

U.S. HOUSING REPORT

JUNE 2005

"Bubble & Bust" or "Rational Boom"?

A MACROECONOMIC DISCUSSION OF
THE SINGLE-FAMILY REAL ESTATE MARKET

Executive Summary

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From the cover of *Time* magazine to the wall-to-wall coverage on financial news network CNBC, there has been no shortage of concern expressed about the housing bubble. Market commentators fear that the bubble will eventually burst, causing a cascading effect that will spread throughout the housing market, leaving economic ruin in its wake.

Are the pundits overreacting to and exaggerating the size of the bubble and the danger of an implosion? Is this a bubble about to go bust or a rational boom? If this is a bubble, it is one of the most publicized bubbles in history. In contrast, before the stock market collapsed in March of 2000, conventional wisdom argued we were in a "new era" and that the old rules no longer applied. The pundits were busy rationalizing a "market gone wild". Today, perhaps because of that experience, they see disaster around every corner.

This report attempts to sift through the evidence and separate fear from reality by reviewing the historical record of the housing market. How this situation evolves will have important economic and investment market implications.

The report begins by creating a worst case scenario and examining the evidence of a housing bubble. It then looks at the case for a rational boom and attempts to remove some of the angst and myths surrounding the market.

We conclude that the housing boom has been rational and that there is no national overvaluation in home prices. Although some localized over-exuberance will likely lead to at least a "timeout" in some markets, this may only be a "pause that refreshes" rather than a trigger for a collapse. Ironically, the biggest risk to the housing market and the economy may be that all the talk of bubbles and collapse could become a self-fulfilling prophecy.

In the next recession, it would not be unusual to see localized corrections of 15% to 20% in the most overheated markets. The problem is gauging when the market will peak. Are we near the market top or is there another 15% to 20% more to go? Timing market tops in any market is difficult, especially one that is as illiquid and sticky as the housing market.

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BUBBLE & BUST OR RATIONAL BOOM?

*“This is like déjà vu all over again”
-Yogi Berra*

The Nightmare Scenario

There is growing fear that we are in a housing bubble that, like the stock market bubble before it, will burst, eliminating a sizable chunk of consumer wealth. In this nightmare scenario, high debt levels and low savings rates will finally force consumers to retrench, reducing consumption and triggering massive job losses. Newly unemployed homeowners, homeowners with lower quality mortgages and those who owed more than the value of their homes would have difficulty making their house payments, causing delinquencies and foreclosures to rise at the low end of the market. A collapse in the low end of the housing market would restrict the flexibility of trade-up buyers, and price deterioration would spread up through the market. Since the American home has become a virtual ATM, if housing prices slow or decline, that weakness could feed back into the economy and create a vicious cycle of weak income growth, lower affordability and rising delinquencies and foreclosures. In addition, with delinquencies and foreclosures rising, the trillion-dollar plus mortgage backed securities market could collapse and trigger a financial crisis.

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INDICATIONS OF A HOUSING BUBBLE

Indications of a Housing Bubble

A Housing Bubble?

- Strong Demand - Record Home Sales and Housing Starts
- Rapidly Rising Home Prices
- Real Home Price Growth Above Trend
- Double-Digit Price Gains
- Bay Area Price Gains
- Home Prices Rising Faster than Income
- Home Prices Rising Faster than Rents
- Record Home Ownership
- High Mortgage Debt/Declining Home owners' Equity
- Lower Quality Home Ownership
- Markets With Highest Percentage of ARMS
- Anecdotal Evidence

Record Home Sales and Starts

(millions of units)

Strong Demand

	<u>1979-1991</u>	<u>1992-2004</u>	<u>2005-2014 (e)</u>
Existing Home Sales	3.0	4.3	6.1-6.4
New Home Sales	0.6	0.8	1.1-1.5
Housing Starts	1.5	1.6	n/a

Source: DataStream, NAR, U.S. Census Bureau

Real Home Price Growth Rising Above Long-Term Average

Rapidly Rising Home Prices

Historically, home prices have appreciated at a rate of 1.0% above inflation (real rate 1969-2004). More recently, the real rate has been growing at a very rapid 4.7% per year, over the last three years (2002-2004).

	Average Median Home Price Year-Year % Change		
	<u>1969-1991</u>	<u>1992-2004</u>	<u>2002-2004</u>
Nominal	6.5%	4.7%	7.0%
Real	0.3%	2.1%	4.7%

Source: NAR

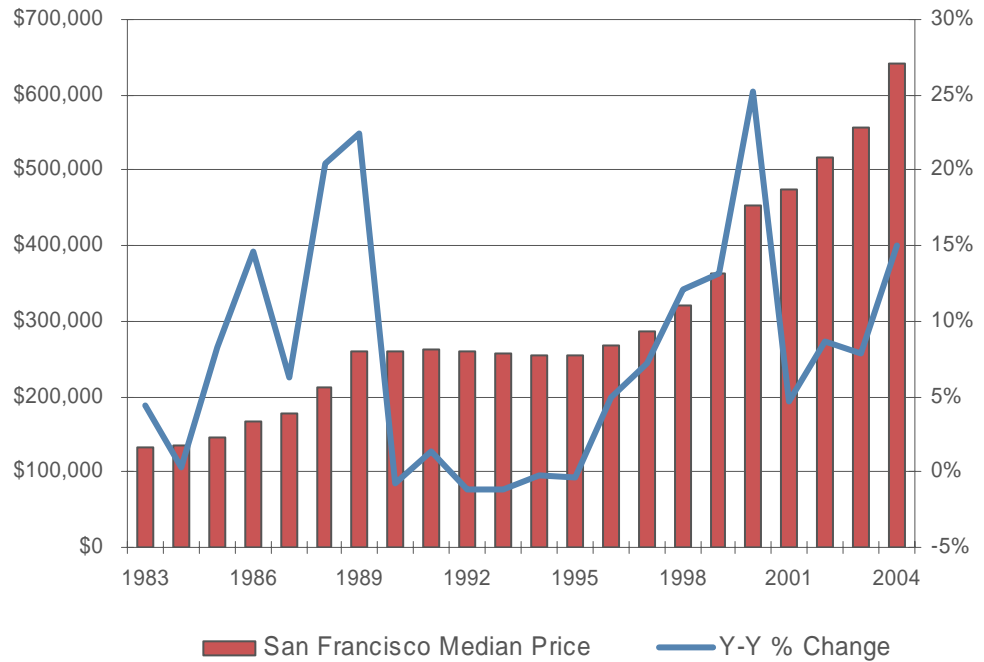
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INDICATIONS OF A HOUSING BUBBLE

Double-Digit Price Gains

In 66 of 136 metro areas tracked nationwide by the National Association of Realtors (NAR) and the California Association of Realtors (CAR), median home prices are rising at a double-digit pace. Not surprisingly, the San Francisco Bay Area is one such region.

San Francisco, CA Median Home Prices



Source: CAR

Every County in the S.F. Bay Area is Seeing the Double-Digit Gains

Bay Area Price Gains

County	San Francisco Bay Area Median Home Prices				
	Dec.-03	Dec.-04	% change	Apr.-05	% change from Dec.04
Alameda	\$425k	\$497k	16.9	\$552k	11.1
Contra Costa	401	480	19.7	530	10.4
Marin	629	732	16.4	779	6.4
Napa	447	550	23.0	574	4.4
San Francisco	565	683	20.9	751	10.0
San Mateo	570	668	17.2	731	9.4
Santa Clara	494	569	15.2	619	8.8
Solano	323	404	25.1	409	1.2
Sonoma	408	484	18.6	534	10.3
Bay Area	458	533	16.4	586	9.9

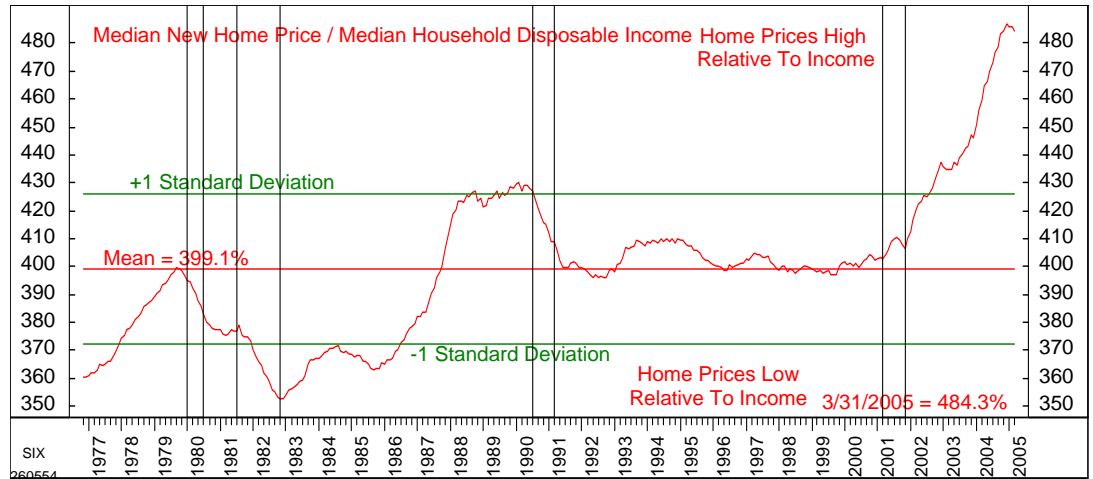
Source: DataQuick Information Systems; Bailard Research

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INDICATIONS OF A HOUSING BUBBLE

Median Home Price-to-Median Household Disposable Income 1960-2005 has climbed sharply and is now over two standard deviations above normal. Two standard deviation events are usually associated with bubbles.

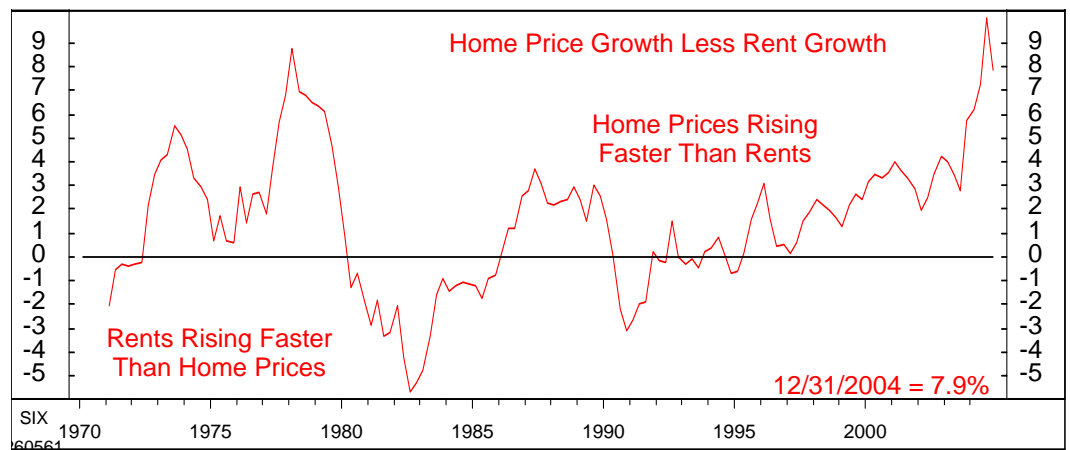
Home Prices
Rising Faster
Than Income



Source: Ned Davis Research

Median Home Price Growth Less Rent Growth has surpassed levels not seen since the late 1970's.

...& Faster
Than Rents



Source: Ned Davis Research

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INDICATIONS OF A HOUSING BUBBLE

Record Home Ownership

National Home Ownership Rate

2005 (Mar)	69.1%
2000	67.4
1995	64.7
1990	64.1
1985	63.5
1980	65.5
1975	64.5
1970	64.0
1965	63.4

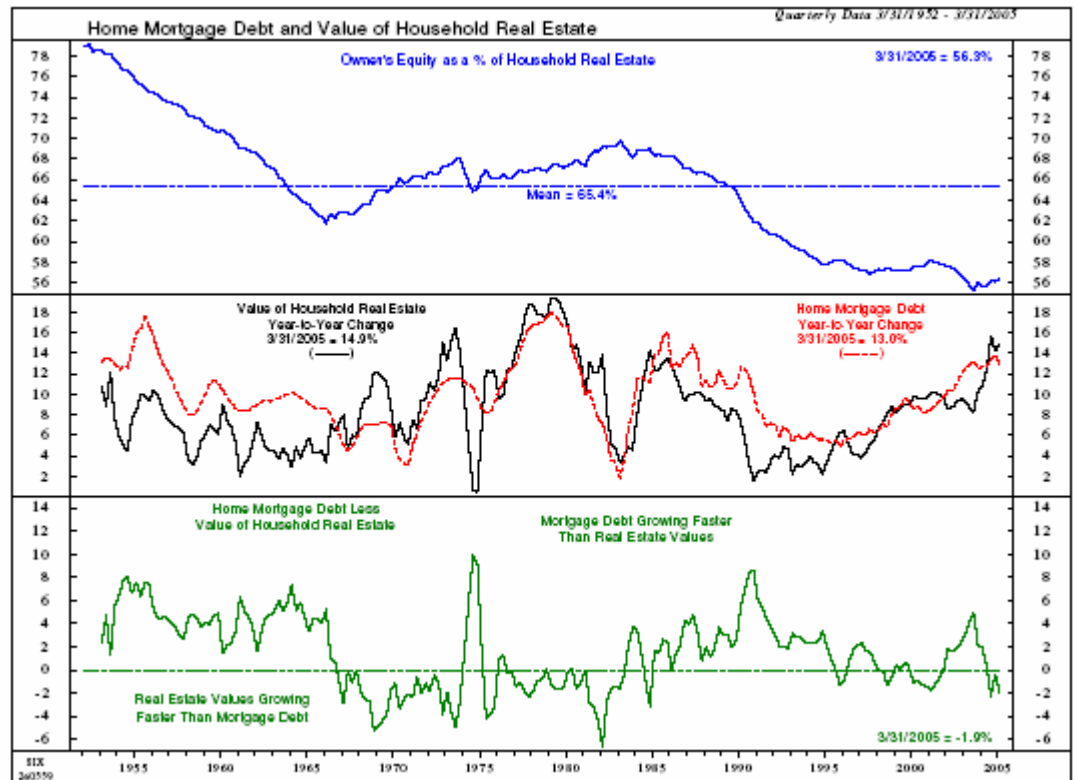


How much higher can it go?

Source: U.S. Census Bureau, Bailard Research

Declining Homeowners' Equity as a Percent of Household Real Estate

High Mortgage Debt & Declining Homeowners' Equity



Source: Ned Davis Research

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INDICATIONS OF A HOUSING BUBBLE

Sub-Prime lending has increased but conventional mortgages remain around 70% of all mortgages initiated. Government sponsored mortgages have declined as a percent of total originations.

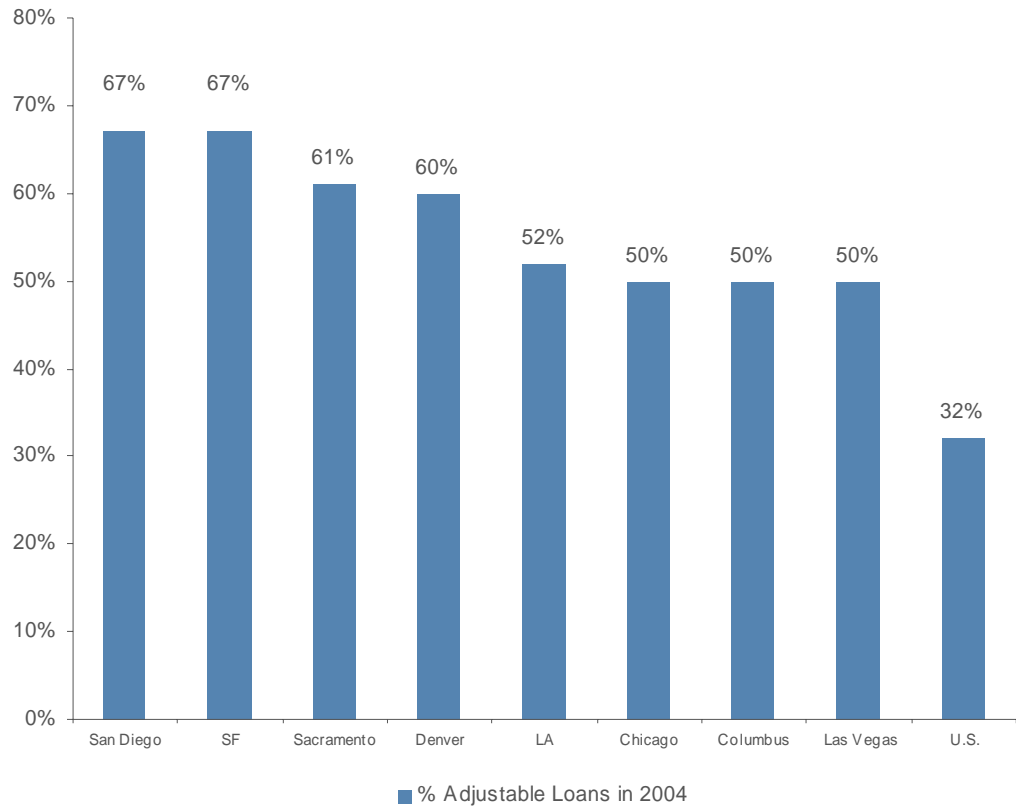
Lower Quality Home Ownership

<u>TYPE OF PURCHASE (ooo's)</u>	<u>1993</u>	<u>%</u>	<u>2000</u>	<u>%</u>	<u>2001</u>	<u>%</u>
Conventional Prime	1,688	70.0	2,531	69.0	2,665	70.0
Government	650	27.0	756	21.0	824	22.0
Sub-prime	31	1.3	266	7.0	246	6.0
<u>Manufactured</u>	<u>37</u>	<u>1.7</u>	<u>117</u>	<u>3.0</u>	<u>73</u>	<u>2.0</u>
Total	2,406	100	3,670	100	3,808	100

Source: MBA

Adjustable Rate Loans became the favorite in 2004 for the least affordable markets.

Markets With Highest Percentage of ARMS



Source: NAR, Federal Housing Board

Anecdotal Evidence of a Bubble

Anecdotal Evidence

- Multiple bids
- Increase in speculative purchases
- Final sales price greater than listing price
- Less than four months' supply of new homes
- Aggressive lending practices/competition among lenders
- Government push to lend to higher risk borrowers
- Heavy pre-construction purchase/sales
- Flipping
- Cocktail Chatter/Media Focus

Possible Catalysts for a Bust

Possible Catalysts for A Bust

- Sharply higher interest rates
- Significant build in inventories
- Recession and sustained job losses
- Speculator exit
- Restraints on Freddie Mac and Fannie Mae that could limit amount of mortgage debt and the ability to service the low end of the market
- Change in the tax code affecting deductibility of mortgage interest
- Backlash against immigration will lead to reduced demand at the low end of the market

Moderate Correction Likely

Moderate Correction Likely

- Nominal price declines are rare
- Real price declines tend to be mild
- Price declines tend to be local, not national

Strong Demand and Higher Prices Don't Make a Bubble

What's a Bubble?

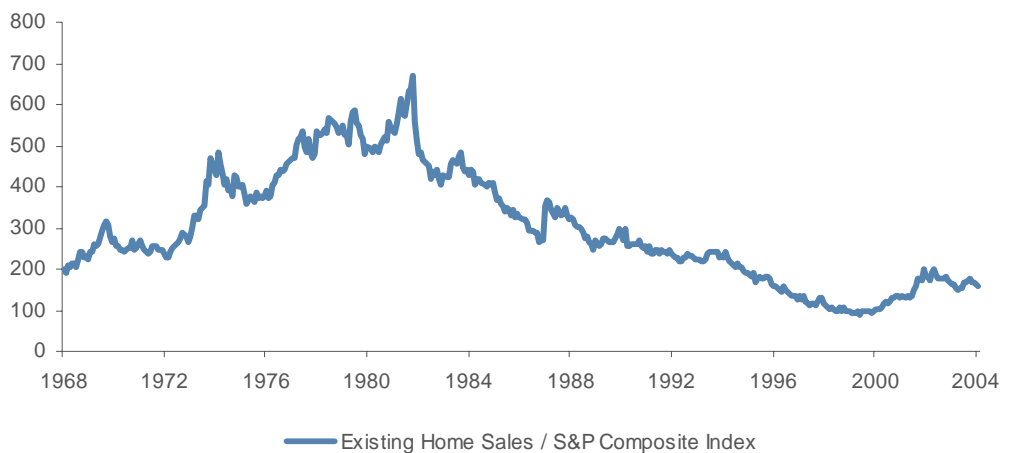
"If the reason a price is high is only because investors believe that the selling price will be higher tomorrow—when "fundamental" factors do not seem to justify such a price—then a bubble exists." -Stiglitz (1990)

Long-Term Fundamentals Remain Constructive

Fueling the Boom

- Housing inventories remain low
- Nationwide affordability is high (defined as median income/ median monthly cost)
- Demographics are positive for household formations
 - Baby Boomers entering peak earning and home ownership years.
 - Second home demand is growing
 - Children of the Baby Boomers are becoming homeowners.
- Immigration strengthens housing demand
 - New immigrants per year
 - 1.3 million legal
 - 800,000 illegal
 - Older immigrants have higher home ownership rates
- Low income and minority home ownership programs and new financial options boost demand
- Retirement population is living longer, reducing supply of homes for sale and increasing demand for retirement properties
- Real estate has become a safe haven after the tech stock bust
- Increased speculative buying as investors diversify portfolios

Why Has the Housing Market Been so Strong?



Existing Home Price / S&P 500

Source: NAR, DataStream, Bailard, Research.

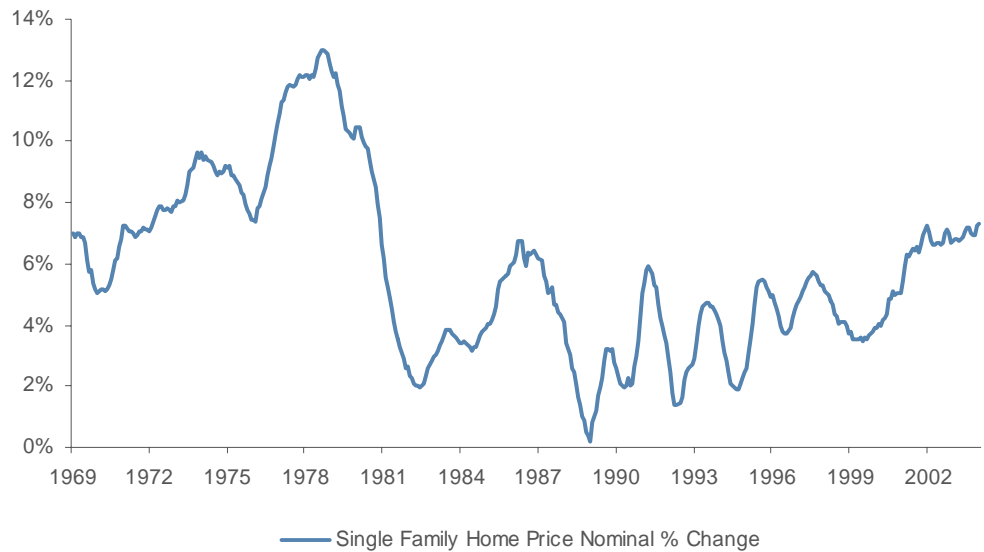
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NOMINAL VS. REAL PRICE MOVEMENTS

Nominal Home Price Declines Are Rare

Home buying and financing have been exuberant but “rationally exuberant,” and housing fundamentals remain solid. Evidence of a nationwide housing bubble is debatable; the likelihood of a bust is even more so. Nationwide home price appreciation may slow, but a significant decline in median prices is unlikely. Historically, falling home prices are rare, occurring only in periods of recession or high interest rates. Nominal home prices have not declined at the national level since the Great Depression.

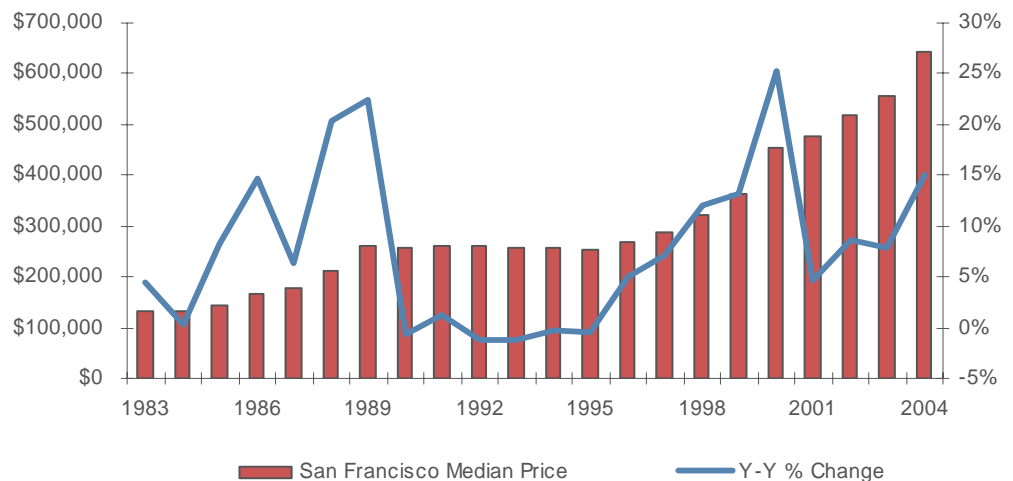
National Percent Change in Nominal Single Family Home Price



Source: NAR, Bailard Research

San Francisco Bay Area Median Single Family Home Price

...Even In San Francisco



Source: CAR

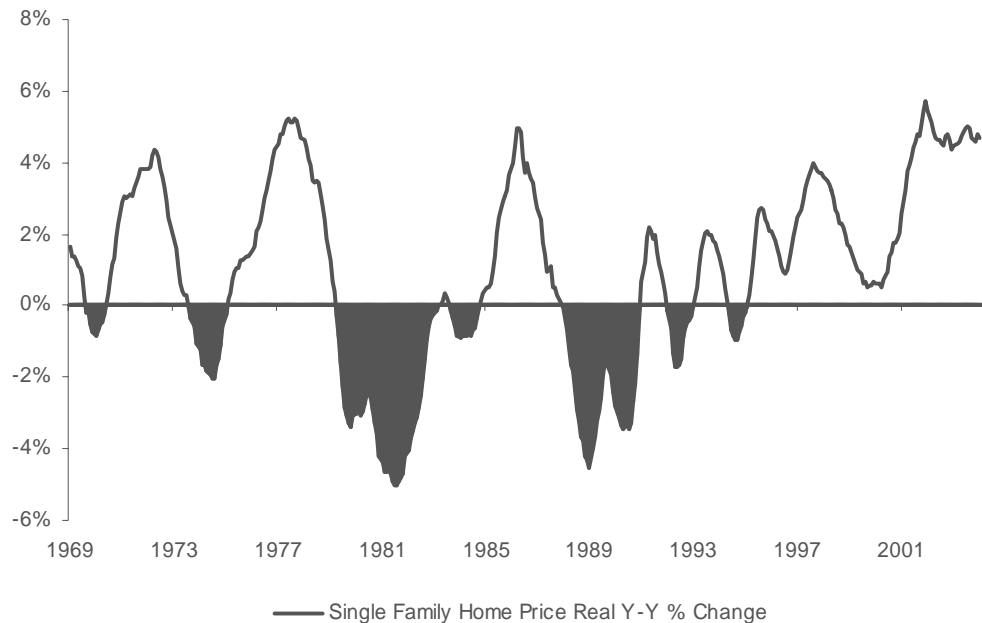
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NOMINAL VS. REAL PRICE MOVEMENTS

Real Price Declines Tend To Be Mild

Housing is cyclical. It will likely slip in the next downturn but should not slide out of control. In the early 1980's and 1990's, real home prices fell only about 5%, as employment and income growth slowed and mortgage rates rose. The only other time real home prices rose as fast as the last three years was from 1976 to 1979, when they grew a cumulative 15%. This boom was followed by a 10% cumulative decline that was triggered by a doubling in mortgage rates, a 50% decline in home sales and a very steep economic recession. These conditions seem unlikely in the near term.

National Percent Change in Real Single Family Home Prices



Source: NAR, DataStream. Bailard Research

Homeowners Do Not Necessarily Suffer From Price Declines

Homeowners Care More About Nominal Price Appreciation

Hypothetical Example

Purchase Price	\$200,000
Equity (20% down)	40,000
Nominal Price Increase	2%
Minus: Inflation	-3%
Equals: Real Price Decline	-1%

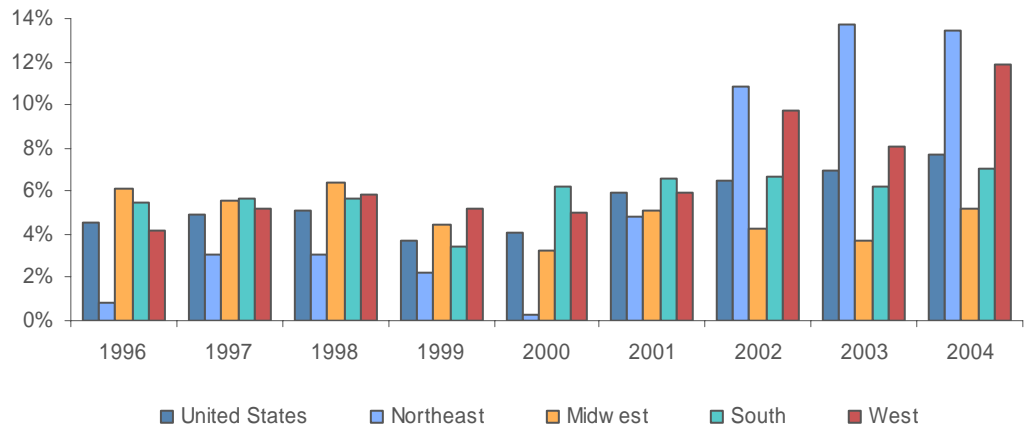
Rate of Return (before interest and taxes) = $\$4,000^* / \$40,000 = 10\%$ vs. 3% inflation

*Purchase price of \$200,000 times 2% nominal price increase.

Regional Fundamentals are Heterogeneous and Housing Prices are Localized

Housing markets can be volatile on a regional or local basis, but this volatility does not show up in nationwide aggregate statistics. Recently, many local markets have had strong price moves and thus should be more vulnerable to economic shocks. The West and Northeast have had the strongest price gains over the last three years.

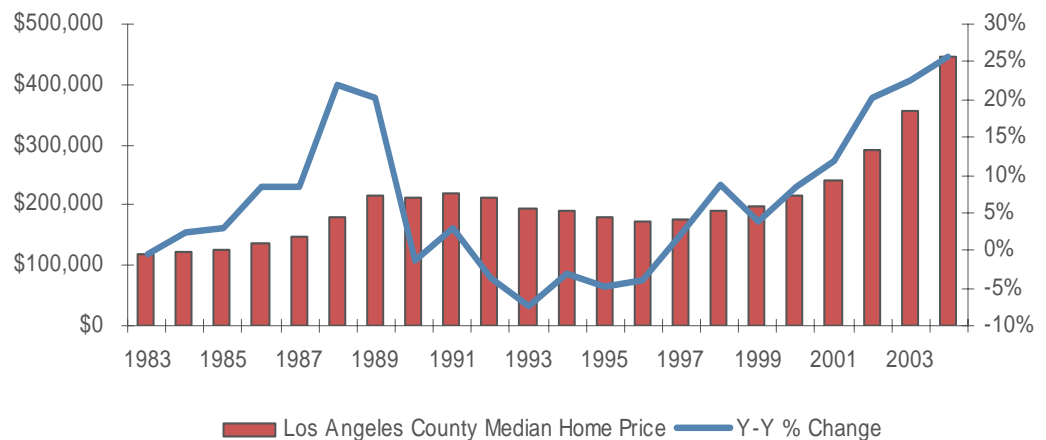
National and Regional Percent Change in Median Home Prices



Source: NAR

In the next cyclical decline, many local markets may have air let out of their mini-bubbles. Although local market price declines could look scary, we do not believe they will trigger the nightmare scenario of the doom and gloom crowd. In the past, real estate corrections have been regional, not national. A decade ago, in the early 1990's, home prices fell a cumulative 18.5% in Los Angeles (1990-1996). **A 15% to 20% cumulative correction in some markets, seems likely in the next recession.**

Median Los Angeles, CA Home Price



Source: CAR

Local Volatility Is Not Unusual

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REGIONAL FUNDAMENTALS

However, even on a regional basis, steep price declines are unlikely absent concentrated job losses and oversupply.

Steep Price Declines Unlikely on a Regional Basis

CITY	1990 Recession				Single Family Home Price Decline
	Job losses peak-to-trough	Duration Years	Housing Inventory mos. supply (1991)		
Boston	-12.7%	3 yrs.	16 mos.		-7.2%
New York	-10.9	2	12		-10.0
Los Angeles	-10.0	4	15		-21.4
San Francisco	-7.3	3	14		-3.8
Houston	-8.3	1	9		-23.1
National Average	-1.6	1.5	10		Positive
April 2005 Y-Y %	+1.7	na	4		Positive

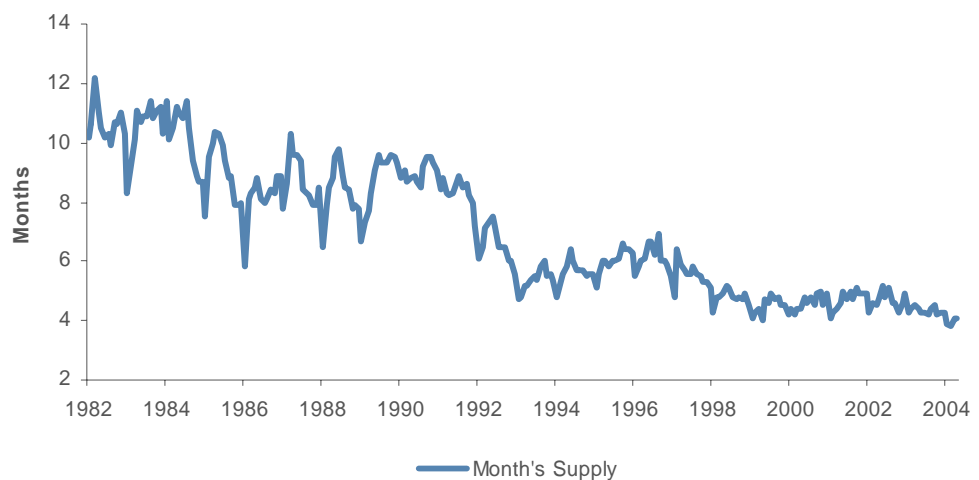
Source: NAR, Bailard Research

Continued Employment Growth

Currently, the economy and job creation remain healthy, and housing inventories are near record lows.

Low Inventory of Unsold Homes

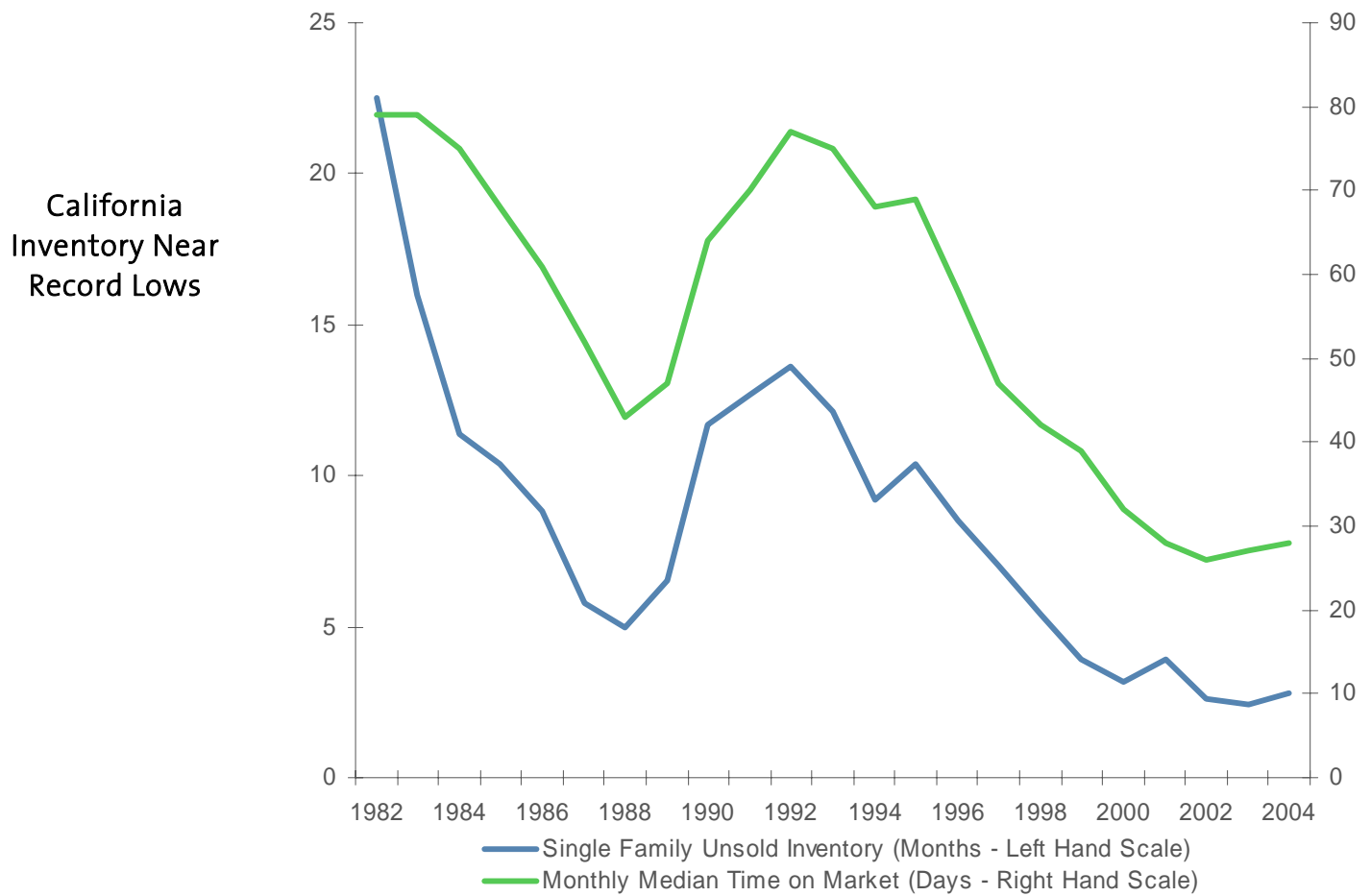
Months Supply of Unsold Homes



Source: DataStream

In California, because of strong demand, the inventory of unsold single-family homes remains near record lows. The number of days homes are on the market is also very low at 28 days.

California Single Family Inventory and Days on Market



Source: CAR

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AFFORDABILITY REMAINS HEALTHY

People tend to buy homes almost regardless of interest rates as long as household formations are rising, job growth is firm, income prospects are favorable and potential buyers are confident about the future. However, with interest rates at low levels, housing remains very affordable nationwide, as well.

It is misleading to look at Home Price-to-Income or Price-to-Rent ratios as measures of value without considering the cost of financing. As interest rates decline, the monthly cost of owning the same house falls or you can afford more house for the same monthly payment.

Purchasing Power of \$3,000 Mortgage Payment

**Declining
Interest Rates
Increase Buying Power**

Interest rate	Amount Financed (20% down)	Purchase Price
8%	\$411,576	\$514,470
7%	\$453,553	\$566,941
6%	\$502,876	\$628,595
5%	\$561,173	\$701,466
4%	\$630,000	\$788,079

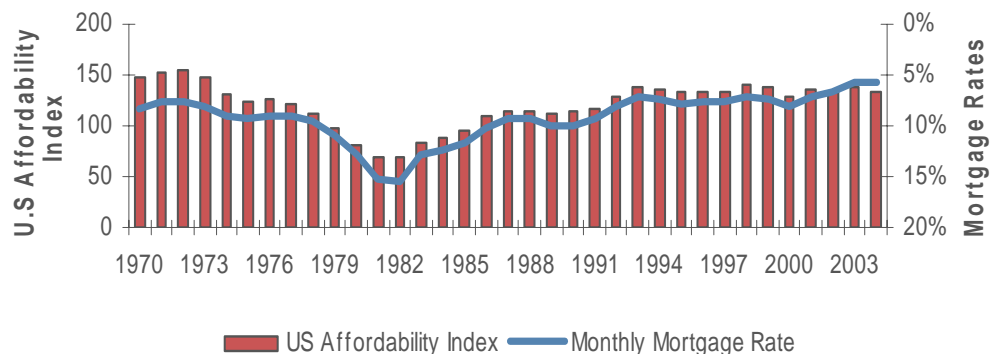
Source: Bailard Research

NAR calculates Housing Affordability Indices, which evaluate how much of the cost of a median priced house a family earning a median income can afford. It assumes 20% down, an effective mortgage rate based on loans closed on existing homes from the Federal Housing Finance Board and a qualifying ratio of 25% (principle and interest payments as % of income).

In February 2005, the National Housing Affordability Index was 134. In other words, a family with a median income could cover 134% of the cost of an existing home. To get back to the early 1985 level of 100, rates would have to increase to 8.6%. Absent a steep rise in interest rates, houses on a nationwide basis are still very affordable.

U. S. Housing Affordability Index and Mortgage Rates Inverted

**National Housing
Affordability Near
Record High**



Source: National Association of Realtors

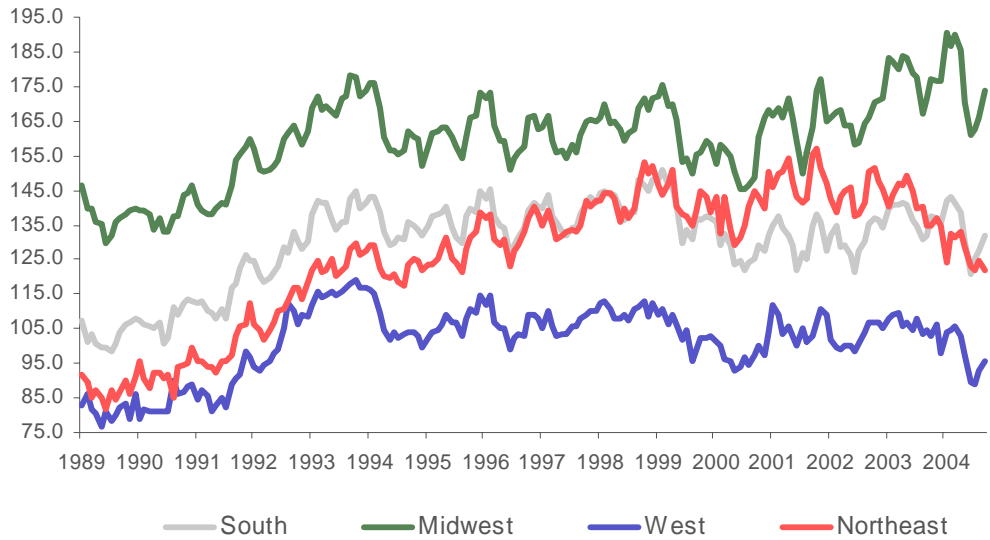
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AFFORDABILITY REMAINS HEALTHY

While affordability is falling in some regions, regional housing affordability is still above the levels of the early 1990's.

Regional Housing Affordability Indices

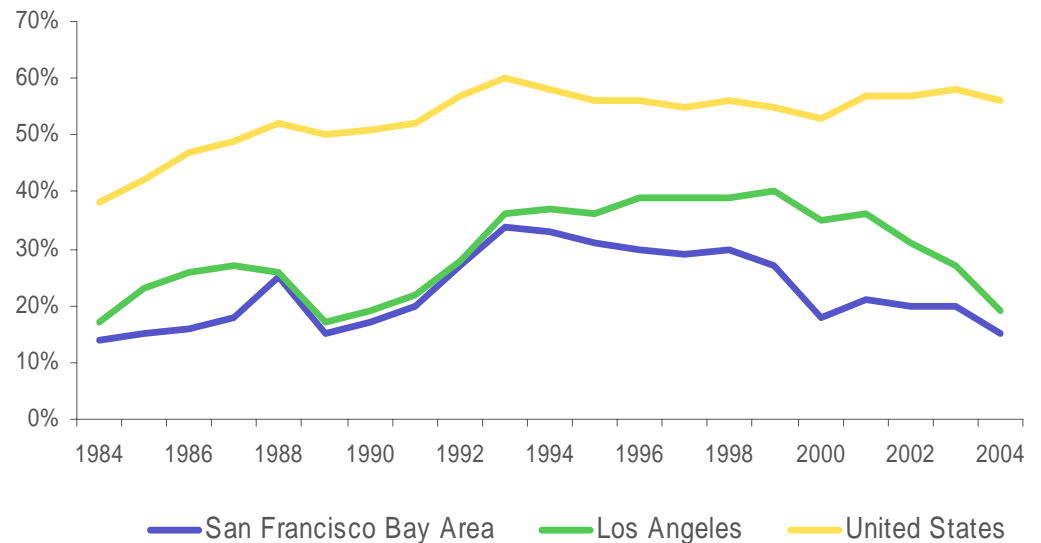
Regional
Affordability
Above 1990's
Level



Source: NAR

California Association of Realtors Affordability Index*

California
Affordability
Below National
... It Always Is



*Percent of households who can afford to purchase a median-priced home

Source: CAR

Quality Adjusting Home Prices

Real Price Change Reflects Quality Change

The median home price-to-income ratio does not make an adjustment for the improved quality of homes. The Census Bureau makes an adjustment for home quality on a quarterly basis. This is a national aggregate, so for many urban subsets the aggregate could be misleading. The Constant-Quality New Home Price Index answers the question, "How much is the sales price today for the same quality house as in the base year?" Currently the base year is 1996. Quality includes physical size (square footage), number of amenities and geographic location. In this way, you can differentiate between the price appreciation due to inflation and that due to home quality changes. The difference between the median home price and the Constant Quality Index can be used as a gauge of quality changes. As can be seen in the chart below, homeowners have been getting more house for the money. In response to affordability issues, smaller houses with fewer amenities may help keep affordability high.

Year	Average Home Price	5yr % Change	Constant Quality Home Price	5 yr % Change	Quality Change	CPI Change
1980	\$76,400	n/a	\$99,000	n/a	n/a	n/a
1985	100,800	31.9%	117,600	18.8%	13.1%	26.9%
1990	149,800	48.6%	141,600	20.4%	28.2%	22.3%
1995	158,700	5.9%	163,400	15.4%	-9.5%	14.7%
2000	207,000	26.0%	192,000	17.5%	8.5%	13.4%
2004	274,500	32.6%	236,100	23.0%	9.6%	9.5%
1980-04 cum.		259%		138%	56.0%	121%
Annualized		5.5%		3.7%	1.8%	3.4%

Source: U.S. Census, Bailard Research

Favorable demographics should support housing over the next ten years

Population growth	You need more housing if you have more people. Although the U.S. Census Bureau shows some slowdown in population growth through 2010, over the next 30 years, population growth should be stronger than in the 70's and 80's.
Echo boom	Children of the Baby Boomers are entering the prime home buying age group of 25 to 34 years old.
Second Homebuyers	As Baby Boomers enter their peak earning and wealth years, second home ownership should continue to rise.
Aging of the Baby Boomers	Home ownership rates tend to go up as you get older. Home ownership rates generally do not peak until age 65. The youngest Baby Boomers, those born in 1964, are 41 years old this year; the oldest Baby Boomers, those born in 1946 are 59. Baby Boomer household formation is likely to continue to grow.

Home ownership Rates By Age

<u>All Races/Ethnicities</u>	<u>1993</u>	<u>2003</u>
Under age 35	38%	42%
Age 35-44	66%	68%
Age 45-54	75%	76%
Age 55-64	80%	82%
Age 65-74	80%	82%
Age 75 and over	74%	78%

Source: JCHS

Immigration

Absent a radical change in immigration policy, immigration should continue to support household formations. The Joint Center for Housing Studies at Harvard estimates legal immigration will be about 1.3 million immigrants per year over the next decade. Immigration should help push total household formation to 14.5 million households, greater than the 12.5 million households of the 1990's. In addition, the longer an immigrant lives in the U.S., the greater the home ownership rate. The foreign-born household home ownership rate is initially very low partially because new immigrants tend to be younger, and the home ownership rate is lowest in the under 35 age group. However, the longer you live in the U.S., the greater the home ownership rate. Immigrants here less than five years have ownership rates of around 20%, but, by the time an immigrant has been living in the U.S. 15 to 20 years the ownership rate is the same as that of a native-born head of household.

Foreign Born Ownership Rates Should Rise

Foreign-Born Home ownership Rates

Ownership Rate:	Date of entry				
	<u>2000</u>	<u>1990-99</u>	<u>1980-89</u>	<u>1970-79</u>	<u>before 1970</u>
	21%	40%	58%	73%	85%

Source: U.S. Census Bureau, JCHS

If demographic trends remain the same, during the next two decades, minorities will account for 2/3 of household growth. Minority populations tend to be younger (an age group with lower home ownership rates). Although minority home ownership rates still lag white households, ownership rates are rising fastest for minorities and there is plenty of room for catch up. With increasing access to capital from government sponsored programs, minority home ownership should continue to rise.

U.S. Racial and Ethnic Composition*

	<u>1990</u>	<u>2000</u>	<u>2025</u>
White	80%	76%	62%
Hispanic	7%	11%	18%
Asian	2%	3%	7%
Black	11%	10%	13%

*Hispanic is considered ethnicity not a race

Source: U.S. Census, NAR

Minority Ownership Rates Have Room to Grow

National Minority Home ownership Rates Still Lag

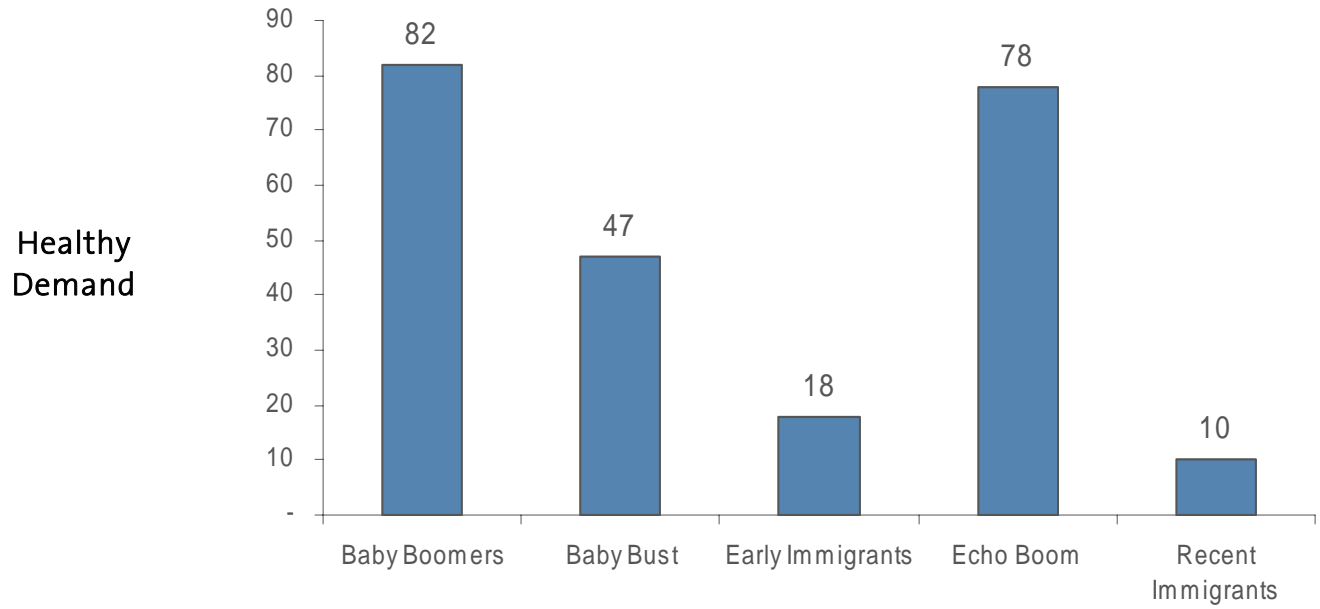
White		Asian/Other		Black		Hispanic	
<u>1993</u>	<u>2003</u>	<u>1993</u>	<u>2003</u>	<u>1993</u>	<u>2003</u>	<u>1993</u>	<u>2003</u>
70%	75%	52%	57%	43%	48%	40%	48%

Source: JCHS

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DEMOGRAPHICS

Healthy Potential Demand Estimated through 2015
(Millions of People)



Trade Up Buyers

First Time Buyers

Source: JCHS 2004

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FINANCING CONTINUED BOOM

Mortgage Debt Well Collateralized

Although mortgage debt is rising, it is well collateralized by underlying asset values. Debt is increasing faster than real estate values, due to new homeowners who tend to take on more debt and have less equity. Given the tax deductibility of mortgage debt, consumers have also rationally substituted mortgage debt for installment debt.

Consumer Balance Sheet (trillions of \$'s)

	<u>1995</u>	<u>2005Q1(e)</u>	<u>\$ chg.</u>	<u>% chg.</u>
Assets	\$30.3	\$59.8	\$29.5	97%
Stocks & Bonds	\$16.4	\$31.0	\$14.6	89%
Real Estate	\$10.8	\$23.0	\$12.2	113%
Cash	\$ 3.2	\$ 5.8	\$ 2.6	81%
Liabilities	\$ 4.8	\$11.1	\$ 6.3	131%
<u>Mortgage Debt</u>	<u>\$ 3.2</u>	<u>\$ 7.8</u>	<u>\$ 4.6</u>	<u>144%</u>
Net Worth	\$25.5	\$48.7	\$23.2	91%

Source: Federal Reserve Flow of Funds, Bailard Research

Home Buyers Are Acting Normally

Home Buyers Not Adopting Risky Financing Options

Fixed mortgages as a percent of total mortgages have been stable over the long run at around 80%. Although there have been cyclical shifts, the availability of adjustable rate mortgages (ARMS) has helped smooth out the housing cycle. Over the past few years, the steep yield curve made the ARM option a reasonable financing alternative, not a risky gambit.

Loan-to-price ratios have also remained quite stable at 75% to 80%. While low down/no down loans have increased, the market is still dominated by the traditional 30-year fixed, 20% down mortgages. If anything, in recent years, the average down payment has increased and the loan-to-price ratio has fallen. The percent of mortgages with greater than 90% loan-to-price ratios has been stable at about 20%.

Terms of Conventional Single-Family Mortgages (annual averages, rounded)

<u>Year</u>	<u>Effective Interest Rate %</u>	<u>Term to Maturity (yrs.)</u>	<u>Loan/Price Ratio %</u>	<u>Fees %</u>	<u>Percent of Loans With</u>		
					<u>Loan/Price Ratio > 90%</u>	<u>ARM</u>	<u>Subprime % of Total</u>
1980	12.9	27	73	1.9	10	n/a	n/a
1985	11.6	26	76	2.5	21	50	n/a
1990	10.0	27	75	1.7	8	27	5
1995	7.8	27	80	0.9	27	31	10
2000	8.0	29	78	0.7	22	21	13
2004	5.7	27	74	0.4	20	32	9

Source: JCHS; Federal Housing Finance Board, Mortgage Statistical Annual

U.S. HOUSING REPORT

FINANCING CONTINUED BOOM

Despite rapid home price appreciation over the last few years, it still makes financial sense to buy rather than rent.

RENT VS. BUY Annual Median Cost (National)

Hypothetical Example

National
Rent vs. Buy
Decision

	Homeowner	Renter
Annual Mortgage/Rent Payment	\$10,475	\$11,472
Property Taxes (1.2%)	2267	0
Property Insurance(0.4%)	755	55
Maintenance (0.25%)	472	0
Before Tax Annual Cost	\$13,969	\$11,527
Mortgage Interest Tax Deduction	-1,990	0
Property Tax Deduction	-340	0
After-Tax Annual Cost	\$11,639	\$11,527
Historical Appreciation (1.5% real, 4.0% nominal)	-7,556	0
Rent Increases (with inflation)	0	286
Psychological Benefits of Ownership	non-quantifiable	0
Total Cost of Housing	\$ 4,083	\$11,813

Mortgage Payment based on Median Home Price in Dec. 2004 of \$188,900, 20% down and 30-year fixed loan at 5.7%. Median Income \$55,399. Combined marginal tax rate on \$30,000 taxable income 19% (15% Fed +4% Calif). CPI=2.5%; Rent=\$956/mo.

Source: Bailard Research, HUD, U.S. Census Bureau, NAHB

U.S. HOUSING REPORT

FINANCING CONTINUED BOOM

In hot markets, while there is the risk of significant price corrections, the timing of such corrections is a risky gambit. Even assuming corrections, it may make sense to buy rather than rent if future home price appreciation returns to its average annual rate.

RENT VS. BUY Annual Median Cost (San Francisco)

Hypothetical Example

San Francisco
Rent vs. Buy
Decision

	Homeowner	Renter
Annual Mortgage/Rent Payment	\$37,709	\$30,000
Property Taxes (1.2%)	8,160	0
Property Insurance(0.4%)	2,720	120
Maintenance (0.25%)	1,700	0
Before Tax Annual Cost	\$50,289	\$30,120
Mortgage Interest Tax Deduction	-12,821	0
Property Tax Deduction	-2,040	0
After-tax Annual Cost	\$35,428	\$30,120
Historical Appreciation (1.5% real, 4.0% nominal)	-27,200	0
Rent Increase (with inflation)	0	750
Psychological Benefits of Ownership	non-quantifiable	0
Total Cost of Housing	\$ 8,228	\$30,870

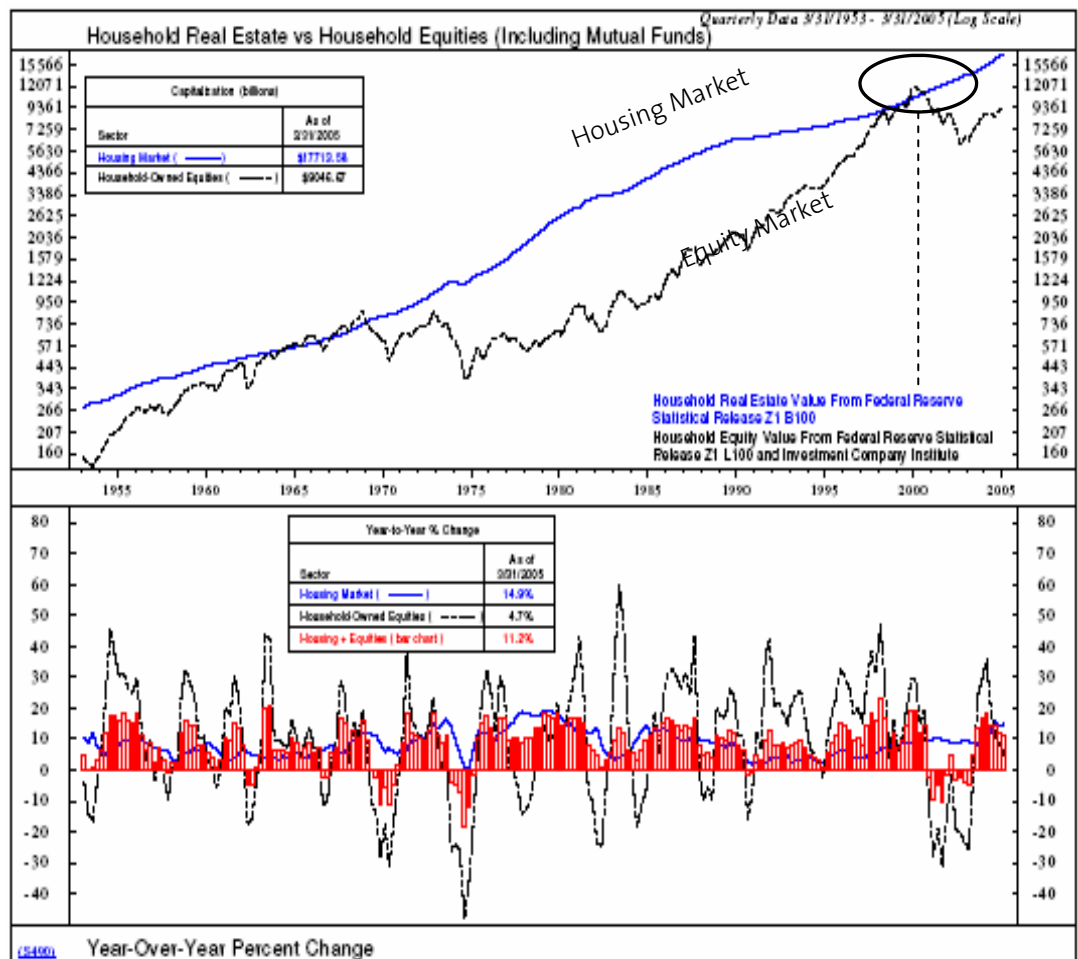
Mortgage Payment based on Median Home Price in Dec 2004 of \$680,000, 20% down and 30-year fixed loan at 5.7%. Median Income \$95,000. Combined marginal tax rate on \$45,000 taxable income 34% (25% Fed +9% Calif.) CPI=2.5%, Rent=\$2,500/mo.

Source: Bailard Research, HUD, U.S. Census Bureau, NAHB

Other Reasons for Housing Strength

- The housing boom is catching up to the income, economy and equity market growth of the mid to late 1990's, when home prices were relatively unchanged.
- Over time, home prices have tended to appreciate greater than stock prices.
- The capital gains tax cut on houses in 1997 increased the after-tax value of homes.
- The decline in the long-term unemployment rate has added value to homes as job loss risk has declined.

Aggregate Home Equity vs. Stock Wealth



Source: Ned Davis

How High is too High?

U.S. Real Estate is Cheap Compared to Some Foreign Markets

The U.S. housing market is more reasonably priced than many other foreign housing markets.

	<u>Price-to-Rent</u> <u>% above norm*</u>	<u>Price-to Income</u> <u>% above norm*</u>
U.S.	32%	23%
U.K.	60%	50%
France	46%	n/a
Australia	60%	33%
Spain	60%	68%

**All of ratios are above norm, but norms are not adjusted for historically low interest rates*

Source: NAR, The Economist, Bailard Research.

U.S Price per Square Foot is Low Compared to Other Major Cities.

<u>City</u>	<u>Condo/Apartment</u> <u>Price/sq. foot</u>
Tokyo	\$1,271
Hong Kong	\$1,220
London	\$1,101
Singapore	\$906
Manhattan	\$890
Sydney	\$839
Paris	\$700
San Francisco	\$620

Source: NAR, Corcoran Group

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“It ain’t over until it’s over”
-Yogi Berra

Bottom Line:

- A “Rational Boom” not a “Bubble”
- Some localized over-exuberance
- A timeout is likely
- Probably only a “Pause That Refreshes”
- Next recession will likely see some localized corrections of 15% to 20%

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