B&D BUILDING YOUR BUSINESS MARKET STRATEGIES

Keep a wary eye on the resale and rental markets

Metro markets in the Southwest will be the first to bounce back.

By Patrick Duffy

Most home builders have accommodated the changing market by lowering prices and with balance sheet impairments, the 'sticky' resale market, however, has been much slower to adapt. Consequently, the combination of paralyzed resale and credit markets make it difficult for potential buyers to purchase all but the most entry-level of homes (usually defined as under $417,000, the conforming loan limit). In the southwestern U.S. the market is experiencing something different. The states of California, Arizona and Nevada are the regions with the most stable prices, highest affordability ratios and strongest rental markets and those are the markets that will arise first – like a phoenix, pun intended – from the ashes.

For example, it makes sense that through the end of 2007 the largest annual declines for listing prices were in the less desirable and more inland areas of Sacramento (-20 percent) and the Inland Empire (-17 percent), which attracted more speculators due to huge price increases. Yet for areas such as Tucson and Reno – which came late to the housing boom party and didn't drink as much of the spiked mortgage punch – the annual declines remain in the single digits. And, with its affordability ratios of over 30 percent – by far the highest of the three states noted – Arizona should also perform better in the medium term as its inventory is eventually absorbed.

A glaring weak spot in unsold resale inventory is California's Bay Area, driven in large part due to a rising number of foreclosed homes that sit idle as lenders hang onto hoped-for prices that were last seen in 2006. Similar spikes in unsold inventory levels have also hit Phoenix and Las Vegas, which will be forced to balance a large portion of foreclosed home listings against economies which continue to hum and affordability levels which are extremely competitive with those in California. In other areas such as San Diego and Orange County, listing prices have declined by just 15 percent (versus a promised 30 percent from numerous housing bears) because homeowners, like stock investors, realize that paper losses are only taken when they actually sell – assuming, of course, that they can hang on and wait for the rebound.

Fortunately for most of these regions, the rental markets remain strong, with vacancy rates in the single digits – and most below the 5 percent level generally considered supply/demand equilibrium – with annual rent increases of 2 percent to 9 percent. The true test of the rental market's strength will be its ability to absorb unsold homes – known as "shadow rentals" – along with traditional apartments. After all, why rent a two-bedroom unit at 'Paradise Arms' when the same price might get you four bedrooms with a private pool (rafts not included)?

Potentially, this rising tide of foreclosed homes could enact a two-stage "push-pull" scenario in which (a) rents first rise as the demand by the newly homeless exceeds demand before (b) falling as newer homes in need of renters to pay the bills compete with older or smaller and higher-density apartments. That's when a projected annual rent growth of 5 percent or more in places like San Jose or Orange County (or approaching 9 percent in San Francisco) can come under considerable pricing pressure.

Finally, there's the historical relationship of monthly rents to home prices, which averaged about 5 percent for decades until the recent boom, in which speculative buying activity pushed it down to 3.5 percent. So although a 'global marketplace' city such as San Francisco might re-achieve the 5 percent ratio due to a Web 2.0 economy, it could be a tougher road ahead for the East Bay or Tucson, Ariz, where rents won't rise as quickly. Or maybe they will! Stay tuned.

Southwestern United States Resale Inventory by Metro Area
(Ranked by % Increase in Annual Inventory)

Rank	Region	12/31/07 Unsold Inventory(1)	Annual % Change
1	SF-South Bay	7,065	63.70%
2	SF-Peninsula & East Bay	15,375	35.50%
3	Phoenix	48,346	26.40%
4	Las Vegas	28,395	26.20%
5	Los Angeles	41,715	23.70%
6	Inland Empire	49,895	22.50%
7	Sacramento	16,071	18.60%
8	Orange County	16,950	16.80%
9	Tucson	9,675	13.20%
10	San Diego	19,419	7.20%

Source: HousingTracker.net

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