

A Hard Landing in **California**

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Last year the air rushed out of California's housing bubble. Housing sales and new-home construction have nosedived. Home prices have fallen. The real estate and housing finance industries are scouting the horizon for a recovery in sales. Meanwhile, a turnaround in home prices and construction could take years.

After enduring hard times, there's a certain relief when you can finally say, "I'm so far down, the only way to go is up." For California, even that sort of relief seems a bit far off—but some already see signs of hope. ■ California is facing one of America's sharper housing market corrections, enduring a slump that has been under way since the latter half of 2005. A greater reliance on nontraditional lending practices, along with a higher level of investor speculation, are widely blamed for creating a bigger housing bubble here than elsewhere. ■ Market observers contend that a rising volume of sub-prime and alternative-A lending helped drive up housing demand and speculation. Further, sharply rising defaults and foreclosures on risky loans in some places are bringing home prices down even faster than they rose. ■ Economists and real estate market observers and investors are divided on when home sales and prices will hit bottom, and how long it will be before prices begin to rise again.

The housing downturn, which most observers believe started after the middle of 2005, accelerated in the middle of 2007, sending sales and new-home construction totals falling. By December 2007, sales volume for existing single-family detached homes in California had fallen 56 percent to 287,600 on a seasonally adjusted annualized basis, from the peak of 650,775 in October 2005, according to the California Association of Realtors® (CAR), Los Angeles.

In December 2007, while actual sales were lower, the seasonally adjusted, annualized sales volume rose to 301,040—the first time seasonally adjusted numbers had risen above 300,000 since August 2007.

By comparison, existing-home sales for the entire United States fell 32 percent (compared with California's 56 percent) from a seasonally adjusted, annualized 7.21 million in August 2005 to 4.89 million in December 2007, according to the National Association of Realtors (NAR), Chicago.

The median sales price for an existing home in California has fallen 20.4 percent, from a peak of \$597,640 in April 2007 to \$475,460 for December, according to CAR. The California home-price decline is almost double the 10.6 percent rate of decline in median prices for the nation, where prices fell from a peak of \$230,900 in July 2006 to \$206,500 in December 2007, according to the National Association of Realtors.

"The residential real estate market in California is in a dangerous and difficult situation at the moment," says Stuart Gabriel, professor of finance and director of the Richard S. Ziman Center for Real Estate at the University of California, Los Angeles (UCLA) Anderson School of Management. While sharply falling prices from Sacramento, California, through the Central Valley to the Inland Empire (Riverside–San Bernardino metropolitan statistical area [MSA]) have captured the headlines, both coastal and interior areas face a difficult future, he says.

"Today we really don't have a functioning secondary market in nonconforming loans," Gabriel says. "This means sharply reduced financing opportunities for California's expensive coastal communities, which have relied heavily on non-agency or private-label financing. While portfolio lending can potentially take up the slack, such lending remains limited by the capital requirements of depository institutions," he adds.

In addition, lenders have tightened underwriting. "California's coastal markets cannot prosper without liquid [private-label secondary] markets," Gabriel says. "So, we're very concerned about the lack of jumbo mortgages," he adds. Gabriel believes the temporary increase in the Fannie Mae and Freddie Mac loan limits included in the economic-stimulus legislation will be critical to stabilizing those markets. The economic-stimulus package passed both houses of Congress on Feb. 7, and was signed into law by the president on Feb. 13.

California's interior markets—from north of Sacramento through the Central Valley to the Antelope Valley (which includes such cities as Lancaster and Palmdale across the San Gabriel mountains north of Los Angeles) and the Inland Empire in the south—have been hit by significant, elevated levels of nonperforming loans, defaults and foreclosures, Gabriel notes. Indeed, these markets are prominent among the highest default and foreclosure markets in the country, with Merced and Stockton tied at the top in the rankings of the state's leading foreclosures markets,

Modesto next and Riverside–San Bernardino not far behind (see Figures 1 and 2).

California last suffered a significant housing decline in the early 1990s, in the wake of the end of the Cold War and the downsizing of the nation's aerospace industry, which was heavily concentrated in the state. The recovery was long and slow. However, in 1997, prices began to rise. From a median price for existing homes at \$177,270 in 1996, the last year of the prior slump, the median soared to \$556,640 in 2006, according to CAR. By comparison, median prices for existing homes in the United States rose from \$115,800 in 1996 to \$221,000 in 2006 (see Figure 3).

The year 2008 "will be the worst year in California history for residential real estate—it's a mathematical certainty," claims Bruce Norris, president of The Norris Group, Riverside, California, a real estate investor, forecaster and adviser. Norris predicted in 1997 that housing prices would double between 1997 and 2005, based on his analysis of data on demographics, affordability, the level of housing inventory and the pace of new-home construction, among other indicators. (In fact, the boom was even stronger than predicted—median prices rose 2.8 times from \$186,490 in 1997 to \$522,670 in 2005.)

Yet, there may be a silver lining to the speed with which housing sales volume and prices have moved lower in California.

"I think we're probably near or at the bottom in terms of the volume of building and in terms of the volume of resale transactions. Both are . . . well below the levels sustainable by the state's population and job growth," says Steve Levy, director and senior economist at the Center for the Continuing Study of the California Economy, Palo Alto, California.

"I think prices are maybe now halfway to where they will eventually correct. They've dropped a lot in the last six months, and I think we may be in the middle or a little past the middle," he adds.

"At the speed at which this correction [in prices] is going, it might be over in a year," Levy says. If this turns out to be the case, then "prices will have fallen further in two or three years than they did in six or seven years in the 1990s," he says.

The scene on the ground

The signs of a housing slump are everywhere in the Golden State:

■ Cesar Dias, an enterprising real estate agent and loan officer at Approved Financial & Real Estate Center, Stockton, California—the nation's foreclosure capital—set up a weekly Repo Home Tour of foreclosures in September for potential homebuyers, dubbed "a magical misery tour" by *The Los Angeles Times*.

■ A single real estate auction house—Real Estate Disposition Corporation, Irvine, California—held a five-day auction of more than 1,000 houses in Southern California over three weekends in January and February 2008, most of them bank-forsclosed homes with a few new homes thrown in. This may be the single largest mass auction in the state's history, according to Norris.

■ Like virtually all other home builders operating in California, KB Home, Los Angeles, sharply reduced the price of new homes in late 2007 at its Orchard Pointe single-family development in Madera, California, near Fresno, in the face

of sharply falling sales. The base price on one popular model with 2,177 square feet was listed at \$219,000, with upgrades also to be sharply reduced in price. By comparison, in the second quarter of 2006, the median new-home price in Fresno County was \$367,320, according to the Real Estate Research Council of Northern California, Pomona, California. "The bank took back two of our models, along with the furniture," a sales representative on site at Orchard Pointe informed prospective buyers curious about why not all the models shown on the sales sheet were available for viewing.

■ In Sacramento, Governor Arnold Schwarzenegger and the California Legislature face a projected \$14.5 billion budget shortfall due to a slower economy weakened by the declines in housing activity, home construction, finance and retail businesses such as home-improvement stores, whose fortunes are tied to housing activity.

An economic slowdown

Opinions divide on the likely economic fallout from the housing slump in California. Most believe a slowdown is under way, but it is unclear whether or not it will mean an outright recession in the state.

Some think the recession is already under way. "The California recession may have started as early as May 2007," says Mark Zandi, chief economist and co-founder of Moody's Economy.com, West Chester, Pennsylvania. Zandi expects California's recession to continue through the end of 2008, with unemployment, currently at 5.5 percent, peaking at 8 percent.

Zandi expects revisions to the employment data for the state in March will show the job losses that have been occurring in California for some time. He traces the job losses directly to the decline in housing and the state's mortgage woes—trends that have pushed down jobs in construction, real estate, home-improvement retail sales and finance.

Zandi predicts housing-sales volume will bottom out and housing inventories will peak this spring for the nation, and in the fall of 2008 or later for California. The value of new-home construction for the nation will hit bottom in late 2008, and late spring 2009 or later for California. Finally, Zandi forecasts that home prices for the nation will stop falling by mid-2009 and will not rise until mid-2010, while California will see a house-price bottom in early 2010 but may not see home-price gains until mid-2011.

Others are less pessimistic. They maintain that the current correction for California may not be as bad as the one in the early 1990s, which was the worst economic decline in California since World War II. "In no way is this a more severe correction; it just seems to be going more quickly, in part because the normal correction in the market is exacerbated by the foreclosures," Levy says.

Despite the recession drumbeat in the media, Ryan Ratcliffe, an economist at the UCLA Anderson School of Management's UCLA Anderson Forecast, does not see a "full-blown recession" for California.

"Real estate has been a really significant drag on growth, but hasn't been enough to tip the economy into recession yet," he says.

"California has seen significant job loss in construction and worse-than-expected job loss in the financial activities sector, which is primarily driven by mortgage-related job losses," he adds. "Outside of those two sectors, the rest of the California economy is moving slower than [a year ago], but still holding up OK."

Real estate job losses will continue through most of 2008, according to Ratcliffe. He predicts unemployment will peak at 6.1 percent for the state late this year. Real growth in the gross state product (GSP) and personal income is expected to be in the 1 percent to 2 percent range this year. A contraction in state and local government will "derail the momentum of a private sector beginning to recover in 2009," Ratcliffe predicts.

While it will feel like a recession for the real estate sector, it will be a "near-miss" for the state economy as a whole, he says.

Foreclosures concentrate the mind

According to his biographer, James Boswell, Samuel Johnson once quipped: "Depend upon it, sir, when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully."

Today one might say the same thing about foreclosures. And a ranking of the metropolitan areas with the highest foreclosure rates may prove to also concentrate one's understanding of the housing market in California.

A ranking of the state's top MSAs by highest foreclosure rates prepared by First American CoreLogic for *Mortgage Banking* shows how quickly the situation has deteriorated in the state. Topping the list with the highest foreclosure rates are Merced and Stockton in the Central Valley. Merced went from a foreclosure rate of just 0.3 percent in December 2006 to a rate of 1.6 percent in December 2007. Stockton went from 0.4 percent to 1.6 percent during the same period. Modesto went from 0.3 percent to 1.4 percent over that same one-year period. And all these foreclosure rates are expected to continue to climb (see Figure 1 for foreclosure rates in other California communities).

Public awareness of the state's high foreclosure rates and the media spotlight on the auction of both foreclosed and new homes have brought the reality of the declining market to California homeowners in a more immediate way than is typical, according to the Center for the Continuing Study of the California Economy's Levy. "[Thus], the process of adjustment is much quicker because of the fact everybody now knows there are a bunch of homes that lenders and/or borrowers can't renegotiate on, and [they] are just sitting there. The other thing that's happened is that the new-home builders cut prices immediately," says Levy.

The role of lending

Levy identifies more high-risk lending and the reverse side—riskier borrowing by consumers who knew they were taking on more than they could afford—as key factors in driving prices too high and setting the stage for the current meltdown. This was further aggravated by the false hope on the part of many home buyers that prices would keep rising.

"The prices got too high in relation to incomes here, and in relation to competitive prices in other markets," Levy says. "The loan structure didn't matter as much as that whatever [borrow-

ers] have done, they bought on the anticipation of higher prices”—even when their incomes could not sustain the cost of the monthly mortgage and other home expenses at the initial interest rate. If borrowers had not overextended themselves with mortgages they could not now afford, the price of homes would not now be falling quite so fast, Levy explains.

“It shortened [the period of price adjustment] because some of the homes have to be put on the market [as foreclosures], and it called attention to the fact that home prices were under pressure and is helping people adjust their expectations, which normally take a long time to adjust,” he says.

Michael Carney, professor of finance and real estate at the College of Business Administration at California State Polytechnic University, Pomona, California, also identifies riskier lending and borrowing as a major factor in the creation of the bubble—and now in the ugly aftermath. “All financial bubbles are fueled by easy money,” says Carney. In California, the rising market became a bubble market in 2005 and 2006, pushed along by looser lending practices, he contends.

Carney says that while many of the loan products were appropriate for sophisticated buyers who were putting down at least 25 percent, some lenders pushed their standards for such loans to “zero,” giving 100 percent loan-to-value ratio (LTV), no-income/no-asset loans to lower-income wage earners with poor credit. Some anecdotal evidence has surfaced to give credence to Carney’s claims. According to a Dec. 6 report in *The Wall Street Journal*, a Brazilian immigrant, 27-year-old housekeeper Naira Costa, obtained a \$713,000 subprime mortgage for a home in South San Francisco.

Carney believes the excesses of the real estate bubble in California and around the country can also be partly blamed on the government. “The government at every level, as a general matter, promotes homeownership—and this is part of the problem,” he says.

By pushing programs that get low- and moderate-income people into homes with little or no money down, and sometimes without even a job or income, governments encourage lax lending and risky borrowing with predictable consequences.

“Equity is ownership,” says Carney. To the extent that homebuyers put nothing into a home and are unable to stay in the home, they have no equity and thus no ownership, which harms the borrowers and others who have been responsible, but who see the equity in their own homes disappear as a result of the riskier lending practices, he says.

Refinancing blues

Falling house prices now make it difficult for homeowners to refinance—a troubling prospect for people who obtained adjustable-rate mortgages (ARMs), option ARMs with negative amortization or interest-only (IO) loans that are now going to reset, this time with a principal payment.

Monthly payments can jump as much as 80 percent on IO loans. This means that many more California homes could be headed for default and foreclosure. “Things deteriorated this time faster than before,” says real estate investor Norris. “This time, prices have fallen off the shelf, and a lot of people were caught by surprise,” he says.

Many homeowners who thought they had equity to refi-

nance because they had put down 20 percent or more are now finding they have to send in a check for a substantial sum (usually at least 10 percent of the new market value of the home) to get refinancing. In this cycle, too, an estimated 40 percent of first-time buyers in California had 100 percent LTV financing in 2006, Norris says.

Norris, like Levy and Carney, puts the blame for the plight of many California homeowners on the back of all the parties in the pipeline from the homebuyer to the lender to investors to those who put together the mortgage-backed securities (MBS) and derivatives. “They created loans that didn’t require people to qualify for financing in any legitimate fashion,” says Norris. He estimates that all the excess equity created by access to easy money will have to be given up in California before house prices reach a bottom.

Norris says that prices in Riverside have already fallen 30 percent, driven by sharp declines in new-home prices. He predicts that many homeowners will walk away from their homes because they are underwater, including people who could afford to continue making payments.

Homeowners will be competing against foreclosure sales this year and for much of 2009, Norris predicts. Furthermore, buyers will not be willing to stretch themselves to buy a home. Norris reports he has found that during a rising real estate cycle, homebuyers in California are willing to spend more, with a state average of 52 percent of income. However, in a housing downturn, buyers are more conservative, and will only spend 32 percent of income on housing. “It’s a very big swing,” he says.

Like Moody’s Economy.com’s Zandi, Norris does not expect to see home prices in California start to head back up until 2011.

Private-label vacuum

A much higher percentage of California’s home lending has been financed by the private-label mortgage-backed securities market rather than through the agency market (Fannie Mae, Freddie Mac and Ginnie Mae) than one finds in the rest of the United States. This is due partly to the fact that a majority of California home prices have been, until recently, too high to qualify for conventional conforming loans, which had been set at a limit of \$417,000; however, this limit was temporarily raised through the end of 2008 to \$729,750 by Congress. Secondly, California also has relied more on alt-A lending and many of those loans were adjustable-rate mortgages such as payment-option ARMs (with the potential for negative amortization) and interest-only loans. Alt-A loans, like jumbo loans, can be held in portfolio, but much of the volume has been funded through securitization.

Finally, before February 2008, most California home prices were too high to qualify for the Federal Housing Administration (FHA) program, whose loan limit was \$362,000. This made it hard for loans to California subprime borrowers to qualify for federal guarantees that tend to lower the mortgage rate and, thus, the monthly payment. It has also made it difficult for most Californians to take advantages of such refinancing programs as FHA Secure, a program that has helped 228,000 subprime borrowers to refinance since it was launched last fall, according to Department of Housing and

Urban Development (HUD) Secretary Alphonso Jackson. The Senate and House have passed varying versions of FHA reform legislation, which contain hikes in the FHA loan limits. However, in the new economic-stimulus package, both houses agreed to include a temporary increase in the FHA loan limit to 125 percent of the median sales price, with a maximum of \$729,750 through the end of 2008. This higher limit should help many first-time homebuyers in California stuck in high-interest ARMs that are resetting.

A temporary increase in the loan limits for Fannie Mae and Freddie Mac, which was a key part of a compromise economic-stimulus package worked out between the White House and the House of Representatives, could give California's higher-priced coastal markets a further reprieve from the illiquidity in the secondary markets. The agreement would grant temporary authority until the end of 2008 to purchase or securitize loans as high as \$729,750 in high-priced markets. UCLA's Gabriel sees this as critical to California's coastal communities and other high-priced markets.

"I believe that this portion of the fiscal-stimulus package could be very significant to the stabilization of housing markets in those high-priced areas, as well as the ultimate restart of the secondary market for prime jumbo loans," Gabriel says. "The lack of a secondary market for prime jumbo loans is very challenging to the housing markets at this moment, because there's very little room on lender balance sheets to originate and hold these loans in portfolio," he adds. "This will probably support home sales up into the region of \$1 million, which would be extremely helpful to major parts of California and the East Coast."

For California, a heavy reliance on private-label or non-agency financing in the secondary market, which is now almost extinct, has translated into a sharp downturn in the availability of financing for its higher-priced homes. In December 2007, the issuance of non-agency residential mortgage-backed securities (RMBS) fell to \$6.06 billion, according to FBR Investment Management Inc., Arlington, Virginia. By contrast, in December 2006, non-agency RMBS issuance was \$93.78 billion. By this measure, the market collapsed by a staggering 93 percent over a one-year period. For all of 2007, non-agency RMBS issuance was \$57.1 billion, compared with \$138.4 billion in 2006, according to FBR Investment Management.

While non-agency jumbo securitization is a shadow of its former self, it has held up better than other segments of the non-agency market. In December 2007, for example, non-agency RMBS jumbo issuance volume was \$3.78 billion, more than half of the total \$6.06 billion RMBS issuance volume. Alt-A RMBS issuance, by comparison, was only \$860 million in December 2007—a mere hint of the \$27.2 billion alt-A non-agency RMBS issued in December 2006.

The other segments of the non-agency issuance in December were as follows: subprime, \$965 million; home-equity line of credit (HELOC), \$442 million; with closed-end second mortgages at absolute zero.

When one looks at the degree to which California depends on non-agency financing, it is clear just how devastating the collapse of this market has been for the state. In a brief commentary note issued last October, Fannie Mae reported that

agency loans represented a minority, or 45.5 percent, of all outstanding securitized loans in the Golden State. By comparison, agency loans represented 68.5 percent of all outstanding securitized loans for the nation (see Figure 4).

Alt-A loans in California took the next biggest share, at 24.5 percent of outstanding securitized loans. This is double the national alt-A level of 12.6 percent. Not surprisingly, California has a big share of jumbo loans—16.3 percent of the outstanding securitized loans—which is more than double the national level of 7.6 percent. Finally, California's subprime loans represented 13.7 percent of outstanding securitized loans, somewhat higher than the 11.4 percent share for subprime nationally.

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California's reliance on private-label securitization for so much of its financing is now a major factor in the accelerating pace of home-price declines. "Prices were slumping, but now they're caving—in large part because the subprime financial shock just cut off mortgage credit," says Zandi. He points out that "85 percent of the mortgage originations in the Bay Area in 2006 were private-label, nonconforming." Without such financing available today, it has "just completely undermined the market" for home sales, Zandi says.

On the plus side

The fate of California's residential real estate market is a key factor affecting the economic fortunes of the state, according to Levy at the Center for the Continuing Study of the California Economy, which does five- and 10-year projections of economic activity. From the broader perspective, the big drop in prices is, in fact, a good thing for the long-run outlook for the state, Levy claims.

"I think California would have been in deep trouble as a competitive economy from housing prices" if prices were not falling, he says. "As painful as this is, it is a correction that needed to happen if industries here in the state economy are to have any chance of hiring the number and kind of people they want," Levy adds. If prices had not fallen, California would be stuck with the high-price market that "was good for people making \$200,000 a year or more—and not much good for anybody else," he says.

Lower prices are particularly helpful in what Levy calls California's safety-valve markets—places like the Sacramento region and the San Joaquin Valley in the north and center of the state, and the Inland Empire and Antelope Valley in Southern California. Eight or nine years ago, prices in these markets were at the national average, he says. "People [complained] about the commute, but you could buy a house out in

those areas for \$100,000 or \$150,000, or fancy houses at \$200,000," Levy says. Because housing was affordable in these areas, half of the state's increase in housing in recent years has occurred in the safety-valve markets. Unfortunately, "prices there went nuts," Levy says.

Levy says that prices in Sacramento jumped from \$150,000 to \$400,000, and jumped to \$400,000 in the Inland Empire. For Santa Clarita in the Antelope Valley, prices rose to somewhere between \$400,000 and \$500,000. Even Fresno, in the heart of the state's agricultural belt, saw prices rise to \$300,000, Levy says. "At the peak in 2005 and 2006, we had no place where an ordinary family could buy a house, unless they took out one of these new we-won't-look-at-anything mortgages," he says. "We had no housing markets where the median was under \$300,000." (See Figure 3 for trends in median home prices.)

Levy believes prices must fall back to the affordability levels that prevailed before the run-up in home values if the state's new-home construction market is to return to the building pace that prevailed before the bust. New-home construction stood at 209,000 in 2005, but fell to 112,000 in 2007,

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according to the California Building Industry Association, Sacramento, California.

At the peak, the industry generated \$68 billion to the state's economy and employed nearly 500,000 people, according to Robert Rivinius, the association's president and chief executive officer. In November 2007, sales of new homes fell to 2,968—55 percent below the 6,536 level of November 2006.

Lower home values will lead to a turnaround in new construction and send construction levels higher, Levy contends. Right now, however, people are not sure prices have bottomed, he adds. "It's not only the investors who don't know what the houses are worth," he says. "The potential buyers are [not sure]," he adds. "So, the turmoil creates paralysis, which is why resales have dropped from near 700,000 to below 300,000," Levy says. "It's not just that people aren't writing jumbos and that people can't get credit as easily. It's [also the fact] that many people can postpone the most expensive durable [goods] purchase they'll ever make. Why shouldn't they?"

The Real Estate Research Council of Southern California, Pomona, California, and its partner organization, the Real Estate Research Council of Northern California, track prices by having appraisers re-appraise the same house again and again over the years in order to track prices in a way the spon-

sors believe better reflects actual price changes, according to Carney.

The primary data source for median and average home prices comes from DataQuick Information Systems, San Diego. The median-price numbers for homes in markets across the nation are among the most commonly quoted data for the housing market. DataQuick numbers include all homes sold, based on local government filings. Trends in median prices may be affected by a "shift in the mix" of homes that are sold in a given period, according to John Karevoll, analyst with DataQuick.

According to the method employed by Carney and the two Real Estate Research Councils, prices in the third quarter fell in all the counties they track in both Northern and Southern California, except for San Francisco and Santa Clara (home of Mountain View, California-based Google Inc. and its many newly minted multimillionaires). This counters some reports that have found price increases in some coastal markets. In those two counties, prices rose very modestly in the third quarter, according to Carney. DataQuick's report on median prices for December, however, found prices fell marginally even in San Francisco County (\$745,000 in December 2006 to \$733,500 in December 2007) and Santa Clara County (\$668,500 in December 2006 to \$664,000 in December 2007).

Inventory run-off

In order for the housing slump to play out and come to an end, home sales need to rise enough to run down the excess inventory of homes for sale. If one looks at historical trends on how long it takes to run through a down cycle, one finds that California is well on its way through the current cycle, according to Andrew "Drew" Gissinger III, executive managing director, residential lending and insurance, at Countrywide Financial Corporation, Calabasas, California. Historically, it has taken 28 months for sales volume to fall from peak to trough. Historical data also show that sales volume in California from peak to trough will fall 53 percent for new homes and 24 percent for existing homes.

In the current cycle, by January 2008, the down cycle in sales volume had already lasted 30 months. Further, October sales volume for new homes had already fallen 47 percent, while sales of existing homes had fallen 30 percent.

"So new-home sales and existing-home sales are at those historically low levels," Gissinger notes. Operating on the belief that "all things return to the norm," Gissinger thinks home-sales volume will hit bottom in the second quarter of 2008 for California (but the first quarter for the nation as a whole.)

He sees one of the benefits of the sharp drop in prices, especially new-home price cuts, is an improvement in the affordability index that showed up in the third quarter of 2007 and continued into the fourth quarter. "We expect the affordability index to grow materially in California in 2008," Gissinger says.

Gissinger calculates that in 2007 there were 2.1 million vacant existing homes for sale in the nation overall, nearly double the historical average of 1.1 million. At the same time, there were another 180,000 completed new homes for sale, more than double the 80,000 historical average for the United States. "The underlying fundamentals of homeownership have

not changed” despite all the current problems in California and the nation, says Gissinger. “People still need a house to live [in],” he says.

“There’s a certain amount of relocation, divorce, death, migration,” which adds up to net new demand each year of 1.4 million homes, according to data on household formation from the Harvard Joint Center for Housing Studies, Cambridge, Massachusetts, Gissinger notes. Then, there’s also a certain amount of demolition—about 200,000 homes a year—which increases the demand for new housing to 1.6 million a year. If one then looks at the rate of new-home construction—an annual rate of 1 million for December 2007—that means that normal demographic factors will absorb 600,000 homes a year. Given the 1.1 million in inventory, that means that the excess housing could be absorbed in just under 1.8 years.

Similarly, demographic trends in California—from immigration to inland migration—will help absorb the excess inventory in the Golden State. “The ultimate key will be the job market, because if you have a job and you’re working, you pay your house [payment],” Gissinger says. “So, if jobs are good and [moves] by the Fed are accommodating, this will be the primary stimulus that mutes any sort of long, drawn-out downturn,” he adds.

Countrywide, he says, sees the nation hitting a bottom in home-sales volume in the first quarter of 2008, with California in the second quarter of 2008, and sees the nation hitting the bottom in terms of home prices in the first quarter of 2009, with California in the second quarter of 2009.

The role of builders

An important turning point will come when new-home construction hits bottom and starts to head back up. “Once the industry stabilizes, it’s really no longer a negative effect. It’s just not a positive effect,” says Levy. “Once you’ve adjusted construction and financing to selling 300,000 homes a year and building 110,000 homes a year, it’s not going to go down. It’s just a question of when it turns around and goes back up,” he adds.

Carney points to the number of permits issued for units for single-family and multifamily as the indicator that can signal a turnaround in new construction. So far, it’s only pointed downward, but it may be getting close to a bottom.

Total residential-permit units reached a peak in 2004 at 212,920. Permits fell to 26,997 units in the third quarter of 2007, a 55 percent decline from the quarterly peak of 59,272 in the second quarter of 2005. At the same time, the unsold inventory of tract housing has been steadily rising. It was 1,973 homes in the six largest counties in Southern California in the second quarter of 2004, rising to 18,761 in the third quarter of 2007, declining slightly to 17,756 in the fourth quarter of 2007.

In some locations, such as San Diego, the increase is proportionally higher. “In San Diego, the builders went nuts building condos,” Carney says. The inventory of unsold new homes in San Diego reached the highest level in its history in 2006, he adds. Since then it has remained high, standing at 4,208 for condos (attached homes) in fourth-quarter 2007 and 1,405 for detached homes.

Home-builder woes

Needless to say, California home builders are in a pinch. One consultant who has advised builders in Northern California and the Central Valley for the past 10 years on how to price homes and what incentives and premiums to offer, reports that customers want to buy but cannot obtain financing. “It’s not a lack of traffic [of potential homebuyers looking at models]—they have traffic, which wasn’t the case in the early 1990s,” says Greg Paquin, president of the Gregory Group, Folsom, California, located just west of Sacramento.

“You have people coming in who are willing to buy a house, but they can’t qualify [for a mortgage] based on current standards and current credit conditions,” Paquin says. “They don’t have the credit scores, or their income needs to be more,” he adds, noting that stated-income loans are no longer available.

In Paquin’s view, the sharp decline in home prices in the inland markets of California is being driven by pricing decisions made by home builders—and not by homeowners who read about foreclosures and adjust their prices downward. He notes that in the downturn in the early 1990s, there were far fewer builders that were public companies working in new-home construction in the Sacramento area, and many of the inland markets where prices have risen so steeply.

During the boom years over the last decade, there have been more publicly held builder companies, and this is now affecting the pace of pricing declines, he says. “In a market like Sacramento, over 50 percent of market share is public companies,” he says. For example, Centex Corporation, Dallas, has 19 projects—12 of which are in master-planned communities, he notes, “and they’re going to do what they can do to get out of there.”

KB Home, Fort Worth, Texas-based D.R. Horton Inc. and Miami-based Lennar Corporation are also trying to move inventory as much as possible. “They’re moving product much faster in order to bring in cash to balance up the balance sheet and write off assets,” he says. This means sharper price reductions. Private companies do not behave the same way, because for one thing, they do not have the same short-term outlook, according to Paquin.

In this cycle, home builders in California and elsewhere are going beyond speeding up the sale of inventory and slowing down new-home construction, to shutting down entire projects and selling the vacant lots. Lennar Corporation, for example, and Morgan Stanley Real Estate Fund II LP, Los Angeles, an affiliate of Morgan Stanley & Co., New York, formed a joint venture land bank at the end of November. Lennar is expected to sell 11,000 lots worth \$1.3 billion for \$525 million. This deal gets the depreciated land off Lennar’s balance sheet, which will give it a big cash infusion.

The properties in the deal are in 32 communities in major projects in California, as well as Colorado, Florida, Illinois, Maryland, Massachusetts, Nevada and New Jersey. Paquin expects to see more land selling in the Sacramento area. Other builders that can afford to do it may just mark down the value of the land, taking the loss now on their books, and then sitting on the land until a recovery begins, he adds.

Sometimes, however, the bank takes back the lots because it has called the loan on the property because the values have fallen, and the builder walks away from the lots. Shutting

down projects and bank foreclosures on lots can significantly reduce potential inventory, which is good for home values, he says. Paquin believes the new-home inventory has, indeed, peaked in Sacramento and is headed down. The first half of 2008 will be worse than 2007 for the real estate market, but he sees a possibility that housing markets will stabilize in the second half of the year—or at least it “stops getting worse.”

If there is no recession, Paquin expects that sales will rise in the spring of 2009. The Central Valley may come out of the slump later, because the downturn started there in 2006 instead of 2005 for most of the state.

Where will prices be when this is all over? Paquin says that net pricing in Sacramento has come down 20 percent from the peak, falling from \$500,000 to about \$425,000 or so. He thinks it will fall to less than \$400,000, perhaps to \$375,000, by the end of 2008 in the Sacramento area.

Paquin also measures the ratio of income to loan amount in the local market as a way to measure where builders should price their units. He says the ratio of the homeowner’s income to the value of the mortgage loan was 6.0 in 2000 in

The fate of California’s residential real estate market is a key factor affecting the economic fortunes of the state, according to Levy.

Sacramento. It rose to 9.0 in 2005. Paquin expects it to fall back to 6.0 by the end of 2008, putting the income/home-price ratio back to where it was in 2000.

Paquin believes the market for new homes will come back. “When we look long-term—five, 10 and 20 years—there are huge opportunities in Sacramento and the Central Valley,” says Paquin. “You’ve got an aging population in the Bay Area; you’ve got equity values in those homes,” he says, noting that a lot of the demand for housing in Sacramento comes from people who’ve sold their homes in the Bay Area and relocated. “There’s an increase in population in the state of California. We’re nowhere near meeting the demand of housing,” he says. “Any way you slice it, the opportunities long-term are, to my mind, very, very good,” Paquin says.

Despite its current woes, California’s climate and way of life are expected to once again draw people and businesses to the state when the housing market becomes more affordable. Next time, however, many hope that housing construction and real estate values move ahead at a more measured, sustainable pace, and that the state avoids a new bubble. Vigilance and common sense can certainly help curb potential future excesses. But will people remember how bad it was once the good times start rolling again? **MB**

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