

The California Crash

By Bruce Norris, The Norris Group

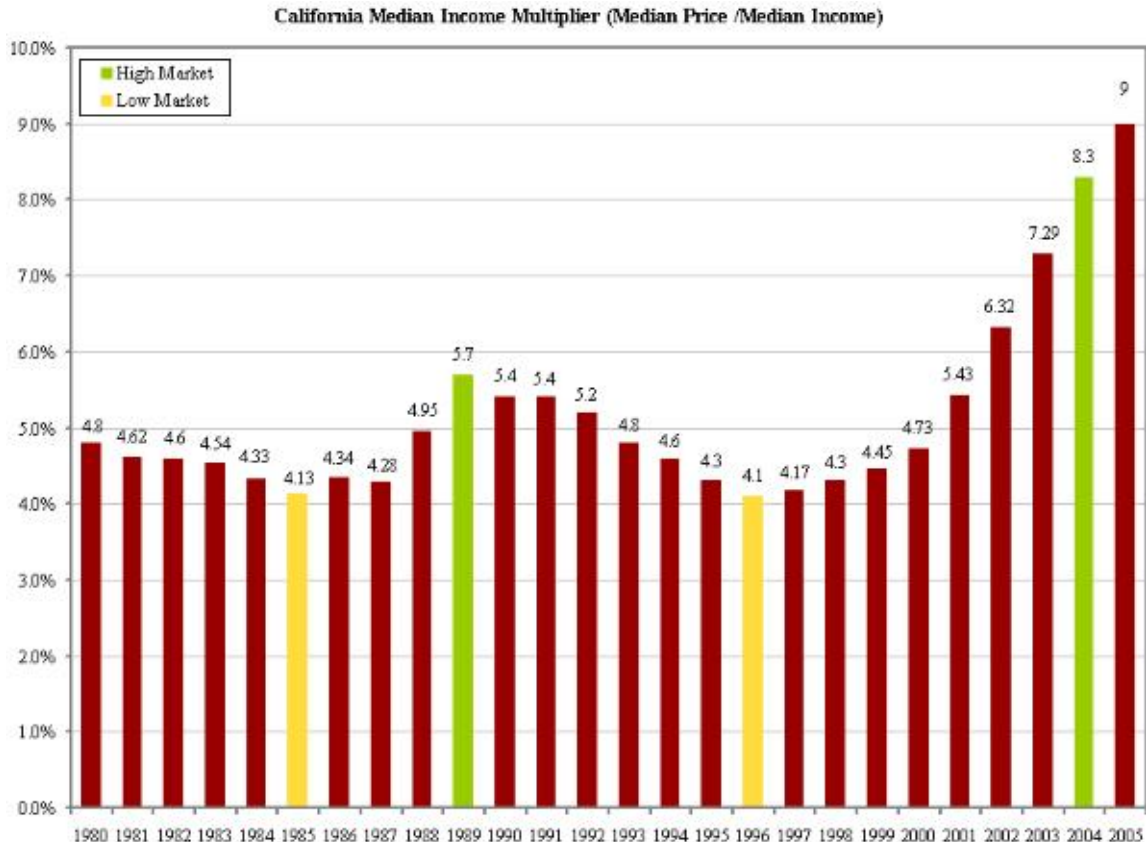
In January 1997, I wrote a report called The California Comeback. It predicted the doubling of California's real estate prices by January 2005. Fortunately, that turned out to be not only correct, but conservative. California's median price in 1997 was \$177,600, with an affordability rate of 40%. In August 2005, the median price has skyrocketed to \$568,890, with an affordability rate of 14%. The monthly affordability rate of 14% equaled the all time low reached only one other time in July, 1989. For only the third time in California's history, will we have an affordability rate for a year reach 17%.

For me, this is a very significant event! Every other down cycle for California's real estate market began with the initial event of reaching 17% annual affordability. Affordability is calculated by assuming the purchase of the median price home with the buyer putting up a 20% down payment. Combine that remaining balance with the going interest rate results in a monthly payment. The affordability rate is how many households would qualify for that payment.

It's bad enough that we've reached the 17% affordability rate. The real problem is how we got there this time. In 1980, we reached 17% affordability with a median price and a 16% interest rate. In 1989, we reached 17% affordability with a median price and a 10% interest rate. In 2005, we've reached 17% affordability with a median price and a 6% mortgage rate.

By contrast, the price increases stopped in 1980, because interest rates finally made the payments too high. In 2005, the payments have reached the breaking point solely on price increases. This is going to cause a real problem!

This chart shows how far out of whack our prices are when compared with our median income.



Historically, when California has a price boom, households are willing to spend a greater percentage of their income to purchase a home. In 1989, households were willing and able to purchase a home 5.7 times their median income. When the market shifted into reverse, households paid only 4.1 times their median income for housing. Prior to this last cycle of price increases, the historical high multiple of income was 5.7 times. Today, that multiple stands at 9.0. This is a very significant problem!

The only way we will be able to maintain the price levels we have is if interest rates stay at 6% or below. If we experience interest rate hikes, the price levels in California will be damaged significantly! In 1989, with a 10% interest rate, a 5.7 multiple of income caused a 17% affordability rate. We are at the 17% affordability rate in 2005 with a 9.0 multiple because of the 6% rate. If you woke up tomorrow and interest rates changed to 10%, the price hit would be as follows:

Current median price of \$540,000 = 9.0 x \$60,000 median income

Change the interest rate to 10% and the maximum multiplier to 5.7

5.7 x \$60,000 would be the new maximum median price of \$342,000.

Now, let's paint with a more realistic scenario. Can you envision an 8% interest rate by 2010? By 2010, California real estate will be at the bottom of the next cycle. History shows that we pay a 4.1 multiple times our median income during the bottom of a down cycle.

If California's median income in 2005 is \$60,000, we've calculated a 3% increase annually and by 2010, the median income is about \$70,000.

\$70,000 times a 4.1 multiple is \$287,000. Because we only reached an 8% interest rate, we can add 25% to that price. {8 x 1.25 = 10}

\$287,000 x 1.25 = \$358,750.

How ever you slice it, California's median price is not sustainable!

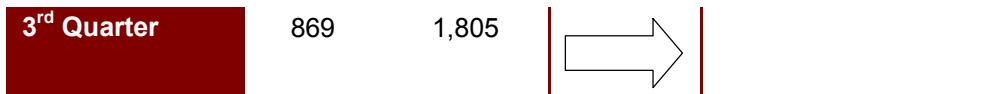
Reaching 17% affordability affects the velocity of real estate sales. We simply can't pass our house to the next buyer as quickly, and inventory builds. This creates motivated sellers and the inevitable slowing of price acceleration and eventual price declines.

The prototype for California's future problems is being played out in San Diego. In early 2005, I debated a number of economists about what I saw coming. They completely disagreed with me, saying that San Diego was not going to have a downturn. They cited as reasons a shortage of land, more demand than supply, and a diverse economy.

Since that time, the number of listings in San Diego has increased from 3,000 to over 15,000. The number of unsold new houses has gone up 400%. In a November 7th article, a builder doing condo conversions in San Diego brushed off the fact that he had so many unsold units: "I think San Diego is just starting. San Diego is a lifestyle city, and lifestyle cities over the next five years are going to grow more than any other cities in the country. Demographics point to a long term demand for housing. I can see nothing that can slow San Diego down."

He said that in spite of the facts:

	Sold	Unsold	Number of Units Being Converted
2 nd Quarter	1,843	1,446	3,541



He's bringing exactly the wrong product to market at a very inopportune time!

By the way, if by demographics he means continued net migration gains for California, he's wrong there as well. In a recent article put out by economy.com, they stated California lost 110,000 in domestic migration between April 2003 and April 2004. I was surprised at the large loss and called the author of the article. His source turned out to be tax returns filed with the IRS! I then called Sacramento and asked them to comment. They had authored a report early in 2005, claiming net domestic migration was positive during that same time span by 50,000. I asked the woman who had written the Sacramento report her opinion of what economy.com was saying. She said those numbers could not be correct. I had her call and confirm their accuracy with economy.com. She then called me back and said, "Well, as it turns out, his numbers are correct."

On February 25th and 26th, we'll be holding a seminar to discuss the future of California's real estate market. We'll cut through the bureaucracy and share what we think is in store for California in great detail. This time it will include commercial property. We'll also be speaking at the AOA Million Dollar Trade Show at the Long Beach Convention Center on Thursday, May 18th. Please give some serious thought about attending.

*FOR MORE INFORMATION PLEASE CALL STEPHANIE YOUNG AT
(951) 780-5856 OR ENROLL ONLINE AT www.TheNorrisGroup.com and enter promotional code 181168*