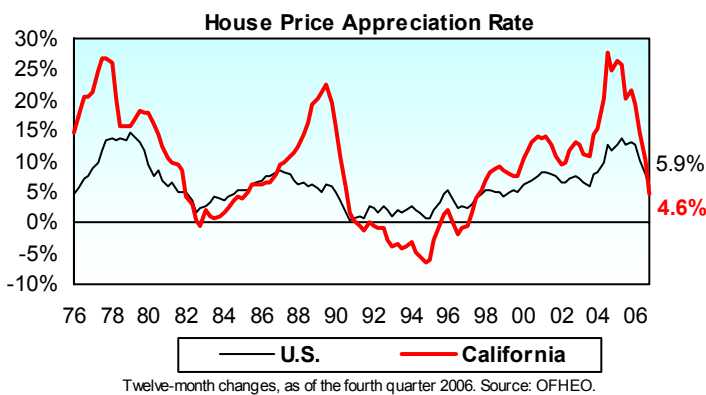




## What's REALLY Wrong with the Housing Market?

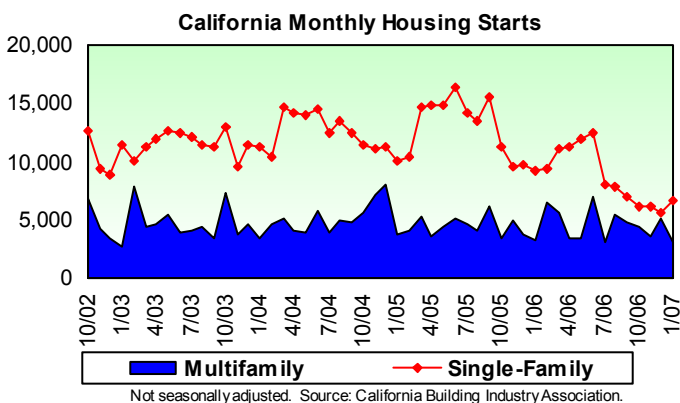
It's once again time for us to take a look at the California housing market, and it's not a pretty picture. The most recent report from the Office of Federal Housing Enterprise Oversight (OFHEO) shows that the price of homes in the state dropped by 0.4% during the fourth quarter of 2006. California was one of the four states where home prices decreased during the quarter. Over the 12-month period, home prices in the Golden State rose 4.6%, less than the national average of 5.9%, as shown in the following chart.



### Major adjustments are in progress.

The California Association of Realtors data paint an even more pessimistic picture. The median price of existing homes rose by a paltry 2.7% between the fourth quarter of 2005 and 2006. During the same period, the number of existing home sales fell more than 20%.

DataQuick Information System reports that the number of mortgage default notices filed in the fourth quarter of 2006 was 36.9% higher than the previous quarter, and up by 145.3% from the fourth quarter of 2005. At the same time, new home production in 2006 dropped 21.8% from 2005, according to the California Building Industry Association. (See the chart below.)



It's clear that adjustments in the housing market are in progress, especially in terms of new home construction activity and transaction numbers, though sales volume has stabilized in recent months and is no longer falling rapidly.

Fortunately, the current adjustments look decidedly mild compared with previous housing corrections the state has experienced, and the housing market slowdown has yet to evolve into an economic crisis. A thing to note is that home values are by and large stable; accumulated gains in home values have not evaporated, as some analysts earlier speculated they might.

But are these adjustments a real problem or symptoms of something fundamental and, therefore, more serious? I would argue that both the recent housing boom and the current slowdown are the product of the same root cause—a lack of housing affordability in California.

### Real problem—a lack of affordability.

Most people would agree that falling mortgage rates between 2000 and 2003 created a feeding frenzy in the market. But the frenzied market condition came about because so many people were previously excluded from owning homes in the face of already high prices. When lower mortgage rates cracked open the door to homeownership, everyone rushed in. Conversely, when mortgage rates rose last summer, buyers retreated and price appreciation halted.

No doubt that homeownership has advantages. Many households in California benefited handsomely from gains in the value of their homes. In addition, monthly mortgage payments (with principal amortizations) are a form of forced savings that strengthens the financial base of homeowners.

As of January 2007, the median home price in California was \$559,640, more than two and a half times higher than the national median of \$210,600. In contrast, per capita income in California (a rough proxy for household income) is only 7% higher than the national average. It's not an illusion that homes are expensive here. Everyone has to stretch to buy a house in California, and first-time buyers, including young families and newcomers to the state, must stretch the hardest.

### Ordinary people are forced to take extraordinary risks.

Those new buyers took advantage of recent innovations in mortgage products, including interest-only loans, fixed-adjustable rate hybrids with low initial rates, and optional-payment adjustable rate mortgages (option ARMs), not to mention the whole new genre of subprime lending. The end result was that ordinary Californians took extraordinary risks, not because they were reckless, but because that was the only way for them to participate in the housing market.

That sometimes led to a mismatch of a mortgage product and the borrower. For example, option ARMs, which allow choices of payment amounts each month, were originally introduced to meet the needs of people with fluctuating income, such as salespeople on commissions. Instead, the product often attracted borrowers who could only make the minimum payment, thus increasing the size of their mortgage debts—and the probability of defaults.

#### **No quick fixes.**

How, then, do we solve the affordability problem? Affordability is a function of home prices and buyers' income, so to improve affordability, we only need to reduce the price, increase the income, or both. Sounds simple, doesn't it? The big problem, of course, is in implementation.

First of all, how do we reduce or even stabilize home prices? The state faces many supply constraints, including a topography that limits the amount of land available for development, shortages of water and electricity, insufficient transportation infrastructure, and environmental concerns, including the need for open space.

Some local regulations, such as density restrictions, zoning, and setback requirements, tend to limit higher-density developments that are needed to increase housing supplies. Strong local and statewide leadership is needed to work through these issues to find long-term solutions.

How about increasing the household income? California does produce many well-paying jobs, in the professional service and technology sectors, for example. At the same time, the state also has a large immigrant population who often lack education to access even mid-skill jobs. Raising the skill level of this segment will be especially challenging. All in all, there are no quick fixes.

We also need to improve consumer awareness of both the benefits *and* risks associated with homeownership. Private sector companies, including mortgage lenders, escrow and title companies, and brokerage firms, should take the lead in this effort because they are the ones who regularly interact with homebuyers.

Free or low-cost seminars should be made available to potential homebuyers, and the abovementioned industries should strongly encourage their customers to attend them. Reflecting the demographics of the state's homebuyers, the program must be available in multiple languages.

#### **Some positive factors help stabilize the market.**

At the moment, there are a couple of positive factors that will likely make the current housing market adjustment mild. First, mortgage rates remain stable, because of low inflation and a slowing national economy. The rates are currently back where they were a year ago. The low rates will allow some homeowners to refinance and avoid costly re-pricing.

Second, continued employment growth in the state should strengthen the housing demand. The California unemployment rate in January 2007 was 4.8%. The rate was identical with the 2006 annual average, the lowest since 1976 when the state employment data series was started. The labor market is the tightest in over 30 years.

These, however, should not be excuses for complacency. Continued efforts must be made to solve the fundamental problem with the California housing market—a lack of affordability. Otherwise, economic stagnation, accompanied by severe housing market corrections, will eventually “fix” the situation, and that's not an appealing option.

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### Economic Forecast – March 2007

<b>UNITED STATES</b>	2005	2006	2007	2008
Real GDP Growth (%)	<b>3.2</b>	<b>3.3</b>	2.5	3.2
Unemployment (%)	<b>5.1</b>	<b>4.6</b>	4.7	5.0
Nonfarm Employment Growth (%)	<b>1.7</b>	<b>1.8</b>	1.2	0.8
CPI Change (%)	<b>3.4</b>	<b>3.2</b>	2.0	2.2
Federal Funds Rate (%)	<b>3.2</b>	<b>5.0</b>	5.2	4.8
10-Year Treasury Rate (%)	<b>4.3</b>	<b>4.8</b>	4.8	5.1
<b>CALIFORNIA</b>				
Real GDP by State Growth (%)	<b>4.3</b>	4.1	3.0	3.5
Nonfarm Employment Growth (%)	<b>1.8</b>	<b>1.9</b>	1.3	0.9
Personal Income Growth (%)	<b>6.0</b>	6.4	5.3	5.5

**Bold: Actual.**

The information in this report is based on data available as of March 5, 2007, 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.