we say distressed vs. non-distressed, we are talking about the type of sale, not a particular location or region). Also, we provide two caveats to our forecast: 1. if distressed prices rise, non-distressed prices

would likely not need to fall as much to catch up, which may cause our forecast to be too severe, and 2. if the pace of liquidations were to speed up significantly, distressed prices could decline further, which may cause our forecast to be too benign. In both cases, we could fall out of our projected range, and would need to re-evaluate our view.

Note that while our projections are based on an index similar to the Case-Shiller USA index, it can also be applied to other similar indices such as RPX, CoreLogic, and other Case-Shiller indices – with slight adjustments. We do not quantify such adjustments here, but we would expect them to perform along the same relative basis to the Case Shiller USA index that they have exhibited in the past. In Exhibit 3, we present our revised projections, along with our previous projections published on December 8, 2010 for comparison. For reference, we also show the peak to current changes for major indices in Exhibit 4.

Exhibit 3
Revised vs. Old Home Price Projections¹

Publication Date	Peak to Trough View	Current to Trough View	Trough Timing	Initial Month for Current to Trough View
12/8/2010 (Old)	-32% to -36%	-6% to -11%	Spring 2012	September 2010
4/22/2011 (New)	-35% to -39%	-6% to -11%	Spring 2012	December 2010

1. The new current to trough forecast is lower than the previous one even though the range is nominally the same. This is because the new forecast fixes the current point at Q4 2010 instead of the prior Q3 2010. The index declined nearly 4% from Q3 to Q4 2010
Source: Morgan Stanley Research

Exhibit 4
Peak to Current Changes for Major Indices

Home Price Index	Peak to Current Change	Index at Cycle Low?
Core Logic HPI	-34.5%	Yes
Case Shiller USA	-31.4%	No
Case Shiller 20-MSA	-31.8%	No
RPX 25-MSA	-35.9%	Yes

Source: CoreLogic, S&P, Radar Logic

Following the projected trough in spring 2012, we continue to forecast a flat environment for home prices (+/- 2% annually) for 3-4 years. This is roughly the amount of time we believe is required to work through the shadow inventory of homes. We point out too that, given the lag in home price reporting and the fact that our forecast is tied to quarterly data from December 2010, slightly more recent data suggests that home prices have already declined in early 2011. In Exhibit 1, indices that are reported monthly have already shown 1-4% declines since December 2010. Finally, since we track these indices on a non-seasonally adjusted basis, we do expect seasonality to cause them to rise on a month-over-month basis from the spring selling season into the summer.

Clearly, our outlook for aggregate home price indices has declined. However, as we have written several times before,

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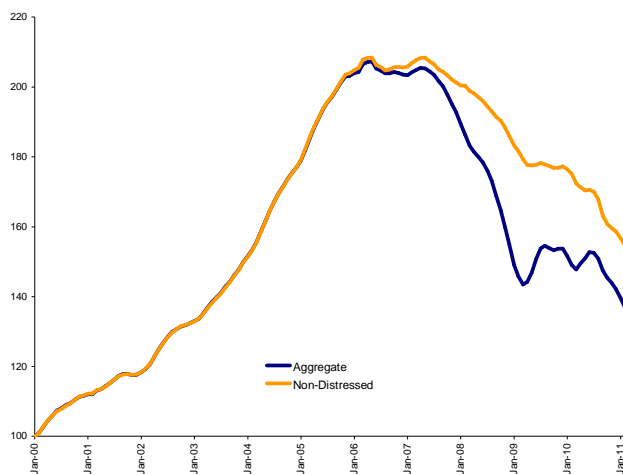
these aggregate numbers do not accurately reflect what is happening to actual home prices – which is really what matters. To get a better idea of the actual trends in home prices, we need to disentangle the two key components of the market: distressed and non-distressed.

Distressed vs. Non-Distressed

Since we first wrote about this tale of two markets last year (see [Housing Market Insights: Location, Location, Location](#), July 29, 2010), we have continued to observe the dichotomy in home price performance with distressed prices mostly outperforming non-distressed prices across major MSAs. Recently, some other research and index calculations have been published that may be inconsistent with our findings for the most recent few months. In light of this possibility, we took a closer look at our view and re-evaluated the supporting data. In doing so, we are now more convinced than ever that we are correct in our view that distressed prices are outperforming non-distressed prices, despite weakening somewhat recently. Even with that weakness, distressed prices appear to have stabilized over the past 12-18 months, while non-distressed prices not only continue to fall, but have picked up their rates of decline.

To re-affirm our position, we took a three-pronged approach. First, we attempted to re-construct some of the seemingly inconsistent data by calculating our own repeat-sales index following an industry standard methodology for both all sales (aggregate) and non-distressed sales only. In Exhibit 5, we show the performance of these indices.

Exhibit 5
Non-Distressed Prices Continue to Decline

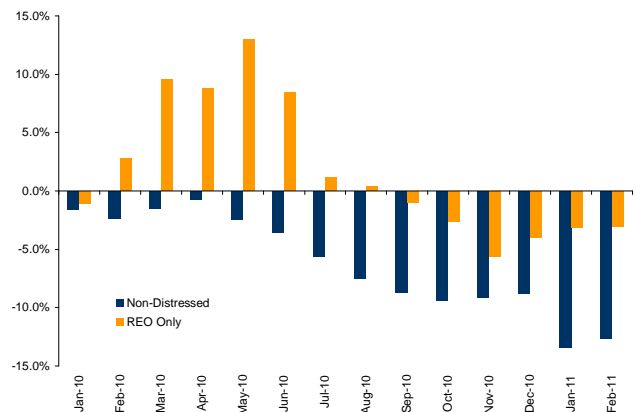


Source: DataQuick, Morgan Stanley Research

As we can see in the chart, and is consistent with all other major index data, the overall index is showing declines. However, in the case of the non-distressed index, we can see that the recent declines are **equally** severe, not less. We do not show an equivalent distressed index (and neither do other repeat sales index providers) because there are few sales that were distressed in both sales in a sales pair. It is also not fair to simply assume that distressed prices must have risen if non-distressed fell, because that would not take into account shift-in-mix effects, which are exacerbated in the wintertime (due to the fact that non-distressed sales are at seasonal lows, while distressed sales are less seasonal).

Second, we updated our internal median price per square foot indices. We calculated the average year-over-year declines across 25 MSAs for several months after breaking out sales by non-distressed sales and REO sales. Here we ignore foreclosure sales and short sales for purposes of distressed sales due to their higher volatility, but their year-over-year patterns closely track that of REO prices.

Exhibit 6
MS Median PPSF Comparison (25 MSA Average)



Source: DataQuick, Morgan Stanley Research

In Exhibit 6, we see that distressed prices have shown much more stability over the past 12 months, although they have weakened slightly very recently. This weakness may be attributable to an increase in the percentage of all-cash REO purchases, which occur at a discount to mortgage-dependent REO purchases. In any case, it is clear that non-distressed prices have underperformed, and that their rates of decline have picked up.

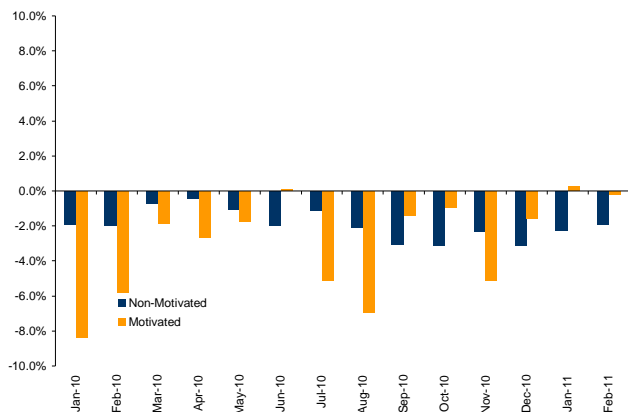
Finally, we look to an external source of home price data to verify our position. In Exhibit 7, we show recent distressed vs. non-distressed index trends for the RPX 25-MSA Composite.

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Again, we can see that while the differences are not quite as severe as in our previous measures, the distressed index is still outperforming the non-distressed over the past 6 months.

Exhibit 7

Radars Logic RPX 25-MSA Composite Comparison



Source: Radar Logic, Morgan Stanley Research

Based on these observations, both from internal and external sources, we believe that our assertion that distressed prices are outperforming non-distressed prices is still valid. Beyond the numbers, the logic also makes sense to us. As we showed in our previous report (see [Housing Market Insights: Cash For Closing](#), March 21, 2011), the number of all-cash buying in the distressed market is increasing, suggesting a decent level of investor demand. On the other hand, mortgage-dependent buying is falling, which implies that higher-priced non-distressed home demand is still weak. In the next section, we introduce another valuation methodology to support our view that distressed prices are now cheap on an asset basis.

Cap Rates of Distressed Homes

When looking at home prices, most economists choose to focus on broad, aggregate measures such as national home price indices. We believe that because houses are such a heterogeneous asset, a better understanding of home prices must come from a more detailed analysis of separate components of that market – hence our focus on distressed vs. non-distressed sales. Further, when attempting to determine if housing is “cheap” or “rich”, most economists will use ratios to rents or incomes and compare such ratios over time. We have also followed this methodology, however again breaking out prices by type of sale.

Here, we introduce a markets-based approach to determine the relative cheapness or richness of housing. Specifically, we use the commercial real estate capitalization rate (cap rate) framework to see if distressed and non-distressed properties are cheap or rich relative to other similar assets. As a quick overview, the cap rate for a real estate asset is calculated by dividing the net operating income by the capital cost (typically cost of acquisition). Luckily for us, there happens to be a very similar asset to single-family homes: multifamily rentals.

While we have not opined in detail on the multifamily market to date, it is undoubtedly a critical part of the US housing market. It represents housing for roughly 35% of American households, and it is experiencing a very different path of recovery than single-family homes. In opposition to the continued declines in home prices and weakness in home sales, multifamily vacancies have declined by record rates over the past few quarters, and rents are rising across the country. While we may write about this sector in more depth in the future, even at a high level it provides a great comparison for valuation purposes for owner-occupied housing.

Thanks to Swaroop Yalla from our REIT research team, we know that multifamily assets have rallied significantly over the past couple of years as new construction has remained low but demand for such shelter has improved substantially. As a result, multifamily assets are now trading at cap rates (net operating income (basically net rent), divided by asset value) in the mid-single digits – typically between 4-5% for better assets in better locations, and 5-6% for lower tier assets.

Exhibit 8

Two Examples of Distressed SFR Cap Rates

	Distressed SFR #1	Distressed SFR #2
SQFT	1500	1500
PPSF	\$30	\$60
Purchase Price	\$45,000	\$90,000
Renovation Cost	\$10,000	\$10,000
Total Asset Cost	\$55,000	\$100,000
Annual Rent	\$12,000	\$15,000
Property Tax	\$550	\$1,000
Insurance	\$700	\$700
Management Fee	\$1,200	\$1,500
Repairs/Maintenance	\$1,500	\$1,500
Net Rent	\$8,050	\$10,300
NOI Margin	67.1%	68.7%
Cap Rate	14.6%	10.3%

Source: Morgan Stanley Research Estimates

In Exhibit 8, we show two examples at different dollar prices of possible distressed single-family residence (SFR)

investments available in today's housing market, making assumptions for rents and costs based on data we acquired either directly from active housing investors, or our own estimates, which we have verified with those investors. The differences between the two examples would likely be due to location as we are assuming the same sized properties. These prices are also consistent with those we found in our last report (see [Housing Market Insights: Cash For Closing](#), March 21, 2011).

Exhibit 9

Cap Rate Comparison to Multi-Family Properties

	Class A Multi-Family	Class C Multi-Family	Distressed SFR #1	Distressed SFR #2
Asset Acquisition Value	100%	100%	100%	100%
NOI Margin	65%	55%	70%	67%
Cap Rate	5%	6%	15%	10%

Source: Morgan Stanley Research Estimates

In Exhibit 9, we also compare the equivalent cap rates of our two examples for SFRs to typical multi-family assets. As we can see, at current prices distressed homes are cheap to multifamily assets – and not just by a little. At the same time, due to the higher prices of non-distressed homes (roughly a 60% premium), their cap rates (not shown) would be much lower – slightly better than lower tier multifamily assets.

While this is a high level comparison between assets, we believe this supports the price-to-income and price-to-rent ratios that we published previously (see [2011 Global Securitized Product Outlook](#), December 8, 2010) which showed that distressed pricing is indeed cheap, while non-distressed pricing is not.

Impact on Mortgage Collateral Performance

Given our view that distressed prices have generally stabilized, while non-distressed prices continue to fall, we believe the impact on mortgage collateral performance is in line with our previous opinions. That is, we believe that the stabilization and eventual improvement in distressed prices will help recovery values. We believe this is especially true for those asset classes for which the vast majority of collateral is already distressed and priced to default, including both subprime and dirty alt-a mortgages. On the other hand, we believe that the continued declines in non-distressed prices will more adversely affect those assets classes for which the vast majority of collateral is not distressed and is priced to stay current. This type of collateral, which includes prime mortgages, is simply more exposed to the non-distressed housing market. We reiterate our caveat that if the rate of

liquidation were to pick up significantly, distressed prices could decline further.

Furthermore, it is important to point out that improved recovery values do not necessarily or immediately translate into flat or lower severities as timeline delays and advances are such a large component of severity right now that they may offset any flat or improved recovery values – particularly in the next year or so until we work past these issues. Over time, however, we believe that improved recovery values will eventually drive lifetime severity improvements as liquidation timelines return to normal.

In addition to recovery values, continued declines in prices for non-distressed houses can also adversely affect default rates. As we've written before (see [ABS Market Insights: Understanding Strategic Defaults](#), April 29, 2010), mark-to-market LTV is a major driver of defaults, both for the involuntary and strategic varieties. For strategic defaults, we also saw that borrowers with higher credit scores and larger loan balances were more likely to exercise their default option efficiently, adding to default risks for prime jumbo borrowers when their mark-to-market LTVs increase – particularly as they pass the 115-120% LTV mark. Given our view that home prices will remain flat for several years following the trough, strategic defaults may also increase from borrowers remaining at those higher mark-to-market LTVs for longer periods of time without seeing a recovery in their home values.

Highlighting Housing Finance Issues

Now that we have lowered our home price projections, re-confirmed our views between distressed and non-distressed prices, introduced a new way to value single-family housing, and discussed the impact on mortgage performance, we finish by addressing some of the major external factors surrounding the future of housing finance. We believe that the resolution of these issues will prolong the start of an eventual housing recovery because expensive and elusive mortgage credit will limit demand for homes and an extension of the shadow inventory problem will weigh on supply.

GSE Reform

The crux of GSE reform is to pave the way for the future of housing finance by either the creation of a new entity to facilitate guaranteed mortgages to borrowers (think of it as a newco GSE), or to remove the government from the business of providing mortgages altogether (see [Securitized Market Insights: The Treasury White Paper: First Impressions](#), February 14, 2011).

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While this will be a very long process (estimated at 1-2 years for decision making and 3-5 years for implementation), a recommendation white paper from the US Treasury has already been published. In that paper, the recommendations range from an entity with a smaller than prior role in housing finance based on a private-public capital model, to no entity or role at all. The theory is that with less government involvement in the mortgage market, private investors will no longer be crowded out of the market and will take the place of providing capital. In our view, this would either limit the total availability of mortgage credit, increase the cost of credit (since it would no longer be guaranteed), or both.

Dodd-Frank Securitization Rules

This issue revolves around the ability and cost to securitize mortgages in the future. The timeline is sooner than that of GSE reform, but still a couple of years away from implementation. Key issues for housing include risk retention requirements for sponsors of securitization transactions, which may limit the ability or desire to securitize mortgages, as well as a definition for a “qualified residential mortgage”, the securitization of which would be exempt from risk retention (see [Securitized Market Insights: Risk Retention Proposal: Implications to Securitization](#), April 6, 2011).

With both the potential to impact future securitization and tightening the requirements for those mortgages that can be securitized without risk retention, we see the potential resolution of this issue as again negatively impacting both the availability and cost of mortgage credit.

Foreclosure Settlements

Finally, there is the issue of settlements between regulators, state attorneys general and mortgage servicers over servicing practices. Just last week, settlements were signed between large servicers and federal agencies, although other investigations continue. While the federal settlements appear to be rather benign as far as hindering the foreclosure process or adding to servicing costs, details released in the past few weeks regarding a potential settlement with the group of state AGs were quite different (see [ABS Market Insights - Foreclosures - Far From Settled](#), March 23, 2011). These requirements could make it harder and take even longer for servicers to liquidate properties through foreclosure.

This issue is sort of a lesser of two evils issue. If foreclosure processing is allowed to proceed easily, the result could be a pick up in liquidations, which leads to further declines in distressed prices, which would pull all prices down. However, if foreclosure processing is delayed even further, the shadow inventory problem will only extend the period before the

market can attempt a sustainable recovery since oversupply issues will remain outstanding longer without a driver for price reductions.

Conclusion

With home prices declining faster than anticipated, and continued weakness in sales, mortgage-dependent buying and an increase in the percentage of sales that are distressed, we have revised lower our projections for home prices as measured by aggregate home price indices.

We continue to believe, however, after re-evaluating our view, that distressed prices have generally stabilized and are outperforming non-distressed prices. Further, we believe that the entirety of our projected aggregate home price declines will come from a combination of non-distressed price declines and a shift-in-mix toward more distressed sales.

Looking at it from a different angle, we used a cap rate valuation model adapted from the commercial real estate world used to value multifamily rental assets to show that distressed home prices are cheap relative to similar assets, while non-distressed home prices are not – again consistent with our findings when using more conventional price-to-income and price-to-rent ratios.

These findings also support our views on mortgage collateral performance, as we believe that asset classes with higher exposure to distressed prices, such as subprime and dirty alt-a, will fare better than asset classes with higher exposure to non-distressed prices.

Finally, we believe that important external issues such as GSE reform, proposed securitization rules and foreclosure processing settlements will negatively affect housing in the near to medium term. By both potentially extending the liquidation period of shadow inventory and restricting credit availability and increasing its cost, we view the eventual resolution of these issues as prolonging the time before a sustainable recovery in US housing.

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Equal-weight/Hold	1153	40%	406	40%	35%
Not-Rated/Hold	114	4%	22	2%	19%
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