

2006 Economic Forecast
for
Real Estate
“Why the Pundits Keep Getting It Wrong!”

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“What Happened to Our Housing Bubble!”

I. Another Bad Year for the *Other* Forecasters:

	<u>UCLA</u>	<u>Ca.St.Fullerton</u>	<u>Chapman</u>	<u>Gary</u>	<u>ACTUAL</u> Homes	Condos
2005 Price Forecast: big declines		-10%	-3.6%	+15%	16.2%	17.8%
1 st Quarter of 2006:				+15%	15.3%	14.7%
This Decade:	-40% to 45%	-6% (e)	+10.4%	+92.5%	+100.7%	

II. Why They Continue to be Wrong!

A. Affordability Index – 40 year (+) Index That Does Not Work!

1. There were only three loan programs: VA , FHA, and CONVENTIONAL when the index was first set-up. Homeownership averaged 43% and prior to 1970, most people did not make a lot of money, if any, from the sale of their home. Conventional lenders were requiring a 20% down payment (usually \$5,000 to \$6,000 for OC), so these factors were incorporated into the index.
2. Using this formula today, forecasters tell us that, in California, only 14% of buyers are able to buy. Just **11%** of the buyers can purchase in **Orange County!** It gets worse in Sonoma, Santa Barbara and Napa at 7%, and San Francisco at 4%. Only 1% can qualify in Santa Cruz.
3. However, two things have changed. One, homeowners are making money on their houses . . .

In the past 5 years, California residential equity has gone up by \$1 trillion and the average net gain from the sale of a home is \$220,240.00!

And two, incomes have risen dramatically . . .

From 1945 to 1979, incomes increased at the same rate for all tax brackets. However, since 1980, after-tax per capita incomes are up 61% and from 1979 to 1997, the **top 1% increased 157%!**

4. Today's buyers have equity, rising income and, with lower interest rates, their mortgage costs are lower than they were in the early '80s when they represented 30% of household income. Today, mortgage costs only average **17.5%** of U.S. household income!
5. Only 1/8 of homeowners spend 50% of their household income on house payments, while 1/3 spend 30%. In Orange County, **43.2% pay 30%** or more but that is due to the upper ranks of OC jobs increasing by 50%!

II. Why They Continue to be Wrong! (continued)

Median Income to Median Sales Price: It Does Not Compute!

- ◆ In Orange County, the median home sales price is \$617,000, while the median income is only \$64,646. With these formulas, the forecasters are telling us that buyers can't afford our Orange County homes. Therefore, the price must come down! **Wrong!**
- 1. Orange County has significant levels of *low income wage earners* (9% make less than \$20,000 yearly) which pulls down the median income for this county. Our *homebuyers* have a median *household* income of **\$75,700.00** – one of the highest in the nation!

Orange County is ranked #3 in the nation with yearly retail sales exceeding \$57,000 per household!

- 2. Last year, buyers purchased **7,342 million dollar homes of which 56** of the sales exceeded **\$5 million dollars!**
- ◆ **Since 2000, Orange County residential property prices have gone up 100.7% and today, 15% of all home purchases exceed \$1 million dollars!**

We rank #3 in the U.S. with 113,299 millionaires while 5 billionaires choose to call Orange County their home!

- 3. During 2005, **48,666 million dollar homes** were sold in California. This represented an increase of 47% over last year and equates to 1 out of every 13 homes sold in the State! For the first time in the U.S., there are 1 million people living in million dollar homes – of which 450,000 are here in California!
- 4. Incomes exceeding \$100,000 (+) in the U.S. are growing 6 times faster than the population.
- 5. In 2004, 2.5 million people had net financial assets exceeding \$1 million dollars, which is up 10.3% from the previous year.
- 6. The Federal Reserve says that consumers have 5 trillion dollars in liquid cash and that is after they spent **\$210 billion dollars** remodeling their homes last year!

C. What the forecasters should **NOT** be looking at: **Rising Interest Rates**

- 1. Huge employment gains are causing a *gushing of money* into the Treasury, and the U.S. economy is the only economy big enough to soak-up the trillions available for investment.
- 2. There is a *global savings glut* that has translated into heavy competition to lock in long-term yields. U.S. corporations have nearly \$2 trillion in cash, a record high. Banks, insurance companies, equity funds, venture capitalists, hedge funds – all are desperately looking for investment opportunities with more money than they can profitably, prudently put to work.

C. What the forecasters should **NOT** be looking at: **Rising Interest Rates** (continued)

- 3 This past summer, Congress passed the *Prudent Investor Act*, allowing state funds to be invested in hedge funds, buyouts funds and real state partnerships. Pension funds, insurance companies and public/private corporations are all trying to off-set retirement obligations – especially with the 78 million baby-boomers looking towards retirement, and converting various IRAs, 401Ks and other retirement accounts into income funds.
4. Wall Street has become a big-time player in mortgage-backed securities. Access to information and capital is why real estate prices will continue to go up as there are so many ways to invest in real estate!
5. Add to this the fact that excess manpower and machinery are being reduced in most industries, and you can begin to understand why the **core index** has risen from 1.9% a year ago to only 2.1% as the year ends. In February, it dropped again and it is now at 3.6%, vs. the long-term historical average of 4.2%.
6. Our supposedly *record deficits* are very small when compared to our **\$12.6 trillion** gross domestic product (GDP)! Plus, these *deficit dollars* often return to the U.S. as foreigners purchase our government T-Bills, Notes and Bonds.

Federal deficits are only 2.7% of the GDP (6.0% in 1983 and 4.7% in 1992)!

D. What if rates do go up . . . so few are affected!

1. Here is what the Mortgage Bankers Association tells us about home loans in America:
 - ◆ 35% of owners own their home outright – so no interest rate problem there;
 - ◆ 50% have fixed rate loans – many refinancing to lower rates with fewer years;
 - ◆ 15% have adjustable rate/ interest - 8% of those being *high wealth* income earners.

Therefore: Only 7% of all mortgages are rate sensitive!

2. This also explains why foreclosures are going through a 10-year decline and are at a record low. The U.S. foreclosure rate is 1.0% - the lowest in 26 years. “*Expensive*” California is at **.15%- the lowest in the nation!** Last year, in Orange County, only **142 homes of the 48,883 sold were foreclosure sales!**
 - ◆ 60% - were unaware the lender had payment options
 - ◆ 75% - did not return calls.
 - ◆ 90% - would have called if they knew the lender would help

The Federal Reserve states that American households’ net worth at the end of 2005 was \$52.1 trillion dollars!

IV. Economics 101 – You cannot have a bubble when demand exceeds supply!

A. Demand for Housing – Current housing boom has lasted 14 to 16 years!

1. In 1990, 2.9 million existing homes were sold in the U.S., and existing home sales for 2005 reached a record 7.1 million!

**Demand for existing homes has grown 114% - while supply has fallen 4%!
New home demand is up 143% - with only 23% increase in supply!**

B. What is Causing all this Demand?

1. The State population grew approximately 608,000 last year. Over the past 4 years in southern California, the population has increased by 1.39 million!
2. In the next 10 to 15 years, 3.5 million more people will reside in southern California.
3. This demand is coming in *waves*, the *1st wave* being the *baby boomers* who are now between the ages of 42 and 60. They found a way to mix leisure with work and are not ready to fully retire – they have *money and income* and are still investing in real estate.
 - ◆ *40% of all sales in 2005 were for investment and 2nd homes!*
 - ◆ *“OC” investors represent 10.1% of the market while 4.1% are 2nd homes.*
4. The *2nd wave* of home buyers are predicted to grow at a rate of **1.17 million** per year for the next 8 years. They are *1st time* home buyers (median age 36). Those purchasing upscale properties have a median age of 45.
5. The *3rd wave* of home buyers is the largest group. They are presently 23 to 33 years of age and will total **1.2 million** new households per year for the next decade!

Over this next decade, there will be a 25% increase in the population who are over 50 years of age. They have more money than any preceding generation due to having dual incomes, equity growth, and record inheritances!

D. Demand for Housing – *here come the immigrants!*

1. Immigration of new buyers is largely due to a U.S. policy on *family reunification*. In the U.S., there are 34 million immigrants, making up 12 % of our total population. Of all incoming immigrants, 2/3 go to 6 states. California is the #1 destination, receiving 22.4%!

Latinos are the fastest growing segment of the housing market!

- ◆ Since 2000, 1.1 million more foreign immigrants have moved to California – which, for the first time, is a larger number than the number of migrants from other states!
- ◆ Four of the top 11 *counties* attracting immigrants in the U.S. are in California! Los Angeles is #1 – receiving 400,000, followed by Santa Clara (#5) and Alameda at #9. Orange County is # 11, with 82,794 foreign immigrants arriving since 2000!

D. Demand for Housing (continued) *here come the immigrants!*

- ◆ From 1980 to 2000, over 6.2 million minority households joined the ranks of middle-income earners and are purchasing housing. Those who arrived in the '80s and '90's with children and now have children who are looking for a home!
- ◆ These *2nd generation* Americans now account for 15% of the population between 11 to 20 years of age. If history repeats itself, they will out-earn their parents and be an even greater source of housing demand.
- ◆ As 1st time home buyers, they acquire homes at 26 – a full decade before non- immigrants! Today, they represent *35% of the 1st time* resale market vs. **22% in 1991!**

E. The Supply Crisis – Six Consecutive Years of Housing Appreciation Exceeding 10%!

1. In the past 12 months, the U.S. population grew by 2.8 million persons. Between now and the year 2015, demand for new homes is on track to total as many as 20 million units annually. By 2030, there will be 80 million more people living in the U.S.!

The resulting housing needs will require that an average of 2 million units per year are built, but our record for building is 1.12 million a year!

2. There are now 74.8 million homeowners (1.7 million new homeowners in the past year) who make up 69% of our population – a new high!
3. Adding more pressures to the *already strained* housing market are the new players in home-ownership. There has been a 30% growth among women owning homes and a 27% increase in minorities owning homes (15.7 million). Single or unmarried homeowners are remaining single longer. They are also maintaining larger homes for their “floating children.”

In 2004, home purchases by “single buyers” exceeded “married with children”!

4. We have **100 million acres** of land in California, but *only 5 million acres can be developed!* With 36.8 million residents, California ranks #1 in population in the nation.
5. Demand for housing is staying strong, but land available for development is diminishing. Environmental issues restrict or reduce the size of developments, while political or regulatory-driven supply constraints continue to hamper development of new housing.
6. Last year, California built 207,200 units, breaking a 15 year record! Demand called for 250,000 units. In 2006, the state hopes to build between 185,000 to 205,000 units.

These issues are creating a state of permanently higher prices!

7. In the past 20 years, Orange County developers built 260,000 homes, condos, and apartments. In the next 20 years, they will build 56,000 units and then all the land will be gone!

There are currently 44 high-rise condominium towers under construction or in various stages of pre-development in Orange County!

V. So Where is the Risk? . . .

The only risk to housing is a *big decline* in employment!

A. Our Growing U.S. Economy – **Gross Domestic Income of \$12,600,000,000**

1. The U.S. has now had 11 consecutive quarters in which our Gross Domestic Product exceeded 3%. Forecasters are stating that the U.S. GDP will remain above 3% throughout 2006. Last quarter's 1.1% GDP was largely due to the hurricanes.
2. In the past 12 months, the U.S. employed 2.1 million new people – a growth rate of 1.7%. The economy added 2 million jobs last year, which closely matches 2004's 2.2 million jobs (the best since 1999).
 - ◆ But there's more to the story. Add another 1 million jobs for self-employed and incorporated individuals, who do not show up on the employment rolls. Today, there are 12.2 million self-employed people and another 3.2 million who are incorporated.
 - ◆ March's unemployment rate is 4.7% (lowest since 2001) as 211,000 new jobs were added! Gains in taxable income are adding large sums of money to the Treasury!

B. California – The Power State for the Nation

1. Eleven percent of all employed workers in the U.S. are employed in California. They produce almost 15% of the total GDP of the nation. In the past 12 months, California added 223,000 jobs, and today there are over 14.879 million workers in the state!
 - ◆ If you count the new 214,000 self-employed over the past year, the total employment for the state grows to almost 18 million workers and explains why the State treasury's office took in a surplus of **1.2 billion dollars** in the 3rd Quarter.
2. California has one of the most diversified economies in the world, serving the *Pacific Rim* through **trade**, a growing **service sector**, and expanding **electronics** and **manufacturing!** Add **high-tech**, the **financial sector**, **bio-tech**, **tourism**, **agriculture** and **government**, and it is easy to see why California is one powerful state!
3. When northern California lost 250,000 jobs during the *dot.com* period, real estate prices continued to rise. The Bay Area's worst year of appreciation was 2003, when prices rose only 11.5%.
4. In southern California, there are over 10 million people employed, plus another 1.5 million that are self employed. The unemployment rate for southern California is 4.5%.

**In southern California, 95% of companies employ fewer than 50 people!
Today's technologies enable companies to become highly productive with fewer people, ending the *boom-bust* cycle and its massive lay-offs!**

B. Orange County – An Economic Powerhouse

Using World Bank formulas, Orange County would rank as the 34th most powerful country in the world (out of 184) with a *gross county income* of \$160.7 Billion.

1. “The OC” added 32,500 jobs in the past 12 months and ranks #5 in the U.S. in job creation. It has a highly educated and skilled work force numbering 1.54 million, plus another 300,000 that are self employed.

Orange County’s unemployment rate is 3.6%, the lowest in the state. For major metro areas in the U.S., Orange County has the 2nd lowest unemployment rate!

2. In the nation, OC ranks #8 in manufacturing, with 182,700 jobs.
3. *Venture capital investment* in the county rose **73%** last year to **\$490 million** dollars. For the second straight year, OC ranked **#1** in Business Week’s “100 Hot Growth Companies” by having the most companies in the top “100” per county or area!
4. Even with all the new office buildings going up in the county, especially in the South County area, vacancies are at a 5-year low!
5. The reason we continue to lead the State and rank highly in the nation for low unemployment is due to what economists call ***The Triple Endowment!***
 - ◆ An Entrepreneurial Culture ◆ Access to Capital ◆ Educated *Pool of Talent*
6. “The OC” is a magnet for tourists – attracting 44.7 million visitors who spend \$7.7 billion annually; 625 trade shows drawing 1.1 million visitors.
7. Since 2000, the County’s population growth ranks it the 8th fastest growing county in the nation. The county’s population exceeds 3,040,000 and equals 1% of the U.S. population. The “OC” has only 798 square miles of land. It has become the 3rd most densely populated area in the nation, with 3,600 people living in every square mile!
8. Orange County has a *dynamic economy* in one of the most *desirable locations* in the world. Most of the county was, and continues to be, developed under *strict zoning guidelines*. Meanwhile, our *population growth* continues to keep upward pressure on the housing market!

Last year, only 1% of all sellers moved out of Orange County!

- ◆ As of the 28th of March, active listings were at: 10,227 vs. 5,000 last year.
- ◆ Sales from mid- February to mid-March 3,290 vs. 4,195 last year
- ◆ Current housing supply is at 12.48 weeks

VI. The Orange County Housing Numbers

A. Ending Year's Housing Supply Ratios vs. Next Year's Appreciation

1. 2001	10.7 weeks	2002	16.8%
2. 2002	6.2 weeks	2003	19.1%
3. 2003	2.9 weeks	2004	24.8%
4. 2004	8.1 weeks	2005	16.9%
5. 2005	7.9 weeks	2006	15.0% forecasted

<u>March:</u>	<u>Listings</u>	<u>Sales</u>
2004	2,454	4,902
2005	5,000	5,033
2006	9,140	3,290 (last 30 days)

B. Housing Overview: mid-March

	<u>% of sales</u>	<u>median price</u>	<u>appreciation rate</u>
a. single family homes:	54.0%	\$ 698,000	14.1%
b. condos / townhomes:	27.0%	\$ 469,000	13.0%
c. new home:	19.0%	\$ 627,500	9.6% (condo conversions)

C. Financing:

- a. average down payment: 22.7%
- b. adjustable financing: 52.5%
- c. fixed rate financing: 40.3%
- d. paying all cash: 7.2%

Orange County Median Monthly Appreciation Rates (<i>year to year</i>)												
	<u>Jan</u>	<u>Feb</u>	<u>Mar</u>	<u>Apr</u>	<u>May</u>	<u>Jun</u>	<u>Jul</u>	<u>Aug</u>	<u>Sep</u>	<u>Oct</u>	<u>Nov</u>	<u>Dec</u>
2004:	22%	24%	13%	30%	36%	30%	23%	25%	24%	21%	24%	18%
2005:	19%	17%	16%	10%	9%	12%	15%	(14%	14%	14%	14%	14%)*
2006:	15%	15%	14.1%									

*** condo conversions driving down the appreciation number!**

“Why the Housing Bubble is Bogus!”

I. Historical View of Bubbles

A. The last *nationwide* bust of home prices occurred in the late 1930s!

- i. In the past 30 years, the Federal Deposit Insurance Corporation counted **63** home-price run-ups in *various cities* but only **9** of these ended in a bust – all being regional!

86% of the time, the run-ups in *city* home prices did not end in a bust!

- ii. In the past 25 years, the FDIC says there were **54** instances of *regional* housing booms (defined as 30% or more in appreciation – happening in 3 or fewer years)
During the same 25 years, the FDIC found that a “bust” occurred only **21** times (defined as a 15% decline or more and happening over a 5 year period)

62% of the time, *regional booms* do not end in a regional bust!

3. A joint study by Columbia University and the Wharton School of Business found that the *bubble is a myth!* The growth in housing prices of 46 single-family markets over 25 years is due to basic economic fundamentals, strong incomes and low interest rates!
4. In the past 30 years, there were only **9 years** when home prices did not keep pace with inflation – those years were in the early 1980s and again in the early 1990s.

Since 1970, the median home price in the U.S. has never gone negative!

B. California Housing Bust of 1990 – 1996 was caused by a huge decline in aerospace and defense jobs.

1. In the mid 1980s, President Regan proposed a *Star Wars* defense project. California was receiving 1/3 of all defense contracts with 40% of that total going to northern California and almost 60% going to southern California!
2. The builders began large housing developments to meet the employment demands and built these tracts based upon the *economy of construction*
3. November 9, 1989 – the Berlin Wall came down, ending the Communist regime in the Soviet Union and with it the *Stars Wars* program. The major defense contractors, followed by the smaller sub-contractors, began massive lay-offs.

Southern California lost 750,000 jobs in 3 years!

4. The builders’ supply of empty and unfinished housing rose significantly developmental Land sat vacant; foreclosures began. By the end of the decline, many property lost 30% of their value!