HOUSING MARKET OUTLOOK:
SAN LUIS OBISPO, CA AND SURROUNDING AREA

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2008: A Year in Review

Starting between 1999 and 2000, national home prices began a period of unprecedented growth, increasing at a pace more than 8 times their annual average until peaking in early 2006. National home prices appreciated over 100% on average during the 6 year period before declining 27% from 2006 through Q4 2008. Markets across the sunbelt, namely Florida, Southern California, and Arizona saw prices appreciate as much as 180% from 2000 to their peak in 2006; these areas have also declined the fastest and hardest, falling as much as 50% and boasting the highest foreclosure rates in the country.

Chart 1 shows national home price appreciation stayed relatively in line with inflation from 1978 through 1999, appreciating at an average real rate of less than 1% annually. Even the housing booms of the late 70’s and 80’s stayed within a 20% range from base to peak. This historical trend broke dramatically in 2000 with real home values rising over 100% in six years at nearly 8% on average per year through 2006.

Other housing indicators paint the same picture: At the end of 2008, nationwide inventory levels stood at 10 months supply, the highest in more than 20 years; housing starts continued to decline sharply, falling below the lows of the 80’s and 90’s recessions to levels not seen in at least 30 years. New home sales came to a standstill, falling more than 80 % since their peak to 30 year lows, while existing home sales fell back to their mid 90’s levels (a 40 % decline from their ’06 peak).

Chart 2 shows existing homes sales in thousands and months of inventory from 1987 through November 2008.
2009: Modest Signs of Improvement

For the first time in three years the national housing market has begun showing signs of improvement. While it’s far too early to call a bottom, a number of recent indicators show that we may be close. February data showed that both new and existing home sales increased 4.65% and 5.1% respectively from a month earlier and inventory stayed level at 9.7 months supply. While prices for new homes continued to drop, the average sale price for an existing home remained relatively unchanged, increasing less than 0.5% January to February ‘09.

Mortgage rates and housing affordability present another possible silver lining. Fed policy has driven interest rates to their lowest levels on record, sending rates for 30 year fixed rate mortgages as low as 4.78%. This in turn has sent the housing affordability index to all time highs; (a higher index number means housing is more affordable; a lower index number means housing is less affordable.) So, even with housing prices still above average relative to income and inflation, monthly payments for an average loan on a midpriced home are at the lowest levels on record.

A further sign of improvement comes from the ratio of home prices to rents. Data from both S&P/Case-Shiller and the FHFA show the ratio of rents to home prices at or near average historical levels. The average price-to-rent level using 35 years of data stands at 110 for FHFA and 90 for S&P/Case-Shiller. The ratio’s peaked in early 2006 at 145 and 130 respectively.

What’s Next?

Although the above data lends reason for optimism, the devil is in the details, and there is good reason to believe that we are not yet out of the woods. Most of the recent existing home sales have been due to foreclosures: The National Association of Realtors estimates that up to 45% of existing homes sold in February ’09 were distressed properties in or near foreclosure. Further, the majority of these foreclosure sales came from the hardest hit sunbelt areas. Nevada, California, Florida and Arizona for the fourth quarter of 2008 home sales more than doubled over a year earlier; foreclosure sales accounted for most of the increase at over 50% of total sales in most sunbelt states. While sales of homes not in foreclosure have dropped significantly over the past year, distressed property sales have shot up to historic highs, supressing prices in the process as banks rush to get the non performing assets off their books by selling them at huge discounts.

Instead of seeing the normal increase in demand that brought with it the bottom to previous housing downturns, many of todays buyers are investors, buying largely in cash and in the hardest hit areas that have seen 40-50% drops in home values. While inventories have dropped significantly in markets with high foreclosure rates, the majority of the nation currently sits at above 10 month inventory levels, nearly twice the historical average. The trend of most improvement in the worst hit markets should come as little surprise: home prices in sunbelt states have fallen enough to stimulate demand and begin clearing out inventories. Unfortunately, “falling enough”, has in many cases been 35-50% compared to a national average decline of 27% from peak to current levels.
So can we expect similar declines to 35-50% across the rest of the country before seeing sales increase enough to reduce inventories to normal levels? Not necessarily. Graph 3 shows historical real price data with a projected trajectory back to the 30 year trendline. A retracement back to the bottom of the trendline would mean a 10% drop from current levels. While this means we likely have further to go before reaching bottom, national price declines similar to those seen in sunbelt states is an unlikely scenario.

A drop back to the average appreciation trend range is in line with estimates from most major economists and forecasting firms. To name two, Moody’s predicts a further 11% decline nationally and Meredith Whitney, a closely followed bank stock analyst expects a further decline of more than 9%.

Two main variables add uncertainty to these estimates: government intervention, and a deeper than expected recession with prolonged high unemployment. Consensus estimates from the Fed and leading forecasting firms call for a peak national unemployment level of 10% or less. Currently unemployment stands at 8.5%; since the Great Depression unemployment rose above 10% only once, peaking at 10.4% during the early 80’s. If unemployment does rise above the consensus estimate of 10%, foreclosures will likely rise further than expected causing more downward pressure to home prices and extending the housing recession.
Additionally, the effects of the Obama housing stimulus and Fed easing on stabilising home prices are yet unknown. While lower interest rates, fiscal stimulus and legislative changes could help stem foreclosures they could also prolong the housing recession by temporarily propping up prices and interrupting market adjustments. Further policy from Washington to aid the housing market is inevitable, but the specific changes and ultimate affect on home prices is highly unpredictable. While recent price data shows signs that government intervention has helped, it will take months if not years to see the full result.

It pays to keep things in perspective: the current recession has repeatedly been called the worst since the Great Depression by government officials and private analysts alike. If this is true, one would expect unemployment to surpass levels reached during the 1980’s. Current home price declines have largely been fuelled by the housing bubble and subprime crisis, not traditional macroeconomic forces. If we see a longer more drawn out downturn than expected, a second wave of foreclosures on prime loans more akin to past recessions could likely drive prices lower.
Overview:

On average, home prices in the San Luis Obispo area have fared similarly to the overall California market. Across San Luis Obispo County, prices increased over 175% on average from 2000 to their peak in the second quarter of 2006 and have since declined 30% to current levels. This compares to a 181% increase and 29% decline over the same period for California and 109% vs. 27% Nationally.

Chart 4 displays a comparison of OFHEO data for California, National and San Luis Obispo-Paso housing markets. As the graph illustrates, the price increases and declines in California and SLO –Paso have been significantly steeper than the rest of the Nation.

Chart 4

HPI Historical Price Comparison
(Nominal terms)

Note: OFHEO only provides data on home resales for loans through Fannie and Freddie. Local data represents survey area San Luis Obispo – Paso Robles, not San Luis Obispo county.
While average price declines in San Luis Obispo County have stayed in line with the rest of the state, performance has varied widely between Santa Maria and different areas within SLO County. While Santa Maria has been the hardest hit, dropping 52% from peak levels, San Luis Obispo has declined only a modest 12%. Price declines across the rest of the County are widely within that range, with Paso declining 30%, Arroyo Grande 42% and Pismo 18% from their respective peaks. Chart 5, below shows a comparison of price declines for single family homes in SLO and the surrounding area, from their respective peaks to February 2009 levels.

As Chart 5 clearly shows, prices have fallen the most in the North and South County and have stayed most stable in San Luis Obispo City and the coastal regions. South County and Santa Maria prices have seen the largest percentage drop since their peak, however sales and inventory data show the most signs of stabilization compared to the rest of the region.
Annual sales data for SLO city, Paso and Santa Maria are shown in Chart 6. While SLO prices have stayed relatively stable, combined sales of new and existing homes continue to decline for SLO while Paso and Santa Maria show the most signs of improvement.

The sharp increase in sales for Santa Maria can be attributed to the high percentage of foreclosures compared to SLO County. In 2008, foreclosures accounted for over 75% of total sales in Santa Maria compared to less than 30% for SLO County.
Inventory levels for the region confirm sales data. While inventory remains high for San Luis Obispo City and most of SLO County at 8-10 months, Santa Maria inventory has fallen from a high of more than 20 months to less than 3 months in February 2009.

High foreclosure rates and sharp price declines in Santa Maria have sped up inventory reduction compared to SLO County and Paso, bringing inventory well below the County average to levels signalling a buyers market. While Paso has seen higher foreclosures than the County average and sales have begun to pick up, inventory levels still remain high at 8 months.
What's Next?

A bottom for the housing market in the San Luis Obispo area depends heavily on the performance of the overall economy during the coming months. With this said, prices in the South County and Santa Maria appear closest to reaching a bottom compared to the surrounding area. Santa Maria prices have fallen back to their '01 levels and are back in line with the historical trend. Prices for SLO County will have to fall on average another 20-35% before reaching '01 levels and coming back in line with their average price trend. Further, for demand to increase enough for inventory to reach the average of 4-6 months, prices for SLO County will likely need to drop further from current levels.

The one exception may be San Luis Obispo City. Unemployment for SLO has seen more stability than the surrounding areas and overall SLO has weathered the current recession much better than the rest of the state. Home prices around the Cal Poly campus will likely bottom higher than the rest of the county on a percentage basis due to increasing enrollment and high demand for student housing. However, even with this taken into account, prices likely have a ways to go before reaching bottom. As with the rest of the county the key indicator will be inventory reduction. It is highly unlikely that increased demand for student housing alone can reduce inventories to normal levels; prices will have to decline closer to the current national average of 27% before buyers will be willing to enter the market on a large scale.
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