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### Dear Reader,

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## THANKS FOR WRITING IN

Thanks to those of you who have written in. Please keep those cards and letters coming – we welcome your feedback.

Several of you have asked about guest-writing features for upcoming newsletters. If you have expertise in an area that could be of interest to our readers, please email us at [info@pathfinderpartnersllc.com](mailto:info@pathfinderpartnersllc.com) with information about your proposed subject matter – we will be happy to consider it for a future edition.

## CHARTING THE COURSE

### Ten Calls for '11

By Mitch Siegler, Senior Managing Director



When we last tossed confetti in the air with a champagne glass in hand, we offered up "Ten Predictions for 2010." The year just ended brought a moderate (stimulus-induced) recovery that seems poised to continue into 2011. Once again, we find ourselves ignoring Mark Twain's sage advice (never predict anything, especially the future). Before we step out on a limb for 2011, let's see how we did with last year's predictions:

- 1. The fat lady hasn't yet sung on unemployment ("A")** – Last year, we said “We expect unemployment to remain at uncomfortably high levels in 2010.” This December, the national unemployment rate popped from 9.6% to 9.8%. More than 40% of those out of work have been unemployed more than six months. And, Fed Chairman Bernanke, on a recent *60 Minutes* interview, predicted that unemployment likely won't return to 6% before 2015. 'Nuf said.
- 2. Beware confusing positive GDP with a hunky-dory economy ("B+")** – Last January, most economists said the recession has ended and called for GDP growth in 2010. We concurred but cautioned that “positive GDP does not a healthy economy make.” While GDP did grow at a 2.9% annual clip in Q4, it's still a mixed bag with record-high unemployment and a truly anemic housing market.
- 3. Tough times ahead for FHA, Fannie Mae, Freddie Mac and FDIC ("B-")** - We foresaw danger for these government-sponsored entities (GSE's) and agencies. FHA remained active last year, accounting for the vast majority of loans to first-time homebuyers. The FDIC was busy, closing 157 banks in 2010. While the GSE's and the FDIC will have challenges for years, they managed to keep out of the headlines during 2010.
- 4. Another big foreclosure wave is coming ("A")** – Foreclosures in 2010 topped 1.2 million, up from 900,000 in 2009. And, the “robo-signing” scandal that broke in Q4 shut down the foreclosure machine for two months; otherwise, the total would have been even higher. Foreclosures in 2011 will top both 2010 and 2009 levels.
- 5. Dubai is just the warm-up act ("C")** – Last year, we said “If you thought Dubai World's recent \$60 billion quasi-default was scary, consider that China is Dubai on steroids.” Boy, we sure were early on this one, as China's property markets reached new heights and GDP grew at a blistering 10% pace in 2010. In December, Beijing announced a renewed focus on cooling inflation – if they get serious, look for China's growth to cool in 2011 and overheated equity and property markets to take a breather or correct.
- 6. 200+ banks to fail in 2010 and 600-800 to go down 2010-2012 ("B-")** – Our reach exceeded our grasp as 157 banks were seized in 2010, up from 142 in 2009. This is as much a reflection of bottlenecks in the FDIC as a healthier banking system. The number of banks on the FDIC's unpublished "problem list" rose by 56% from 552 on September



30, 2009 to 860 on September 30, 2010. We see enough zombie banks in our daily work to know that the pace of FDIC takeovers must increase. We're tweaking our 2010-2012 forecast to 500.

- 7. CMBS won't be back anytime soon ("B+")** – Last year, we said “Collateralized mortgage-backed securities (CMBS) loans...the bonds underlying commercial real estate transactions...will remain toxic for at least another year or two.” Not so fast. About \$10 billion in new CMBS loans were issued through November 2010, a nearly \$8 billion increase from 2009's pace. That said, 2010's volume was 95% below the \$207 billion in CMBS loans issued in 2007, the height of the credit crisis.
- 8. Commercial real estate market will "begin" to find bottom in late 2010 ("A-")** – Last year, we forecast low transaction volumes combined with “newfound reality for banks and the FDIC, which will begin offloading troubled assets in a more meaningful way [in 2010].” Well, it was a tale of two cities as trophy properties sold for peak prices (4 and 5-cap rates for top apartments and offices in New York, Washington, D.C. and San Francisco) while smaller properties and those in second-tier markets did not trade or sold for distressed prices. Low mortgage rates did prop up the market; we're looking for a continuation of this trend through mid-2011.
- 9. Office and retail will be a bloodbath ("B")** – In 2010, we thought heavy job losses in financial services, real estate and professional services, which had caused office space absorption to be negative for seven consecutive quarters, would lead to increasing vacancies and more retail bankruptcies and store closings. It was a mixed bag on this one in 2010 – tough for suburban office buildings and smaller projects but a feeding frenzy for trophy properties. Specialty retailers struggled as consumers paid down debt and increased their savings while demand remained strong for neighborhood (grocery/drug-anchored) retail centers.
- 10. Business bankruptcies will continue to skyrocket ("A")** – For the year ending September 30, 2009, business bankruptcy filings increased 52% from the same period in 2008 (from 38,651 to 58,721). Business bankruptcies through the nine months ending September 30, 2010 were 58,322 – practically reaching the full year 2009 level. Bankruptcy filings are a lagging indicator, so we'll likely see increased bankruptcies for several quarters, even after the economy turns back up.

Overall 2010 marks: A-

## **Ten Predictions for '11**

We've come a long ways since the dog days of spring, 2009. The stock market seems to have found its footing. Trophy commercial properties are selling for premium prices. Interest rates are at 50-year lows. Job losses aren't getting a whole lot worse and the employment situation has actually begun showing signs of stabilization. These are hopeful signs for the economy.

As we enter 2011, we have concerns about the investment climate. Asset prices have been increasing, not because of a solid economic foundation but because of government-induced

stimulus and inflationary monetary policies around the world. In this environment, we think it may be more important to focus on return of principal as on return on principal. Ten calls for 2011 (including a few that could surprise you):

**1. Unemployment rate will decline but will remain painfully high** – We recall Okun’s Law, after economist Arthur Okun and his 1962 research, which states that unemployment is 50% correlated to potential Gross Domestic Product (GDP) – for every 2% increase in GDP, unemployment decreases 1%. Since Q4 GDP is bumping along at about 2.9%, it’s hard to see the current 9.8% unemployment level falling much below 8.5% by the time the ball again descends on Times Square. We find ourselves agreeing with Fed Chairman Ben Bernanke, who predicted on a recent *60 Minutes* that the unemployment rate wouldn’t fall below 6% before 2015.

**2. Inflation and interest rates will remain low** – There’s plenty of slack in the economy so we’re looking for rates to remain unchanged until Q4, 2011. While the Fed believes it can ratchet up interest rates at the first hint of inflation, this may be easier said than done in the face of high unemployment and the approaching 2012 presidential elections. The good news is high unemployment gives the Fed cover to keep short-term rates low.



**3. Consumer credit will continue to decline** – We’re the minority view, but we think frugality is here to stay. Consumer credit shrank by \$12 billion in Q3, the fifth decline in six quarters. The expiration of the first-time homebuyer’s tax credit and dwindling tax refunds as the year unfolded played a part. The biggest factor, though, is declining credit card loans. Tighter scrutiny by card issuers combined with household deleveraging will continue through 2011 and beyond.

**4. The recent positive retail news won’t last** – A solid Christmas for retailers followed strong November retail sales, up 7.7% over prior year. Auto purchases jumped at a 27% annualized rate and households planning to buy a major appliance trended up as well. A *New York Times* article on December 23, 2010 said “The last-minute holiday surge is heralding the return of the American consumer, who is shedding the recession’s thrifty ways and rediscovering the pleasures of shopping.” Sure, there’s pent-up demand and consumers may be buoyed by the improvement since spring, 2009 in their stock and retirement portfolios. But, we fear that moves like this are unsustainable. Consumer spending is fueled primarily by wage and salary gains. Any signs of a housing double-dip, stagnant labor markets or a softening stock market could herald the return of thrift.

**5. Housing will roll over (again)** – The first-time homebuyer credit strengthened the market this spring by pulling forward demand from summer and fall. We’re seeing weakness in new housing starts, sales volumes and prices, pending sales and new mortgage applications. Mortgage rates are up nearly .65% in the past 90 days. The inventory backlog, at 6.3 million U.S. homes (11.6 months’ supply at current sales levels), dwarfs the six months common in a normal market. That’s before we mention the additional 6.5 million units in the “shadow” market (homes in default or in the foreclosure process), bringing the total inventory overhang to 23 months. Foreclosed properties are 25% to 50% of inventories and foreclosures will eclipse last year’s 1,200,000 and 2009’s level of

900,000. According to research from the Dallas Fed, complete mean-reversion of housing prices would mean a further 23% price reduction from current levels. Another 5-10% decline in 2011 seems baked in the cake.

6. **Mid to high-end housing prices will be hard hit** – It's tough for buyers to get jumbo (\$750,000+) loans. A leading residential broker in tony La Jolla (San Diego County), CA tells us there were just three sales of \$5 million+ homes in that community in 2010, with 26 current listings. High-end sellers haven't been slashing prices and buyers haven't been budging for a couple of years now. But, it only takes one to make a new "comp." Mark Hanson of Mark Hanson Advisors, who has forgotten more about residential housing than most of us will ever know, says the high-end Santa Clara County (Silicon Valley), CA market is a perfect example of an awful market, with sales plummeting since spring, listing prices falling 10% and for sale inventory skyrocketing.
7. **Mortgage interest tax deduction will be scaled back** – The Bowles-Simpson Commission proposed a laundry list of suggestions for reducing the budget deficit. Voter surveys indicate 60% favor a modification of the mortgage interest deduction, especially caps on the amount and exclusions for second homes.
8. **Dozens of municipalities will default on their bonds** – State and municipal governments' fiscal challenges will make headlines in 2011. The National League of Cities reported in a recent survey that 80% of its members will institute layoffs and 70% have cancelled or delayed capital spending projects. Prominent bank analyst Meredith Whitney predicted on *60 Minutes* in December that 50-100 U.S. cities will go bankrupt and several states could need federal bailouts in 2011. At least American workers aren't rioting in the streets like those in Athens, Dublin, Rome and Madrid.
9. **The Euro will fall** – We've been saying so since early 2010 when the Euro was \$1.45. Now, it's \$1.32 and seems destined to retest last year's \$1.19 low. Look for a decline in the next couple of quarters as investors conclude that sovereign debt from Ireland, Portugal and Greece (and maybe Spain and Italy) can't be financed without steep hikes in interest rates. A good year to plan that European vacation?
10. **The consensus may be wrong on the stock market** – Sentiment for stocks is wildly bullish, which makes the contrarian in us downright giddy. The December *Barron's* "Outlook 2011" issue had ten out of ten strategists calling for an up market this year, with the average forecast for a double-digit advance and a range for the S&P 500 of 1,250 to 1,450. That could be the eggnog talking but groupthink can be dangerous.



Volatility brings opportunity. The collapse of the VIX (volatility index) to 15.5 – a level last seen in July, 2007 – is a contrarian indicator extraordinaire. We wish you and yours a very happy and profitable new year. We'll report back in 12 months to let you know how we did.

*Mitch Siegler is Senior Managing Director of Pathfinder Partners, LLC. Prior to co-founding Pathfinder in 2006, Mitch founded and served as CEO of several companies and was a partner with a boutique investment banking and venture capital firm. He can be reached at [msiegler@pathfinderpartnersllc.com](mailto:msiegler@pathfinderpartnersllc.com).*

## SELECTED PATHFINDER CLOSED TRANSACTIONS

*Pathfinder Partners, LLC is the sponsor of the Pathfinder Opportunity funds, which acquire with institutional capital partners, distressed real estate properties and the underlying mortgages from financial institutions.*

### HAWTHORNE 44

*\$6,500,000 defaulted senior mortgage on new, 27-unit condo project in Portland, OR*

September, 2010

### HEWITT ST. LOFTS

*\$12,500,000 defaulted senior mortgage on new, 33-unit condo project in Los Angeles, CA*

September, 2010

### ISIS CONDOMINIUMS

*The acquisition of a new, 41-unit condominium project with ground floor retail in Orlando, FL*

August, 2010

### CRIMSON PARK

*\$26,500,000 defaulted senior mortgage on a 268-unit student housing property at the University of Oklahoma (Norman, OK)*

August, 2010

### VALENCIA HOMES

*The acquisition, from a commercial bank, of the Valencia subdivision, a 72-unit detached, residential project in Coachella (Riverside County), CA*

July, 2010

### LEUCADIA SHORES APTS.

*The acquisition of a 14-unit "value-add" apartment project in the beach community of Leucadia (San Diego County), CA*

July, 2010

### COLORADO PORTFOLIO

*The acquisition, from a commercial bank, of a portfolio of eight residential projects in Denver and Colorado Springs, Colorado*

December, 2009

### BLAIRWOOD CONDOMINIUMS

*The acquisition, from a commercial bank, of 19 new, class-A townhomes in Carmichael (Sacramento County), CA*

December, 2009

### PATHFINDER UNIVERSITY

*\$8,400,000 defaulted senior mortgage on:  
32,000 square foot mixed use (office/retail) project in San Diego, CA*

September, 2009

### GARDENS AT THYME SQUARE

*The acquisition, from a commercial bank, of 38 new, class-A townhomes in Cloverdale (Sonoma County), CA*

September, 2009

### PATHFINDER VICTORVILLE

*The acquisition, from a national bank, of 19 new, detached, foreclosed homes in Victorville (San Bernardino), CA*

August, 2009

### FONTANA PACIFIC HOMES

*\$9,300,000 defaulted senior mortgage on:  
35 new detached homes in Fontana, CA*

July, 2009

## FINDING YOUR PATH

### The Business Social Network

By Lorne Polger, Senior Managing Director



Facebook. MySpace. Twitter. Linked In/Linked In groups. Your college/graduate school alumni network. If you're not logged in, you may as well be like the Unabomber, in a shack in the woods. If you don't get it, you should. It's not just changing our social habits, it's starting to change our professional habits. And in 2011, we're just at the cusp.

As I close in on 50, I'll admit I haven't completely embraced the social media revolution; there are large parts of social networking I just don't get. For example, I'm happy I was able to reconnect with one of my college fraternity brothers. On the other hand, after reestablishing that connection, I don't sense the same level of importance he felt about the cup of coffee he had in Portland this morning. Good for him – I don't begrudge anyone a great cup of coffee. I've had a few myself. But, really – the broadcast element?

Flashback 25 years ago, when I started in business. Scene: 9:30am, in the office. Lights blinking on the phone. No computer on the desk. Intercom (remember those?) buzzes.

Heidi: "Lorne, your old fraternity brother, Steve on Line 3."

Lorne: "Thanks, Heidi." "Oh, hey Steve, how's it going, haven't talked to you in awhile."

Steve: "Going great, Lorne, just had a great cup of coffee here in Portland this morning."

Lorne: "Really, Steve, that's great. So, why are you calling?"

Steve: "No reason, just wanted to tell you about the coffee – it was really good."

Lorne: "Okay, Steve. Good to hear about it. I'm going to run; maybe we can catch up later."

#### 10:30am (one hour later):

Heidi: "Lorne, that guy Steve is calling you again on Line 5."

Lorne: "Steve, what's up?"

Steve: "Oh, hey Lorne, I really liked that photo that Mindy took the other day."

Lorne: "What photo was that Steve?"

Steve: "You know, the photo of Mindy and her yellow cat? You remember Mindy, from our European History class in 1981?"

Lorne: "Okay Steve, well thanks for calling again. I'm going get back to work now."



#### 11:30am (two hours later):

Heidi: "Lorne, I don't know what's going on, but that guy Steve is calling again, on 8."

Lorne: "Thanks Heidi. I've got to get rid of this guy." "Heh, Steve, are you a little bored?"

Steve: "No, not really. I mean, sometimes I get a little distracted, but not really bored. Anyway, I just called to let you know that I'm a fan of the latest John Grisham novel, and I hope you can be a fan, too."

Lorne: "Well Steve-O, I'm happy for you. Maybe I'll call you back after you get a life?"

You get my drift. Like most people, I find the minutiae that people write about kind of silly at times. And as a fan of both business and personal productivity, I can't think of a bigger time waster than having your browser open all day to gaze at regular updates of drivel on Facebook. Moreover, my experience with the various sub groups on Linked In has demonstrated similar ineffectiveness; a 20:1 ratio of pretenders to contenders. On the other hand, the various professional and social networks have created absolutely amazing tools for establishing and maintaining business relationships. Putting aside the cup of coffee in Portland, if used effectively, these may be the most influential and powerful tools we've seen in a generation.

Each of my two teenagers has over 700 friends on Facebook. Now, I know they really don't have that many true friends. In fact, terming some of their contacts "acquaintances" might even be a stretch. But, the reality is that there are now tools that allow them (and us) to regularly get in front of large audiences of prospective business partners in a way we could not have even dreamed of just five years ago.

Over the last year, I've started to change some of the ways I do business. When I meet a new professional acquaintance, I try to do three things within the first 24 hours of that initial contact. First, I add them to my Outlook contact database and include as much profile information as I can. Second, I add them to our internal company database. Third, I friend them on Facebook and link with them on Linked in. Am I a stalker? Hardly. Can you think of a better way to have a regular interaction with hundreds (even thousands) of people you do business with? Given the current reach of Pathfinder (we currently own or are looking at property in nine states), it's simply not possible to conduct business the way our father's generation did.

Today, I text as much as I call. I receive no calls on my home phone, except from immediate family members. Every business and social contact has my cell phone number. Many business associates I know in their 20's and early 30's don't have land lines at home. Pathfinder's e-newsletter (our own social media networking) now reaches thousands of professionals every couple of months for pennies. There is no way that would have happened ten years ago. I've started to adapt. Have you?



Is the new social media a substitute for human interaction? Not at all. You can't hug a computer. You can't judge body English from written words. You can't look into the eyes of the guy trying to buy your building to see if he's real or fake. You can't grab a cup of coffee or a meal on the Internet. I believe it's difficult to establish anything more than a superficial relationship if you can't press the flesh; there's no substitute for that. But, you can't grab a quick cup of coffee with thousands of people (although there are now enough Starbucks to allow you to try). Facebook now has about 600,000,000 users. That's close to one out of ten people in the world. And the company was only founded six years ago.

I estimate that at least 25% of all interactions have some business purpose. So, don't fear the new social media technology. Give it a try for your business. What's the worst that can happen? Reconnecting with your cousin from Toledo?

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## **ZEITGEIST - SIGN OF THE TIMES**

*A compendium of notable news articles relating to the economy, commercial lending and real estate which we've edited and commented upon.*

### **Economic Growth Beats Forecasts; U.S. Home Sales Rise at Faster Pace**

The U.S. economy grew slightly faster than the government's previous estimates during Q3 and forecasters are raising estimates for Q4 and for 2011. Optimism about the recovery has grown in the past two months, driven by reports showing stronger consumer spending, fewer job losses and improvements in housing.

The National Association of Realtors reported that U.S. existing home sales rose 5.6% in November from October, to a seasonally adjusted annual rate of 4.7 million units. The housing market remains extremely weak, with a huge supply of unsold homes and about one-third of existing homes sold being under financial distress (in foreclosure or short sales – with proceeds bringing in less than the amount of the bank loan).

### **Foreclosures: Signs of Improvement But Still a Long Way to Go**

The number of U.S. homeowners who owe more than their homes are worth declined marginally to 10.8 million in Q3. That bit of good news – combined with a decline in the overall loan delinquency rate (from 7.0% in Q2 to 6.9% in Q3, continuing a positive trend since the peak in Q4, 2009) and a bottoming of values for entry-level homes in many markets – may signal stabilization in the real estate market. The drop, however, was the result of more homes slipping into foreclosure rather than rising home prices or other positive economic news.

These “underwater” homes represented 22.5% of all homes with mortgages as of September 30, as compared with 23% on June 30, according to CoreLogic. Underwater borrowers are at higher risk of foreclosure, which depresses values and prevents start-up buyers from selling and purchasing homes in the more expensive “move-up” market. It's a vicious circle as fear of declining home prices leads more borrowers to default, furthering this self-fulfilling prophecy.

This is the third straight quarterly decline of mortgage loans either delinquent or in foreclosure. Unfortunately, renewed home price declines and a soft labor market led to a rebound of homes *entering* the foreclosure process to the highest level in a year – a jump from 1.11% in Q2 to 1.34% in Q3. That’s a big spike – 20% in just one quarter! And, of particular concern – most of the increase was for prime, fixed-rate loans.

Foreclosures this year are likely to top the 1.2 million level of 2010. That makes sense because many lenders halted foreclosures in November-December after learning that procedures for signing off on foreclosure documents might not be in compliance with the law. Continued high unemployment will pressure already struggling homeowners and upcoming interest-rate resets on adjustable rate mortgages will increase payments.

Longer-term, the outlook for foreclosure seems to be improving. Loans 30 days delinquent have declined 11% from early 2009, according to the Mortgage Bankers Association’s chief economist, Jay Brinkmann. There’s an inverse relationship between foreclosures and housing prices; further price declines are sure to spur increased foreclosures. Moody’s/Economy.com’s Mark Zandi is forecasting a 5% decline in housing prices during the first half of 2011. RealtyTrac’s Rick Shrager is calling for a 5% dip for 2011.

*[Editor’s Note: The figures underscore how fragile the housing market remains. As home prices fall, more borrowers will sink underwater. Another 5% decline in prices would leave an additional 2.4 million homeowners underwater, according to CoreLogic.]*

### **Better News for Banks**

The news for U.S. commercial banks is looking brighter with bank loan loss provisions, actual write-offs and non-current loan balances all showing improvement.

- **Bank Loan Loss Provisions at Lowest Level Since 2007** – Provisions for future loan losses in Q3 2010 totaled \$34.9 billion, the lowest quarterly amount since Q4 2007 and \$28 billion (45%) less than Q3 2009. Lower loan loss reserves were the single biggest driver of higher bank earnings, followed by interest income (because of large interest rate spreads – caused by record low bank borrowing rates).
- **Actual Bank Write-Offs Also Declining** – Similarly, net charge-offs (NCOs – write-offs for actual loan losses) were lower in Q3 than in both Q2 and Q3, 2009. Prior to the past two quarters of improvement, quarterly NCOs had increased year-over-year for 13 consecutive quarters.
- **Non-Current Bank Loan Balances Falling, Too** – The amount of loans and leases that were 90+ days past due or in non-accrual status fell for a second consecutive quarter, declining \$8.3 billion (2%) in Q3 following an \$18.9 billion (4.6%) decline in Q2. Before these two declines, the banking industry’s non-current loan balances had increased for 16 consecutive quarters.

*[Editor's Note: Declining 90-day delinquent loans signal improving health of the banking and financial system. This, when taken together with declining net charge-offs and an improving picture for loan loss reserves, suggests a banking system on the mend. We're not out of the woods – see below for information on the FDIC's "Problem List".]*

### **FDIC's Bank "Problem List" Grows 7% in Q3 2010, 56% Year-Over-Year**

The number of insured institutions on the FDIC's "Problem List" increased 7%, from 829 to 860 during Q3 and by 56% year-over-year. This is the largest number of "problem" institutions since March, 1993, when there were 928. Another 41 and 31 financial institutions failed during the third and fourth quarters, respectively, bringing the total bank failures to 157 for 2010.

### **492 Days – the Average Age of Loan in Foreclosure**

A new survey just released by LPS Analytics shows that the average time to conclude a foreclosure hit 492 days (16 months!) in October as overwhelmed loan servicers and a backlogged court system compound the problem of millions of challenged borrowers. Consider that there are 4.3 million home loans that are at least 90 days delinquent. Plus, another 2.7 million home loans that are delinquent but haven't yet hit the 90-day mark. That's seven million delinquent home loans, including 1.4 million which haven't made a payment for at least two years and – are you sitting down? – still aren't in foreclosure!



It's staggering to think that a borrower hasn't made a payment on their home loan in two years and the lender hasn't even initiated foreclosure. Loan servicing experts say the average carry cost of a home in foreclosure is 1.5% of unpaid principal balance per month. For a \$200,000 loan in foreclosure, that's \$48,000 in accumulated carry costs based on the above average age of a loan. This may explain why loan servicers are increasingly declining to make principal and interest advances on the basis that many loans can't be recovered.

*[Editor's Note: With backlogs and carrying costs like these, there's plenty of opportunity for lenders and servicers to restructure defaulted home loans, reduce payments and modify loan terms. We see more restructurings – they're in the lender's and servicer's interest. Also, we've heard a lot about the potential for lender lawsuits from buyers of bonds upset over poor underwriting. We won't be surprised to see shareholder derivative suits against bank officers and directors because of negligence in servicing their loan portfolio.]*

### **"Put-Backs" – a New Challenge for Banks in 2011**

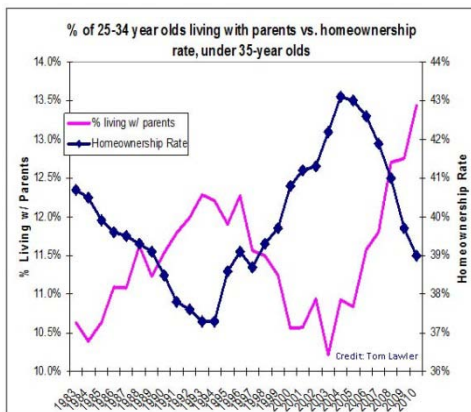
Despite healthy profits allowing many banks to repay TARP loans and dispose of troubled

assets, a new threat has emerged that could affect bank earnings in 2011-2012.

Banks face potential liability from the \$2 trillion in subprime, alt-A and option-adjustable rate mortgages they underwrote and sold to investors, mostly as mortgage-backed securities during the boom of 2005 to 2007. The losses on these mortgages will be huge before it's all said and done – an estimated \$700 billion on these and “non-agency” mortgage securities, according to New York mortgage broker Amherst Securities Group.

Investors – from government-sponsored enterprises like Fannie Mae and Freddie Mac – to private bond managers like PIMCO and BlackRock – are attempting to put back the mortgages to the banks that originated them. Their argument: originators violated representations and warranties in purchase contracts, misrepresenting the poor quality of mortgages in pools.

Buyers have had some early successes; Fannie and Freddie have put-back \$13 billion in defective mortgages in just the past few months with more on the way. Analysts estimate that Fannie and Freddie alone could account for more than \$30 billion in put-backs.



### Under 35: Living with Parents vs. Homeownership Rate

We found this graph from economist Tom Lawler pretty interesting. It compares the percent of 24-34 year olds living with mom and dad to the homeownership rate for their peers.

Note the inverse relationship, which suggests some pent up demand for housing units (maybe rental units?) when the employment picture improves.

### Ten U-turns in Consumer Spending

*Have Consumers Become More Frugal?* is a piece in the Federal Reserve Bank of New York's Q3 report on household debt and credit. In a word, yes. The Fed's analysis shows that consumer spending ballooned on borrowed money in the years leading up to the Great Recession. Now, not only has the borrowing stopped, but Americans are cutting back on purchases to pay off their debts; consumer spending fell by \$150 billion in 2009.

At the household level, the Consumer



Expenditure Survey shows the same pattern, with household spending peaking in 2006 at \$51,688. In 2008, the average household spent \$50,486, or \$1,200 less after adjusting for inflation. On many categories of goods and services, the average household *reversed the direction of its spending* in the 2006-08 time period compared with the 2000-06 time period. The ten biggest spending U-turns:

**1. Restaurants (from +8% to -6%)** – Average household spending swung from +8% during the 2000-2006 period to -6% between 2006-2008, adjusted for inflation. Americans are spending more on groceries and eating out less.

**2. Mortgage Interest (from +21% to -5%)** – Virtually all Americans have been hit by the housing bubble but 35 to 44-year-olds have been hardest hit. That's because these are peak home-buying years so this group spends the most on mortgage interest. And, when housing prices peaked, many had paid top dollar for homes. Now, many are losing their homes so spending on mortgage interest is falling.

**3. Stationery and Gift Wrap (from +15% to -11%)** – The quintessential discretionary purchase and an easy cut-back.

**4. Day Care (from +16% to -8%)** – Inversely related to unemployment. Since unemployment will likely remain high, don't expect a big turnaround anytime soon.

**5. Furniture (from +1% to -22%)** – Though houses were selling at a blistering pace in the early part of the decade, furniture sales were lackluster. Since the housing bubble burst in 2006, household spending on furniture has cratered.

**6. Household Textiles (from +24% to -23%)** – Towels, sheets, blankets and curtains – another category that rises with home sales and, well, you get the idea.

**7. Baby Clothing (from 0% to -9%)** – A double whammy as it's driven by births, which climbed to a record high of 4.3 million in 2007 and have fallen since.

**8. Drugs (+6% to -12%)** – Household spending on drugs should benefit from the heavy advertising by pharmaceutical companies, the growing number of pill poppers and the hard-line attitude of medical insurance companies. These factors have been overpowered by the recession and the 2006 Medicare Prescription Drug Plan.

**9. Admissions to Entertainment Events (from +1% to -5%)** – During the downturn, households continued to spend on high-definition TV's but cut back on other entertainment categories. One loser was this category, which includes movie theaters and theme parks.

**10. Charitable Contributions (from +34% to -13%)** – Donations to charities are plummeting, according to the *Chronicle of Philanthropy*. Average household charitable giving climbed strongly when Americans felt flush and fell just as fast as times turned

tough. *[Editor's Note: This one stings – let's all do our part.]*

### **The Decline of Risk-Taking**

Events like the General Motors bankruptcy and trillion dollar deficits have combined to make investors fearful about what new surprises tomorrow will bring.

In such an environment, it's no surprise that many have developed an aversion to risk and businesses and consumers are paying down debt. The most recent monthly University of Michigan consumer survey reports that a majority of Americans expect no increase in income next year – for the 23<sup>rd</sup> straight month! Confidence isn't likely to return until jobs come back. Companies are sitting on huge piles of cash but prefer to hoard it – or use it for stock buybacks, dividend increases or debt repayments rather than investment in new plant and equipment. Individual investors, too, are hoarding cash – mutual fund inflows, which were \$91 billion in 2007, are on track to come in below \$35 billion for 2010.

### **2014 Could be a Very Good Year**

We're not sure about the caliber of California Cabernets in 2014 but the economy should look much better. In December, Fed Chairman Ben Bernanke appeared on CBS' *60 Minutes* and said that the unemployment rate might not bottom until 2014. RealtyTrac predicts that the housing market might not bottom until – you guessed it – 2014.

### **Or, Maybe 2018 – if you Believe the Chamber of Commerce**

Good news for the under 14 set: Assuming the current rate of economic growth, employment should return to pre-recession highs for the college class of 2018.

This from Martin Regalia, chief economist at the U.S. Chamber of Commerce, who's been struggling to figure out why the past three economic recoveries have been significantly weaker than in the past. Following the '74-'75 recession, employment recovered to its pre-recession peak in nine months. The recovery after the double-dip recession that ended in 1982 took 12 months. But following the 1991 and 2001 recessions, the employment recovery took 24 and 39 months, respectively.

The recession officially ended in the summer of 2009, but we've shed 7.5 million jobs since the peak. Although the economy has recently been creating 100,000 to 150,000 jobs per month, that pace is not sufficient to turn the tide on unemployment, because about 1.5 million part-timers can't find full-time work and another 1 million enter the labor market every year. According to Regalia, "At the rate of 150,000 jobs per month, you are seven to eight years away from where you want to be."

Some blame it on the outsourcing of manufacturing jobs, an education system that hasn't kept up with the need for engineers and scientists or the banks not lending, so businesses can't invest and create new jobs. Per Regalia, it's because we feel poorer than we did in 2007, so we're reducing our spending, which dampens employment and growth.

The Great Recession erased \$10 trillion in wealth as stock portfolios shrank and home values declined. While we don't have to recover all that lost wealth for Americans to feel better, we do need to reverse the trend, especially in housing prices.

*[Editor's Note: Given delinquency and foreclosure trends, we could be a few years away from an ebullient housing market. And, government fiscal and tax policies can make us even more frugal. QE2 adds to the pain of lost-wealth by debasing the currency.]*

## **Homeowner Perks in Jeopardy?**

The recent report from the Bowles-Simpson Deficit Reduction Commission, headed by former White House Chief of Staff Erskine Bowles and former Senator Alan Simpson (R, WY) left no political or economic ox un-gored in its effort to reduce U.S. deficits. Among the proposals is a reduction on the mortgage-interest deduction, the largest government subsidy for housing.



Some housing analysts say the benefits of the mortgage-interest deduction are overblown and that the deduction primarily encourages wealthier Americans to take out larger mortgage loans. Other developed countries, including Canada and the U.K., have homeownership rates comparable to the U.S. without similar tax deductions.

Current law allows taxpayers to deduct mortgage interest up to \$1 million for primary and second homes and up to \$100,000 in additional home-equity borrowing. The Bowles-Simpson panel proposed capping the deduction at \$500,000 and eliminating the deduction for second homes. A recent *Wall Street Journal/NBC News* poll found that 60% of Americans agree with eliminating the deduction on second homes and mortgages over \$500,000.

Also under fire are government programs aimed at shoring up the housing and mortgage markets, notably the Federal Housing Administration's support for the mortgage market as well as subsidies from government-sponsored enterprises Fannie Mae and Freddie Mac, all of which have racked up massive losses during the past several years. Without this support, analysts say mortgage rates could be two to three percentage points higher.

## **Say Goodbye to the Flippers**

Certainly, few now expect to sit on a property for a couple years and then get rich off the equity. Real estate agents complain that even record-low mortgage rates – about 4.6% for a 30-year, fixed-rate loan – won't budge many potential buyers, given the tough outlook for price appreciation.

A few markets showed renewed life earlier this year, but mostly due to the first-time home

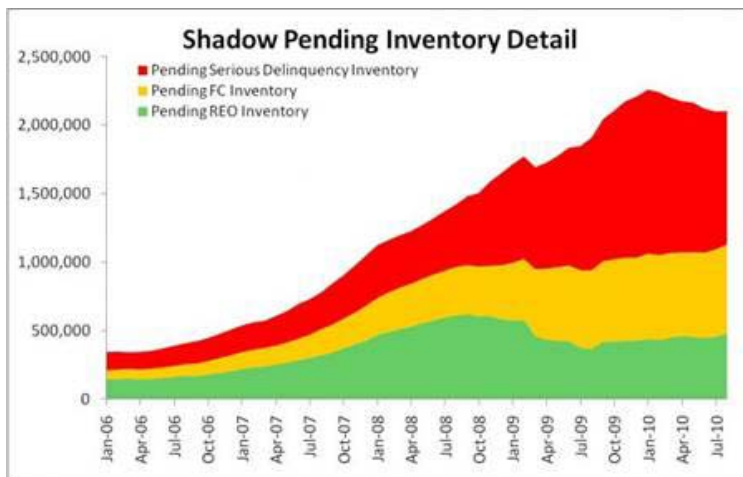
buyer tax credit, which expired June 30. First-time home buyers accounted for an estimated 50% of all home sales in 2010, up from 47% in 2009, according to the National Association of Realtors. (That’s a record since 1981, as far back as the data go.)

Home values in five major California markets, including L.A. and San Francisco, turned negative again in Q3 after climbing for five consecutive quarters, according to Zillow. Despite an average 3.6% year-over-year gain in single-family home prices nationally in Q2, prices fell in 70% of the 384 metro areas, and many markets experienced double-digit drops, Fiserv-Case Shiller said in its November Home Price Insights report. Fiserv-Case Shiller expects double-digit declines to continue through summer.

### **CoreLogic: REOs could depress home prices, accelerate market decline**

The “shadow inventory” of homes likely to be repossessed by lenders or already in their real estate owned (REO) inventory but not yet on the market reached 2.1 million units in August up from 1.9 million a year ago, according to the latest analysis by data aggregator CoreLogic.

Because home sales also slowed, the shadow inventory represented eight months of housing supply, up from five months a year ago, CoreLogic said.



Weak demand for housing is “significantly increasing the risk of further price declines in the housing market,” said CoreLogic Chief Economist Mark Fleming – a problem that’s exacerbated “by a significant and growing shadow inventory that is likely to persist for some time” because of the length of time loan servicers have been taking to liquidate properties.

Combine the 2.1 million “shadow inventory” with the 4.2 million homes on the market in August, and the total months’ supply of unsold homes was 23 months – about double the 11.6 months the National Association of Realtors estimated in September.

CoreLogic estimates that the “visible inventory” of 4.2 million homes, which NAR estimates were based on, represented 15 months of supply. A six- to seven-month supply of housing is a normal balance of supply and demand.

CoreLogic estimates shadow inventory by calculating the number of properties that are seriously delinquent (90 days or more) or in foreclosure that will, in all probability, end up

REO. CoreLogic also counts properties that are already in lenders' REO inventories, but not yet listed on a multiple listing service (MLS), as "shadow inventory."

Fleming said there's no escaping the conclusion that shadow inventory will weigh down price appreciation in some markets and put more downward pressure on others.

### **Mortgage Rates Rise, New Mortgage Applications Fall**

Applications for new mortgages ended the year at about the level they began it, after a torrid pace of new activity in the spring and summer – largely fueled by the first-time homebuyer tax credit. In parallel, rates for 30-year mortgages increased about 69 basis points – from a 40-year low of 4.17% in November to 4.86%.

*[Editor's Note: Mortgage rates remain at historic low levels – under 5%. When a renter pays more for rent than an owner pays for a mortgage payment and associated costs, it's a good time to buy a home. That's the case for entry-level homes in many markets, though it's not the case for mid and higher-priced homes almost everywhere.]*

### **Has the Bond Market Turned?**

It sure looks like it. The interest rate on five-year Treasury bonds has increased .74% over the past two months, from 1.17% on November 1, 2010 to 2.03% as of December 29, 2010. The 10-year yield has leaped from 2.66% to 3.35% in the same period. The 30-year is now paying 4.4%, nearly 100 basis points above its rate just a few months ago.

### **Economic Snapshot – Q4, 2010**

In October, we heard economist Sam Chandan, Global Chief Economist of Real Capital Analytics and Professor at the University of Pennsylvania's Wharton School, speak at the Trigild conference, which brings together hundreds of bank special assets experts, special servicers and fund managers to ponder the state of the world for distressed commercial real estate loans and properties. Sam is one of the more engaging speakers out there, notwithstanding challenging subject material. His hour-long remarks, in ten bullet points:

- Real estate values: a dichotomy – There's a feeding frenzy for trophy properties while second-tier properties and those in tertiary markets go wanting.
- We've recently been witnessing a decoupling of pricing from fundamentals which resembles the overheated conditions in 2006-2007; Are we planting seeds for a new real estate bubble?
- There are considerable risks of interest rate shocks as we head into 2011.
- There remains a considerable supply of unresolved distress; a large pool of distressed assets has built up in banking system, which remains vulnerable to external shocks.
- Many foreclosed homes have been sold to speculators at roughly 50% discounts to peak prices. After fixing them up, these buyers resold the homes for prices about

50% higher than their costs (though still representing discounts of about 25% from peak prices). Many retail buyers received FHA loans with down payments of just 3%. So, these buyers have very little skin in the game. If the employment situation worsens, interest rates spike or values decline meaningfully, we could experience another wave of distress from these latest re-sales.

- Failed banks are typically taken over by healthier institutions under loss sharing arrangements with the FDIC. So, many acquiring banks have no incentive to sell – and every incentive to hold for several years or to wait for a better day. In fact, many have an incentive to hold the properties and milk for asset management fees.
- Banks have had a dozen quarters to write-downs distressed assets, which has enabled the healthier institutions to mark down the value of their troubled loans to approximate real collateral values in today’s market
- Today, about 11% of CMBS loans are in special servicing. Loans in special servicing are likely to remain at high levels because of the large number of current loans that won’t qualify for refinancing. About 70% of CMBS modifications to date have been pure loan extensions (what banks call “amend and extend” and what pundits dub “amend and pretend”).

*[Editor’s Note: This suggests that the housing market is a long way from returning to normal and could be a signal that a double-dip in the housing market may be imminent. And, the foreclosure moratorium during November-December is not yet in the data and may cause fourth-quarter numbers to look better only because the robo-signing scandal caused banks to kick the can on foreclosures until the first quarter of 2011. The spring selling season could tell the tale.]*

## **TRAILBLAZING: HAWTHORNE 44, PORTLAND, OREGON**

### **Capitalizing on an up-and-coming neighborhood in a solid market**

In November, 2009, Hawthorne Lofts, a newly built, 27-unit, live/work condominium project in Portland’s Hawthorne district, received its certificate of occupancy from the city. It was too little, too late for the project’s California-based developer, which had already fallen behind on their construction loan payments. Hawthorne, planned in 2006, during the height of the housing bubble, was conceived as for-sale condo project with price points in the \$300,000-\$400,000 range. The project’s location within Portland’s gentrifying Hawthorne district, spacious units, and attractive floor plans appealed to both the developer and the lender, an Oregon community bank.

As the housing market unraveled, the developer couldn’t sell condos and defaulted on the loan. The lender decided to sell the non-performing loan.

*Hawthorne Lofts, Portland, OR*



*Street View*



*Unit Interior*

On September 30, 2010, Pathfinder acquired the loan, secured by first deed of trust, from the lender, meeting their objectives for a quick (quarter-end) and certain closing. In October, we negotiated a deed in lieu of foreclosure with the borrower. We immediately hired a leading, Portland property management firm and have since brought the occupancy rate to 90%. Deferred maintenance has now been concluded and new signage and landscaping features are being installed at the property. During the past several months, Hawthorne Lofts has been transformed from a defaulted loan on a floundering condominium project to a healthy rental community in an up-and-coming neighborhood.

## **NOTABLES AND QUOTABLES**

“The last-minute holiday surge is heralding the return of the American consumer, who is shedding the recession’s thrifty ways and rediscovering the pleasures of shopping. The malls are jammed, parking lots snarled and sales expected to stay strong in the few remaining days through Christmas.”

- *New York Times* article, December 23, 2010

“When the experts agree, something else is going to happen.”

- Bob Farrell’s Rule #9 (Farrell was former Chief Global Market Strategist for Merrill Lynch & Co.)

“My feeling is this: Your recession is going to last. And it’s going to last, and it’s going to last, because essentially the trust has broken down.”

- Hernando de Soto, Peruvian economist and author of 2000 book “The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else”

“The Fed will have to execute a near-perfect balancing act to fight inflation, but not so much that it stifles the recovery by raising interest rates too high and too fast.”

- Marcus & Millichap’s 2011 Investment Outlook

“Anyone who tells you the housing problem is ‘bottoming’ either has an agenda or simply does not pay attention to the data. I really want to see housing bottom and then turn around and the home builders come back; the nation desperately needs the jobs. But my job is to be realistic. When we see 3-4 months of non-stimulus-induced housing sales growth, then we can start talking about bottoms.”

- John Mauldin, Publisher, Investor’s Insight

“It’s not the hurricane hitting the shore, it’s just a long and persistent rain, and that dampens the spirit all the way through.”

- CoreLogic chief economist Mark Fleming on home foreclosures

*As we turn the page on 2010 and embark on the second decade of the 21<sup>st</sup> century, we thought “change” might be an appropriate theme. We hope you enjoy these pearls of wisdom.*



“People only accept change when faced with necessity, and only recognize necessity when a crisis is upon them.”

- Jean Monnet

“Failure is not fatal, but failure to change might be.”

- John Wooden

“There’s nothing wrong with change, if it’s in the right direction.”

- Winston Churchill

“We must always change, renew, rejuvenate ourselves; otherwise we harden.”

- Johann Wolfgang Von Goethe

“We must be the change we wish to see in the world.”

- Mahatma Gandhi

“Nothing endures but change.”

- Heraclitus (Greek philosopher, 535-475 BCE)

“Only the wisest and stupidest men never change.”

- Confucious

## **Important Disclosures**

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