

Coming Cyclical Changes Noted in Property Markets

by John V. Kamin

More and more new evidence of a change in the real estate market is emerging every week.

Supply Changes

Certain large cities have noted an increase in the supply of homes for sale. One example: a change from a two month supply of homes for sale to a seven month supply of homes for sale, new and used. This increases the supply.

Here's another supply change: a downturn in building permits for new housing construction. Fewer new houses built mean less supply, not more. You can watch housing permit totals. Government leaders watch this figure closely because the construction industry spawns many new jobs. A drop-off in housing permits could also mean layoffs among major housing builders and more unemployment claims.

Another key indicator is that mortgage loan applications have been weak, then picked up slightly, then turned weak again. If fewer people are applying for mortgage loans with mortgage brokers, that indicates less real estate sales activity.

Resales (used homes) are also turning weaker. We're watching trends rather than actual numbers because sales activity is still at record levels. Prices are still rising – slower.

Demand Shifts

Any tighter supplies in new homes means more people must buy a used a home. That's for people who already own a home, or several, and want to sell one or more existing homes.

Important distinction: resales of used homes do not generate jobs the way new home sales (new construction) do. Already-built homes may undergo some rehab but also may not. However, a drop-off in resales of used homes at some later date may indicate a very soggy sales market.

More New Indicators

If you are a property owner or someone active in real estate, ask yourself if you are getting "more property offerings" by people you don't know or know only slightly. For example, in the widespread Philadelphia/South Jersey market where prices are still cheap on existing homes, contractors are having trouble selling both new and refurbished homes at market levels. This would indicate a softening of the home sales market in the metro Philadelphia area.

What's Up? Commercial Deals

Commercial building sales, small buildings, office buildings and strip malls are proceeding at a normal to increased pace. There has not been a measurable fall off (yet) as there has been in home sales.

Important New Trend: Commercial building resales are holding up well because commercial rents are rising.

Rental properties are often sold or appraised on the basis of the rents they generate (GRI or Gross Rental Income yearly). Rising rents and reasonable multiples (other than

Orange County, CA) tend to stabilize or increase commercial property values and resales of already-built buildings.

Analysis: More property buyers are searching in new property sectors for greater values. Among these new areas are apartment buildings, small business buildings, strip malls, vacant lots or commercial-zoned buildings, etc. Many of these resales are based not only on upon yearly GRI, now increasing, but also location, location, location. Commercial activities are not usually subject to the same competition that plagues homebuilders with excessive inventories.

Commercial building resales are more appropriately based upon: 1) rental income generated, 2) higher replacement construction costs and 3) location. It's a numbers game, not a potential homeowner romance game.

Do You Play the Game? Your Uncle's "VIG".

This economist finds it useful to think of real estate cycles as a game, rather than some kind of totally objective pursuit, whether its homeowner sales or commercial property sales.

Much of final sales prices depends upon how good you are at negotiations, buying or selling. (See our helpful booklet *How to Negotiate for Profit – 25 Ways to Buy Cheaper, Sell For More Money and Improve Your Lifestyle Through Better, Easier Negotiating.*)

The Biggies: while larger commercial properties and tenant-in-common properties are selling, that tends to be more of a numbers game and depends upon income tax issues; not necessarily property tax issues, although property tax is an issue; but more dependent upon capital gains profit tax issues and income taxes – state and federal.

Home sales prompted by tax issues, seven figures, eight figures and up usually draw upon the existing team resources of CPAs, appraisers, insurance companies and other lenders' financing. 1031 exchanges evolve.

For example – big deals normally do not involve large numbers of individual buy/sell commercial property owners, six figures to low seven figures – an entirely different game!

Predictions and Forecasts for 2007 – 2009

For homeowners, supply and demand issues are more pressing.

Forecast: Outside developments, politics, probably will affect individual home sales during 2007 to 2009 in a weak to negative market.

I recall in the 1969 – 1972 real estate property cycle that many property owners would not cut home prices ... even as home supply offerings increased. That led to a stagnant market.

In the Los Angeles area in from 1966 to 1972, medium priced homes (\$25,000 to \$27,000 for four bedroom, two bath commuter homes) relatively new could be picked up by dozens to the 100s in individual sales. Listings were massive leading to oversupply and a buyer's market. You probably should have bought a few homes with five percent down and 95% financing on \$25,000 prices, then rented them out. Those same homes are now median-priced listing to \$600,000, paid off. And home rental rates are increasing, due to a shortage of homes for rent!

It would not surprise me to see home sales soggy for two to three more years. But it's probably too soon to make great deals on new homes or rehabs. For example – prices

could fall in this area \$50,000 to \$100,000 on medium-priced homes. But perhaps the market will just stagnate instead as it did leading up to the Wall Street Crash of 1929-1932.

More data, time and information is needed to refine Forecaster predictions on commercial properties.

Forecast: I expect the slight boom in small commercial properties to continue in 2007-2008 in the outlying areas of major metro job centers. Much depends upon outside factors, non real estate related such as returning vets from Iraq, Afghanistan, federal budget deficits, the hike/no hike movements of the Federal Reserve regarding interest rates. Most property, both commercial and residential is purchased with borrowed money. While politics and rates are factors outside the real estate market, they do influence it, especially in combination.

1945-1949 Repeated Cycle?

During WWII and shortly thereafter, building at home lagged. You couldn't get building materials, iron, copper or lumber. Gas was rationed at 5 gallons per week. Economists in 1945 predicted a horrible recession for the USA when all the military folks returned home.

But the Contrarian view prevailed instead. As all the soldiers and sailors came home, they started families and took advantage of easy government financing to buy new homes. There was a waiting list on new cars extending all the way from 1945 to 1949 before production cured shortages. It wasn't until the short-lived 1949 recession that car sales finally dropped off as supplies caught up to existing demand. Recession ended when North Korea invaded South Korea in 1950-1953. From 1942 to 1945 you could not buy a new car. Drivers drove on bald tires as all resources including rationed gasoline pretty much were prioritized for military usage. By 1946 Americans were so overjoyed at the end of WWII that they threw away their now useless ration books for food, consumer goods and gasoline once building materials and cars again became available as the war ended.

Entire factories were cut over to produce consumer goods, cars and household appliances. War surplus Jeeps and trucks became popular for a time when you couldn't get cars. How does 1946 relate to consumer demand for cars and houses in late 2006?

2007-2009 Predicted

The end of the Iraq conflict is not yet in sight. There may be other breakouts of hot wars and brushfire conflicts in the Mideast, Iran, Syria and even in the Persian Gulf. Events can overtake rational decisions.

Hence, our advice for the last two years, 2004-2005 still applies in 2006. If you own multiple properties, sell your worst one or two properties now while there is still some strong demand. But keep the best; keep the rest as 2006-2007 commercial and residential rents are still rising.

The length and direction of the real estate cycle requires more study, more incoming data – not available until later in 2007-2008.

We'll keep you informed in the Forecaster with Contrarian analysis, from your professional private economist. You'll need Forecaster Moneyletter strategy more than ever as cycles change and as new trends emerge in 2007 to 2009.

Newest Trends: Cash-Flow Properties

New Trend #1: Vacancy rates on apartments are rising nationwide to about 6%. There are some exceptions, such as New York City, Washington D.C. (election related?) and a few other tight markets.

But many markets in Florida and elsewhere are being affected by condo conversions being reconverted back to apartments due to slowing sales. The increased supply of apartments, ex-condos, for rentals, is a countervailing force holding down rent increases.

Trend #2: Rent increases are coming anyway, even as vacancy rates go up slightly. Some doubling-up among tenants is happening; taking in roommates for the first time, rather than renting single apartments.

Trend #3: Nationwide, rents have been increasing to \$900 average for apartments. But, in certain more-in-demand areas, such as Los Angeles, an average rental exceeds \$1,400. Same for Chicago, Boston, San Diego, San Francisco and a few other higher-priced metro areas.

According to a *Wall Street Journal* article by Alex Frangos, January 5, 2007, one pro says, "If you are at 97% to 98% occupancy, you're not pushing rents hard enough." My personal experience, if you've had 100% occupancy for some time, you're probably way behind the market on rents.

Continued new trend from recent months: Condo sales are slowing, and condo speculators are turning condos back to the apartment rental markets to get some cash flow from rentals to support the condo mortgages and expenses.

FORECAST: Increased vacancy trend is likely to continue throughout 2007-2008.

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