

May 2011 Alvine Newsletter

The US real estate double dip presents a buying opportunity.

Key Issues

US real estate is now falling. A backlog of repossessions has been difficult to absorb with mortgage availability still sparse. However, economic growth should limit future losses.

Key Recommendation

Investors seeking protection from future inflation should now consider re-engaging in the US real estate market. In particular, distressed mortgage bond funds can deliver real running yield as well as the upside of capital appreciation.

Jonathan Ruffer, writing on the prospects for inflation, described ‘an airless valley from which there is no escape.’ I do not presume to cover old ground here, but merely to refer you to Alvine’s September newsletter. With smart investors like Ruffer backing this story, we are in exulted company. Even if you are a little more sanguine, it should be equally clear that a great deal of money has been made in other inflation-busting investments. Whether it is the ability for companies to pass on price increases and hence flatter their earnings, a bullish call for stocks or the out and out appeal of commodities – let alone gold – many market players have profited from a fear of inflation.

However, with the exception of a few prime residential hotspots in city centres such as Manhattan, the general property market in the US has languished. This is quite unlike previous cycles when stocks and real estate have tended to move back in favour in tandem.



Case shiller Index, *Source: Bloomberg*

Double dip - now it's official

US real estate prices bottomed pretty much with the stock market in Q1 2009, down somewhat 35% from the bubble highs of 2006. Fuelled by record low interest rates and a plethora of government initiatives, they recovered modestly over the following 12 months. However, the rally has proven to be short lived as the latest figures now testify.

The damage was really set by a continued supply of bank-owned repossessions. As Clear Capital explained, **“the latest data through April shows a continued increase in the proportion of distressed sales that are taking hold in markets nationwide”** (*Source: clearcapital.com*). Various futile attempts to delay or frustrate the foreclosure process, while they may have been well intentioned, have tended to give a sense of an endless flow of properties hitting the market. As Rick Sharga of RealtyTrac explained, **“part of it is exacerbated by robo signing** [speaking of the paperwork scandal at major banks discovered last year]. We really believe that a big part of it is simply market saturation.

If you are a lender sitting on tens of thousands of properties you already can't sell, why on earth would you be motivated to accelerate proceedings on another 3.7million homes?" (Source: *CNBC.com*, 12/5/11).

Mortgage availability remains tight, together with weak overall confidence in the market. Previous black spots such as Las Vegas and Florida have now been joined by whole swathes of the mid-West, where poor job prospects are the main problem.

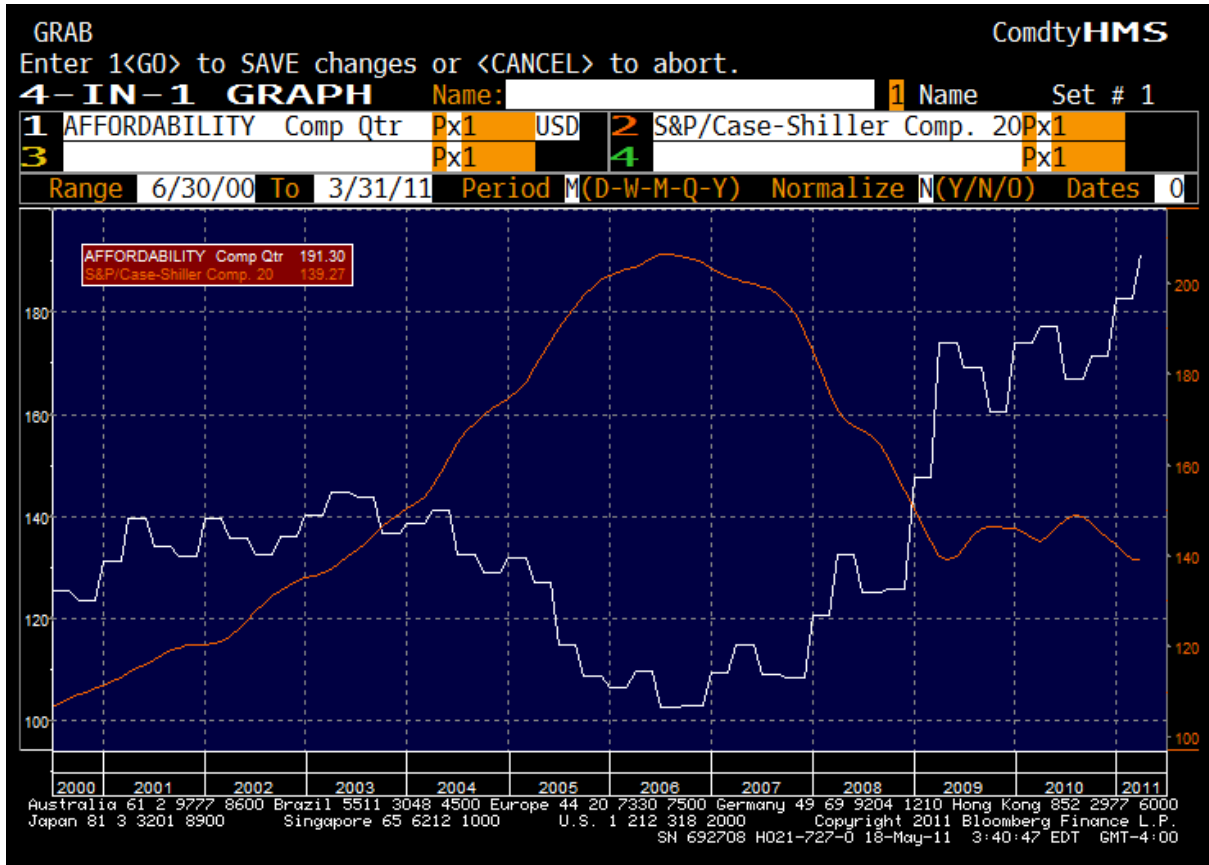
The magic wand has gone – government exhaustion

The Federal Reserve was the first to try to come to the rescue of the housing market by cutting rates close to zero, and holding them ever since. The Federal Government bailed out Fanny Mae and Freddie Mack, and now these Fannie alone originated in 2010 nearly 40% of all single family and 35% of multifamily mortgages (source Fannie Mae mission statement April 2011.) **Total funds support to the mortgage market throughout 09/10 was a staggering \$1.5trn.**

Next came generous tax credits to buy a new home. Finally, attempts to thwart the foreclosure process.

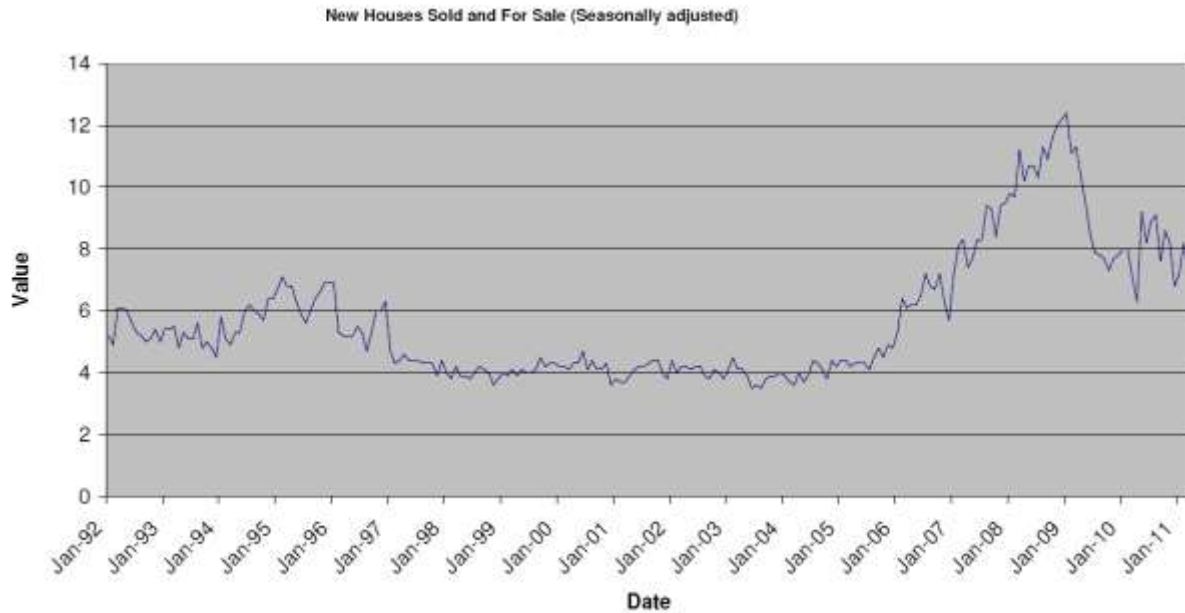
Interest rates can – and probably will – stay low. But other efforts are increasingly being seen as futile, as Washington begins to grapple with its own financial limits. There is likely to be limited future assistance from government quarters.

Valuations - historically cheap



Source: Bloomberg

Markets are volatile, and trying to predict tops and bottoms is a tough call. As Keynes put it, “markets can remain irrational far longer than you or I can remain solvent” (*Source: maynardkeynes.org*). But it should be a comfort to know you are buying something that represents value, at least historically.



Source US census Bureau

Sales gradually reverting to the mean

It's the economy, stupid

One of the problems with the past bull market, not least concepts such as 'ninja' loans of no income and no assets, was that the overall health of the economy was seen at best a peripheral issue, and at worst of little consequence for real estate prices. The bubble could simply inflate forever.

So, when job creation stalled out and with it real incomes, the market was slow to realise how devastating this would be for the ability to finance – and ultimately re-pay – mortgage loans.

While jeremiahs exist, positive job creation has resumed and that will bring higher incomes. With global economies on a firm footing, there are bright prospects for the US economy to press forward. This will be the key to the prospects for the property market.

US housing statistics – some detail

The picture on actual housing sales is not as unrelenting as might be believed, at least that's what Don Brownstein, CEO of Structured Portfolio Management, thinks.

"I am not suggesting that we are on the verge of having a major housing recovery. The housing market has actually sort of bifurcated into the distressed and normal sales segments and what's happened is that the price levels in the normal market actually recovered a little bit in the last couple of months" (Source: *cnbc.com*, 16/5/11).

Brownstein's fund was one of the top performing hedge funds in 2010, and what he seems to be explaining is that **foreclosures are the problem**. While that may not exactly surprise too many people, it emphasises the point that once the foreclosures have worked their way through the system, the market may return to health quite quickly.

What are the alternatives?

Even if you are a deflationist, it is worth understanding how far other asset markets have moved since the nadir of the recession in Q1 2009. The S&P 500 has more than doubled, while crude oil tripled from its low near \$30 a barrel and I don't even need to mention gold for investors to understand my point.

There is no perfect correlation between asset classes. Stocks and bonds can sometimes go up and down together, and at other times move in opposite directions. But, if you have bought large quantities of commodities because you believe in inflation, it is hard to maintain a resolutely bearish view on US real estate. Demographics and a continued zero interest rate policy are at least two reasons.

Conclusion—REITs/residential and specialist funds

Positive demographics, and recovering economy and decent valuations all lead to a bullish conclusion for US real estate. Best areas to focus on are prime residential in leading US cities such as **Miami/New York and Los Angeles that are going to benefit the most from the arrival of foreign money. (As in London an increasingly important investor base.)**

Some REITs that might be worth looking at include the iShares FTSE NAREIT Residential Capped Index fund, Vanguard REIT ETF and the PowerShares Active US Real Estate fund. These are all large, well established funds with reasonable fees. We are less keen on office where we see longer term shifts in corporate lifestyles. Do you really need to run a business with so much office infrastructure in the 21st century?

Finally there is a small group of smart managers that have grown up out of the debris of the mortgage debacle. These savvy players are feasting on an industry with literally billions of mispriced securities. Only a complete blowout would negate the opportunities, with even a static market yielding rich picking. We've met with some over the last couple of months and one of them, Rretro might be one to look into. If you want to find out more about opportunities in the US real estate market, please feel free to contact us.

Model Portfolio

April was an acceptable month, with our picks delivering an overall return of 0.45%. At the time of this newsletter going to press we note another market scare has apparently taken grip. On this occasion the egregious rally in silver and other commodities seems the culprit.

We will return to the subject of commodities in our June newsletter, and it is worth reporting that as part of our 2011 market forecasts Alvine Capital was broadly neutral on this asset class fearing bouts of extreme speculative activity.

For our overall bullish equity view we remain unconcerned. The basics of recovering growth, ultra easy US monetary policy (which of course covers the world's largest economy), together with the longer term growth of emerging economies are all still in place. Profitable investing should be achieved by taking broad based trends, and then following them.

If risks to our central premises occur, they are in the crowding out of cheaper alternatives, and here we are encouraged by the major rally in government bonds since year end.

So we will make no changes in our TAA for this month.

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