

**The Residential Resale Market
In the Central Valley of California
May 2007
Glenn M Race, CRB, CRS, GRI**

Trying to explain this current resale market in the Central Valley is a challenge. It's right out of Charles Dickens, "It was the best of times it was the worst of times".

Real Estate is **still** the hot topic anytime two or more people gather to talk. There have been quite a few changes in the past year. ***

It's been interesting how many are dealing with these changes.

On the one hand, we have some real estate agents who are having career years in 2007. Despite what is happening in the general market, their sales volume exceeds that of previous years. We also have agents leaving the business in droves because they cannot make a living in this market.

The media paints a picture of doom, gloom, disaster and even pestilence.

Yet, many housing experts, NAR economists and industry cheerleaders are still referring to this market as "normal." I think we are somewhere in between.

As we look back at 2006, there really wasn't the "Bursting Bubble" as predicted. But we are facing record numbers of short sales, foreclosures, and distressed sales which are adding to an already swelling inventory of homes for sale-the highest inventory of unsold homes in a decade.

The answers to where we are -and where we are going may come from considering and analyzing four forces that drive our market, and really any housing market.

In analyzing today's market, we need to consider **mortgage rates, the general economy, inventory levels and affordability.**

In the last half of 2006 we actually saw improvement in the mortgage interest rate arena. Rates increased marginally in January 2007 but have been relatively stable and in a narrow range since then. There is a fear, and the general consensus is, rates will be edging up in the very near future-perhaps by this summer. Yet for today, rates are still at historical levels and by rights, should be motivating more buyers to buy.

Secondly, we need to consider general economic conditions that affect our market. Our national and state economies seem to be moving forward. We have solid, but not outstanding job growth. We are currently enjoying a lower than usual unemployment rate in our area. Our local economy is in a gradual transition with growth in the medical and service sectors.

Nationwide, the 2007 economy is moving forward at a pace that is slightly below a 3-4% growth rate. Thus, we have a lower chance of recession. The Federal Reserve seems more concerned with inflation than it does recession. As a nation, we still hang on the words of the Federal Reserve Chairman every six weeks, to get some sense of what's to come.

The third condition we need to consider is the supply and inventory of available homes for sale. Current inventory levels and average days on market are up significantly today compared to 2005. We are up from 2006. We have gone from near record lows to average levels, to way above average levels in the past three years. In the Central Valley, MLS inventory stabilized in the 2nd ½ of 2006 after a few months of growth. In 2007, we are seeing a large increase in foreclosures and short sales which is boosting inventory levels way above normal. This is creating absorption rates of anywhere from 11 – 16 months depending on the community in the Central Valley.

Our 4th consideration is affordability. Affordability is the key to the health of any housing market, but especially here in the Central Valley. We have always been relatively affordable compared to neighboring areas of California. As prices rose through the late 90's and early 2000's Central Valley homes became less and less affordable to Central Valley residents. So then, to help more buyers get in to more homes, along came "the Solution" a menu of "Alternative Financing

Programs.” These new creative mortgage loans were designed to make housing “affordable” for more people. It worked. Our market went on a record setting binge.

But like all good things...

Our market hit the wall in October 2005 when affordability fell to a record low. The market peaked that month but no one realized it: Especially Sellers, Agents and Lenders.

We can plot the history. In 2004 and 2005 there was an increased use of these alternative Mortgage products which increased the buyer pool and due to “perceived” affordability they extended the upswing in the market.

In retrospect rather than saying the mortgages created “**affordability**”, they really created “**Obtainability**” for which many are paying the price now. I’ll examine these loans and their effect on the market a little later.

In late 2005 and through 2006 the buyer’s purchasing power was stretched to the limit. Their inflation-adjusted monthly payments hit record highs in late 2005, surpassing the prior record set in 1989. This dilemma coincided with a decline in sales in late 2005, just like it did in 1989.

When we have steady or lower prices coupled with steady low interest rates, added to job confidence-affordability improves and the market is healthy. We are not there today.

Another factor to consider in this market is the disappearance of investors and 2nd home activity. Due to slower or non-existent appreciation, less equity to convert to down payments and due to higher returns on other investments, we have lost approximately 35% of the purchasers who made up the 2005 record setting bull market.

These potential purchasers are sitting on the sidelines today waiting for signs of what’s next.

I think there are some wild cards that may determine where this market is headed in the Central Valley at least in the years 2007 and 2008. These wild cards raise a lot of questions.

We need to closely watch the consumer’s expectations and reactions to changing home prices and interest rates. Will there be a confidence level strong enough to induce them to move? Are buyers turning a deaf ear to huge concessions, or do they automatically expect them? Are seller paid closing costs, builder incentives and creative packaging enough to get buyers into the serious buying process? What will it take to get the first time buyers and investors back into the game?

Another wild card is the impact of the non-traditional mortgages. The recent collapse and negative publicity surrounding the sub-prime mortgage market melt down will definitely have an effect. Will this fiasco force lenders and underwriters to overcorrect, tightening standards too tight which will limit the number of buyers able to purchase? Will the tightening shut out buyers who are on the edge of underwriting guidelines? Will the over correction eliminate no down payment loan programs? Are stated income loans a thing of the past? Will this meltdown and its after effects have ramifications on how appraisers do their work?

I guess a major question is: will fear stifle or delay a comeback?

NAR has predicted the tightening of standards and proposed new restrictions on new loans may cause a decline of approximately 100,000 – 250,000 sales nationwide in 2007-2008. That’s about 3% per year.

Due to the subprime debacle, FHA is back after an absence of 5-6 years. PMI is back and it’s tax deductible. The 80/20 loans were designed to eliminate PMI, but I’ll bet there are a lot of lenders who wished PMI was used more often the past 5 years.

The good news in this is that **low** down payment financing is still available, with more **traditional** mortgage products.

The last wild card would be any unexpected major downturn in the economy, or an event with severe economic, political or worldwide consequence.

First time homebuyers are the key to a good real estate market. An old rule of thumb is that with every first time buyer entering the market there is a filtering up, which creates three more transactions. A large reason for the successful real estate market of the past five years was the availability of exotic mortgage products allowing just about everyone to become a home buyer, thus fueling the "filtering up" process. It seems that everyone could get a mortgage if they had a pulse. There were mortgages for everyone and every situation. We even had NINJA mortgages. No Income, No Job, No Assets. Yep, NINJA loans.

These mortgage products created a new pool of buyers that, in retrospect, probably should have waited a little longer before they entered the real estate market. These buyers took shortcuts to homeownership with "stated income loans". Today they're called "Liar Loans." They took shortcuts with Zero down payments, Negative AM loans, Interest only mortgages, sellers covering closing costs, and short term suicide loans where the fixed loan period is only 2 or 3 years with an equally long prepayment penalty.

The excitement and demand to "buy a home before it's too late" caused buyers, lenders, and agents to do less due diligence and a lot less explanation. After all, they thought, the sky's the limit in this real estate market. You can only lose if you don't get in on it.

The end of rampant price appreciation has these buyers realizing the time bomb they are holding. In 2005 and again in 2006, 41% of first time buyers used zero down payment financing. Fully 1/3 of buyers took interest only or minimum payment mortgages (pick-a-payment). Now that prices have flattened and dropped, they can't just refi their way out anymore. Their home is no longer an ATM machine. When they hit a financial snag, their home is in jeopardy.

This situation is having a dramatic effect on today's market. It will have an impact on how soon the housing market will recover. Delinquencies, Short sales and foreclosures are happening now, and it's safe to predict they'll increase over the next few years. The "toxic" mortgages taken out in 2004, 2005 and 2006 are re-setting, causing problems for many who **gambled** on continued appreciation. They were playing "**House Poker**", and many are "**All In**" right now.

As we look to the future, there is another disturbing trend. Once many of these sellers are shortsold or foreclosed out, they won't be able to re-enter the housing market anytime soon, due to their damaged credit. We will lose a part of the "move up" segment of the market. Thus the recovery may take longer than in previous corrective cycles, because we are losing a large segment of potential buyers needed to feed the housing food chain.

Let's look at the numerical effect of short sales and foreclosures on today's market.

According to Metrolist MLS statistics for the Central Valley; In the first 4 months of 2007, there have been **1733** listings identified as foreclosures or REO's. Compare that to **1149** in all of 2006. As for short sales in 2007. From January 2007 to April 2007 there have been **2094** properties identified as short sales compared to **2043** for the 12 months of 2006. As you can imagine, this huge increase is having a dramatic effect on the re sale market. The amount of short sales and foreclosures have increased exponentially each month in 2007, and there seems to be no end in sight.

There are many challenges in dealing with this extraordinary influx of distressed sales. There is a whole new breed of asset managers and loss mitigation personnel that were not around in the last round of foreclosures in the 1990's. Their inexperience is providing challenges to lenders, appraisers, agents and consumers in liquidating these properties. They are overwhelmed and inexperienced. There will be rough sailing for awhile in disposing of and closing these properties.

In speaking with brokers and agents who handle foreclosures on a large scale, their frustrations are uniform. The asset managers are pricing the REO's too high and often are ignoring local market conditions in their pricing. In trying to mitigate their losses, their inexperience is

impeding the disposition of these problem properties. Typically they are slow to respond to bona fide offers, they often counter offer with restrictions so hard to live with that buyers walk. Thus, the loss mitigators are losing the "best" buyers.

One Broker who currently is carrying 150 REO listings told me the other day he feels lucky if 8 per month go pending. What many of these Brokers share is that 2 out of 5 fall out of escrow at least once. The tightening of mortgage underwriting criteria because of the sub-prime market woes does not bode well for the distressed sale market. We have marginal buyers chasing marginal properties. As you all know, REO's are properties that HAVE TO BE SOLD. They are not selling quickly enough to not be a drag on this market and are affecting the market values of all homes in the market place.

Every week it seems another media outlet or news source cites Stockton, Modesto and Merced as leaders in delinquencies and foreclosures, not only in California but nationwide as well. This certainly does not help our market.

The loans posing the greatest risk of delinquency and/or foreclosure were underwritten in 2005 and 2006 with interest rate re-sets due in 2007 and 2008. The largest number of these "Toxic" mortgages were written in 2005, so we are seeing stress on the market and on the economy in 2007 and we will see even more so in 2008. To put it in perspective, we're talking about a trillion dollars in mortgages set to re-adjust in 2007-2008. With that considered, the effect of foreclosures and short sales will be felt for a **long time** here in the Central Valley due to our high percentage of delinquencies, troublesome mortgages and affordability challenges.

TRENDS AND REALITIES

Each time I have had the privilege of meeting with you, we invariably touch on the internet and its effect on our businesses and on how we do business.

Each year the percentage of buyers and sellers who go to the internet prior to contacting an agent increases. According to a recent CAR study 82% of consumers accessed the internet as their first step in entering the real estate market. The internet empowered consumer is changing the way we all do business. They want information and immediate answers. So much so that It's rare today to find a Realtor® or a mortgage lender who doesn't have their cell phone or palm device linked to their website and email for instant communication with these internet consumers. Voice mail or leaving a message doesn't cut it anymore. Speed and connectivity has become paramount for success with today's consumer.

I saw a study the other day that found 67% of internet enabled consumers did business with the first agent who contacted them and then kept in touch until the consumer was ready to act.

These internet surfers tend to do research twice as long as traditional customers and it's often frustrating for agents who are used to the "old way" of buying and selling property. The internet enabled consumers like their anonymity and usually start their research 18-24 months before their eventual move. Because of how they do their searching, agents get frustrated when they don't return calls, ignore emails and don't seem engaged in the process. They often don't treat them as "serious clients" when in truth they are. They just don't want interaction with a sales person until they are ready. They want to do business on their terms.

The internet buyer buys in half the time and looks at fewer properties than the traditional buyer. It has been a paradigm shift for many veteran agents. Interestingly, the newer, younger agents get it.

When the internet consumer is on the web doing their research, they inevitably go to Zillow.com., Trulia.com or similar property sites.

Zillow.com has made some significant moves since I last spoke with you. It was commonplace in the past for real estate practitioners and appraisers to laugh off, pooh- pooh or ignore Zillow due to its inaccuracies. The public, however, was curious, hungry for "insiders"

information, and visited the site often. It became common for agents to go on a listing appointment and find the sellers had a "Zestimate" in their hands. Zillow changed the landscape, and even added a new term –"Zestimate," Zillow's estimate of value.

All the while we were minimizing them, Zillow was planning their next moves. They began by offering ad space and links to real estate agents, lenders and appraisers. Next, they offered FSBO's and Realtors® the opportunity to list their properties on Zillow.com for free! Adjacent to the listing would be the "Zestimate" which could present a challenge if the two numbers are not in sync.

Zillow is catering to the consumer as well. Zillow is creating a webpage for every home in the United States, where a seller can go to their property, fill in details, make corrections and update the data on their home. The seller can also enter a "make me sell" price which is essentially inviting offers on their home.

We can no longer ignore the Zillows of life. We need to ask, "What are they up to?" "Are they trying to displace appraisals as we know them?" "Is Zillow trying to create a Nationwide Real Estate Brokerage Company?" "Are they trying to create their own "Multiple Listing Service?"

Despite the challenges Zillow is facing in Arizona with the appraisers organization over using "Zestimates," we need to watch and learn as these internet based business models impact our business and the ways we do business in the future. More and more Zillows will surface in the near future.

There are some happenings in the real estate brokerage community that are reflective of our current market and will have an effect on the Central Valley residential market in the near term.

First, you may have noticed the deluge of new agents entering the business has abated somewhat. Simply put, in 2006 and 2007 there are not enough sales to sustain the large population of agents walking around with licenses. To put this in perspective, in February 2006 there were a little over 3300 members in the Central Valley A.O.R. In February 2007, membership dropped to just over 2500. A net loss of approx 800 members. There is still room for less. As this market continues, and as the efficiency of strong producers increases, there will not be a need for as many agents in our area.

The old rule of thumb in sales was that 80% of sales were made by 20% of sales people. It's called the PARETO principle. In residential real estate in the Central Valley today, and tomorrow, 93% of sales are and will be made by 7% of the agents. There will be teams of agents and mega producers who are technology based, internet savvy, and more effective doing more deals. The part-timer, or less than committed agent will not be able to afford to nor be able to keep up with the changes, or the consumer's demands to remain in business.

Also in October 2007 initial licensing by DRE will change. On that date, for a person to sit for the salesperson's state exam, they will have to have completed the Principles of Real Estate, Real Estate Practice and an elective course *prior* to taking the exam. This is a significant change, since in the past the applicant has 18 months to complete the 2 courses after "Principles." Raising the bar of entry is a positive for everyone.

The increase in efficiency, education requirements and professionalism will be good news for the public and for all members of the Real Estate family.

On another front, you may have noticed some brokerages making changes over the past year. Real Estate Companies in our region – from Lodi to Fresno, have closed and consolidated offices in an attempt to maintain or achieve profitability in this changing market. There is still merger and acquisition activity occurring in the brokerage community, and I believe we will see even more in the next few years.

There are a few distinct reasons for these mergers; first is the creation of economies of scale which hopefully leads to the second reason which is profitability; and the third reason for mergers and

acquisitions is the aging Broker population. There is a desire on the part of some to give up the fight, cash in, and enjoy the fruits of what they created.

The internet and its impact is having an effect in another segment of the Central Valley and in California. I mentioned earlier that somewhere between 77% and 82% of consumers go to the internet as the first step in their real estate experience. So, not only are they not contacting an agent first, they are also not going to the print media first either. Over the next few years, very slowly, you'll notice the size and number of the real estate ads diminishing in newspapers, homes magazines and other print outlets.

It's interesting how our habits change. The newspaper associations acknowledge that newspaper readership is on the decline, so they all have created their own websites. How many of you read newspapers on line each day?

Real Estate ads in the paper will probably never disappear, but you'll notice the shrinkage. It's just not effective to spend hundreds of thousands of dollars in the paper for a minimal response. Those dollars are more effectively spent on where the serious buyers and sellers are - the internet. Brokerages are forming affiliations with Modbee.com, Yahoo.com, Google.com, Trulia, Zillow, and whatever is next.

As I travel from Turlock to Lodi I get asked a lot about the health of the market here in the Central Valley. So much of what the public thinks is derived from what they see and hear in the media. Is it ½ empty or ½ full?

The media's take on the real estate market reminds me of a story about a friend of mine, Fred, who's a duck hunter. Fred has this friend Bob who is never impressed by anything. Bob is truly the eternal pessimist.

Fred goes out and buys this new hunting dog, a real beauty. He invites his friend Bob to go hunting over at their Duck Club in Los Banos to try out the new dog. One Saturday they get settled in the blind and in a few minutes, BAM! They shoot. The dog runs across the pond-right on the water-to retrieve one of the downed ducks. He gets the duck in his mouth and runs right back on the surface of the water bringing the duck back to Fred and Bob. Fred looks at Bob...nothing.

They settle in the blind and again. After about 15 minutes, BAM! They shoot at the flock overhead. The dog again scoots across the pond on the water's surface to retrieve another duck. With duck in jaws, he runs back to the hunters running on top of the water. Fred looks at his buddy for a reaction...nothing.

This happens a 3RD time exactly as before. Finally Fred can take it no more. He looks at his friend and says, "Bob, isn't there anything you've noticed or anything you want to say?" His friend Bob says, "Well, you've got a real good looking dog there, but it's too bad he can't swim."

That's sort of where we are right now in the way this market is being portrayed. All is not doom and gloom. It's just **different** than it was the past 5 years. Interest rates are still at historic lows. There is an abundant selection of homes for sale. There are creative **non-toxic** loan programs to help **qualified** buyers purchase. The hysteria and pressurized market of the past is over. Buyers can do research and make good decisions.

Approximately 42% of buyers in California and 58% of first time buyers are considered minorities. This increasing demographic group will help the housing market now and in the future. Remember the trickle up effect of first time buyers. On average, 3 transactions are created.

Along those same lines, because of market conditions and trends, prices still have further to go down. The number of sales made here in the Central Valley will level off soon due to the factors we spoke of earlier; interest rates, inventory, general economic conditions, and affordability. But the leveling will be sustainable once we have bottomed out.

There are still a lot of SIDS out there. That's **Sellers in Denial**. When a market changes, it often takes 18-24 months for sellers to get it. We're almost at the 20 month stage today. There are still sellers out there who want to get what their neighbor got last year. We need to sober

up our sellers, and the agents who take a listing at any price. Today's buyers are educated on the market. They understand market value. They don't want to overpay and they are super cautious in the process.

Job creation fuels the economy. Jobs solve problems. Despite a few blips, the job picture in the Central Valley is better than usual, better than it was a few years ago. For all the pain of losing a Hersheys we have the gains of small business creating and adding jobs.

The near future of the residential resale market in the Central Valley will be slower than it was, but steady after a continued downward adjustment in prices, and a leveling off of sales.

We have not seen the bottom of prices in the Central Valley. There is too much inventory to burn off and too many distressed properties that need to be sold before we can see a recovery.