

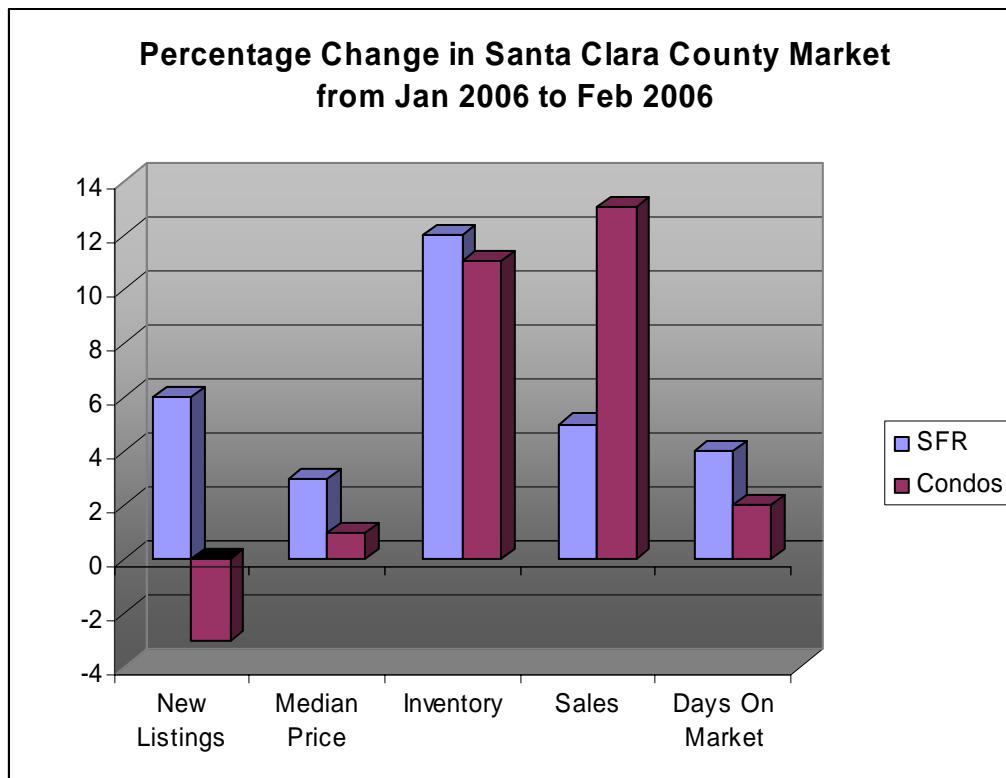
Santa Clara County Real Estate Market Report For March, 2006

Market Performance

The last 3-4 years have been a period of dramatic appreciation for residential real estate in Santa Clara County. From February 2005 to February 2006, resale single family home prices hit a record \$765,000 at a 14% annual appreciation rate. At the same time, condo median prices have increased 22% to \$515,000.

While prices have continued to increase, market activity has slowed down from last year's hectic pace. In 2005, the average days on market was 29 for single family residences and just 21 for condos/townhouses, indicative of the hot seller's market conditions.

In February 2006, that number was up to 46 for condo/townhouses, and 49 for single family residences. Sales volume has decreased overall 14% from February 2005. From January 2006 to February 2006, the market shows a increase in inventory, although that rate is outpaced by the rate of increase of condo/townhome sales.



Overall, the market continues to be strong, particularly for condos/townhouses. Moving into the much anticipated spring season, the market is continuing to perform, even as long term interest rates have been stable.

Affordability

There is some evidence that the boom trend may be slowing. To qualify for mortgage payments, the rate of borrowers in San Jose using interest-only loans has risen from 1% in

Santa Clara County Real Estate

Market Report For March, 2006

2001 to 55% in 2004¹ and even higher in 2005. Some experts cite rental rates, population and job growth rates, median family incomes, and interest rates as key statistical drivers for residential property valuation. Based on these metrics, the local market is overpriced and is poised for a correction.

By any measure, affordability of a median-priced home for median-sized income families in Santa Clara County has never been worse. Rental rates are very low relative to mortgage costs. Short term interest rates have been steadily increasing. Buyers must invest an ever-growing percentage of their income to afford to buy. In California, almost 40% of all buyers spend more than 45% of their income on housing expense. In the Bay Area, that percentage may be even greater.

Affordability issues have been slowing down the market. In Santa Clara County, the number of homes sold from February 2205 to February 2006 declined by 14%.

Economic Trends Foreshadow Rate Increases

During the recent boom, investors and low interest rates have fueled market growth considerably. Today, many economists agree that there is at least a 50% chance that mortgage rates will rise at least 1-2 percentage points in the next 6 months. This will have a dampening effect on the market, and put substantial pressure to reduce prices.

Threatened by inflation driven by growing energy prices, increasing budget deficits, and rising wholesale prices, the upward pressure for long-term interest rates will likely increase. Some economists believe that while rising, today's rates have been kept artificially low in order to foster economic recovery, making adjustments and corrections inevitable.

How Higher Interest Rates Will Impact Our Market

Consider a \$3,000/month mortgage payment (nominally affordable to a family with a \$100k or higher gross annual income) at today's 5.75% interest rate, will pay for a \$628,000 loan amount. If mortgage rates rise to 8%², that same monthly mortgage payment pays for only a \$450,000 loan amount. In short, the increasing cost of money has a very significant depressive effect on the market. Combined with high prices, many buyers relying upon interest-only loans as a primary or secondary method of financing will not be able to afford to buy property in this area.

Speculators Are Thinking Twice

Nine months ago, the *San Jose Mercury News* blared a front-page headline as part of a series: "*Unreal Estate: How Will It End? Sky-high prices fuel valley economy, but the boom can't go on forever*". The article stated that the South Bay Area has the dubious distinction of being the 4th most overpriced area in the entire United States, a prime candidate for "the bursting bubble". This message has been propagated loudly and frequently through the media. The impact has been felt in the investment sector, where "flippers" seem more cautious and less prevalent a market factor than earlier this year.

¹ Source: LoanPerformance, published in October 2, 2005 edition of the *San Jose Mercury News*

² Interest rates for most 2nd mortgages are currently at 9% or higher and rising

Santa Clara County Real Estate Market Report For March, 2006

Timing Good For Sellers

Many independent, respected investment experts believe that this is a great time to sell (the later part of the bubble is always the best time, after you've benefited from the appreciation upswing), and advise keeping a cash position for 1-3 years in anticipation of more favorable market conditions. The rationale is that many homeowners, unable to cope with high payments for variable rate loans, will be looking to sell their properties if future interest rates and/or equity gains are less than favorable. Last month, sellers in Santa Clara County received on average 99.98% of the asking price. Combined with record sales prices, we are seeing that sellers continue to fare well in the market today.

Potential Key Market Driver: Rate Hikes Motivate Fence-Sitters

Last April, we saw mortgage rates rise suddenly by over 1 percentage point. This seemed to really motivate buyers and we experienced a hyper market, with many instances of multiple offers considerably over list price, at terms very unfavorable for buyers (i.e., non-contingent, As-Is offers). The fear of rising rates had apparently served as a powerful impetus for those buyers who had been "sitting on the fence". Interest rates then subsided a bit, and are now on the way back up with 4 consecutive weeks of rate increases. Could we once again experience the market boost from buyers who are eager to take advantage of rates which are virtually certain to increase?

Selling Market Assessment

According to John Karevoll, Analyst at DataQuick Information Systems, "Demand is still very strong out there. The people who want to buy homes still outnumber the people who want to sell." The key question is, for how long? To the extent that sellers become aware that a window of opportunity may be vanishing, they are motivated to put their homes on the market sooner rather than later. Many unemployed, underemployed and retirees continue to weigh their options in the real estate market. With a relatively high cost of living, many of these home owners are tempted to cash out their equity and relocate to lower cost areas.

Summary

As the market is becoming more educated on the risks involved with interest-only loans in general, and ARMs in particular, more buyers will be reluctant to take them on in the face of rising interest rates. On the lending side, the growing controversy over these risky loans has prompted state and federal regulators and financial markets to impose restrictions and more stringent qualification criteria.

While market activity has cooled down somewhat, year to year appreciation remains very strong, particularly in the condominium market. If interest rates stay relatively stable, strong buyer demand should persist, particularly in the low end of the market. Any possible signs of market depression will be noticed first in high end markets, such as Los Gatos.

Many sellers continue to get top dollar for their properties in today's market. While average days on the market have increased since last summer's strong seller market, the result is a more balanced seller/buyer market. If rates continue to remain stable, the condo market in particular could continue to show strong growth this spring.