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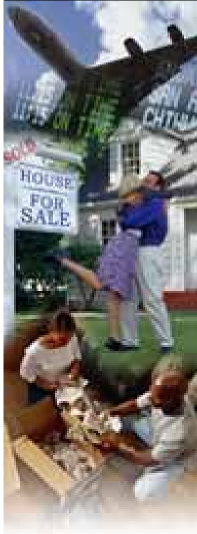

A Turnaround Is Coming — Or Is It?

MOBILITY Magazine, May 2008

Optimists say 2008 will be the "year of the turnaround," while pessimists say "not so." Wagner asserts that it is still too uncertain to make any kind of prediction or bold statements, as diverse factors will mean continued declines in some regions and markets, while other sub-markets throughout the country will improve.

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By Alvin "Chip" Wagner III, SCRP, SRA, IFA

Neither an economist nor a fortune teller, I am a real estate appraiser who reads a lot of the same articles you may read from the National Association of Realtors® (NAR) and homebuilder associations. I read the same reports that give Wall Street the "jitters" and shake global markets: information that now refers to the economy being in or close to a recession; articles and reports on the overall housing industry, weak dollar, slow economic growth, and less consumer discretionary income; and the fear of inflation that continues to make the news almost on a daily basis.

One very large difference between the current recession and the last one (2001-2002) is the housing market. The housing sector thrived and helped keep the economy out of an extended recession during the first part of the decade; this time it is strongly contributing to economic concerns.

There is no comparison in the current down market to what has happened in the past. Previous housing slowdowns were short-lived or a direct result of rising or record-high interest rates or economic recessions. Currently, it is the housing sector and its related fields that are causing the economy's downward spiral, while interest rates are very low.

In retrospect, it is relatively easy to look at historical statistics and see that the housing sector started losing steam in late 2005 in many areas of the country; by late 2006, it was evident that it was nearly nationwide. There are many reasons for this but, simply put, all the talk of the "housing bubble" eventually became reality. There was a bubble and it deflated in many areas, some quite rapidly.

Understanding the Economics of Housing

Many factors have contributed to the current state of the housing sector. First and foremost, the record-low interest rates during 2003 to 2005 encouraged many people to purchase new homes, quite often before they were able to afford them. This included first-time homebuyers entering the market; move-up buyers purchasing larger homes; real estate investors that were rehabbing and flipping properties; other investors and builders razing properties for redevelopment; investors renting properties; and some buyers who were purchasing second homes for vacation and/or their retirement.

"Cautious optimism" was prevalent in 2007 but, in hindsight, it was a "bad" year for real estate markets. According to the year-end statistics from the Headrick-Wagner Consulting Group, Naperville, IL (as of January 1, 2008), 59 percent of metropolitan Chicago suburbs showed declines. Many struggled through 2007, witnessing the sub-prime meltdown, increased foreclosures, builder bankruptcies, significant concessions in both the new and resale markets, increased price reductions, longer days on

market, and an expanding supply of homes—both new and resale. All these red flags combined with fewer buyers actually purchasing homes.

Inventory Level

The inventory level is reported in "months supply." This technique is valuable to real estate professionals in both macroeconomic and microeconomic situations. Macro markets include regions, metropolitan statistical areas (MSAs), counties or parishes, or individual communities. Micro markets would include neighborhoods, subdivisions, school districts, property types, and price ranges.

The months supply is an important number that calculates the inventory of homes available in relation to the typical number of homes to sell per month. A balanced supply would be in the four-to-six-month range. Anything greater would be an oversupply, and less would be an undersupply.

The inventory level is calculated by adding the number of sales (sometimes pending sales may be included) that have occurred in the past 12 months divided by 12. This number is then divided by the total number of active sales, creating a monthly average over a 12-month period to remove the seasonal fluctuations that may take place in the marketplace. Once the monthly average of sales is figured, the current total number of listings should be divided into the average monthly sales to create the months supply.

The basic algebraic formula:
Months Supply = A / (S/12)
A=Total # of Active Listings
S=Total # of Sales in past 12 months

The national and regional reports track a macroeconomic view or a broad perspective on real estate markets.

The Relocation Appraisers and Consultants, Inc. (RAC) tracks these residential inventory levels in major markets across the country. They can be viewed on the Worldwide ERC® website under the new Timely Tools for the U.S. Housing Market (www.erc.org/toolkit/realestate-market.shtml)

Relocation appraisers look at effects from a microeconomic perspective, which is localized and broken down into price ranges and other market factors that influence location. Many relocation appraisers always have tracked and studied inventory levels and absorption rates that measure the supply of homes available in relation to the demand of the market, or how many homes actually are selling.

The law of supply and demand in real estate helps establish prices in an imperfect market—the supply being the active listings and the demand contracts pending, which lead to sales activity and volume. As the supply of homes continued to rise, demand was continuing to stall or fall.

On the demand side of the equation—homes under contract and sales volume—it continues to look bleak. Demand is down from previous years, which is measured easily in sales volume. According to NAR data, the sales volume of homes and condominiums peaked in 2005 with 6.7 million units sold as of January 1, 2006; two years later the sales volume fell to 4.89 million units—a 27 percent drop.

On the supply side—homes available for sale—nationally, listings have increased nearly 44 percent, with 2.91 million listings in January 2006, versus 4.19 million listings in January 2008, according to NAR. With more listings and fewer buyers, together these statistics create an inventory level.

What is interesting is viewing the rising inventory levels and what is causing the changes in inventory. Statistics can be manipulated, misinterpreted, and misleading, which is evidenced in the various reports in the news media.

Months Supply of Inventory

Nationally, according to NAR, inventory rose from a 5.3 months supply two years ago to a 10.3 months supply as of January 2008. The entire Chicago metropolitan market had a 3.7 months supply in January 2006, which climbed to a 9.7 months supply as of January 2008, according to data from the Multiple Listing Service of Northern Illinois.

What is causing this? In most areas, the total number of active listings continues to increase. At the same time, the total number of homes under contract continues to decrease. Also, in most areas, the total number of sales (volume) has decreased.

The decline in pending sales continues to be of concern, as it shows what is happening right now—and the slowdown in homes under contract shows the falling demand. Contracts pending is a statistic to follow closely as we move forward. It will be the first indication of a market that is reversing its downward trend.

Unfortunately, with high levels of inventory, it continues to be a “buyer’s market,” which exerts downward pressure on home prices.

Relocation appraising relies heavily on the real estate principle of substitution. According to the “Dictionary of Real Estate Appraisal, 4th Edition,” released by the Appraisal Institute, Chicago, IL, substitution is the appraisal principle that states when several similar or commensurate commodities, goods, or services are available, the one with the lowest price will attract the greatest demand and widest distribution.

Essentially, this means the lowest-priced home among other similar homes will attract the buyers and receive the contract. Real estate markets still are active in the Chicago area, but they are oversupplied and moving slowly as buyers have so many options. The homes attracting these buyers are either priced most competitively (lowest), or they have features that are not being matched in the competition (features such as positive locations, one-of-a-kind attributes, remodeling, updating, and interior “staging”). Homes lacking these features are being overlooked until they are priced appropriately to compete in the marketplace, which ultimately leads to pricing below market value.

New Construction

New construction competition should be analyzed closely for its effect on the subject property. Builders with inventory often are the most motivated sellers and offer significant concessions to attract buyers during a market slowdown.

New construction competition does not have to be in the subject’s immediate neighborhood—it can be in surrounding areas—sometimes many miles away. Most buyers are searching for homes over a broader market area than a specific neighborhood that an appraiser may be analyzing.

While doing a recent relocation appraisal, I found a similar home priced well below its competition. There were comparable sales suggesting the home was worth more than $350,000, yet the asking price was $325,000 with many showings but no offers. Further investigation found that builders of $400,000-plus homes in nearby neighborhoods were offering concessions up to $75,000 at the time. So, despite appearances, the $400,000-plus homes were competing strongly with the home priced at $325,000, and were luring buyers away from the home I was appraising.

Current Market Data

Analyzing the most recent data possible in the current marketplace also is very important. Measuring market change in the relocation appraisal is a historical analysis; however, in the current real estate market, some housing declines are not evident for three to six months. To understand what is happening at the current moment and the weeks leading up is imperative.

Often, the rate of decline is difficult to measure. The market does not increase or decline at a uniform rate. Using market data that is three or six months old in a declining market can lead to misinformed analysis by the appraiser. They may underestimate or overestimate what actually is occurring.

We already know that in a slower marketplace, fewer homes are selling. Understanding that a buyer is considering homes in many different areas and knowing the specific area they settle on for their purchase will help identify current market conditions.

Real estate professionals may find themselves in a market without current data. Using older data can be misleading if there is more current data in other neighborhoods within the same competitive market area.

Competitive Listings

In a declining market, competitive listings continue to be a key factor for analysis. Relocation appraisals focus on listings and caution should be taken to analyze the competition and its effect on the current market to help predict future trends (a key component for the appraiser's forecasting adjustment in relocation appraisals).

Using the most current sales and developing the market change adjustment are the beginning. Understanding the influence listings have on the market is of key relevance. If the listings are priced lower than the recent sales, this helps to identify future declines in the marketplace.

Is 2008 the Year of the Turnaround?

At this point, it is very hard to tell. The Federal Reserve continues to lower interest rates to help support the economy and the government is attempting to stave off a recession that we may or may not already be in. Creative proposals are being discussed at the grassroots level for the housing industry for economic stimulus.

In fact, 2008 may be the year that we do stabilize (in terms of inventory levels), which could begin later this year. But at the same time, we will see continued decline in the average sales price into next year and quite possibly beyond. This is the continued correction from the strong markets experienced in previous years. There is simply too much housing inventory built up, and it will take a long time for it to drop down to balanced or undersupplied levels in the marketplace.

Therefore, it will take time to change from a "buyer's market" to a "seller's market." It will be a long and slow recovery, and it may take several years to return to a market similar to what was seen in the first half of this decade.

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