Why the Housing Bubble is Bogus!

Orange County Real Estate
2006 Economic Report

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The 2006 Real Estate Economic Outlook for Orange County will be Gary's 32nd year of forecasting real estate trends to our industry.

The following is the outline Gary Watts is using in his current talk on the housing market. It shows why demand for housing continues to remain strong while supply is shrinking. It explains why the forecasting of housing declines by the pundits are wrong, once again, and why real estate values throughout most of California should continue to grow at a 15% appreciation rate. If you're wondering how often Gary has been right, here is his record for the 21st Century.

Year	**Pundits**	**Gary**	**Actual**	
2000	8.0%	12.5%	13.0%	
2001	7.7%	12.0%	10.1%	
2002	2.8%	10.0%	16.8%	
2003	2.0%	15.0%	19.1%	
2004	-2.7%	25.0%	24.8%	
2005	-7.4%	15.0%	17.7%	as of October 2005

His record has been very good and it goes back to 1989 when he told the real estate industry that their Party was Over and real estate would turn downward for at least 5 years losing close to 30% in value! He became known as Dr. Doom & Gloom and Scary Gary - until his 1996 forecast. It was then that he said the downturn was over and we would be in for another great run-up in real estate values that may last 10 years or longer!
And now, his current talk to the real estate industry . . .

"Why the Housing Bubble is Bogus!"

I. Historical View of Bubbles

A. The last *nationwide* bust of home prices occurred in the late 1930s!

1. In the past 30 years, the Federal Deposit Insurance Corporation counted **63** home-price run-ups in various cities but only **9** of these ended in a bust – all being regional!

86% of the time, the run-ups in city home prices did not end in a bust!

2. In the past 25 years, the FDIC says there were **54** instances of regional housing booms.
   - (Defined as 30% or more in appreciation - happening in 3 or fewer years)

3. During the same 25 years, the FDIC found that a "bust" occurred only **21** times.
   - (Defined as a 15% decline or more and happening over a 5 year period)

62% of the time, regional booms do not end in a regional bust!

4. A joint study by both Columbia University and the Wharton School of Business found that the *bubble is a myth*! The growth in housing prices of 46 single-family markets over 25 years is due to basic economic fundamentals, strong incomes and low interest rates!

Since 1970, the median home price in the U.S. has never gone negative!

5. In the past 30 years, there were only **9 years** when home prices did not keep pace with inflation – those years were in the early 1980s and again in the early 1990s.

B. California Housing Bust of 1990 - 1996 was caused by a huge decline in aerospace and defense jobs.

1. In the mid 1980s, President Regan proposed a *Star Wars* defense project. California was receiving 1/3 of all defense contracts with 40% of that total going to northern California and almost 60% going to southern California!
   1. The builders began large housing developments to meet the employment demands and built these tracts based upon the *economy of construction*.

2. November 9, 1989 – the Berlin Wall came down, ending both the Communist regime in the Soviet Union and the *Stars Wars* program. The major defense contractors, followed by the smaller sub-contractors, began massive lay-offs.

Southern California lost 7500,000 jobs in 3 years!

3. The builders' supply of empty and unfinished housing rose significantly; developmental land sat vacant; foreclosures began. By the end of the decline, many properties lost 30% of their value!

II. The 21st Century . . . and "Bubble Talk"

2002 Pundits Forecast – "Burst in 2002"

Why? *Dot com burst* were still lingering, terrorist attacks hit the U.S., disruptions in the economy hurting employment and we began fighting a war in Afghanistan!

Actual: U.S. home prices up 7.8% • California up 14.6% • Orange County up 16.8%
Northern California up 15.6% • Central Valley up 13% • Southern California up 19.3%

2003 Pundits Forecast – "Burst" due to over-priced real estate

Why? Heading towards a war in Iraq and the resulting bigger deficits would mean rapidly rising interest rates – hurting homeowners with adjustable rates.

Actual: Rates did not rise! U.S. up 8.1% • California up 19.4% • Orange County up 19.1%
Northern California up 11.5% • Central Valley up 20% • Southern California up 21.9%

2004 Pundits Forecast – Housing prices declining up to 10%

Why? We were in a war with Iraq, interest rates were definitely going to rise. One forecaster Said "the California economy is rolling along on a false sense of wealth". Affordability Index was dropping, and buyers would have trouble qualifying for loans.

Actual: Interest rates fell. U.S. up 10.4% • California up 20.9% • Orange County up 24.8%
Northern California up 18% • Central Valley up 19.3% • Southern California up 22.5%

2005 Pundits Forecast – Finally the "Burst in the Housing Bubble"

Why? Interest rates would reach 8%! Affordability index at record lows and with the price of oil doubling, adjustable and interest-only loans would hurt buyers and create foreclosures.

Actual: Current interest rates are where they were a year ago with no housing problems!
U.S. housing up 15.8% • California up 17.3% • Orange County up 14%
Northern California up 18.8% • Central Valley up 29.6% • Southern California up 16.1%
Los Angeles up 21.4% • Riverside up 15.7% • San Bernardino up 32.8%

2006 Pundits Forecast – Prices will decline 4% to 10%

Why? Rise in interest rates, inflation on the rise, California real estate over-valued by 40%-45%

One local university wrote this past June (regarding their 2006 forecast for real estate):
"We understand why this forecast might be met with cat-calls. Our inability to accurately forecast housing prices the past several years does not leave us with a whole lot of credibility".

In the real world of human knowledge, to be wrong by such a large percentage, for such a long period of time is taken as an indication you don't have a good grasp on what you are estimating! (tweaking a quote from Michael Crichton's fictional novel: State of Fear)

III. Why They Continue To Be Wrong!

A. What the forecasters should **NOT** be looking at: **1st - Affordability Index**

1. This index assumes a buyer has no equity down payment and is putting down 20% to buy. With this formula, only 45.9% of the population, in the U.S., could purchase a home!

2. In California, only 16% would be able to buy. Only 19% can afford a home in Riverside or San Bernardino while just 11% could purchase in Orange County. It gets worse in Sonoma, Santa Barbara and Napa at 7%, and San Francisco at 4%. Only 1% can qualify in Santa Cruz.

In the past 5 years, California residential equity has gone up by $1 Trillion!
In that time, Orange County residential property prices have gone up 118%!

3. Today's buyers have equity and, with lower interest rates, their mortgage costs are lower than they were in the early '80s when they represented 30% of household income. Today, mortgage costs only average **17.5%** of household income!

Sellers received a net of $220,240 from the sale of their home – an all time high!

4. Last year in California, we sold ***33,107 million dollar homes***. This year, we will easily exceed 40,000! Here is a list of the top 10 median prices by zip code in California:

(1) Atherton	$2,496,533	(6) Santa Monica	$1,749,834
(2) Santa Barbara	$2,176,251	(7) Beverly Hills	$1,582,886
(3) Rancho Santa Fe	$2,144,254	(8) Diablo	$1,452,500
(4) Newport Beach	$2,046,577	(9) Belvedere Tiburon	$1,421,336
(5) Ross	$1,910,263	(10) Los Altos	$1,392,522

B. What the forecasters should NOT be looking at: **2nd – Rising Interest Rates**

1. Huge employment gains are causing a *gushing of money* into the Treasury; funding requirements were reduced by $59 billion for the July/September time period.

2. There is a *global savings glut* that has translated into heavy competition to lock in long term yields. Foreigners purchased $71 billion of T-Bills in the last quarter. Pension funds, insurance companies and public/private corporations are all trying to off-set retirement obligations. We also have 78 million baby-boomers looking towards retirement and converting IRAs, 401Ks, Roth, Sep IRA and other retirement accounts into income funds.

3. Add to this the fact that excess manpower and machinery are being reduced in most industries and you can begin to understand why the **core index** is 2.1% vs. 1.9% a year ago. Even with all the oil price surges, the *consumer price index* is 4.9%.

4. This helps explain why mortgage payments are now 8% less (in the U.S.) than they were in 1989, and .02% less (adjusted for inflation), than they were in California. Since 1980, after-tax per capita incomes are up 61% in the United States.

C. What if rates went up… so few are affected!

1. Even if interest rates were to rise, it would not affect most homeowners. Here's what the Mortgage Bankers Association tells us about home loans in America:

    a. 35% own their home outright – so no interest rate problem there;
    50% have fixed rate loans – many refinancing to lower rates with fewer years;
    15% have adjustable rate/interest - 8% of those being high wealth income earners.

    Therefore: Only 7% of all mortgages are rate sensitive!

    b. Another way to look at this is to note that, out of **$7.3 trillion** in mortgages, only **$83 billion** are adjustable or interest-only loans!

    c. Today, 1/8 of homeowners spend 50% of household income on housing, while 1/3 spend just 30%.

2. The media only talks about the *explosion* in housing debt. Homeowners' equity growth in the 1st quarter of 2005 was up over $300 billion in the U.S. Today, we have **$16.6 Trillion** in household value vs. only **$7.3 Trillion** in mortgage debt.

    This is a 57% equity position – a fairly large buffer against price declines!

3. This also explains why foreclosures are going through a 9-year decline and are at a record low. The U.S. foreclosure rate is 1.0% - the lowest in 25 years. "*Expensive*" California is at **.17%- the lowest in the nation!** Through August of 2005, 41,540 homes were sold in Orange County in 2005, and only **101** of those were foreclosure sales!

IV. Looking at Reality- Demand vs. Supply

You cannot have a *housing bubble* when demand exceeds supply!

A. Demand for Housing – Current housing boom has lasted 13 to 15 years!

1. I n 1990, 2.9 million existing homes were sold in the U.S. Today, existing homes sales are on track to reach7.29 million. In California, repeat buyers make up 2/3 of the market.

    Demand for existing homes has grown 114% - while supply has fallen 4%!

2. The new home market (inventory relative to pace of sales) is near its lowest level. New home sales would have to drop by over 33% for over a year to reach equilibrium.

    New home demand is up 143% - with only a 23% increase in supply!

3. Last year, California developers built 210,000 units (homes / condos / apartments). This was a near record, yet still fell 40,000 to 50,000 units short of the demand. In 2005, builders hope to complete 212,960 units - the best in 15 years!

B. What is causing all this demand?

1. The State population growth rate is 1.6%, with 600,000 more people added last year. Over the past 3 years in southern California, the population has increased by 1.1 million!

2. Four of the 10 fastest growing areas in the U.S. are located in California. The #2 spot goes to the Riverside-San Bernardino-Ontario area - up 15.7%. Stockton is #4 at 14.4%, and the # 8 is the Sacramento-Roseville area up 11.5%. Bakersfield is #10 with a 10.7% growth rate.

3. In the next 10 to 15 years, 3.5 million more people will reside in southern California. That is the current population size of Orange County!

Orange County's housing demand is 15,000 (+) units per year but, in the last 12 months, only 3,758 single family residences and 4,651 condos / apartments were built.

4. This demand is coming in waves, the ***1st wave*** being the *baby boomers* who are now in their early 40's and late 50's. They found a way to mix leisure with work and are not ready to fully retire – they have money and income and are still investing in real estate.

    a. As investors, they average 47 years of age, have an average yearly income of $85,000 and were responsible for **23% of all sales last year**.

    b. As 2nd homes purchasers, they are approximately 55 years of age, are making $71,000 yearly and were responsible for **13% of all sales in 2004!**

5. The ***2nd wave*** of home buyers are predicted to grow at a rate of **1.17 million** per year for the next 10 years. They are *1st time* home buyers (median age 36). Those purchasing upscale properties have a median age of 45.

6. The ***3rd wave*** of home buyers is the largest group. They are presently 23 to 33 years of age and will total **1.2 million** new households per year for the next decade!

C. It's happening all over the world! *Residential real estate is up $30 trillion in 5 years!*

Appreciation Prices as of June 2005 for the past 12 months

Country	**Price Appreciation: 1997-2004**	**Numbers for '05**
Ireland	174%	11.1%
Spain	21%	15.5%
Britain	16%	5.5%
Australia	113%	1.1%
California	**94%**	**17.3%**
Netherlands	75%	11.3%
Sweden	67%	15.7%
France	59%	15.0%
Belgium	54%	8.2%
Italy	54%	10.8%
United States	**53%**	**15.1%**

D. Demand for Housing (continued) – ***here come the immigrants!***

1. The immigration of new buyers is largely due to the U.S. policy on *family reunification*. In the U.S., 2/3 of all immigrants go to just 6 states. California is the #1 destination, receiving 22.4% of all immigrants.

Latinos are the fastest growing segment of the housing market!

   a. Since 2000, 1.1 million more foreign immigrants have moved to California – which, for the first time, is a larger number than the number of migrants from other states!

   b. Four of the top 11 counties attracting immigrants in the U.S. are in California! Los Angeles is #1 – receiving 400,000, followed by Santa Clara (#5) and Alameda (#9). Orange County ranks # 11, with 82,794 foreign immigrants arriving since 2000.

   c. From 1980 to 2000, over 6.2 million minority households joined the ranks of middle-income earners and are purchasing housing. Those who arrived in the '80s and '90s with children now have children who are looking for a home!

   d. These 2nd generation Americans now account for 15% of the population between 11 to 20 years of age. If history repeats itself, they will out-earn their parents and be an even greater source of housing demand.

As 1st time home buyers, they acquire homes at 26 – a full decade before non-immigrants!
Today, they represent 35% of the *1st time* resale market (22% in '91)

E. The Supply Crisis – Adding Up the Numbers!

1. In the past 12 months, the U.S. population grew by 2.9 million persons. Between now and the year 2015, demand for new homes is on track to total as many as 20 million units annually. By 2030, there will be 80 million more people living in the U.S.!

The resulting housing needs will require that an average of 2 million units per year be built, but our current record for building is 1.1 million a year!

2. The housing market continues each year to set new records. New home sales totaled 1.1 million units last year, while sales of existing homes passed the 6.94 million mark! There are now 74.8 million homeowners (1.6 million new homeowners in the past year), who make up 69% of our population – a new high!

No state in the U.S. has recorded a decline in housing prices!
The median home price is up 15.8% (year to date) to $220,000!

3. Adding more pressures to the already strained housing market are the new players in home-ownership. There has been a 30% growth among women owning homes and a 27% increase in minorities owning homes (15.7 million). Single or unmarried homeowners are remaining single longer. They are also maintaining larger homes for their "floating children."

Last year, home purchases by "single buyers" exceeded "married with children"!

E. The Supply Crisis (continued)

4. We have **100 million** acres of land in California, but only ***5 million acres*** can be developed! With 36.8 million residents, California ranks #1 in population in the nation.

5. Demand for housing is staying strong, but land available for development is diminishing. Environmental issues restrict or reduce the size of developments, while political- and regulatory-driven supply constraints continue to hamper development of new housing.

These issues are creating a state of permanently higher prices!

6. California now has 6 consecutive years where housing appreciation exceeding 10%. The median home prices (as of October) for some counties look like this:

Marin- $899,000 ♦ San Francisco- $757,500 ♦ San Mateo - $816,000 ♦ Santa Clara- $705,000

7. In Orange County, developers plan to build 54,815 units over the next 10 to 15 years. The strategy for development in the county will be similar to San Francisco and Los Angeles, where demand-driven development has gone vertical as less build able land is available.

There are currently 34 high-rise condominium towers under construction or in various stages of pre-development in Orange County!

8. Equilibrium (or an equal number of buyers and sellers) tends to average between 5.5 to 6 months in the U.S. today, the supply averages only 4.8 months. California's supply now averages 2.8 months. Northern California's the lowest at 1.5 months. The Central Valley's at 2.8 and southern California averages 3.6 months. LA is at 2.6 and OC is at 2.0

V. So Where is the Risk? . . .

The only risk to housing is a big *decline* in employment!

A. Our Growing U.S. Economy – **Gross Domestic Income of $11,750,000,000,000**

1. The U.S. has now had 10 consecutive quarters in which our Gross Domestic Product exceeded 3%. Forecasters are stating that the U.S. GDP will remain above 3% throughout 2006.

2. In the past 12 months, the U.S. has employed 2.1 million new people – a growth rate of 1.7%. The economy added another 1.5 million jobs so far this year, which is on target to match 2004's 2.2 million (the best since 1999).

   a. But there's more to the story. Add another 1 million jobs for self-employed and incorporated individuals, who do not show up on the employment rolls. Today, there are 12.2 million self-employed people and another 3.2 million who are incorporated.

3. The unemployment rate for September was 5.2% - the lowest since 2003! Gains in taxable income are adding revenue to the federal government, and the federal deficit is actually shrinking – based upon its percentage of the GDP!

Federal deficits are only 3.6% of the GDP (6.0% in 1983 and 4.7% in 1992)! Consumers are spending $200 billion annually - helping to fuel economic growth.

B. California – The Power State for the Nation

1. Eleven percent of all employed workers in the U.S. are employed in California. They produce 12%-15% of the total GDP of the nation. In the past 12 months, California added 223,000 jobs, and today there are over 14.8 million workers in the state!

2. California has one of the most diversified economies in the world, serving the Pacific Rim through ***trade***, a growing ***service sector***, and expanding ***electronics*** and ***manufacturing***! Add ***high-tech***, the ***financial sector, bio-tech, tourism, agriculture*** and ***government***, and it is easy to see why California is one powerful state!

3. When northern California lost 250,000 jobs during the dot com period, real estate prices continued to rise. As of September, the median home price in the Bay Area was $724,890! The Bay Area now employs 2,393,300 people and the Central Valley employs 2,174,700. Southern California has added 90,000 new jobs in the past 18 months for a total of 9,917,100 jobs!

In southern California, 95% of companies employ fewer than 50 people! Today's technologies enable companies to become highly productive with Fewer people, ending the *boom-bust* cycle and its massive lay-offs!

4. The State unemployment rate of 5.2% is declining in almost every county. Northern California is at 4.74%, the Central Valley is at 7.3% and the 7 southern California counties average 4.71%.

C. Orange County – An Economic Powerhouse

Using World Bank formulas, Orange County would rank as the 34th most powerful country in the world (out of 184) with a *gross county income* of $160.7 Billion.

1. "The OC" added 32,800 jobs in the past 12 months. It now has a highly educated and skilled work force numbering 1,576,800 people, and ranks #3 in U.S. in job creation.

Orange County's unemployment rate is 3.6%, the lowest in the State. For major metro areas in the U.S., Orange Count has the 2nd lowest unemployment rate!

2. In the state, OC ranks #1 for local jobs in the wholesale trade and ranks #2 for jobs in finance and insurance. OC ranks #6 in the nation, with a job growth rate of 2.2%.

3. In the nation, Orange County ranks #8 in manufacturing employment (184,800 jobs). By June of 2005, venture capital investment had more than doubled from all of last year. For the second straight year, OC is ranked #1 in Business Week's "100 Hot Growth Companies." Office vacancies are at a 5 year low – even with all the new buildings coming on line!

4. The reason we continue to lead the State and rank high in the nation for low unemployment is due to what economists call ***The Triple Endowment!***

   a. First, an entrepreneurial culture where new business ideas can evolve.
   b. Second, access to venture capital so those business ideas can become reality.
   c. Third, an educated *pool of talent* that is very difficult to duplicate.

C. Orange County – An Economic Powerhouse (continued)

5. "The OC" is a magnet for tourists – attracting 44.8 million visitors who spend $7.85 billion annually. The County receives 45% of Disneyland's $3.6 billion annual revenue dollars.

6. Since 2000, the County's population growth (at 3.9%) ranks it the 8th fastest growing county in the nation. Orange County's population exceeds 3,040,000 and equals 1% of the population of the entire United States. OC has only 798 square miles of land. It has become the 3rd most densely populated area in the nation with 3,600 people living in every square mile!

7. Orange County has a dynamic economy in one of the most desirable locations in the world. Most of the county was, and continues to be, developed under strict zoning guidelines. Meanwhile, our population growth continues to keep upward pressure on the housing market!

Since only 1% of our sellers move out of this county, it is easy to see why our demand continues to exceed our supply!

8. Today, OC has only 8,190 active listings vs.8,968 a year ago! We have entered the seasonally declining cycle where the net amount of listings should continue to decline through March '06.

We presently have an 8 week supply of homes. Over the next 3 months, we should lose one week a month, leaving OC a housing supply of 5 to 6 weeks as we enter the *buying cycle*!

VI. The Orange County Housing Numbers – Demand vs. Supply

A. Ending Year's Housing Supply Ratios vs. Next Year's Appreciation

	Ending Year's Housing Supply Ratios		Next Year's Appreciation
1. 2001	10.7 weeks	2002	16.8%
2. 2002	6.2 weeks	2003	19.1%
3. 2003	2.9 weeks	2004	24.8%
4. 2004	8.1 weeks	2005	17.0% (to date)
5. **2005**	**5 - 6 weeks**	**2006**	**15% - 18% (f)**

B. Sales to Date: 37,940 vs. 36,437 last year (September to September)

1. Housing Overview - **September**

	% of sales	median price	appreciation rate
a. single family homes:	60.0%	$ 675,000	17.1%
b. condos / townhomes:	29.7%	$ 455,000	20.1%
c. new home:	10.3%	$ 668,000	- 8.3% (building smaller homes)

2. Orange County Median Monthly Appreciation Rates ***(year to year)***

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2004:	22%	24%	13%	30%	36%	30%	23%	25%	24%	21%	24%	18%
2005:	19%	17%	16%	10%	9%	12%	15%	14%	14%	14%		

3.	Orange	Los Angeles	Riverside	San Bern.	San Diego	Ventura
Median Home Price:	$617,000	$494,000	$388,000	$344,000	$493,000	$592,000
Appreciation Rate:	13.6%	21.4%	16.2%	31.8%	2.1%	15.2%
Unemployment Rates:	3.8%	5.0%	5.6%	5.1%	4.3%	5.0%

Data Sources:

DataQuick Information Systems, SoCal MLS, California Association of Realtors, National Association of Realtors, Freddie Mac, Fannie Mae, Office of Federal Housing Enterprise Oversight, Federal Reserve, World Bank, U.S. Bureau of Labor Statistics, Commerce Department, California Department of Finance, California Employment Development Department, Center for Demographic Research, The Economist, Business Week, The Register, LA Times . . . and I'm sure a few other sources I can't remember at the moment!

About the Author:

Gary Watts has been selling real estate for the past 34 in California.

Gary has long been recognized as a forecasting expert by the real estate industry. His long-term analysis has also drawn the attention of the media due to his consistent accuracy. His Economic Outlook has been spotlighted in regional newspapers, including the Los Angeles Times and the Orange County Register. He holds a degree in Economics with advanced studies in psychology from California State University at Sacramento. Gary's economic forecast and lecture notes are one of the most widely circulated information pieces by real estate agents in Orange County.