

Appraisal Institute

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The Residential Re Sale Market in the Central Valley – 2006

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We are in a time of great change. Although we often fight or dislike change, I believe we can handle and better deal with change if we are aware **of the trends** that cause changes.

The reality of today's residential resale market in the Central Valley is somewhere between two extreme views. The market is no longer **white hot and booming**, nor is it in a **downward death spiral either**. We are transitioning into **normalcy** – a more balanced market – **and it's painful**.

After soaring to record levels for 3 consecutive years, the single family housing market is heading toward a "soft landing" for 3 primary reasons: **rising interest rates, affordability issues, and a smaller pool of investors and speculators**. All contributing to a softening in demand. We are experiencing all 3 of these in the Central Valley today.

Mortgage interest rates have bounced between 5.5 and 6.75% over the past 12 months. There does seem to be a trend toward gradual increases in the 30 year fixed rate mortgages. The trend of increasing rates seems set. But remember, we are still well below historical norms.

Affordability in the Central Valley has become a big issue for today's buyers in deciding either **how much to buy** or **whether or not to buy**. As you all know, affordability is a function of home prices.

Based upon the percentages of the buyers who could afford the Median Priced home, here are the %s for our area:

AFFORDABILITY STATS

COUNTY	EOY 2005	EOY 2004
San Joaquin County	9%	17%
Stanislaus County	14%	26%
Merced County	10%	19%
California	14%	19%

Lenders are usually pretty quick on the draw, and pretty creative in devising new programs to help more buyers get into homeownership.

We've experienced 100% no down payment mortgages; 80/20's with no PMI, we've seen the interest-only mortgages and adjustable mortgages tied to just about every imaginable index other than the **weather**. And for the past 3 years, it worked to spur on the market.

In dealing with rising rates and lack of affordability, the Big Buzz of the future was 40 year mortgages. Now they're here. Pick up any newspaper today, you'll read about 50 year loans. They're not that far off. These are just some of the ways lenders are dealing with the affordability challenges posed by escalating prices in today's market.

Lenders have also softened many underwriting criteria to smooth the way for more buyers, and more homes to be sold. The loosening of criteria and guidelines may have an effect on how you do your work. Will OREA guidelines and practices be able to be reconciled with the lender's looser guidelines and their demands to make more loans work?

Investors and speculators are no longer a driving force in our market – which is contributing to the decline in demand today.

There are however, many opportunities in this market. There is money to be made for those who understand the trends and utilize time proven strategies.

For the first time in the 5 or 6 years I've been fortunate to speak with you, I can no longer safely predict another record year ahead.

After topping out in the 3rd quarter of last year, it's pretty clear the resale market is in a period of transition. Pending sales are trending

toward **more sustainable levels**. That being said, the slowing housing market is not likely to derail the economic expansion our State is going through right now. If anything, the housing sector is yielding its position as the **economy's major growth engine** to other sectors of the economy. The Housing Industry over the past 7 years was **the driving force** in keeping our State's and our Nation's economy afloat.

We are going through an **adjustment**, not a **collapse**. Some of the "clouds on the horizon" I mentioned last year are coming true.

So, I'd like to give you a snapshot of where we are now, and what I think is ahead for the rest of 2006. I'd also like to touch on some of the changes and trends likely to have an effect on the residential market in our area over the next few years.

We used to analyze and characterize the housing market year by year. For those of us in the trenches practicing each day trying to figure out what's happening – it's safe to say we have to look at our market's trends quarter by quarter - if not month by month.

January and February 2006 were disastrous compared to the same period in 2005. Sales in the re sale market were off by 50% in almost every area of the Central Valley. March 2006 showed a slight increase in the pending sales index, but well below 2005 levels. March's sales numbers were tempered by excessive rain in our area which seemed to dampen consumer's spirits and their desire to seriously look at homes. Sellers seemed reluctant to list during the rainy period. In the first two weeks of April many potential customers were consumed by and focused on steep increases in the price of gas. When 43% of the Central Valley's resale market is fueled by commuters, **shock at the pump** has a dramatic affect on the market. It affects the decision to move or stay put.

Fortunately, the 2nd half of April and the 1st half of May have shown modest increases in the number of pending sales. Along with that, there has been a steep rise in the inventory of available listings for sale.

Metrolist MLS, the largest mls system in our area reported the other day there are 29,809 active listings in their 9 county service area compared to 10,000 at this time in 2005.

Nationwide, unsold inventories are at their highest level in 19 years.

As we analyze this market, it's not only about interest rates anymore. Although record low interest rates invigorated the market the past 5 years, and we are still in a low interest rate environment, other motivators appear. Overall consumer confidence, employment growth, job stability and "will I get a good deal?" are the main motivators for today's buyers. 6 ¼ or 6 ½ has almost become **secondary in importance** to today's buyers and sellers.

An anomaly of the current resale market is that the numbers of sales are down while both the average and median prices are up from a year ago. It's no wonder all the real estate pundits and gurus have so many different theories. No wonder the rest of us are confused – **especially our customers.**

For the first third of this year ending April 2006 the median price for a single family detached resale home in the Central Valley was \$350,750, as compared to \$311,750 in April 2005. An 11.1% increase. Comparing April 2006 to April 2005 there has been a 26% decrease in the number of sales.

David Lereah the chief economist and cheerleader for the National Association of Realtors has continued to predict 2006 will be the 3rd highest year in residential resale's nationwide - Right behind 2005 and 2004.

Will this hold true in the Central Valley? It bears examining a few factors.

In 2005 fully **25%** of all sales in our area were made to **investors**. Included in that 25% were the speculators and "flippers". What we are seeing currently is the speculators and flippers have stepped out of the market. The long term investors are on the sidelines waiting for a clearer picture of where this market is headed. **What we**

fear and don't want to see is investors dumping homes on an already overloaded market.

Throughout the Central Valley there are 4 to 5 times as many homes available for sale as there was a year ago. In 2005 we averaged a 2-3 month supply of listings through the first 3 quarters. Since October 2005 we've grown to a 6 - 9 month supply of homes on the market.

Based upon that absorption rate I think we could characterize this as the textbook definition of a "normal market." The buyers today have many more choices. They are much more cautious. Because of their cautiousness, they are bold in demanding concessions from sellers – whether it be price, closing costs, or a list of repairs. There is a large segment of potential buyers out there who are anxiously awaiting possible future price drops. They still believe it will happen.

If we were to define the progression of a changing market, especially one going from "white hot" to "normal", I think we'd agree that Buyers are the first to sense it. After all, they are in the arena. They are online, at open houses, scanning the papers and they're out looking at homes with agents. The actions and reactions of buyers are the first indication the market has changed.

Next in the progression come the Agents. The Realtors® get a clue that the market has changed - usually 3 months after the buyers get it. They then panic and start hammering their sellers to reduce their prices.

Lastly, the sellers finally catch on and **face the new reality**. This often takes 6-18 months to sink in. Sellers still say, "well, my neighbor got \$_____ last summer." It takes longer for sellers to accept the market has changed. **That's where we are right now.**

Let's examine the mindset of today's buyer since it explains a lot of where we are. The buyers are making lower than list price offers after shopping extensively, and they are asking/demanding concessions from Sellers in all price ranges – not just starter homes.

Many Sellers are still holding out for **"last year – the good old days."** Thus, we have conflicting expectations. Today's buyers don't have the same sense of urgency they've had the past 5 years. There's no more: **"Buy now or else."** They are no longer as pressured to make a move. We are seeing more cancelled contracts and sales falling through-sometimes right at the last minute.

Buyer's remorse and obstinate sellers are today's reality.

The resale market from \$400,000 and up is facing serious and severe competition from new home builders.

Just the other day in Stockton one of our listings was reduced from \$549,000 to \$525,000 - seemingly market value. After 6 months on the market, we finally attracted a potential buyer ready to make an offer - only to be lost the next day to a comparable new home which was just slashed to \$450,000. Very similar in # of bedrooms, square footage, and location. Oh, and in the subject property's price range and area there are 135 competing listings. That is a typical scenario in today's resale market.

All is not doom and gloom however. In the Central Valley over the past few years we experienced an unprecedented run up in the # of sales and astronomical price increases that were simply unsustainable in the long term.

Sales have fallen proportionally more than other areas of the county. "The bigger they are the harder they fall." Yet prices are still rising although at a lower rate than before.

There are structural issues and trends happening in the real estate industry that may clarify and shine a light on where we're headed.

Interest rates, for now, continue to be below 7%. Job creation continues to grow in the Central Valley. Just last Saturday the Modesto Bee carried an article on Stanislaus County's drop in unemployment. Builders are still building - both residential and commercial. The market appears to be stabilizing as we enter the delayed prime selling season.

One of the significant trends we face is the fallout from some of the exotic mortgages and overly creative financing of the past few years. This fallout will pave the way for short sales, an increase in delinquencies and ultimately in more foreclosures.

The 100% no down payment loans where Sellers also paid the Buyer's closing costs, where the **buyers have no skin in the game** may turn out to be troublesome in a price downturn or a prolonged flat market. Variable, interest-only loans when the adjustment kicks in will pose affordability problems for many homeowners. The day of reckoning will be problematic for our market.

It has been more and more common recently for our agents to meet with Sellers who want or **need to move** and they have been in the property less than 2 years. They purchased it with 100% financing, then got a HELOC, and also they've got a pre payment penalty. Not only do they have little equity left, they're facing tax consequences as well. Many used their HELOC to consolidate debt and pay off their Visas to make the new house payment more affordable. They have already spent their equity. Many have gone out and maxed out their credit cards again. They are between the proverbial rock and a hard place. A disturbing trend is the homeowner who uses his home equity as a personal ATM machine.

I think you can expect a large increase in calls from lenders looking for price opinions and valuations on properties they're considering for a short sale or foreclosure. **It's déjà vu all over again.**

Another trend worth noting is the **Internet effect**. Every part of the Real Estate family is being impacted by the information available on the net. Often times the sole purposes of these sites is to make money from us by selling ad space and banners as they try to disinter mediate all of us from the transaction, and offer their limited services directly to the consumer.

Sites such as Zillow.com, Trulia.com, FreeValues.com and whatever is next, offer the public information they never had, 24/7 and it's free to them. Although we may question its accuracy and its value, the public has an almost VOYEURISTIC hunger for this "**insiders**" view of data. They perceive themselves as quasi-experts on setting values.

Escrow and Title Companies are not exempt from the internet effect. Right now online transaction platforms are being offered by the major title companies in our area. Everything online. I can picture 2 college dropouts somewhere over in Silicon Valley as we speak, sitting in their garage inventing a 100% online internet-based Title and Escrow Company. No paper, no bricks and mortar, and very few employees. It's not that far fetched. I just read of a title company in New Jersey that has bowed to internet pressure and is now open on Sundays. The consumers love it.

If you watch TV at all, you're inundated with commercials for internet lenders – everything online. Many of you probably do work for them now. Lendingtree.com, Ditech.com, MortgagesOnline.com; Imagine that, **"Banks competing for your business."**

The residential mortgage business has felt the internet effect. The internet has helped spawn a cottage industry of limited service, online Brokers, at minimal costs.

"Pay our fee; we'll put you on MLS, give you a for sale sign, you can download our forms; you do the open houses, you show the property to buyers and negotiate your deal. Oh, make sure you email us when it sells." Successful "Do-It-Yourselfers love it. Yet in reality over 50% of those properties fail to sell-forcing the sellers ultimately list with a full service broker. We have heard the consumers, we are aware of the internet effect, and it will change the way we as full services brokers charge for services.

The last trend I'll mention that will have an effect on the Central Valley market is the **mergers, acquisitions and closing down** of residential Real Estate Brokerages. We are seeing this happen right before our eyes.

The **large Brokers will get larger**; the **small brokers will stay small** operating in niche markets and dealing with loyal past clients and operating on a smaller budget. **The middle will disappear**-due to lack of profitability, aging of the owner/broker or by being acquired or merged into the Big Shops.

There has been a huge influx of new agents into the business the past 5 years. Interestingly, over 65% of the agents practicing today have never worked in a “normal” market. The changing market and the economic realities will create a growing shake out of agents over the next 18 – 24 months. You will be dealing with more long term, career oriented professional agents over the next few years.

Back to today’s market.

Let me close by saying:

Sellers and Buyers need to adopt **more realistic expectations**. There is **no bubble bursting**. “**Last year’s prices are last year’s prices**.” Interest rates will trend upward. The market is not pressurizing buyers and sellers as it has over the past few years. Better decisions can be made.

The **return to normalcy** will be welcome-**once everyone lets it sink in**.

It’s time for everyone, including all of us, to take a Big Deep Breath-and realize we’ve been here before; it’s time for everyone to accept and deal with the changes we are facing.

For **Success and some sanity** in this market, we could all use the slogan from the Marines:

Improvise, Adapt, and OVERCOME.

Thank you.