

## Housing Market: A Slowdown, Not a Meltdown

The latest data from the California Association of Realtors (CAR) and the Office of Federal Housing Enterprise Oversight (OFHEO) show that the housing boom in the United States is still going strong, but has perhaps peaked.

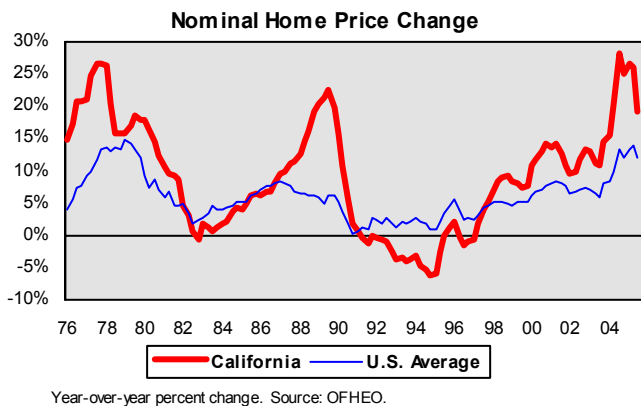
According to the recent OFHEO House Price Index report, rapid appreciation of U.S. house prices continued in the third quarter of 2005. Average U.S. home prices increased 12.02% year over year. This rate, however, was almost two percentage points lower than the near-record 14.01% annual increase in the previous quarter. (See the chart below.)

Homes in California appreciated by a whopping 19.26% over the one-year period up to September 2005. Still, the rate represented a considerable slowdown from a year earlier when the 28.17% annual rise set the record for the state.

annual increases of less than 10%. This changing of the guard in home price appreciation is narrowing the affordability gap between the coast and inland areas.

A similar shift is afoot nationally. Price appreciation has moderated in some of the previously hot markets. Most notably, Nevada—which ranked No. 1 based on one-year home price appreciation a year ago with a 37.18% increase—slowed to a more sustainable 17.59% for the past year. Hawaii and California, ranking second and third a year ago, also have cooled. Conversely, home prices gained much upward momentum in heretofore subdued markets, including Arizona, Oregon, Washington, Idaho, and Utah in recent quarters. If anything, the housing booms both across the United States and in California are not ending, but spreading more broadly.

At the bottom of the price appreciation list are five Midwestern states: Michigan (4.01%), Ohio (4.47%), Nebraska (4.93%), Indiana (4.95%), and Kansas (5.05%). Employment growth has been particularly weak in the Industrial Midwest (Michigan, Ohio, and Indiana) because of the region's heavy dependence on the troubled automotive industry. This fact once again proves that healthy local labor markets are essential for strong housing markets.

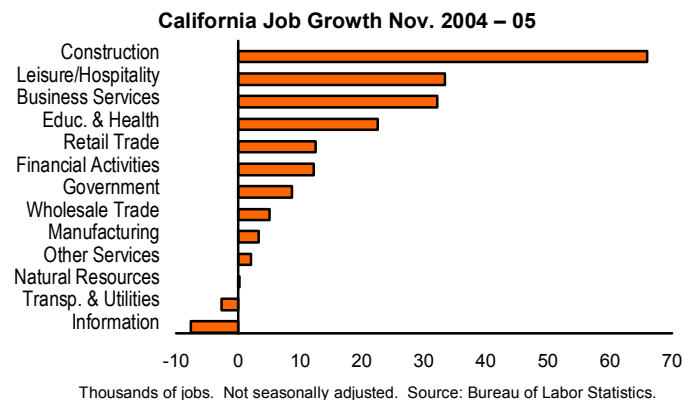


### Home price appreciation accelerates in some markets.

The November home price report from CAR paints a similar picture. The median price of an existing home in California increased 16.2% over the previous twelve months. The annual appreciation rate a year ago was about 23%.

Do those figures signal that the housing boom in the Golden State has ended? Hardly. In fact, some California markets have experienced extraordinary price appreciations over the past year. CAR's monthly housing reports include a top 10 list of communities with the greatest annual home price increases. The November list included Atwater, Bakersfield, Banning, Barstow, Delano, La Quinta, Ridgecrest, Sanger, Twentynine Palms, and Yucca Valley. Their appreciation rates ranged from 45.9% (Atwater) to 79.5% (Delano).

These are all communities in the Central Valley and High Desert regions—the parts of the state once known for affordable home prices. At the same time, the markets that were touched by the boom earlier, such as the San Francisco Bay Area, Orange County, and San Diego, have slowed to



### The housing boom boosts job growth in California.

Fortunately, the pace of job growth in California is fairly strong. Since November of last year, nonfarm payroll employment increased by 1.3% in the state, a little slower than the national average of 1.5%. As the above chart shows, all industry categories, except the information and transportation sectors, have added workers. Job losses are concentrated in subcategories like telecommunications, publishing, movie production, and airlines.

Considering that past regional housing market corrections were invariably triggered by local job implosions, the ongoing employment growth bodes well for the California housing market. Of course, the housing boom itself has fueled job growth in the state. The construction industry has added 66,000 jobs over the past year, accounting for more than one-third of total jobs gained during the period. Tourism, business services, and health care also expanded strongly, contributing almost 50% of new jobs. The service sector expansion will likely keep payroll employment growing in California even if construction activities slacken.

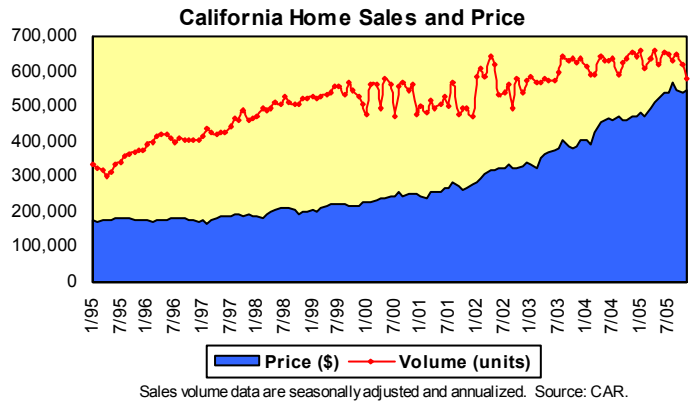
Geographically, employment growth has remained robust in the Central Valley, especially in Bakersfield and Modesto. Growth in Southern California has been steady, but the Inland Empire and Orange County have decelerated from their breakneck pace in 2004. The San Francisco Bay Area had its first payroll employment growth in 2005 after four consecutive years of declines.

**The housing market is headed for a soft landing.**

While the California housing market retains much momentum, especially in inland communities, there are signs that the boom has already peaked. The Unsold Inventory Index for existing, single-family detached homes from CAR was 3.9 months in November 2005, compared with 2.8 months for the same period a year earlier. As we see in the first chart, the price appreciation has also slowed.

Perhaps the most telling sign that the boom is winding down is the falling number of home sales. The sales volume in November 2005 was 11.2% lower than a year earlier, while the median price of an existing home was 16.2% higher. (See the chart on this page.) It is true that the sales volume has declined and recovered several times previously, but this time the support of falling (and then steady) mortgage rates has disappeared and higher property prices will disqualify an increasing number of potential buyers.

We must remember, however, that what has happened so far bears little resemblance to the “bubble bursting” scenario as described by many industry analysts. The California housing market has proved to be more stable and resilient than previously thought. The home sales volume will likely decrease further in 2006, but prices will remain firm. Actually, I wouldn’t be surprised if home prices continue to rise moderately in many local markets.



In that sense, the California housing market seems to be more analogous to a balloon than a fragile bubble. This balloon is not quite as full and buoyant as before, but is also less likely to burst from too much internal pressure. (I am talking about a traditional rubber variety here, not the near indestructible metallic kind.)

So we’re likely to witness a continued slowdown of the residential real estate market, but not a meltdown. Instead of a loud pop that so many analysts have warned us about, what we will hear in 2006 is the barely audible hiss of a deflating balloon.

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**Economic Forecast – January 2006**

<b>UNITED STATES</b>	2004	2005	2006	2007
Real GDP Growth (%)	<b>4.2</b>	3.7	3.8	3.2
Unemployment Rate (%)	<b>5.5</b>	5.1	4.9	4.8
Consumer Prices Change (%)	<b>2.7</b>	3.4	3.0	2.2
Federal Funds Rate (%)	<b>1.3</b>	<b>3.2</b>	4.7	4.7
<b>CALIFORNIA</b>				
Real GSP Growth (%)	<b>5.1</b>	4.0	4.2	3.3
Nonfarm Employment Growth (%)	<b>1.0</b>	1.6	1.4	1.3
Personal Income Growth (%)	<b>6.6</b>	5.7	5.5	5.7

**Bold: Actual.** GSP stands for Gross State Product.

The information in this report is based on data available as of December 30, 2005, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.