Featured Articles on California's Economy

The opinions in these articles are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office. This month's report includes an article by Patrick S. Duffy, Principal, MetroIntelligence Real Estate Advisors, a division of Beacon Economics.

When Will the Housing Market Rebound?

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Following multiple months of dire news on California's housing market, more recently a combination of factors are starting to show the beginning of stabilization in the state which has practically defined sub-prime lending gone sour and greedy speculators reaching beyond their means. While the real estate market is certainly still bad – and is likely to remain so through the end of 2009 – there are some definite signs of hope for 2010 and beyond.

First, the bad news. After a temporary dip in foreclosures during the last quarter of 2008 due to moratoriums and procedural changes in the way lenders handled loan defaults, by February of 2009 the combination of default notices, auction sale notices and bank repossessions in California rose to nearly 81,000 properties – the most of any state and representing a 5% increase from January. When compared with February of 2007, foreclosure activity spiked up by 51%, with auction sale notices alone skyrocketing by nearly 180%. And, whereas the percentage of loans in California entering foreclosure had been far less than those for the overall country as recently as the first quarter of 2007, by the end of 2008 the ratio had flipped, or 1.36% (California) versus 1.01% (U.S.). Furthermore, the ratio for loans already in foreclosure in California leapt from just 0.17% in the middle of 2005 to 4.19% by the end of 2008 – nearly 100 basis points above that of the U.S. (3.3%).

Although the well-meaning $75 billion Homeowner Affordability and Stability Plan announced by President Obama could gain traction in other states where rising unemployment is leading to increasing foreclosures, in California it will likely prove impotent. Firstly, the provisions that will allow Fannie and Freddie to refinance borrowers at a loan-to-value ratio of up to 105% will simply not help the hundreds of thousands of households which used subprime and other 'alternative' mortgage products to buy their homes at high loan-to-value (LTV) rates over the past few years. With prices down 40% from the peak in the state, most of these homeowners are at least 30% underwater. As such, they will not be eligible.

Secondly, further limiting the effectiveness of this program in California is the structure of the payment to mortgage holders for net present value (NPV) losses on renegotiated mortgages. NPV losses are those declines in the current

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market value of a mortgage due to changes in the interest rate and length of the loan while the principal remains the same. The government will pay lenders half of these losses, but only in exchange for declines in payments from a 38% debt-to-income ratio (DTI) to 31% DTI. Since California started the housing bubble with average DTIs closer to 38%, not only are such modifications unlikely to work well in this state, but these are very little of the cost covered by this program. Consequently, California has been left out in the cold, and foreclosures will continue to exert downward pricing pressure statewide throughout 2009 and probably well into 2010.

However, the good news is that there is another mechanism to deal with the glut of foreclosed homes – prices. Every foreclosed home represents an opportunity for a first-time buyer or investor to purchase a home at a substantial discount. Although some analysts are concerned about speculators re-entering the market only with the visions of flipping homes and contributing to a second wave of unsold homes, we would posit that such concerns are overblown, as most investors, bereft of the easy financing that characterized the unsustainable housing boom, are looking at positive cash flow and not short-term appreciation. In fact, according to a recent article in BusinessWeek magazine, cash-rich investors in the Inland Empire are reporting cap rates of 15% to 20% for existing single-family homes based on a purchase price of $75,000, repairs of $20,000 and monthly rents of $1,500. These values are likely exaggerated, but at current price levels, clearly a savvy investor could get a cap rate of 10% to 12%.

The other bit of good news is that California, unlike Florida and Arizona, has not built enough housing over the past few decades. The ratio of housing permits to population growth has been much lower here than elsewhere in the U.S. Of course much of this population growth included lower-income immigrants who were completely priced out of the housing market during the boom years. The fact is that affordability ratios are returning to levels we have not seen in years, and that is good for the housing market no matter the intent of the buyer. For example, as prices for existing single-family homes plummeted by nearly 41% between the fourth quarters of 2007 and 2008, sales activity spiked up by nearly 89%. Between the third and fourth quarters of 2008 alone, as median prices fell by 11%, sales rose by 13%. In other words, home buyers are responding quite positively to the substantial discounting occurring in the existing home sector, and that commitment is what's going to eventually stabilize prices.

What may take longer to heal is the state's new home market. California home builders, looking to gain market share and many enriched with the deep pockets of large, publicly traded corporate parents, continued building throughout the boom years without bothering to objectively analyze potential demand based on the economic fundamentals of growth in population, jobs, incomes and achievable rents. Indeed, the "build it and they will come" mantra that had characterized markets throughout the state since the end of WWII ran smack into the unyielding wall of demographic reality once the well of easy financing dried up.

The price for this collective yet unsubstantiated optimism has been a building industry that has shrunk to about 25% of what it was during the boom years. At the same time, no matter how many incentives home builders pile onto sales

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contracts – estimated by one of the country's largest public builders to exceed $50,000 – they're still finding it almost impossible to compete against substantially discounted existing homes, over half of which are foreclosures. Even with pricing declines of $100,000 from the 2006 peak to under $350,000 for a new home by the end of 2008, that median sales price was still nearly $100,000 higher than for both existing single-family homes and condominiums. Consequently, sales of new homes have continued to steadily decline, reaching just over 10,000 units in the fourth quarter of 2008 – a drop of 73% since the peak reached during the second quarter of 2006.

Still, the arrival of Spring has brought some hopeful signs of life already returning to the state's housing market. According to the California Association of Realtors®, nationwide home purchases in February 2009 jumped 80% from the same month in 2008. Moreover, the rise in sales activity has steadily whittled away inventory of existing homes to just 6.5 months (nearing market equilibrium) versus 15 months a year ago. In fact, this level of inventory is now notably less than the 9.7 months reported by the National Association of Realtors® for the entire U.S.

Many real estate agents attribute this rise in home sales to the $8,000 federal tax credit available for qualified first-time home buyers from January 1st through December 1st of 2009. The credit, which is targeted towards singles and couples making under $75,000 and $150,000 per year, respectively (and is phased out completely at the $95,000 and $170,000 income levels), allows buyers a credit of up to 10% of the value of a home purchase up to a maximum of $8,000. Moreover, although the credit must be used for the purchase of a principal residence, applicants can still be owners of vacation homes or rental properties; the guidelines simply state that buyers cannot have owned a principal residence three years prior to the home purchase.

An additional tax credit is also available from the State of California, but is targeted for buyers of new homes only. This program, which has allocated a total of $100 million in credits, must be taken by buyers over three years and is limited to the lesser of 5% of a home's sales price or a total of $10,000 for purchases made between March 1st of 2009 and the same date of 2010. Available to both first-time and move-up buyers, this credit is limited and will disappear once the funds have been allocated, but could ultimately help builders sell more than 10,000 homes; as of April 1st, applications had already been made against 25% of the total. And although new home sales continue to decline, there have been anecdotal reports by builders of increased traffic at their sales offices related to the federal and state tax credit programs.

Still, there do remain a couple of wrinkles for a sustained housing rebound. One is that banks, wanting to avoid further depressing prices, have been sitting on foreclosures and only doling them out to the marketplace in small amounts. Should they release a larger group of properties at once, prices could fall further – although that could encourage even more buyers to snap up the new discounts. Another concern is the much-heralded S&P/Case-Shiller Index, whose primary flaw (like all housing indices) is its inability to accurately gauge the quality of its paired home transactions. For example, if a home that sold at the peak of 2006 sells again as a gutted, semi-destroyed foreclosure in 2009, the decline in value speaks more to structural changes in the home itself than an accurate reading of the local marketplace. Consequently, some critics contend that this index can over-state swings in the marketplace – especially price declines – and magnify equity losses in areas with greater foreclosures.

Yet even the Case-Shiller Index is showing a flattening of price declines, and that's because buyers are starting to show up with visions of low mortgage rates and potential positive cash flow. Finally, as the programs initiated by Realtor groups, home builders, and the federal government begin to gain traction – and as lenders have learned which loan modifications work best – we may see a slowing of foreclosure activity and a rebound to a more market-based housing market sooner rather than later. But patience is still warranted.