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MBS Strategy Group

Laurie Goodman / lgoodman@asglp.com / 212.593.6026

Robert Hunter / rhunter@asglp.com / 703-873-1314

Roger Ashworth / rashworth@asglp.com / 212.593.6095

Brian Landy, CFA / blandy@asglp.com / 212.593.6094

Ke Yin / kyin@asglp.com / 212.593.6093

Housing Overhang/Shadow Inventory = Enormous Problem

Summary:

The single largest impediment to a recovery in the housing market is the large number of loans that are either in delinquent status or in foreclosure that are destined to liquidate. This creates a huge shadow inventory. We estimate this housing overhang at 7 million units, 135% of a full year of existing home sales. We look at the impact on a number of local markets, then look to the causes of the overhang: (1) transition rates are high, (2) cure rates are low and (3) loans are taking longer to liquidate. We are concerned that, in light of this housing overhang, the stabilization we have seen in home prices the last few months is temporary.

With the apparent stabilization of home prices and the increase in new and existing home sales, many investors believe the housing market has bottomed, and is beginning to recover. We believe this optimism is premature. We acknowledge that there are a lot of positives in the market—prices have fallen significantly and housing is more affordable than at any point over the past 2 decades. The tax credit for first time home buyers has helped spur purchase activity. However, investors are overlooking one critical factor—the size of the “housing overhang”; i.e., the # of loans in delinquent status or in foreclosure. We estimate the housing overhang at 7 million units – these loans are destined to liquidate, and are creating a huge shadow inventory.

In this article, we first look at the size of the shadow inventory in a number of geographic areas, then document the causes and magnitude of the housing overhang. **BOTTOM LINE**—Loans continue to transition into the delinquency/foreclosure pipeline at a rapid pace, but are moving out at a very slow pace. *That housing overhang is the single largest impediment to a recovery in the housing market.*

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Housing Overhang Problem = 7 Million Units

We first quantify housing overhang by looking at data provided by the Mortgage Bankers Association. Our rough estimate is that there almost 7 million units are destined to liquidate. That's a *HUGE* rise over the 1.27 million units in this bucket that existed in early 2005.

Let's look at the calculations, starting with the latest set of data. The Mortgage Bankers Association (MBA) Quarterly Delinquency Survey covers 44.7 million units, or approximately 80% of the total universe. Thus, about 55.9 million homes in the United States have a mortgage. Exhibit 1 (below) shows that at the end of Q2 2009, a staggering 13.54% of mortgages in the MBA survey were in some stage of delinquency: 4.3% of units surveyed were in foreclosure, another 3.88% were 90+ delinquent, 1.68% were 60 days delinquent, and 3.68% were 30 days delinquent.

Exhibit 1: Housing Overhang Calculations

Category (seas adj)	MBA Delinquency Survey %	Probability of Liquidation (based on estimated cure rates)	Probability Weighted Liquidation (Delinquency X Probability of Default)
Foreclosure	4.30%	100%	4.30%
90+ Days	3.88%	99.2%	3.85%
60 Days	1.68%	95.6%	1.61%
30 Days	3.68%	72.4%	2.66%
Total Distressed Inventory	13.54%		12.42%
Number of Affected Units (in million, based on 55.9 million homes)	7.57		6.94

Source: Mortgage Bankers Association, LoanPerformance, Amherst Securities

We now look to the private label universe to figure out the probability of eventual recovery. Whatever doesn't cure must eventually liquidate. We refer to this as the "housing overhang."

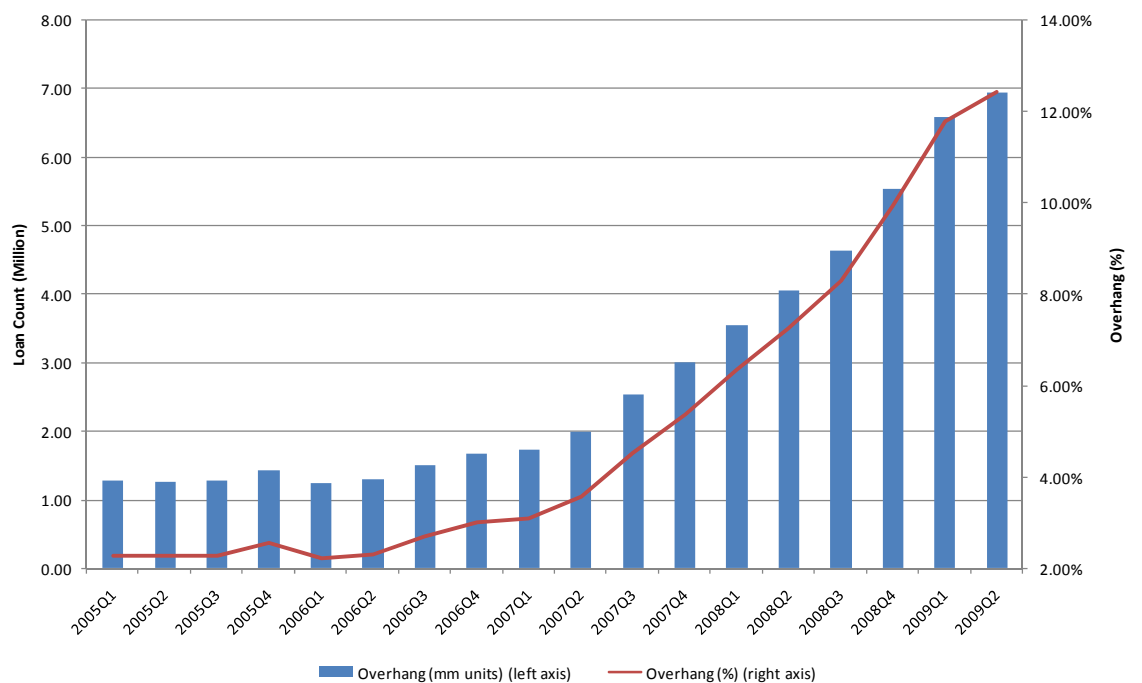
Using transition rates for the calculations, our Q2 numbers indicate that the cure rate is near "0" for loans in foreclosure, and it's 0.8% for 90+ days delinquent, 4.4% for 60 days delinquent, 26.5% for 30-day delinquent loans (thus, we assume 100% of the foreclosure bucket, 99.2% of the 90+ delinquent bucket, 95.6% of the 60 day delinquent loans and 72.4% of 30 day delinquent loans will eventually liquidate). This implies that of the 13.54% delinquent units, we expect 12.42% of units to eventually liquidate. If the MBA data is representative of the mortgage universe, it suggests that 12.42% of 55.9 million units (6.94 million units) are already in the delinquency pipeline and will eventually liquidate.

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To put that into perspective, existing home sales total around 5.2 million units - - so the overhang is approximately 1.35X one year of existing home sales.

Exhibit 2 (below) shows both the % overhang over time and the actual number of units. Note that going back to Q1 2005, the housing overhang was only 1.27 million units—<20% of Q2, 2009 levels. *What accounts for the change? First*, only 4.31% of the units were delinquent in Q1 2005 (2.7% 30 days delinquent, 0.74% 60 days delinquent, 0.87% 90 days delinquent, 1.08% in foreclosure). *Secondly*, the cure rates were much higher in Q1 2005: 84% of borrowers who were 30 days delinquent, 66% of 60 day delinquent, and 41% of 90 days delinquent.

Exhibit 2: Housing Overhang – A Historical Perspective



Source: Loan Performance, Mortgage Bankers Association, Amherst Securities

Realize that these numbers only encompass loans that are *already* delinquent, it does not include loans which are current now, and will go delinquent in the future. In the non-Agency market, during July 2009 (August remit report), of the 3.66 million 1st lien mortgages classified as “always performing”— 60,860 became 60+ days delinquent for the 1st time in July, representing 1.66% of the units and 1.67% of the balances. Supplementing this information with the First American CoreLogic Loan Level Servicing Data (covering 29 million prime loans) and extrapolating, we estimate an additional 240,000 mortgages are becoming delinquent every month.

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Can modifications help? We don't think they can help significantly. The 12-month recidivism rate on modifications has historically been about 70%. That is, after 12 months, 70% of the modifications have re-defaulted. We have argued (*Amherst Mortgage Insight*, May 27, 2009 article entitled "Conflicts of Interest and Tranche Warfare Moves Front and Center") that HAMP modifications are unlikely to be successful in the long run as it does not address negative equity, the single most important determinant of default. And the borrower will still face payment shock as the payments begins to ramp up after the 5 year period in which the payments are fixed.

Let's say we are wrong and the HAMP modifications work much better than older style modifications. How much of the 7 million unit overhang can be cured by modification? The answer is "not much." Even if we assume 85% of all mortgages qualify for a modification (that is, owner occupied, loan size under \$729,750, borrower still in home), servicers are able to reach 50% of borrowers, 50% of these submit all the documentation necessary for a modification and 75% of these modifications succeed (all very high numbers), it suggests that 16% of the overhang or just over 1 million units would be eliminated. And many of these borrowers would default later, if they remain in a negative equity position.

Shadow Inventory—Case Study

This current housing overhang is *huge*, but the true impact does not hit until considering the impact on a local market. We can actually use www.Trulia.com to look at shadow inventory in different markets. Let's walk through an example, and apply that analysis to the 20 cities in the Case-Shiller 20-City Index. Before doing so, we need to understand the sequence of events. The foreclosure process differs state to state, but in a typical defaulted mortgage loan, there are 6 steps in the process:

1. borrower misses 3-6 months of payments
2. servicer files a Notice of Default (NOD)
3. borrower typically has 90 days to bring the loan current
4. servicer sets a Trustee Sale Date (typically, NOD date + 90 days)
5. trustee sale occurs, the property is generally placed into REO (real estate owned)
6. REO property is listed for sale

After 3 to 6 months of missed payments, the lender files a Notice of Default at the County Recorder's Office. This places the borrower on notice that he is facing foreclosure. If the loan is not brought current within 3 months, a date is established on which the house will be sold. The homeowner receives a Notice of Sale, detailing when and where the sale will occur. This notice is also posted on the property, recorded at the County Recorder's office, and published in a local newspaper. At the Trustee Sale, the property is auctioned to the highest bidder. The opening bid,

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set by the foreclosing lender, is equal to [outstanding loan balance + accrued interest + any additional fees associated with the Trustee Sale]. If the opening bid is not met (which is usually the case), the property is deemed a REO and is deeded over to the bank (lender).

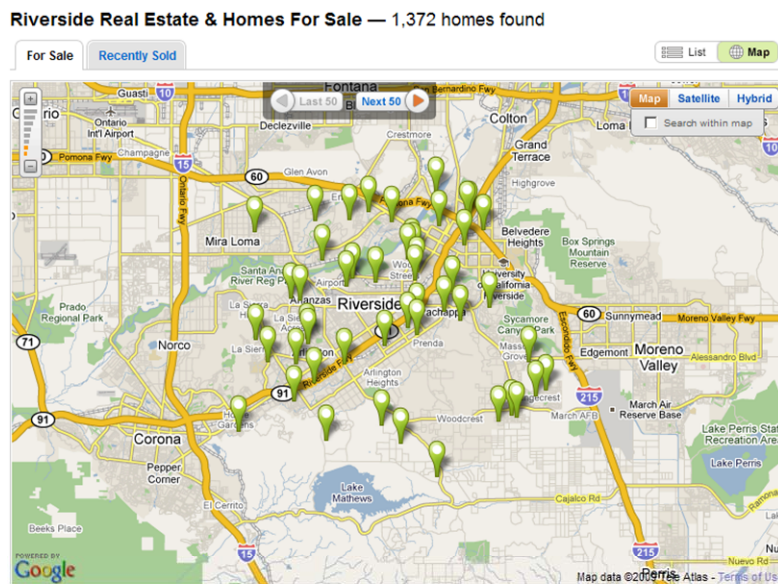
In addition to real estate listings, the staff at Trulia has used RealtyTrac to add 3 additional data sets to their site. Each data set is created from events in the foreclosure timeline.

1. bank-owned properties (REO) not yet listed for sale (auction has already occurred)
2. properties scheduled for auction
3. properties that have received a Notice of Default

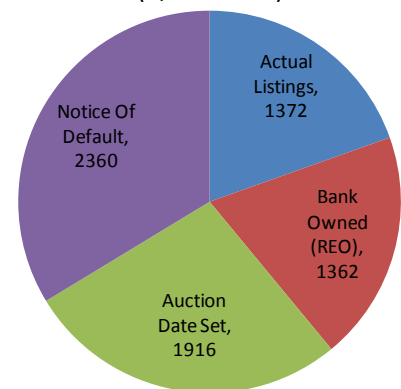
Thus, we can use www.Trulia.com to glimpse that hidden or “shadow” inventory. This data allows us to capture the shadow inventory on units that have received a notice of default. We are not capturing loans earlier in the delinquency process. If we did, the numbers would be even larger. We will use Riverside, California as our case study.

Trulia.com lists 1,372 units for sale in Riverside, as shown in Exhibit 3 (below). With a simple click of the mouse, we can add each data set sequentially and see how our supply numbers change.

Exhibit 3: Riverside, CA Real Estate Listings For Sale



Total Actual Listings Plus Shadow Inventory (7,010 Units)



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The break out is as follows:

For Sale = 1,372 Units

Banked Owned (but not yet listed) = 1,362 Units

Auction Date Announced = 1,916 Units

Notice of Default Issued = 2,360 Units

Total Probable Inventory = 7,010 (1,372 + 1,362 + 1,916 + 2,360)

As of 2007, City-Data.com reports that the city of Riverside, CA had 34,854 mortgaged residential units. It is one of the cities in the San Bernadino/Riverside County areas that experienced rapid home price appreciation during the bubble, with median home prices escalating from \$136,000 in 2000 to a 2007 median price of \$423,400 (for a 17+%/year price appreciation). Using Loan Performance data, we estimate that almost 50% of the mortgaged properties in the city were financed with Alt-A, Pay Option, or subprime loan product. Recent median sales data indicate that home prices have fallen nearly 60% from the peak.

Thus, the Trulia numbers imply a staggering 7,010 potential properties for sale in Riverside, out of only 34,800 units (thus 20% of all properties!). Stated differently, total inventory (actual listings + REO + Auction Date Announced + Notice of Default issued) are actually more than 5X the number of units listed “for sale.” And this doesn’t take account of homes backed by loans where a Notice of Default has not yet been filed.

Shadow Inventory—More Cities

Admittedly, we selected an extreme example. In Exhibit 4 (next page) we apply our analysis to cities comprising the S&P/Case-Shiller 20-City Index (in all cases, we used the city + a 10 mile radius). [NOTE: You can replicate our methodology by using “Refine Search”, then selecting a 10 mile radius.] Thus, in Los Angeles, there are 43,050 listings, another 16,706 homes that are bank-owned but not yet listed, 26,789 listings with an auction date announced, and 37,794 listings in which a Notice of Default has been provided. That total for inventory is 124,439 units, with distressed listings comprising 81,389, or 65.4%, of this number. Stated differently, actual inventory is almost 3X the actual number of units for sale. That number varies from 4.15X in Las Vegas to 1.04X in New York.

Causes—Housing Overhang

Where is this overhang coming from, and how did it get so big? The short answer is that loans have been transitioning into the delinquency/foreclosure bucket at a rapid

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pace and have not been moving out. There are a number a parts to this story; we'll examine them in turn. Briefly, they are –

- a. transition rates are high
- b. cure rates are low
- c. loans are taking longer to liquidate

Exhibit 4: Number of Real Estate Listings within 10 Miles of S&P/CS 20 Cities

CITY	LISTINGS	REO LISTINGS	AUCTION LISTINGS	NOTICE OF DEFAULT	Total Shadow Inventory	Total Inventory	Inventory ÷ Actual Listings
Las Vegas, NV	16,765	16,835	14,879	21,135	52,849	69,614	415.2%
San Diego, CA	10,416	5,603	7,727	11,548	24,878	35,294	338.8%
Los Angeles, CA	43,050	16,706	26,789	37,894	81,389	124,439	289.1%
San Francisco, CA	4,176	1,856	2,265	3,355	7,476	11,652	279.0%
Phoenix, AZ	25,340	14,091	30,777	0	44,868	70,208	277.1%
Denver, CO	17,730	3,020	10,867	1	13,888	31,618	178.3%
Detroit, MI	21,396	10,720	5,202	1	15,923	37,319	174.4%
Tampa, FL	24,235	1,198	1,388	13,712	16,298	40,533	167.2%
Minneapolis, MN	8,533	2,296	3,420	0	5,716	14,249	167.0%
Portland, OR	12,673	2,130	5,976	0	8,106	20,779	164.0%
Chicago, IL	42,698	1,317	7,808	16,787	25,912	68,610	160.7%
Miami, FL	35,489	2,373	4,499	12,808	19,680	55,169	155.5%
Atlanta, GA	28,638	6,692	7,883	1	14,576	43,214	150.9%
Seattle, WA	10,465	1,402	3,328	0	4,730	15,195	145.2%
Cleveland, OH	13,384	2,862	2,131	0	4,993	18,377	137.3%
Washington, DC	13,411	1,754	2,776	0	4,530	17,941	133.8%
Charlotte, NC	24,029	2,091	2,056	393	4,540	28,569	118.9%
Dallas, TX	30,530	2,709	2,518	0	5,227	35,757	117.1%
Boston, MA	11,983	1,036	1	0	1,037	13,020	108.7%
New York, NY	63,022	930	1,642	17	2,589	65,611	104.1%

Source: www.trulia.com

a) Default Rates = High

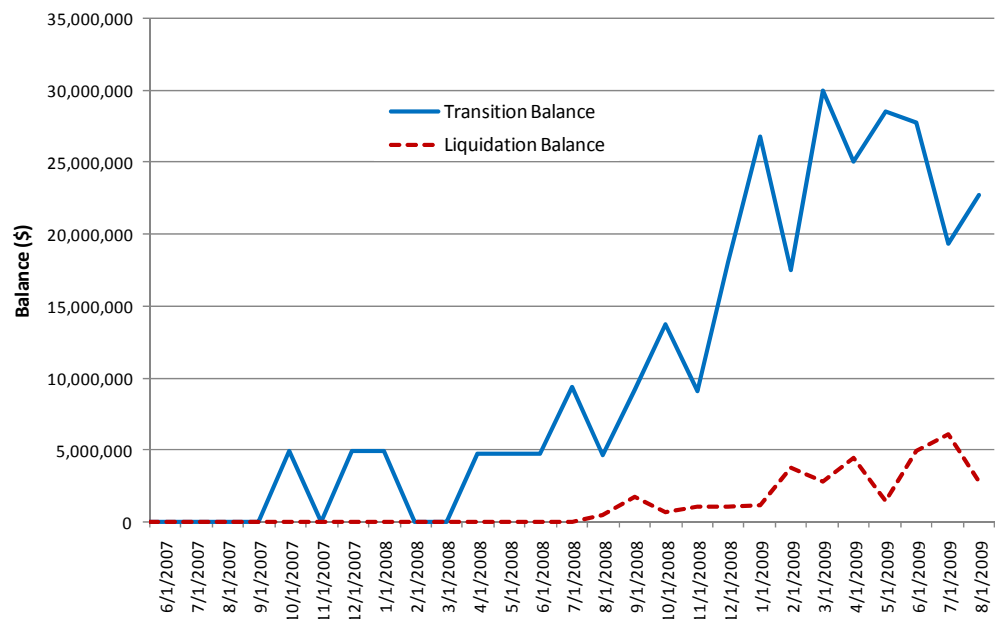
At Amherst, we refer to a loan as defaulted when it becomes ≥ 60 days delinquent, as the loan has only a small chance of recovering. Thus, we look at the single month default transition rate (sTr) – the rate at which loans are moving from the performing bucket into the non-performing bucket. More precisely, we look at the rate at which mortgages are transitioning from the “always performing” bucket (loans that never

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experienced a 60 day delinquency) into the *non*-performing bucket (>60 days delinquent). By contrast, many investors look at liquidations in the remittance reports, and use that monthly default rate as a proxy for how quickly the loans are defaulting. *The difference is that we measure loans as they move far enough into the delinquency/foreclosure pipeline that they have very little chance of recovery.* Many investors are capturing what is emerging from the pipeline (*i.e.* liquidation). With loans taking longer to liquidate, many investors are essentially looking at what went into the delinquency/foreclosure pipeline 18-24 months ago, and ignoring more current info. We made this point very clearly in our 8/10/2009 *Amherst Mortgage Insight* article “Warning: Non-Agency Yields May be Lower than Expected.”

Let’s look at an example: the cash flow history of WFMBS 2007-7 A1, a prime fixed rate security, as shown in Exhibit 5 (below). Note that the liquidation balance on this ~\$4 billion deal has averaged ~\$4.5 million/month (0.11%/month) the last 3 months. By contrast, \$23.3 million/month (0.6%/month) has been transitioning from the always performing bucket to the non-performing bucket. Given very low cure rates, these loans will work their way through the delinquency/foreclosure pipeline, and on average, will be liquidated in 18-24 months.

Exhibit 5: Cash Flow History From WFMBS 2007-7 A1



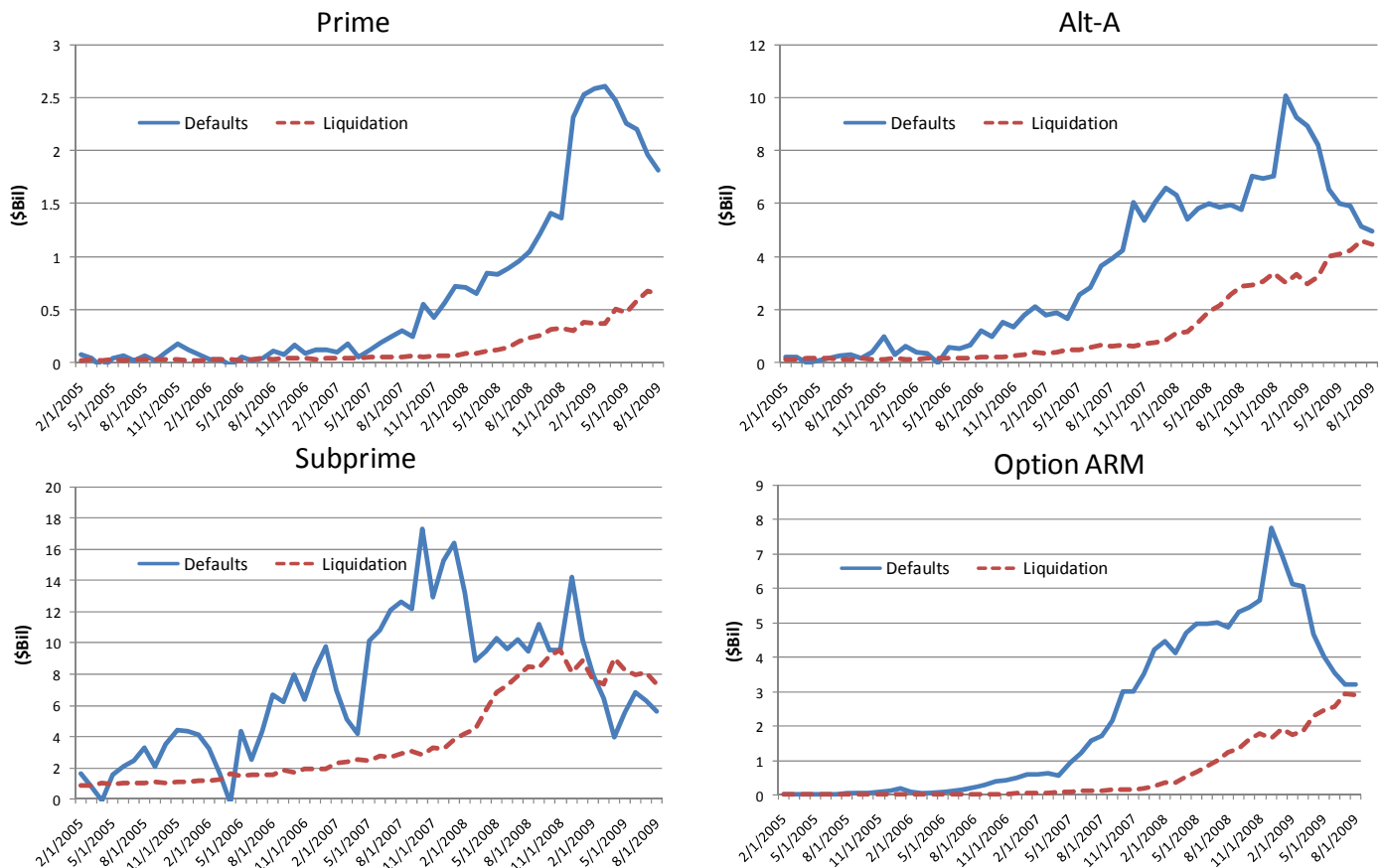
Source: Loan Performance, Amherst Securities

For the non-Agency universe as a whole, new defaults at \$17.3 billion are only slightly higher than the \$16 billion of liquidations. However, this masks very different behavior in different sectors of the non-agency market, as shown in Exhibit 6 (next page). For subprime, liquidations are actually greater than new defaults. Transition rates on these securities began to ramp up in 2007 and early 2008, these loans are

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now being liquidated. New defaults (loans going 60 days delinquent for the first time as a percent of the always performing bucket) are being calculated from a smaller pool of loans, as 47% of the subprime universe is non-performing. For Alt-A and option ARMs, new defaults and liquidations are very close, the size of the delinquency/foreclosure pipeline is roughly constant. By contrast, for prime non-agency securities, new defaults are much higher than liquidations. New defaults have ramped up relatively recently, and liquidations lag.

Exhibit 6: Defaults/Liquidations For The Non-Agency Universe By Product

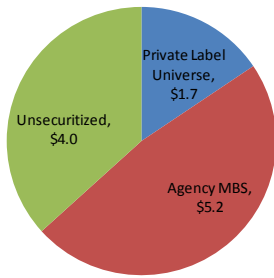


Source: Loan Performance, Amherst Securities

The private label universe, on which we have excellent data, is only \$1.7 trillion or 14.5% of the approximately \$11 trillion US mortgage market. And most of this \$1.7 trillion is very adversely selected collateral, not representative of the mortgage universe as a whole, as evidenced by the fact that 28% of the private label universe is non-performing. The \$9.3 trillion (\$11.0 trillion - \$1.7 trillion) U.S. mortgages not in private label securitizations consists of \$5.2 trillion in agency securities (GNMA, Fannie Mae, Freddie Mac) and \$4.0 trillion held on bank portfolios in non-securitized form; we believe that for these mortgages (the bulk of the US mortgage universe),

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Size of the U.S. Mortgage Market (\$11 Trillion Total)



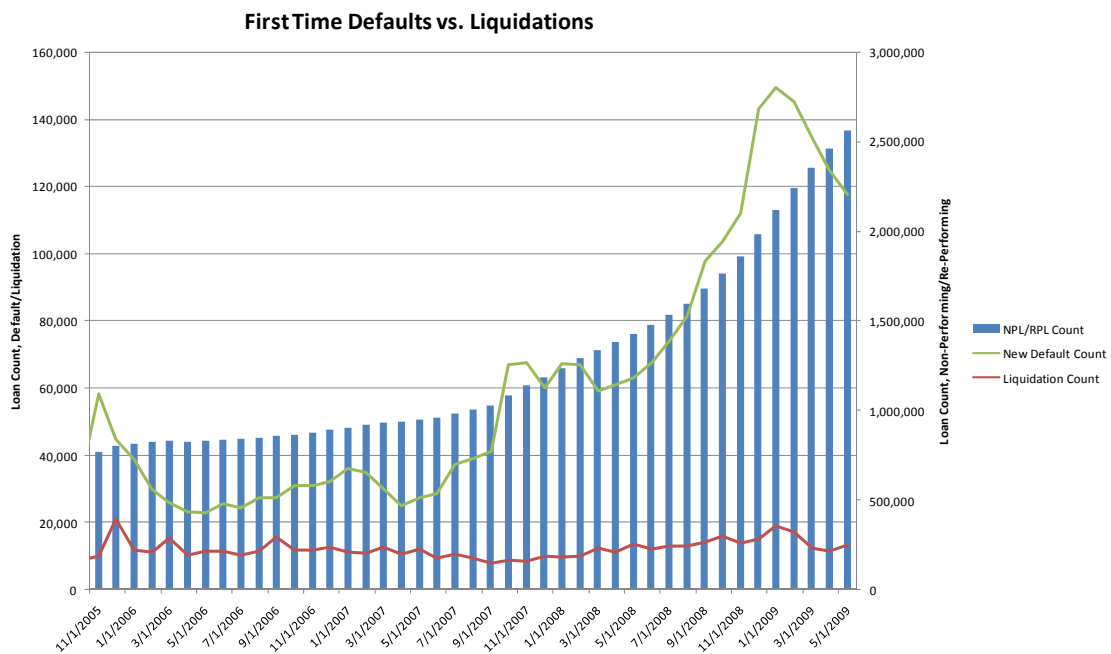
Source: Inside Mortgage Finance

new defaults are far higher than liquidations. That is, the mortgages not in private label securitizations actually behave more like private label prime collateral than private label subprime or Alt-A collateral.

To verify this, we turn to the First American CoreLogic Loan Level Servicer database, which contains data on approximately 29 million prime loans contributed by 12 servicers. (29 million loans is just over half of the roughly 56 million mortgages outstanding.) Assuming this is representative of the rest of the mortgage market, new defaults are much higher than liquidations. Exhibit 7 (below) shows that, for this data set, the new default balances total \$29.1 billion, liquidation balances are a fraction of that, at \$2.7 billion. It also shows that the non/performing and re-performing buckets are growing rapidly. This is the shadow inventory.

BOTTOM LINE—for agency securities and loans in bank portfolios, it is clear that new defaults are much higher than liquidations, as defaults are building rapidly and liquidations lag.

Exhibit 7: First Time Defaults vs. Liquidations for a Robust Sample of First Lien Prime Loans



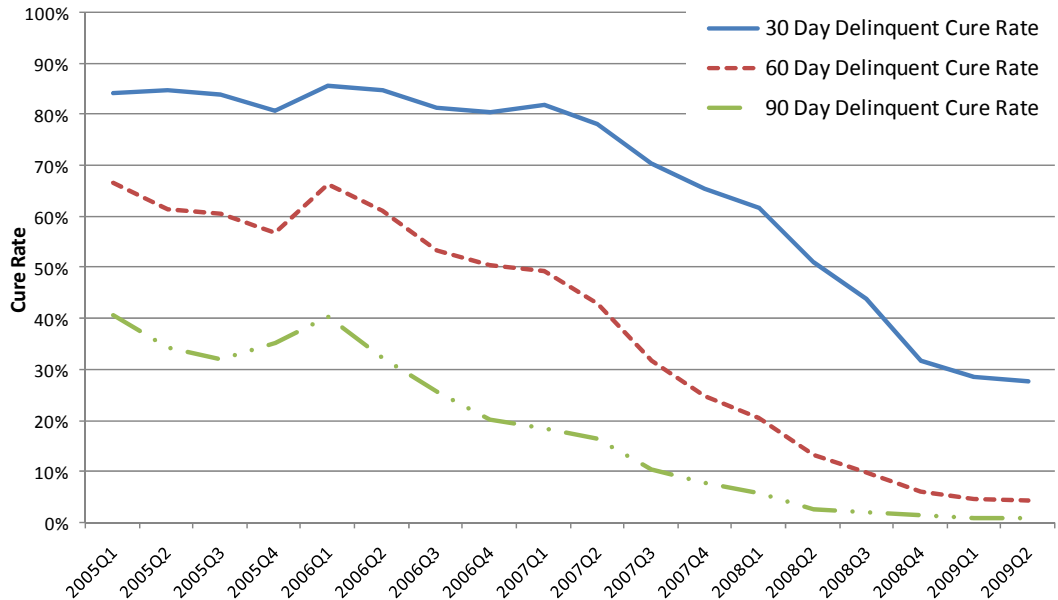
Source: First American CoreLogic Loan-Level Servicing Data, Amherst Securities

b) Cure Rates = Low

A key driver of the housing overhang is the very low cure rates on delinquent loans. Exhibit 8 (next page) shows the time series of cure rates (derived from transition rates that were used to produce Exhibit 2). Note that the cure rate on 60+ loans has decreased from 66% in early 2005 to 5% in Q2 2009.

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Exhibit 8: Cure Rate Time History



Source: Loan Performance, Amherst Securities

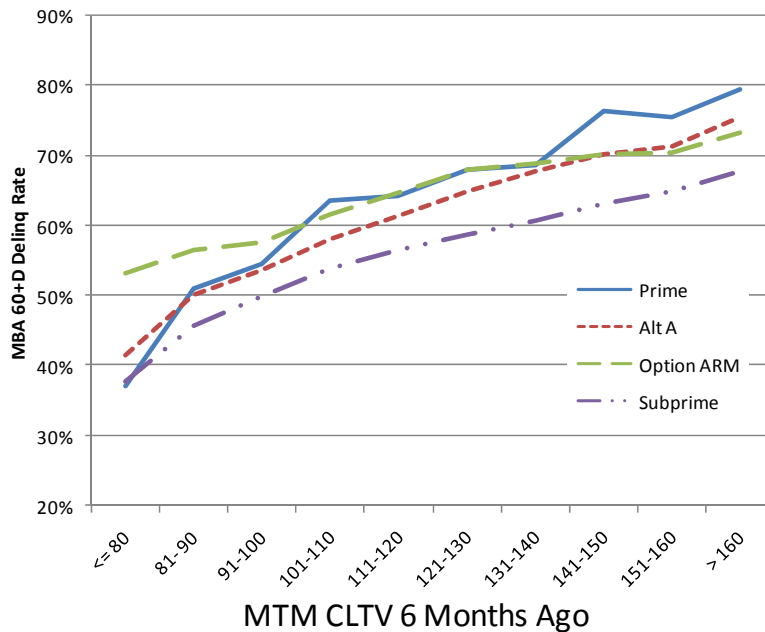
The cure rates are so low because it is non-economic for many borrowers to cure their mortgage, as they have negative equity. Once a borrower goes delinquent for any reason, he must stretch to cure. Thus, it becomes an economic decision. Exhibit 9 (next page) traces the behavior of borrowers who were 30 days delinquent 6 months ago. Note that only 35% of prime borrower with <80 LTV are now 60+ days delinquent, but that number rises to 80% for prime borrowers with high LTVs. In fact, as can be seen from Exhibit 8, prime borrowers are the most ruthless defaulters.

c) Extension of Liquidation Timeline

There is no question that the liquidation timeline has dramatically extended. Exhibit 10 (next page) shows that the time that has elapsed between last payment and liquidation for loans liquidated in 2007, 2008 and 2009. The entire distribution has shifted to the right, indicating that 2009 loans have spent longer in the delinquency/foreclosure pipeline than loans liquidated in 2007 or 2008. And this analysis has a selection bias, as we are only measuring liquidated loans. Harder to liquidate loans stay in the pipeline longer. Out of the loans in the pipeline in August of 2009, 9% have not made a payment in over 24 months, compare that to 4% in August off 2008.

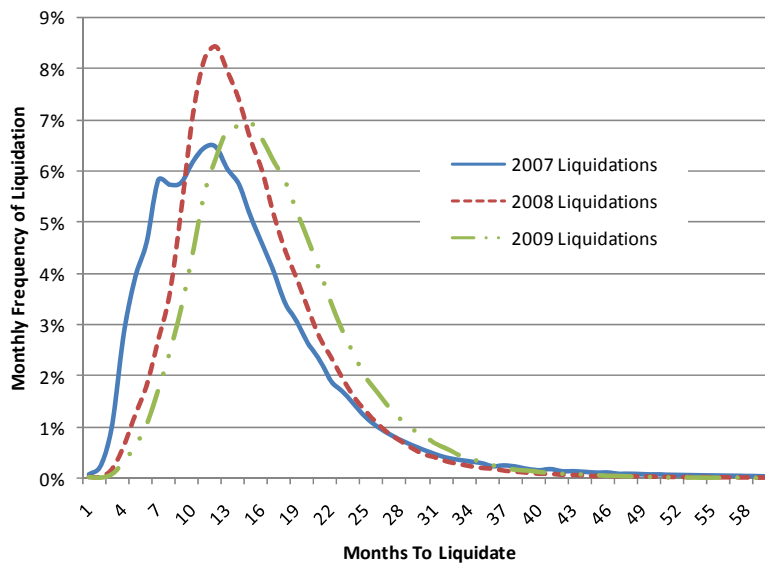
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Exhibit 9: Behavior of Borrowers Who Are 30 Days Delinquent



Source: Loan Performance, Amherst Securities

Exhibit 10: Loans Are Taking Longer to Liquidate



Source: Loan Performance, Amherst Securities

There are numerous reasons for the lengthening of time between last payment and liquidation: foreclosure moratoriums (federal and statewide), longer waiting periods prior to Notice of Default and between the Notice of Default and the Trustee Sale, and a slowing of the judicial process in judicial states (where court approval is

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required to foreclose). In addition, new rules requiring that each loan be tested to see if the borrower can qualify for a modification can tack on additional time (servicers have not completely automated this process).

Let's just look at the changes in California, a non-judicial state, where the lag between default and loan liquidation has been reasonably short. On March 16, 2009, The California Foreclosure Prevention Act was newly enacted to slow the foreclosure process. It added two important features to the foreclosure timeline. First, it required a 30 day waiting period before the NOD is filed (enabling the borrower to become 120 days delinquent before the process begins). The Act also required up to an additional 90 day waiting period between Notice of Default and Trustee Sale. There is some leeway in this second delay if the servicer is proactive in proving they attempted to work with the borrower after the NOD was filed.

Given these changes, it is not unreasonable that a delinquent loan could stay in process for 12 months, versus 6 months prior to recent legislation. And the situation in California is not singular; the extension of the time spent in the delinquency foreclosure pipeline is a nationwide phenomenon. The impact of this increase in lag, is that there are fewer liquidations (temporarily alleviating pressure on housing), and a larger shadow inventory.

We have now established that the housing overhang is a very significant problem. The question is, then—*how can housing look like it has stabilized given this overhang?* We believe there is a strong seasonal effect.

Why Do Housing Prices Appear To Have Stabilized?

The housing market has seen some signs of bottoming; in particular, prices seem to have stabilized the past few months. For example, the Case-Shiller 20-city Index reached a low in April, and is +1.9% through end of June (the latest available). The FHFA purchase Index also reached its low in April and is +1.2% through end-June. There are two effects at work here.

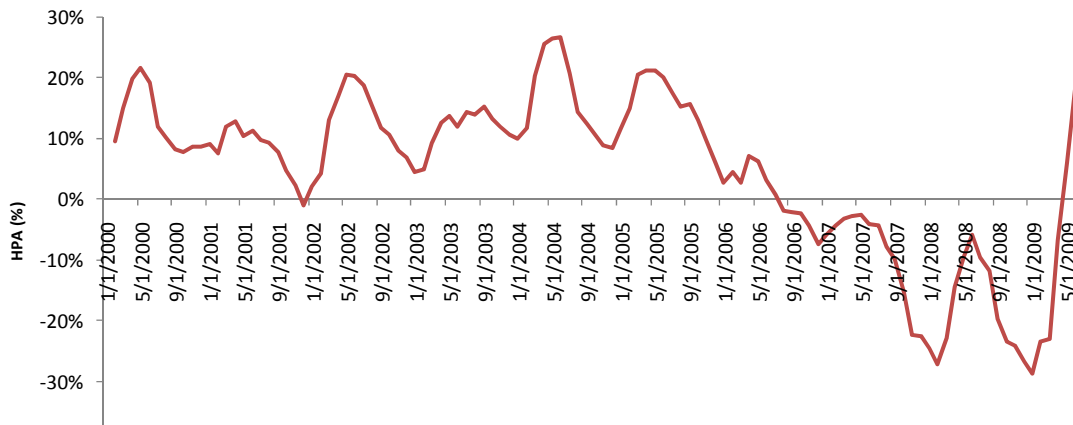
First - housing prices are themselves seasonal. The top section of Exhibit 11 (next page) shows the seasonal pattern of the Case-Shiller Index; the bottom section the seasonal coefficients derived from the 2000-2008 period (we eliminated 2009 observations, as we lacked a full year's data). Note that spring and early summer are generally stronger than late summer, fall and winter. The seasonal coefficient for a give month (i) is calculated as:

$$\text{Seasonal Coefficient} = \frac{(\text{Average HPA [month (i)]} - \text{Average HPA [all months]})}{\text{Average HPA [all months]}}$$

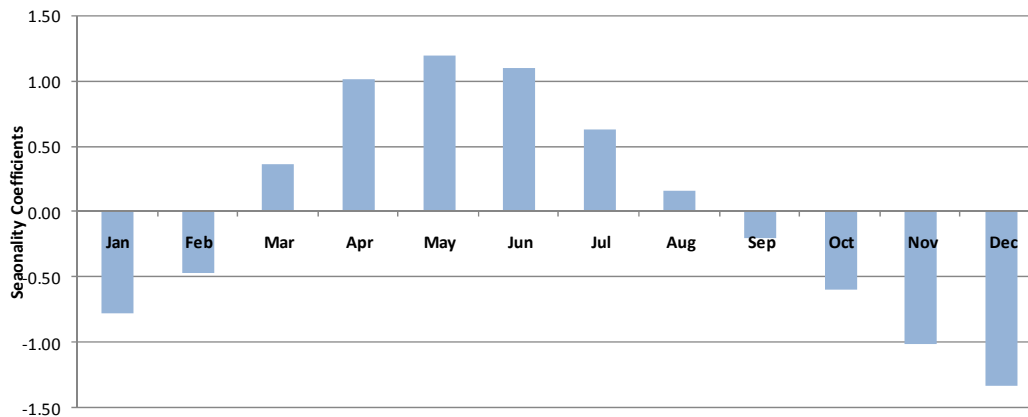
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Thus the seasonal coefficient is the difference between average HPA for that month and average HPA for the entire period, divided by the average HPA for the entire period. So on average, HPA of the month of June is 11.5%, while average HPA for the entire period is 5.5%, so the June seasonal coefficient is 1.19 $((11.5-5.5)/5.5)$.

Exhibit 11: Home Prices Are Highly Seasonal: Annualized 1-Month Changes



HPA Seasonality Coefficient - Deviation From Mean



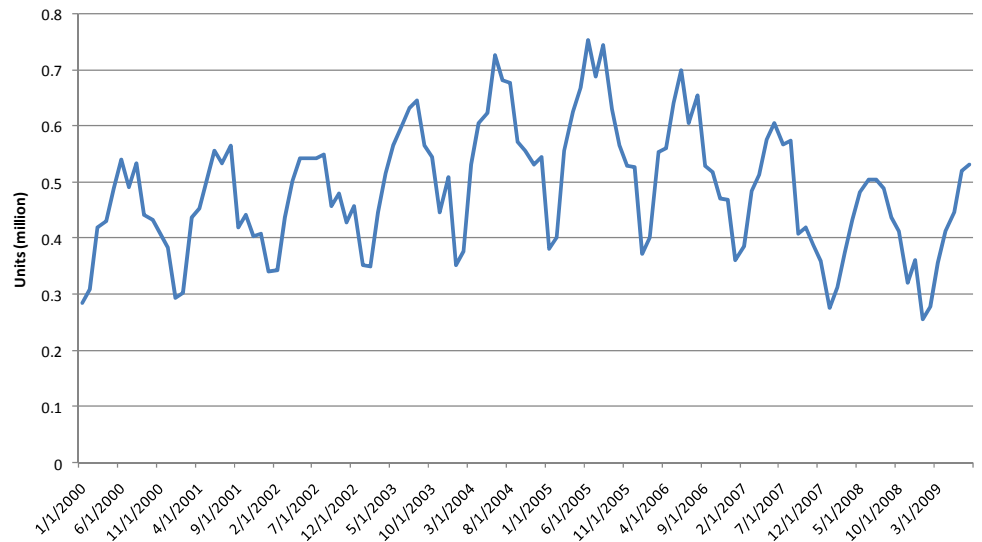
Source: S&P/Case-Shiller, Amherst Securities

Second - we believe the stabilization reflects the fact that home sales are highly seasonal yet liquidation volumes are not. Exhibit 12 (next page) shows the seasonality in existing home sales, liquidation volumes are not seasonal. Thus, liquidation sales constitute a far higher percentage of winter home sales than of summer home sales. To make the math easy, assume foreclosures constitute 1/2 of winter foreclosures and 1/3 of summer foreclosures, and that foreclosure sales trade at a 25% discount to non-foreclosure sales. Further assume that prices of the foreclosure bucket and the non-foreclosure bucket are each constant. The increase in prices would be 4% simply from the composition shift (i.e., 1/6 more of the loans in the summer are non-foreclosure sales, the price difference between a foreclosure

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sale and a non-foreclosure sale is 25%, so the price increase in the market index would be $[0.1666 \times 25\% = 4\%]$. This 4% is often annualized, making the difference appear even larger.

Exhibit 12: Existing Home Sales (Non-Seasonally Adjusted)



Source: National Association of Realtors

This simple example is quite realistic. For the last 5 months, The National Association of Realtors has been reporting the share of existing home sales that are distressed. That number was 50% in March, 45% in April, 33% in May, and 31% in June and July.

We believe the stabilization in home prices reflects these seasonal factors. The favorable seasonals will disappear over the coming months, and the reality of a 7 million unit housing overhang is likely to set in.

Conclusion

The largest problem facing the mortgage market is the “shadow inventory” or “housing overhang” of 7 million units. Nationwide, this “problem” represents a volume considerably larger than 1 year of existing home sales (5.2 million units). We have 300,000 new units/month transitioning into the non-performing bucket (60,000 from the private label universe, 240,000 from the rest of the market); these loans have a low chance of eventual recovery. And to the extent that there is more home price depreciation (causing higher volume of defaults), the problem could escalate.

We do acknowledge that this article has focused only on the negative, we have ignored the fact that housing affordability has been restored and many first time

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home buyers are taking advantage of the tax credit. However, we believe that the housing overhang is the single largest issue inhibiting a housing recovery. We are concerned that, in light of this overhang, the housing market stabilization is temporary, based on seasonal factors, and prices can deteriorate further. We believe a more permanent stabilization must await some resolution of the shadow inventory.

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Contact Us

Austin

Corporate Office

7801 N. Capital of Texas Hwy
Suite 300
Austin, TX 78731

(512) 342-3000
(800) 396-3311 toll free
(512) 342-3097 fax

Boca Raton

925 South Federal Highway
Suite 210
Boca Raton, FL 33432

(561) 620-5855
(888) 235-0009 toll free
(561) 620-8995 fax

Chicago

500 W. Madison Ave.
Suite 2070
Chicago, IL 60661

(312) 382-7746
(312) 612-5230 fax

Greenwich

Two Greenwich Office Park
First Floor
Greenwich, CT 06831

(203) 618-1133
(800) 556-1133 toll free
(203) 618-1475 fax

Houston

1300 Post Oak Boulevard
Suite 850
Houston, TX 77056

(713) 888-9100
(800) 856-1111 toll free
(713) 888-9180 fax

McLean

1650 Tysons Boulevard
Suite 650
McLean, VA 22102

(703) 848-8300
(800) 848-5420 toll free
(703) 848-8838 fax

New York City

444 Madison Ave.
7th Floor
New York, NY 10022

(212) 593-6030
(212) 593-6099 fax

Red Bank

65 Monmouth St.
Suite 307
Red Bank, NJ 07701

(732) 212-1661
(866) 933-9901 toll free
(732) 212-1766 fax

Westport

55 Saugatuck Avenue
Westport, CT 06880

(203) 221-8112
(877) 221-8115 toll free
(203) 221-8114 fax

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