Bubble in Full Bloom

San Diego's most accurate housing analysis by realtor/analysts, featuring our market timing model. Our work is unique because it combines MLS data collection and analysis with work in the field.

Mission accomplished, for now.

In an election year, the Administration is pulling out all the stops to save the banks, avoid the unpleasantries of foreclosures, and hasten an economic recovery by raising house prices. Money is no object: Last year, Fannie Mae lost $26.4 billion of taxpayer money participating in the Administration's Home Affordable Modification Program (HAMP), and Treasury lifted the $400 billion loss cap on Fannie Mae and Freddie Mac. The Federal Reserve spent trillions to prop up the mortgage market.

The White House admits their goal is to raise home prices: ***President Obama's programs to prevent foreclosures will help bolster home prices*** (whitehouse.gov).

The Troubled Asset Relief Program (TARP) Inspector General concurs: … *the Federal Government's concerted efforts to support home prices* ***… risk re-inflating that bubble*** *in light of the* ***Government's effective takeover of the housing market*** *through purchases and guarantees, either direct or implicit, of nearly all of the residential mortgage market.* SIGTARP, Quarterly Report to Congress, 1/30/10 [1].

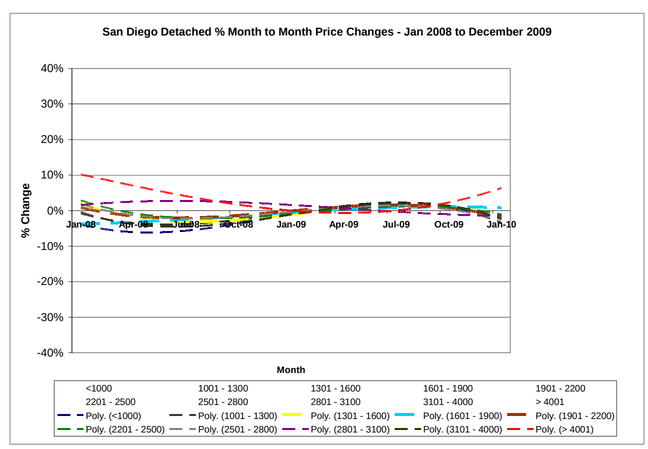
Raising home prices means they must increase demand and reduce supply. Besides the steps mentioned above, they increased demand with tax subsidies and reduced supply with foreclosure moratoria, HAMP, 125% LTV refinancing, and letting banks ignore delinquent loans.

The government must remain willing and able to borrow large sums of money to reflate the housing bubble. We believe our government is willing, but leave it up to the reader to decide whether, and for how long, it remains able.

This interference in the housing market prevented the housing correction that would restore San Diego home prices to its historic multiple of wages and rents. The average price increase of each of ten home size segments rose 18% since March 2009, putting current prices at October 2008 levels. These macro numbers hide the mix and location shift and merely indicate buyers are paying more money for the same size of home. We do know from our work in the field that prices on homes up to $700,000 in the most popular neighborhoods are up 10-15% since March 2009.

Did it ever occur to them that they can't institute a national housing policy? Prices fall for different reasons. They fell in San Diego because of a bubble, in Las Vegas due to overbuilding, and in Detroit due to population loss.

Our proprietary market timing model shows market transition points. Our layman's model combines the second derivative of prices with the slope of months supply. We don't use mathematical formulas. We have remained 3 – 12 months ahead of others since we started this work in the summer of 2004 by announcing the end of the housing bubble as inventory doubled twice in subsequent quarters while sales fell. In October 2008, we reported price declines had stopped. In March 2009, we reported price increases. Each time, we predate the Case-Shiller index by at least 3 months. We avoid flawed metrics, such as median prices which are a distribution number, and $/sq ft which ignores the high fixed cost of land, permits, upgrades, location, views, etc.



Our market timing model shows transition points. January's price increases slowed, which could be seasonal or a change in direction. As of this writing in the first week of March, we see price increases accelerating, and we now know it is seasonal. Months supply is staying flat, hovering around 2.5 – 3 months. We expect inventory to rise until April, pendings to devour it, and sales at the 3000 level, Prices will keep rising.

To give the reader a sense of why prices are going up, we take a little trip into the market. Homes listed at or below market value in all price ranges are getting multiple offers the first day on market, many over the asking price. Hopeful buyers lose out on several offers before they get aggressive enough to "win the house", as one client put it. A friend who listed a $350,000 detached house in Poway had over 20 offers on the first day on the market; she accepted a $375,000 conventional 20% down offer over the highest $381,000 FHA offer. A $795,000 detached house in Torrey Highlands had six offers the first week. An investor told us he was one of 20 people offering to buy a $1.2 mil REO.

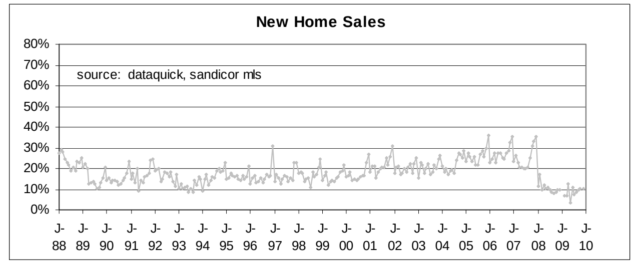
But let's not kid ourselves that sellers are thriving. Prices have dropped 15 – 50% from the peak, depending on the neighborhood, so people who would normally sell to move up are trapped in their homes. These homeowners tell us they are biding their time, exploring options.

The primary reason for selling in California has dramatically changed, from 'moving to a bigger/better home' declining from 76% to 3% of sellers (2006 vs. 2009). Last year for the first time in its seller survey, a new reason to sell was cited: 63% of sellers cited financial distress as their primary reason for selling. The number of first-time sellers tripled to 44% in two years, and one-third of sellers left the state. [2]

Build and they will come

We have a shortage of houses for sale. Land regulation, constrained foreclosure inventory, and negative equity are the main drivers of low inventory. Builders are unable to respond to changes in demand due to "smart growth" policies that delay the construction cycle and raise prices.

Builders with buildable lots and funding are ramping up production to capture sales before the tax credits expire. They are targeting the move-up buyer tax credit. New home sales fell to 10% of sales.

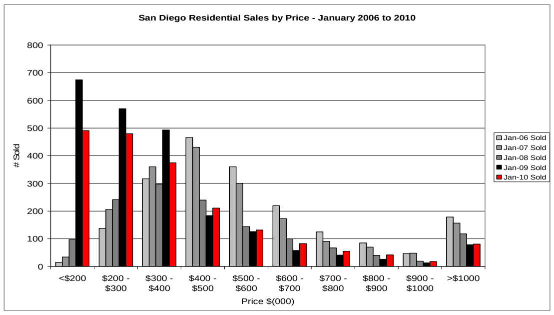


Mid-priced homes at two builder releases in Rancho Bernardo on a beautiful February weekend were bustling with people. These homes are priced from $600k - $800k with $500/month Mello Roos (bond) fees. Our client's application was accepted at Chanteclair, and he was about #100 on the builder's priority list. The following day, in the rain, all priority list applicants returned as the builder went down the list starting with the first position, to sell the 12 available homes. Applicants could buy that day or defer to the next phase; no-shows are dropped from the list. Unfortunately, homes were sold before our client's number came up on the priority list. We learned from our friend, a teacher at the high school, that his son and daughter-in-law, both young teachers, were lucky buyers of a $600k+ home. The couple was #18 on the Andalusia priority list, bought the last and 12th home, thanks to six deferrals ahead of them. The father's comment, "I don't know how they will afford it". We know how: 50%+ debt-to-income financing.

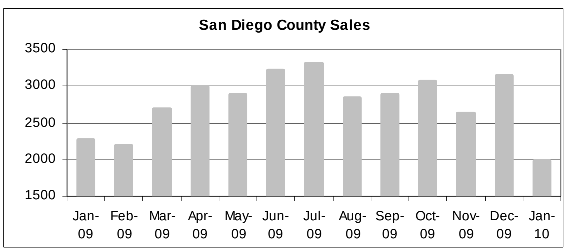
I want a bargain

Documented loans are preventing the housing bubble from getting too far out of control, yet we remain concerned with the high debt that borrowers take on to buy overinflated houses. We have covered the San Diego wage structure in past reports, and obviously today's prices are too high for our wages. It's no wonder that 68% of sales are for homes under $400k. In the last few months, demand rose at the high end, part of a reviving economy, more confidence in some people, and lower interest rates on jumbo conforming and jumbo loa

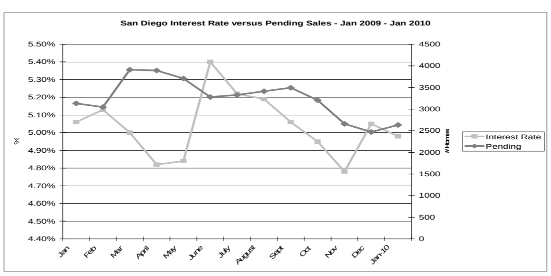
The decline in sales at the low end is probably driven by lack of inventory.



Real estate is emotional, and that is why sales decline in the fall and winter. However, January's year-over-year sales decline of 13% was bigger than usual, and the monthly 37% decline exceeds the average of 25%. We need to look at the pending sales, below, to see whether this is temporary.



In a high-price market like San Diego, buyers are extremely sensitive to the monthly payment. House sales are inversely correlated to mortgage rates. The "unexpected" 12% drop in August 2009 sales was due to a jump in interest rates in June that led to a 12% fall in pendings in June (see our September report for more details). Since then, rates have declined and stayed around the 5% mark.



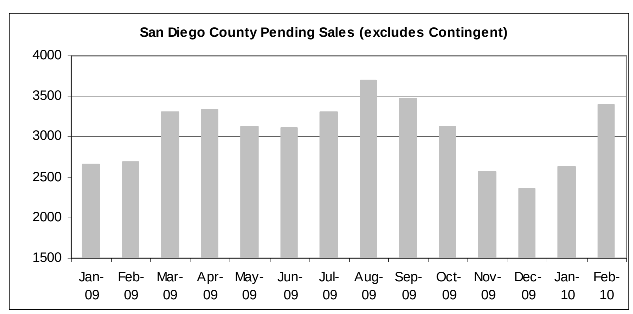
Any rise in mortgage rates spells doom for our housing market. The Federal Reserve is ending its MBS purchases at the end of March, and believes that mortgage rates will stay low, because bond buyers have indicated interest in buying future mortgage bonds, which will be government-backed mortgages. So for now, we expect interest rates to remain low even after the Fed's MBS purchases conclude in March.

The homebuyer tax credit is probably superfluous in housing-obsessed California, a market with 45% renters, most of who will buy as soon as they can afford it. A California Association of Realtors survey found the tax credit's importance declines with income. Many people would buy a home without the tax credit: 30% of singles earning under $100k/yr, and 76% of married couples earning over $100k/yr. While the expiration of the tax credit could damp demand at the lower end from FHA and conventional buyers, we believe those sales will be absorbed by cash buyers. Cash buyers are predominantly buy-and-hold investor/landlords, not flippers, since it's almost impossible to find the discounts these days needed to make money on flipping.

Spring Bounce

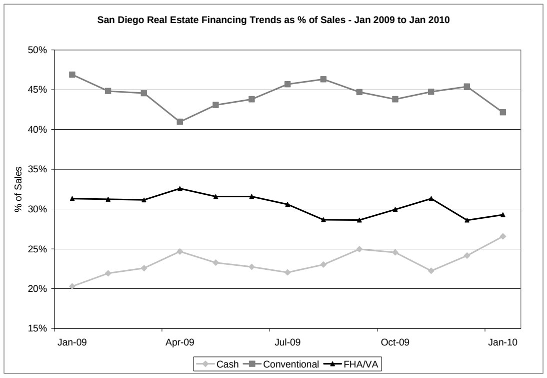
Both listings and pendings* increase in January every year, and this year is coming on strong. Real estate is, after all, emotional, and the warmer weather and longer days drive us humans to change our nests. This spring bounce did not disappoint so far. As of this writing in the first week of March, 4172 homes went pending and contingent (pending lender approval on short sale) in the past 30 days, a 2 month supply. (Due to the delay in agents updating the MLS, we pull our data on the 10th of the month and publish our reports mid-month.)

Pending sales in January are flat with last year. Looking ahead, February pendings are likely to be 25% higher year over year. If only there were more homes for sale, pendings would rise significantly.



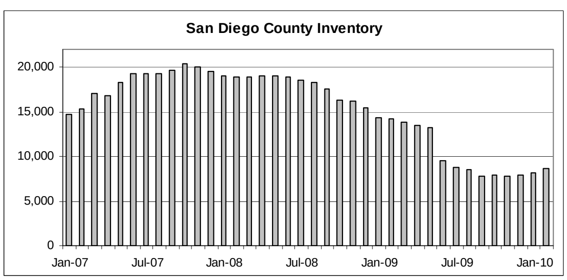
*Note: in May 2009, short sales marked as Pendings moved to the new non-dated Contingent field; thus the drop in pendings.

We keep a close eye on the mix of buyers: FHA, conventional, VA, and cash. FHA and cash buyers continue to dominate the lower end, and their mix shift is unchanged in the last two years, with each having a 25% market share.



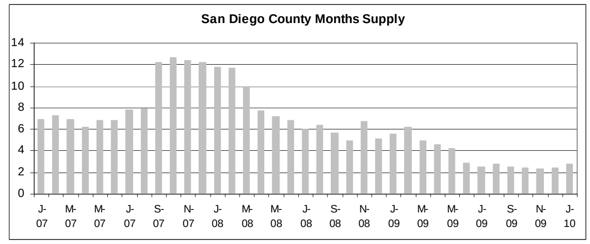
The housing shortage

The supply shortage is easing. After falling for two years, inventory is heading back up, led by regular sellers.

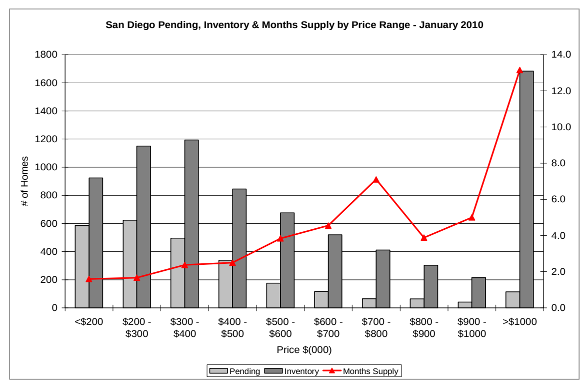


The inventory increase could be short-lived, unless the California Legislature reinstates the tax exclusion on short sale debt forgiveness that expired at the end of 2008. (The IRS temporary exemption still exists.) Short sale listings could decline after sellers figure out they owe California income taxes on the 1099's issued by their lender(s), a topic we [covered] last September. We figured the media would start writing stories on this topic as sellers' tax bills came due this spring and summer, and indeed our friend in Ventura County directed us to [this article]. In short, we could lose 25% of our inventory (depending on how many sellers figure out the tax consequences; don't leave it up to their agents to inform them ☺).

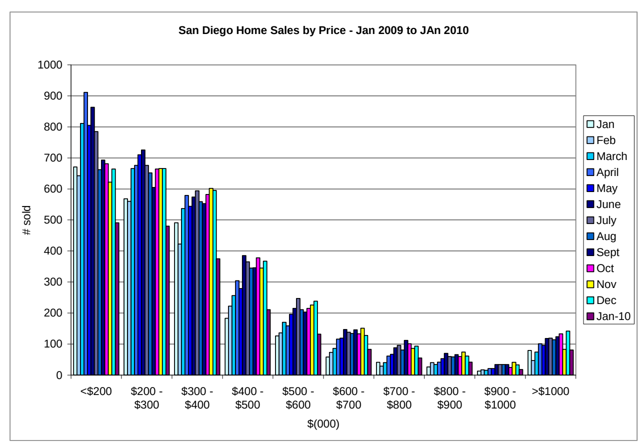
Months supply countywide fell slightly to 2.6 months in January. It may surprise some, that the number of pending + contingent of 9410 exceeds the inventory of 7,923 at the end of January.



Yet all is not rosy. The high end is impaired. Without option ARMs and IO loans, few can afford multi-million dollar homes. Months supply is 12 months for homes over $ 1 million (a decline from 14 months in October), and 3 years for homes over $ 2 million. Homes over $ 1 million are 20% of inventory, yet make up only 4% of sales.



Most sales continue to be at the low end.



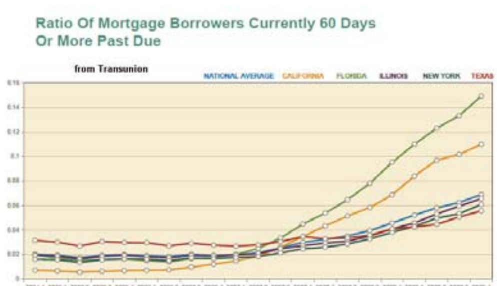
Within all price segments, we have two types of sellers: those who live in reality and price their homes to sell, and those who live in fantasyland and list their homes to expire. The average list price of sold homes is $ 415k, while the average list price of active homes is $922k. It is the former set of homes that generates multiple offers.

Higher priced homes were taken off the market last month, as is typical for December.

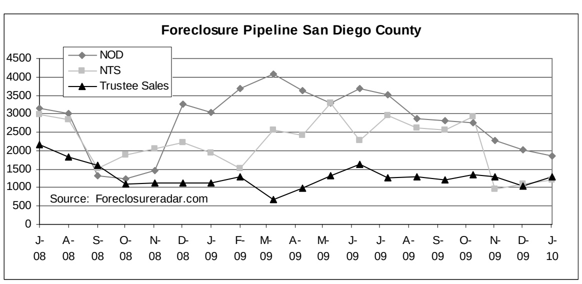
Damsel in Distress

It took us a while to figure out that servicers and lenders are hiding their mortgage losses by ignoring delinquencies. We know several people who are 2 years delinquent, with no foreclosure notice, no modification program participation. We broke this story of the 50%-ignore rate to REO Insider last quarter. What we still don't know is how the servicers decide into which bucket to place the delinquent loan. The evidence for ignoring delinquencies is easy to find.

Delinquent borrowers doubled in California in two years from 5% to 10% of mortgagors.

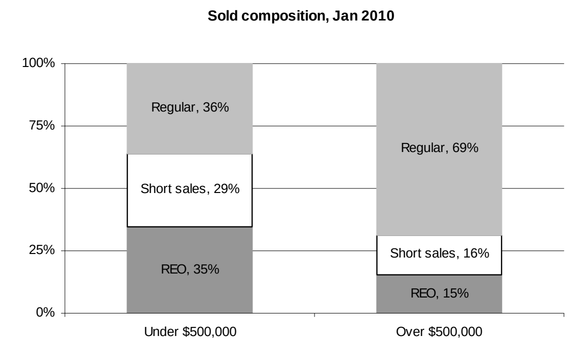


At the same time, NODs fell in half since March 2009, and NTS and trustee sales are falling and flat, respectively.

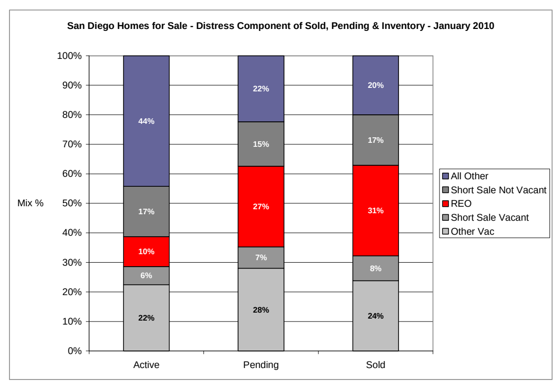


Does everyone see a problem here? Delinquencies rise and foreclosures fall. How long can this continue?

As servicers, banks, and investors keep ignoring California delinquencies, REO listings and sales are a small part of the market. REOs were 15% of homes listed for sale in January, and 30% of sales. They are in high demand for a simple reason: they are listed at or under market price, drawing more buyers and offers.

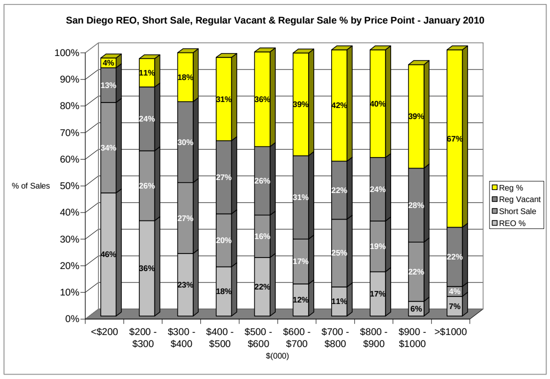


Distress listings include vacant homes, because these homes sell for less than occupied homes. REOs sell for 7% less than short sales and 22% less than regular sales.

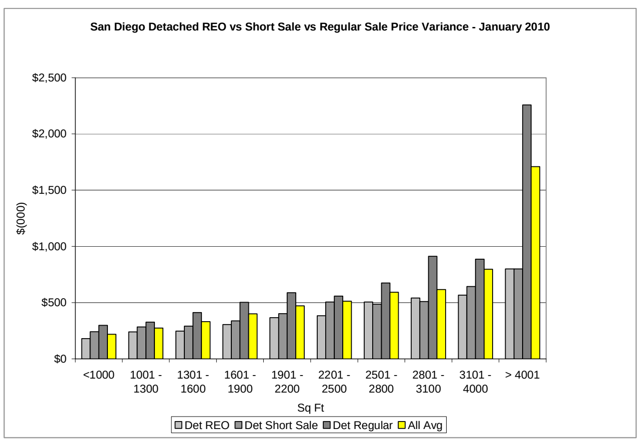


Distress properties are concentrated at the low end. Higher income homeowners have more resources to avoid foreclosure or forced sales, and their IO and ARM terms were 5, 7, or 10 years instead of 2 years. Buyer interest in REOs has really faded. We just never get inquiries about REOs anymore.

As we move up the price ladder, more of the real estate activity is composed of traditional sales.



Distress properties are listed at a lower price than regular sales due to greater seller motivation. REOs are cheaper because of the poor condition. Short sales are cheaper because 1) the owner's motive is to get an offer the lender will accept, not to maximize the sales price, and 2) the long wait time for buyers.[3]



Another way to buy distress properties is at the trustee sale, although half of the scheduled sale were cancelled or postponed the day of the sale. As prices are going up and word of flipper profits spread, more people started showing up at the courthouse steps, making it harder to get the good deals. One of our contacts stopped going last summer because the amateurs were forcing up the bids. We found that flippers are buying $600k and $1 mil homes, presumably because the lender discounts are larger and there is less of a bidding war. At foreclosure sales last month, investors bought 27% of auctioned properties.

We don't credit HAMP with reducing foreclosures. HAMP is a delay tactic. Don't think for a second that servicers are excited about HAMP. A senior housing counselor at the largest non-profit housing agency in San Diego told us the servicers are doing everything they can to avoid modifying mortgages.

They're Easy

Why are we repeating the easy lending mistakes that led to the housing bubble? Why are we not reforming the financial system to prevent the next crisis? Should we prop up house prices? What is the hidden cost of these actions?

Mortgage loans are way too easy to get. Sure, buyers have to show proof of income, W-2s and bank statements, but they can go to 60% back-end DTI (60% of gross income for debt service).

Our lender at a major bank told us today that the lending limits for FHA are 56% DTI on the back end, and VA can go even higher, with some lenders going into the 60% range. Conventional loans max at 50% DTI. In our opinion, borrowers should limit themselves to 28/33% DTI ratio, so they can save money, handle emergencies, and keep up with home maintenance. It still is surprising how many homeowners neglect to keep up the maintenance of their homes, probably because the mortgage payment takes all they have. At sales time, they pay the price.

We are creating the next wave of foreclosures. Both prices increases and higher mortgage rates are the main risk to the housing market going forward.

[1] **Mechanisms for Supporting Home Prices**

Supporting home prices is an explicit policy goal of the Government. As the White House stated in the announcement of HAMP for example, "President Obama's programs to prevent foreclosures will help bolster home prices."384 In general, housing obeys the laws of supply and demand: higher demand leads to higher prices. Because increasing access to credit increases the pool of potential home buyers, increasing access to credit boosts home prices. The Federal Reserve can thus boost home prices by either lowering general interest rates or purchasing mortgages and MBS. Both actions, which the Federal

Reserve is pursuing, have the effect of lowering interest rates, which increases demand by permitting borrowers to afford a higher home price on a given income. Similarly, the Administration is boosting home prices by encouraging bank lending (such as through TARP) and by instituting purchase incentives such as the First-Time Homebuyer Tax Credit. All of these actions increase the demand for homes, which increases home prices. In addition to direct Government activity, home prices can be lifted by general expectations among homebuyers of future price increases.

[2] California Association of Realtors 2009-2010 Seller Report. "The primary reasons for selling mentioned in 2009 were trouble making mortgage payments (30%), job loss (18%), and mortgage payment increases (15%)". The reasons for selling shifted significantly: last year, 3% of sellers moved to buy a larger or better home, down from 75% in 2006. Over 90% of sellers had adjustable rate mortgages. Escrows were harder to close: last year, 50% of escrows did not close on time, up from 36% in 2008, and 63% of homes fell out of escrow before selling. Then there are the FSBOs (for sale by owner), who are down from 4% to 1% of sales. Sellers are not as concerned with commission; it was most important for only 12% of sellers, down from 60% a year ago. The percentage of sellers who considered being a FSBO declined from 45% in 2008 to 15% last year.

Higher-end sellers are concerned about buyer qualifications. When we make appointments to show homes over $ 1 million, the sellers ask a question we were not asked even a year ago: "is your buyer qualified at this price?"

[3] The short sellers are embarrassed and will leave the house before showings, although they stay for realtor previews. Showing times are limited and difficult, they don't show for backup offers, and they accept the first decent offer and quickly get off the market. Then the waiting begins. Buyers must wait 3 – 12 months for lender approval, although one agent is still waiting two years for approval on several Bank of America listings. Wachovia is the envy of all, responding typically in less than one week; Countrywide/Bank of America is the slowest. Our favorite strategy to both avoid the long wait times and get our buyers a home without a bidding war is pursuing contingent listings with long market times. The lender approval is likely imminent, and rarely is the original buyer still around. We are in two deals now on short sales where our buyer is replacing the original buyer. Listing agents love to get buyers without having to go Active again and deal with dozens of offers on short sales. Lenders order BPOs (broker price opinions) after verbal approval of acceptance, and the buyer must pay that price or the house is sold to the "best and highest" among the backup offers, or listed as Active again. The BPO is usually a little under market value to compensate the buyer for long wait times, and if the condition is inferior. So it's a little tough on the buyers to pay off the 2nd lien holders in addition. The 2nd lien holders used to ask for a few thousand dollars as a payoff, but now they want tens of thousands of dollars; they want a percentage of the trust note. Buyers are paying this, even though it puts them over the appraised value. Buyers sometimes have to pay a 1% short sale negotiator fee or termite repair. Sellers get a lower credit score and a tax bill. Short sales are definitely the least desirable of the entire inventory, but with the housing shortage, buyers don't have the luxury of being picky.