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MEMORANDUM

Date: March 1, 2006

To: FRS & FRS Clients

From: Jim Rihn

Re: Market Information

A Confused Real Estate Market

Although it is normally an admirable characteristic to be an eternal optimist, there are times where taking a "realist" position or approach is more warranted. Like many of us, Fidelity Residential Solutions, Inc. (FRS) has heard the frequent and persistent soothsayers lauding the real estate bubble-bursting scenario that is "looming over the horizon." While it is desirable to discount this prediction, unfortunately, based on recent research and analysis, a pragmatic outlook towards the real estate market may be warranted.

Based on research and analysis, the housing market has recently begun to show the first signs of noteworthy slowing from peak levels seen during the last several years and particularly the most recent summer months. The following aspects of the real estate market were considered and played a role in the development of this conclusion:

1. Inventory levels;
2. Pricing trends;
3. Mortgage rates and product offerings;
4. Yield curves; and
5. Foreclosure rates.

Each of these important real estate indicators has been researched and an overview provided below.

Inventory Levels

Generally speaking, inventory levels have begun to rise throughout the country. This could be a temporary "hesitation" in purchasing activity, but it can also lead to longer-term consequences. The hesitation occurs as a result of buyers hearing of a looming real estate "bubble," then displaying reluctance in making a purchasing decision to avoid the risk of buying at the "peak" of real estate values. Simultaneously, sellers, as a result of past demand, frequently maintain expectations exceeding market value. And to further complicate matters, another phenomenon that can occur in a softening market is sellers rushing to place their homes on the market prior to the (or a) bubble bursting.

Irrespective of the reason for rising inventory, where we had a "seller's" market in the spring of 2005 and a "balanced" market during the summer 2005, we experienced a "buyer's" market in the fall on a broad scale. Should this trend continue, "For Sale" and "Open House" signs can be expected to be at all time highs in the spring of 2006. Naturally, some areas will be affected more than others.

The result? In an environment of escalating inventory, buyers have the luxury of separating those who *want* to sell their home from those that *must* sell.

Pricing Trends

Pricing plays a key role in both the actual condition of the housing market and identifying the market's condition.

Pricing has been strongly affected by real estate speculation in the past few years and played a major role in driving home price appreciation. This speculation has artificially driven up demand, which has caused frequent pricing spikes. Relying on history as an indicator, speculative buying that drives up prices is not

sustainable long-term. As with the mentality displayed prior to the most recent stock market bubble, the belief that prices will not subside can be a major downfall to homeowners in general, but specifically to those that have purchased homes at the end of a cycle of substantial appreciation. Therefore, a correction in real estate prices will likely take place if and when speculation is removed from the market.

The market is already seeing double-digit price declines on high-end homes over the past several months in numerous markets. Price declines of 10%-25% could become the norm in late spring 2006 in many states – particularly those states that have seen excessive appreciation over the last several years.

Mortgage Rates and Product Offerings

Fixed interest rates for conforming 30-year mortgages has been on an increasing trend since August of 2005, and according to a recent announcement by Freddie Mac, rose to an average of 6.24% on February 9th of this year. Comparatively, the average was 5.57% a year ago.

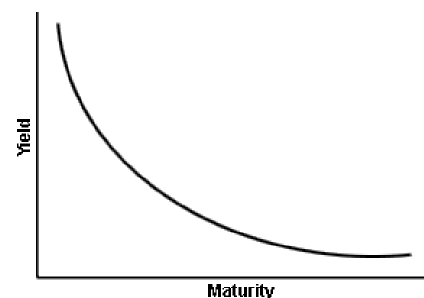
In times of increasing interest rates or ascending home prices, people historically turn to loans with creative terms to purchase properties. Adjustable rate or "negative equity" mortgages can become the norm as opposed to the exception in the marketplace. For example, in 2002, in Orange County, California, three in ten buyers used adjustable rate mortgages to purchase a home. In 2005 it was three out of four. Worse yet, many of these have interest only or negative amortization provisions. Unfortunately, as rates rise, many people with ARM's will experience payment shock. For example, a $500,000 negative amortization loan can grow to a principal balance of $550,000 in three short years. If rates increase by approximately 1.5%, a payment of $1,608 today can jump to $3,752. A 133.3% increase!

Another tactic commonly followed in environments of increasing interest rates or home prices is borrowers putting zero money down -- which obviously leads to zero-equity positions. With no equity, the option of refinancing is non-existent. If somehow the opportunity did arise to refinance at a lower rate, the property would most likely not "appraise," so these borrowers without equity would be required to generate out-of-pocket cash. For those without the cash reserves, alternatives are limited and consequently, may lead to loan defaults (e.g., increased number of REO's).

In the end, individual's futures are often closely tied to continued appreciation in their home values. One mishap, resulting in the inability to refinance or sell the property, can lead to the homeowner losing everything.

Yield Curves

The yield curve is a tool economists use to determine the overall movement of interest rates (commonly referred to as "yields" in Wall Street lingo). Put simply, plot yields for various maturities of U.S. Treasury bills and bonds on a graph and you've got a (yield) curve. In an interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments with the same credit quality, you have an "inverted" yield curve.[1] This type of yield curve is relatively rare, but should NEVER be ignored. It is considered to be an indication of a possible economic recession or at the very least, a "pause" in the market (depending on the severity).



For the past several months, the housing market has had the potential for an inverted yield curve as a result of short term yields "teasing" those of longer terms. This has resulted from the Federal Reserve raising rates to curtail inflation simultaneous to the bond market lowering yields in anticipation of slower future economic growth.

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1 Yield Curve and definition obtained from Investopedia. More information available at www.investopedia.com.

The consequences of the inverted yield curve leads to enhanced scrutiny by financial institutions prior to extending new loans. These institutions can then set restrictions on capital borrowing as the spread shrinks between shorter and longer term maturities. This can potentially have a significant (negative) impact on the creative financing market.

Foreclosure Rates

Foreclosure monitor RealtyTrac®[2], a leading on-line marketplace for foreclosure properties, said the number of foreclosures nationwide was up 24.5% from the first quarter to the fourth quarter of 2005.

RealtyTrac®'s report included properties in all three phases of foreclosure:

- Pre-foreclosures: Notice of Default (NOD) and Lis Pendens (LIS);
- Foreclosures: Notice of Trustee Sale and Notice of Foreclosure Sale (NTS and NFS); and
- Real estate owned (or "REO") properties: those that have been re-purchased by a bank.

"Overall, U.S. foreclosure numbers climbed steadily over the course of the year, with more new foreclosures reported in every quarter," said James J. Saccacio, chief executive officer of RealtyTrac®. "This trend appears to be moving the real estate foreclosure market back to its historic levels."

RealtyTrac® Report Highlights

- Florida documented the nation's highest foreclosure rate and accounted for more than 14% of the nation's new foreclosures in 2005. The state reported 121,843 properties entering some stage of foreclosure -- 1.67% of the state's households;
- New foreclosures in Colorado decreased 4% from the first quarter to the fourth quarter, but the state's annual foreclosure rate still ranked second highest nationwide. A total of 29,630 Colorado properties entered some stage of foreclosure in 2005 -- 1.62% of the state's households;
- 1.5% of Utah households entered some stage of foreclosure in 2005, the nation's third highest annual foreclosure rate. The state reported 11,536 properties entering some stage of foreclosure during the year, but new foreclosures dropped 27% from the first quarter to the fourth quarter;
- New foreclosures in Texas increased 54% from the first quarter to the fourth quarter, and the state documented the nation's fourth highest annual foreclosure rate. A total of 115,643 Texas properties entered some stage of foreclosure in 2005 -- 1.44% of the state's households and more than 13% of the nation's new foreclosures in 2005;
- Other states with foreclosure rates ranking among the 10 highest nationwide were Georgia, Arizona, Indiana, New Jersey, Ohio and Tennessee. All of these states documented annual foreclosure rates of at least 1% of total households and reported new foreclosures increasing from the first quarter to the fourth; and
- Although their foreclosure rates ranked below the nation's 10 highest, California, Illinois, New York and Michigan were among the 10 states reporting the most new foreclosures in 2005. California reported 61,563 properties entering some stage of foreclosure, and new foreclosures increased 16% from the first quarter to the fourth.

"Over the past few years, we've seen historically low mortgage rates, consistently escalating home prices and steady, strong employment," Saccacio said. "This has translated into relatively low levels of foreclosure properties -- particularly bank-owned properties. With interest rates rising and an apparent slowing of property valuations in most markets, we'll be watching closely to see if there's a material effect on the number of foreclosures in 2006." However, Saccacio also noted that the number of 2005 foreclosures needed to be kept in context. "Even with almost 850,000 properties entering some stage of foreclosure across the country over the course of the year, this represents less than 1% of all U.S. households. And the increase in U.S. foreclosures from the third to the forth quarter was just below 5%."

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[2] More information on RealtyTrac® available at: www.realtytrac.com.

Closing Thoughts

As you can conclude from the information above, the current status of the real estate market appears to be in a less-than-ideal state. However, as was noted by James Saccacio, foreclosures make-up less than 1% of national homeownership. Further, with the economic and yield indicators displaying fairly significant pressure on the market, it is unlikely interest rates will rise much further in the near term. Should they remain below the 7% threshold, history has displayed a favorable real estate marketplace. Consequently, our view is so long as there are no substantive and/or unexpected economic events, and of course, no "panic" as a result of continued press on "the bursting of the real estate bubble," the U.S. real estate market may experience some areas of softening, but very little (if any) wide-range devastation.

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This article contains statements related to future events and expectations and as such, constitutes forward-looking statements. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors.

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