

The “B Word”

Is California in the midst
of another bubble?



Prices
Incomes
Rates



CALIFORNIA
ASSOCIATION
OF REALTORS®

The “B Word”

Is California in the midst of another bubble?

Contents

Introduction.....	1
The Facts: 5+ Years of Uninterrupted Price Growth.....	2
So, What’s the Problem?.....	3
Does That Mean It’s Time to Panic?.....	6
What to Watch: Potential Tipping Points.....	8
Conclusions.....	10



Introduction

Looking back on the nearly 8 years since the “Great Recession” officially came to a close, California appears to be much improved:

- We added back all of the 1.3 million lost jobs plus an additional 1.3 million on top of those;
- Unemployment has dipped below 5% for the first time in more than a decade;
- The stock market is near all-time highs across most major indices;
- Interest rates remain near historic lows for mortgages;
- The state government is currently running a budget surplus, even if it rests on a narrow base;
- California remains a popular destination for the rest of the world, with nearly 25 million international travelers this year; and most importantly
- Home prices are rising rather than falling.

Rising home prices have certainly helped many homeowners recover and/or build equity that was lost during the downturn. By the mid-point of 2017, just 3.4% of mortgages were so-called “underwater,” or were worth less than the outstanding mortgage—down from the double-digits at the bottom of the market. Defaults and foreclosures have likewise followed suit.

However, in many ways, the resurgence of our economy has inflamed old ailments that were laying dormant in a weak market. California’s chronic under-supply of new home construction was manageable in a market when prices were falling and home sales were very low, but with demand currently on the uptick, the tight inventory environment has returned. On top of this lack of new supply, many of the structural challenges associated with housing turnover in California have resurfaced and everything from low mortgage rates, potential capital gains taxes, and low property tax bases are exacerbating the housing shortage such that many homes are receiving multiple offers, selling at or above listing price, and are selling much faster than normal.

The unfortunate result is that prices are rising rapidly in California, and both housing affordability and homeownership are trending downward at an alarming rate. According to the Census Bureau, with a 54% homeownership rate, California is already dangerously close to becoming a majority-renter state, and fewer households are able to afford the typical home. This will present long-term challenges if it persists, and over the short run, has led many to begin to question if home prices have reached a level that is no longer sustainable.

Several times throughout the past year, we’ve begun to hear the “B Word” again: have home prices gotten out of whack again? Are we at the tipping point yet? How much longer can this go on? Is California in the midst of another housing bubble?



California Existing Single-Family Median Home Price



The Facts: 5+ Years of Uninterrupted Price Growth

Let's be clear: following a brief pause after the first-time homebuyer tax credits expired, California has experienced robust, consistent home price growth for nearly 6 years—68 months of consecutive year-over-year growth at the time of this writing.

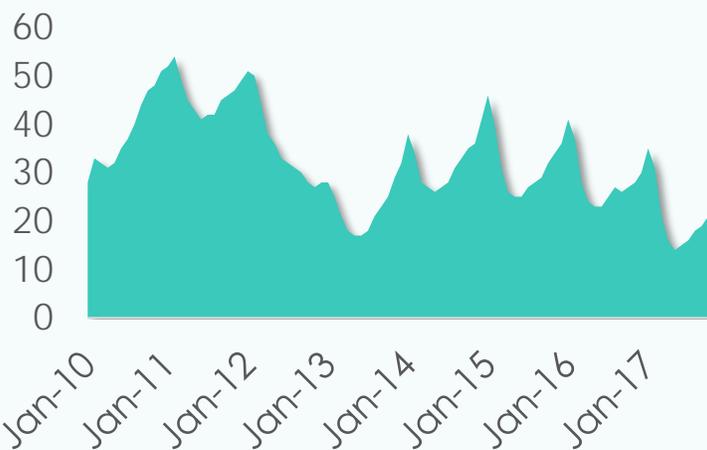
That is welcome news following the devastation that followed the housing collapse. Indeed, after peaking at nearly \$600,000 in 2007, the statewide median price plunged 59% to just \$245,000 by 2009. Since then, prices have regained much of that lost ground: by October 2017, the median price of an existing single-family detached home was back in the \$540,000 range. What's more, the pace of growth has been accelerating through the second half of the year rather than slowing down.

That is still 9% below the pre-recession peak price of 2007, but represents a remarkable run-up in prices nonetheless. And, with inventory that is less than half of what is considered "normal," it has created a favorable environment for would-be sellers in the marketplace. Current estimates are that the typical seller is getting 100% of their listing price—in other words, there is virtually no discounting happening in the market at this point in time. Furthermore, the typical time that it takes for a home to sell has dropped from more than 50 days in 2010 to less than 20 in 2017. If a seller were to put their home on the market today, they could expect it to sell quickly and for top dollar.

If a seller were to put their home on the market today, they could expect it to sell quickly and for top dollar.

It is also important to note that although there has been disproportionate growth in our major employment centers along California's coast, these price gains are not the result of a statistical anomaly

Median Days on Market



Median Sales-to-List Price



owing to more sales occurring in higher-priced areas. Indeed, the price per square foot of housing has seen very similar increases in the overall median prices discussed here—this is genuine price growth we’re seeing.

In some markets, the price growth has been nothing short of remarkable. For example, at the height of the past cycle, Marin and San Mateo saw their median prices rise to just over \$1 million while San Francisco and Santa Clara topped out in the six-figures. Now, all four counties have shot past those previous peaks to new all-time highs. Orange County also reached a new historic high in 2017.

Elsewhere, price growth has been consistent, if not quite as impressive. However, it is not restricted solely to the core, coastal job centers. Prices throughout Southern California and the Central Coast have risen as well. Even the Inland Empire and Central Valley, which were hit much harder by the economic downturn and housing downturn, have seen solid gains. Prices in Kern have nearly doubled and the median price in Sacramento has more than doubled since hitting bottom. The bottom line is that the recovery in home prices that followed the worst housing collapse in history has been both widespread and robust in the past 5+ years.

So, What’s the Problem?

Why worry when, as alluded to earlier, this momentum has wiped out the backlog of foreclosures and cleared the pipeline of distressed mortgages? It has put many homeowners back above water with homes that are finally worth more than they owe on their loans. More importantly, it has created a significant amount of new wealth for families at perhaps once-in-a-lifetime borrowing costs, which is one of the key benefits of homeownership, in addition to providing a roof over their heads.

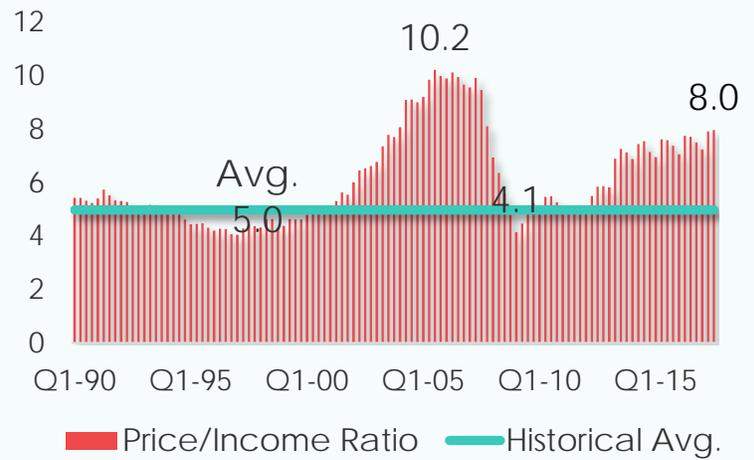
The problem lies in the fact that the strength of the good news for home *sellers*, represents an equally weighty set of headwinds for potential home *buyers*. A more competitive market, where homes sit for just a few weeks before selling and sell for at or above asking prices, means that potential buyers need to offer more for the same home, be ready to move quickly when homes come on the market, and as a result, prices are growing at an accelerated rate.

Unfortunately, this rapid growth in home prices has far outstripped growth in incomes. Looking at trends in incomes and home prices over the past three decades, it becomes clear that prices have begun to

Home Prices vs. Household Incomes



Price/Income Ratio



de-couple from incomes again. California’s median household earns roughly double what it did in 1990. However, the median single-family home now costs almost triple what it used to 30 years ago. Incomes simply have not kept pace this cycle.

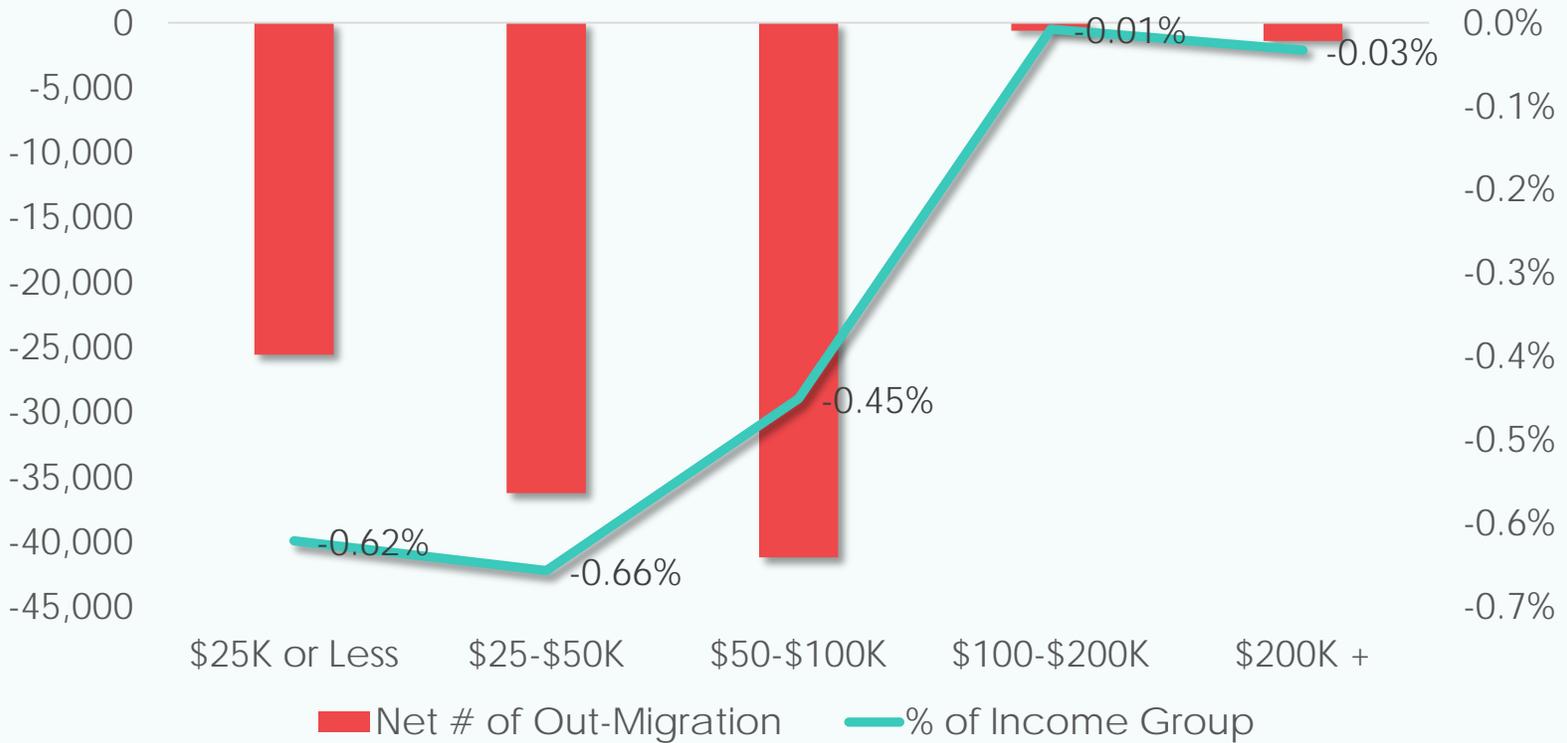
The price-to-income ratio, which measures the fundamental relationship between how much homes cost and what folks can afford to pay for them, has begun to climb as well. Currently, the median home price is roughly 8 times higher than the median household’s income. A few facts jump right out in a cursory glance at the price-to-income ratio’s long-term trend. First, it is well above its historical average of 5-times incomes. Second, there was a once-in-a-generation window in 2009 when homes in California were truly affordable. Finally, although prices have not grown to the double-digit level hit in 2006, the current trend is worrisome from an affordability and, thus, a price sustainability standpoint.

The Housing Affordability Index, which measures the percentage of households that can afford the median-priced home, has already dipped to 28%—meaning that 72% *cannot* afford the median-priced home. And, the sheer level of home prices represents a daunting obstacle for renters to make the leap to homeownership. At \$541,000, a 20% down payment equates to almost \$110,000. The Commerce Bureau reports that the typical savings rate is just 3% of gross income and 10-year bond yields are running at just 2.2%. With those savings patterns, it would take the typical family almost 35 years to save up that much when it used to take less than 10.

Homeownership is already dangerously close to 50%, and each year California continues to lose more people to other parts of the nation due to high housing costs. This rapid growth in home prices puts California at a further disadvantage. In fact, of the roughly 830,000 working-aged adults that have left the state during the past decade, nearly 3 of every 5 went to Texas, Arizona, or Nevada—places that aren’t particularly booming economically, at least not head and shoulders above California—but where home prices are dramatically lower.

Each year, California continues to lose more people to other parts of the nation due to high housing costs.

2016 California Net Domestic Migration



It isn't our oppressive state income tax regime drawing people away either. Although California has, in many ways, earned its reputation for being hostile to business and 'taxing people to death,' the out-migration patterns by income are instructive and even illuminating. Virtually all of the state's out-migrants earned less than \$100,000 per year. That is true whether measured in raw numbers or as a percentage of each income group, but it is the exact opposite of what we would expect to see if it were taxes that were driving folks away. This is a housing issue, pure and simple.

However, its consequences are far-reaching. REALTORS® have been sounding the alarm on deteriorating affordability and declining homeownership for several years, because they are on the front lines of the housing market. Renter groups have also been very vocal on the high cost of housing. However, this was just a preview of the deeper turmoil that our housing crisis will have on California's economy as businesses add their voice to the chorus: a recent study by USC finds that it is becoming a barrier to recruiting and retaining their skilled workforce. "This study shows that high housing costs are burdening our leading employers, either by having to develop special hiring packages, or subsidizing transportation and relocation costs."¹ This quote seems prescient now, as California has shed jobs in recent months—some of which have come from our "tech" sector, which we once thought was impervious to our faults.

While the technical definition of a bubble is nebulous, it is always concerning when home prices get out of whack with incomes in a state. This is particularly true when it comes at the cost of housing affordability, homeownership, and ultimately, our entire statewide economy. This cycle, home prices have been doing just that. Because of our strong economy, and the recovery of all of our high-skilled, high-wage jobs, the demand for housing has pushed against the chronic under-supply of housing to send home prices up to

¹ Bostic, Raphael, "The Affordable Housing Crisis in Los Angeles: An Employer Perspective," [Price School of Public Policy at the University of Southern California](#), Prepared for the LA Business Council Institute, March 2017.

levels that we haven't seen since the last peak. Taken on its face, this evidence has led many to conclude that California is indeed in the midst of another bubble.

Does That Mean It's Time to Panic?

So, prices have de-coupled from incomes, the tech sector isn't as bountiful as it once was, and the steady outflow of California's middle class has resumed. Does that mean we should be rebalancing our portfolios toward canned food and shotgun shells while we await our impending doom?

It's true that price-to-income ratios are high. It is also true that, after adjusting for housing costs, California has the worst poverty in the nation. California ranks 49 of 50 for the highest housing costs for homeowners as a percentage of income and we also rank 49 of 50 for rent burdened households. To be clear, housing in California is certainly unaffordable by relative or historical standards, but that does not necessarily mean we are at a tipping point either.

Interest rates are still keeping us in the game at the moment, and may be our only saving grace. The average contract rate for a 30-year, fixed-rate mortgage remained below 3.9% through the third quarter of 2017. That is actually down from 2013, 2014, and 2015, and only slightly above where rates were in 2016. That has a significant impact on the question of whether home prices are sustainable. After all, it isn't necessarily the level of debt that matters, but the cost of servicing that debt that can tip a borrower into default or foreclosure.

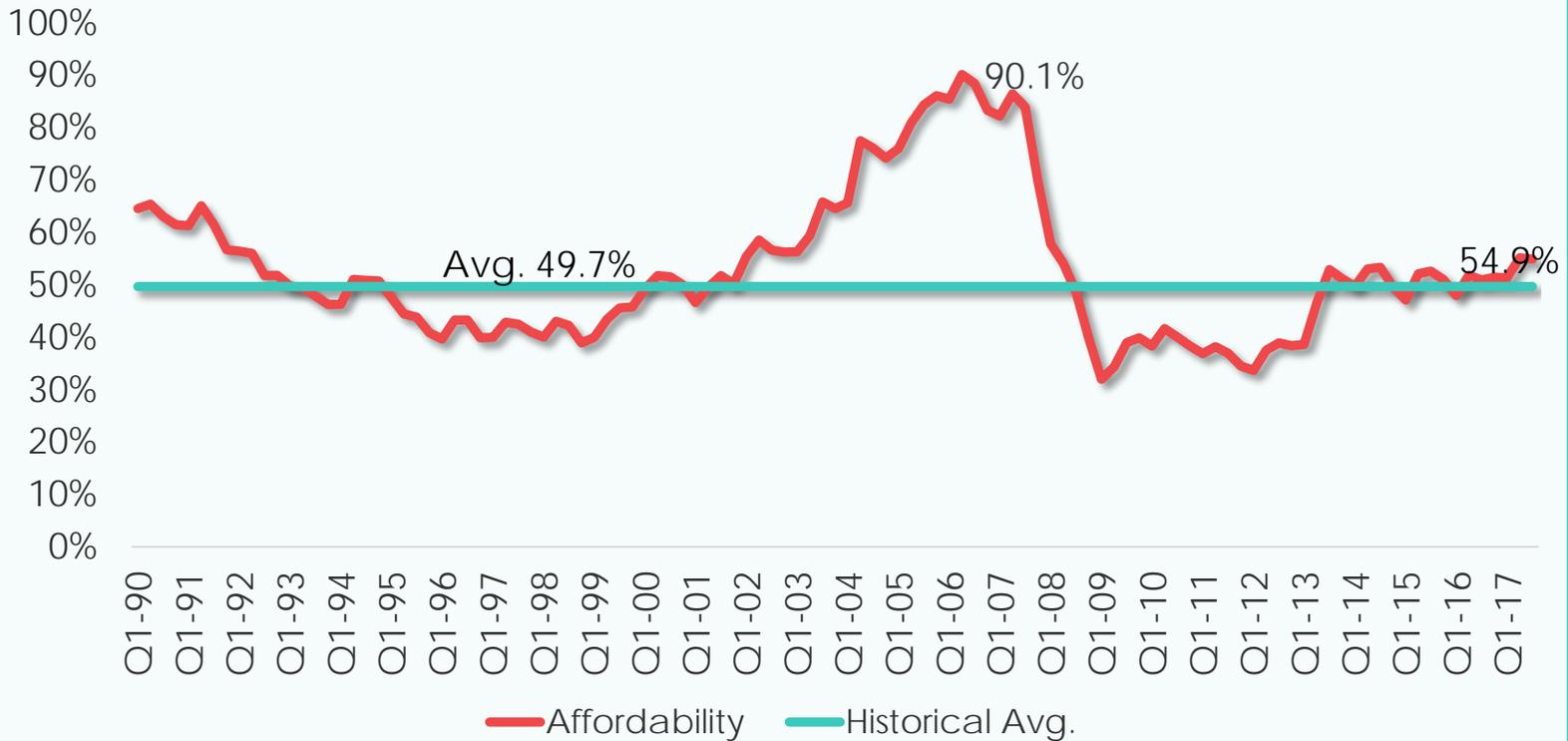
Housing in California is certainly unaffordable by relative or historical standards, but that does not necessarily mean we are at a tipping point either.

Fortunately, the modest decline in rates we've seen over the past two years has helped to offset some of the impacts of rising prices. For example, if rather than comparing prices to incomes, we take the payment of those loans (which takes into account lower rates) and compare those to incomes, things are not as scary as they appeared at first blush.

Overall, the *payment* on the median-priced home would currently consume just shy of 55% of the median household's income. That is higher than the ratio you see in most other states, but it is only slightly higher than California's historical average of 50%. It is also far below the 90% of income that was being consumed in 2006, when prices were high AND rates were in the 6.5% range. It is also encouraging that these prices are at a much higher employment and population base to support them as well. In many ways, California is still hovering near its historically average levels of unaffordability.

Another encouraging aspect of the current cycle is that underwriting standards are completely different than they were during the 2004-2006 timeframe. At the time of this writing, the average FICO score for closed conventional purchase loans is 752. That is down slightly from several years ago, but still represents excellent creditworthiness. Even FHA loans, which tend to service riskier, lower down payment borrowers, average a 681 FICO score. In addition, most borrowers over the past 5 years have had to put

Median Home Payment Relative to Income



at least some skin in the game. There are several 3-3.5% down payment options out there, but 0% down payment loan products are much rarer this time around.

Perhaps more importantly is that with rates so low, most borrowers have locked into fixed-rate loans. Many existing homeowners have also refinanced their mortgages into these types of products at such low rates. That means that, unlike last time, borrowers' payments are fixed—as long as they keep their jobs, the economy doesn't experience an external shock, and prices continue to rise, there is no incentive to go into default or foreclosure.

Last time around when many borrowers opted for zero-down, adjustable-rate loans that often accrued negative amortization and reset to much higher monthly payments overnight and well before the 5- or 7-year periods were up. As such, that ticking time-bomb element in the housing market is much reduced from 2006.

A brief review of the data on HELOCs and cash-out refinancing shows that homeowners have largely kept their skin in the game this cycle. The other variable during the previous housing cycle was that many homeowners used their home equity as a source of funds for consumption. Thus, when prices began to decline, these homeowners had a strategic incentive to walk away from those investments if they suffered an economic hardship or believed their credit scores would recover faster than their home values. This exacerbated the defaults and foreclosures associated with the adjustable-rate distress to precipitate much faster and widespread declines in home values. Even if California does suffer a bout of price declines in the short- or medium-run, that won't be the case this time around.

What to Watch: Potential Tipping Points

Interest rates have largely staved off a deeper pullback in the market and reined in otherwise rising costs of homeownership thus far. However, higher levels of interest rates will have a dramatic effect on affordability if and when they begin to rise. The Federal Reserve has already raised interest rates several times in the past year, and with inflation firming, the outlook for higher rates remains much more likely than the prospects of returning to 3.5% mortgages. If and when 30-year, fixed-rate loans do begin to rise, it will compound the impacts of rising home prices and put downward pressure on demand for homes.

The other thing to be on the lookout for is an external shock that impacts the demand side of the housing market equation. California home prices continue to grow because demand for housing outstrips the chronically under-supplied market. However, an economic shock that takes away demand by ramping up job losses or impacting wealth or incomes, and the upward pressure on home prices in California will be much reduced. At this point, the stock market or the global economy look like the most likely target for a shock. Although the run-up in the major stock market indices has been celebrated of late, fundamentals suggest that equities could be overvalued. For example, the national price-to-earnings ratio is above its normal range, suggesting that the value of companies is currently higher than their profitability would suggest they should be. If those stock prices correct and those firms are forced to lay off workers, it could impact housing demand and therefore home prices in California.

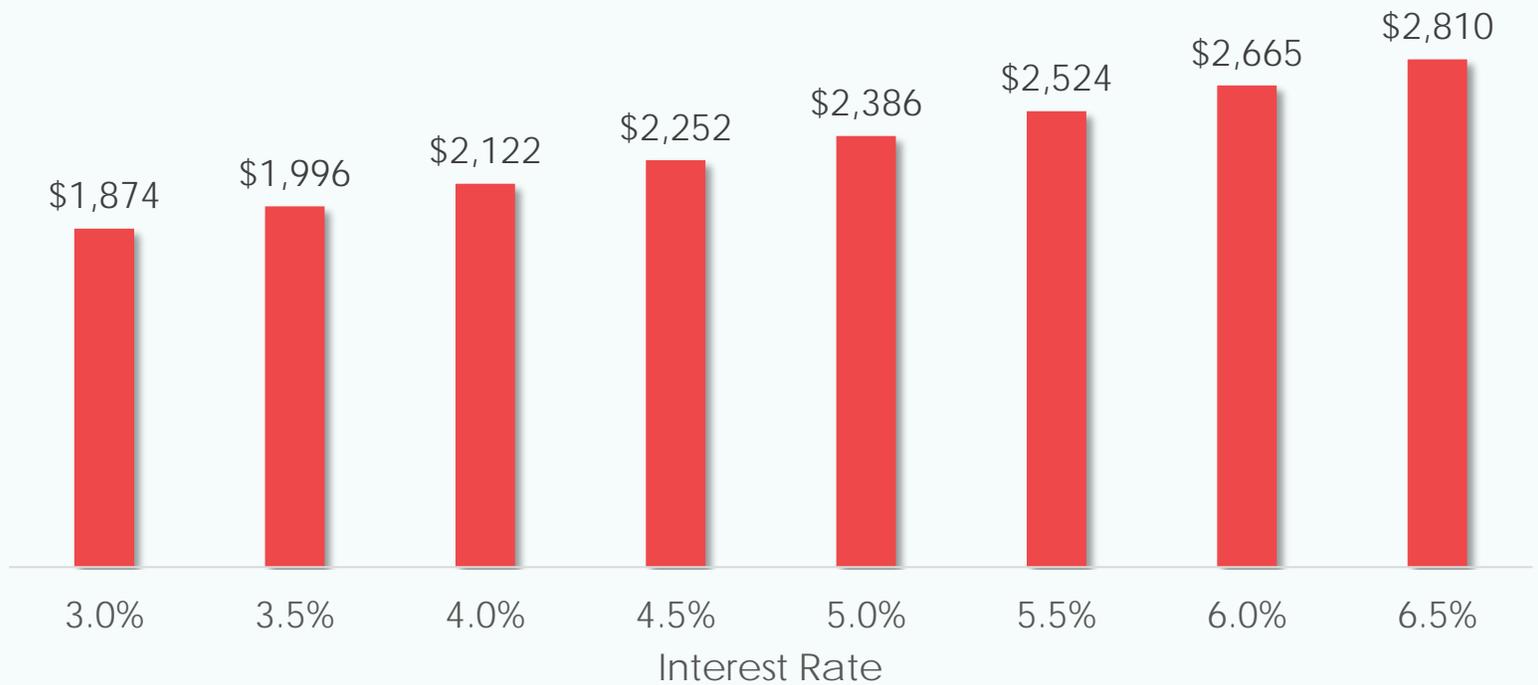
It is also noteworthy that, even in the event of an external shock that precipitates a decline in home values, the damage is not likely to be as widespread as during the last cycle. As noted herein, the most rapid growth in prices, and thus the markets that are most likely overvalued, are much more concentrated in California's core job centers in the Bay Area and Southern California.

If and when 30-year fixed-rate loans do begin to rise, it will compound the impacts of rising home prices and put downward pressure on demand for homes.

A simple thought experiment lets us know what prices should look like in California if the market were clearing. In other words, we are able to compute the price where the median household would be spending 35% of their income on housing after accounting for current rates. Performing this calculation at the statewide level, home prices in California should be between \$365,000 and \$425,000. Thus, at the current median price of \$556,100 means that the state is roughly 24% above that market clearing price.

However, this number varies wildly by area. For example, the most overvalued markets are located almost exclusively in the Bay Area with Orange County joining them at the top. However, many other areas in the far north, Central Coast, and Central Valley still have room to run. This differs starkly from 2006 when you could have thrown a dart at a map of California while blindfolded and had a high level of confidence that the area where it landed would be 40-50% overvalued. If prices do fall, the declines will be much more clustered in these high-priced markets.

Impact of Higher Rates: Monthly Mortgage Payment on Median Priced Home at Various Interest Rates



Of course, this leaves out the impacts of tax reform, which is still largely a question mark in terms of whether it will pass and what the final provisions will be. There are also always wildcards that could tip the balance one way or another.

Overall, California's housing market has seen tremendous growth in the past 5 years leading many to ask whether we are in the midst of another bubble. The view from the CALIFORNIA ASSOCIATION OF REALTORS® is that home prices have indeed de-coupled from incomes again, but this cycle has many unique features that lead us to conclude that we have not reached a tipping point. Rates are still keeping us in the game, overvalued markets are fewer and farther between, and the structure of the current mortgage pool will maintain stability until an external shock arises. That isn't to say that we are not in a housing bubble or that prices are sustainable over the long haul, just that a correction is not imminent and will require a jolt from outside the housing market.

The most over-valued markets are located almost exclusively in the Bay Area with Orange County joining them at the top. If prices do fall, the declines will be much more clustered in these high-priced markets.

Conclusions

Ultimately, this surge in home prices is a symptom of California's systematic inability to produce enough new housing to keep pace with population and economic growth. Since the recession ended through the end of last year, California added roughly 2.1 million new jobs, but permitted just over 450,000 new housing units. And, that shortfall is on top of nearly 30 years of systemic underbuilding leading up to the recession.

The state's Housing and Community Development Department estimates that California needs to build 180,000 new housing units each year just to tread water on housing affordability, and some amount more than that to begin to chip away at the unaffordability crisis in the state. Unfortunately, we've come nowhere close to that this decade, and there are few prospects for seeing that remedied over the short run.

As such, home prices have and will continue to outstrip incomes in the state. That will result in eroding affordability and declining homeownership in a state that can afford neither. This is not only impacting the REALTOR® business, but homeowners, renters, businesses, and ultimately the people who are fleeing the state because they can no longer afford it.

The CALIFORNIA ASSOCIATION OF REALTORS® does not believe we are at the tipping point for home prices yet, but there is no denying that the growth in home prices is not being driven purely by an improvement in household incomes or interest rates alone. And, while we do not believe that a reduction in home prices is imminent, residents in the Bay Area and Orange County will be well served by keeping close tabs on broader economic conditions. Not every market in California is currently overvalued, but if prices do fall, they will hit those areas the hardest.

About

Published by



CALIFORNIA ASSOCIATION OF REALTORS®

The purpose of the CALIFORNIA ASSOCIATION OF REALTORS® is to serve its membership in developing and promoting programs and services that will enhance the members' freedom and ability to conduct their individual businesses successfully with integrity and competency, and through collective action, to promote real property ownership and the preservation of real property rights.

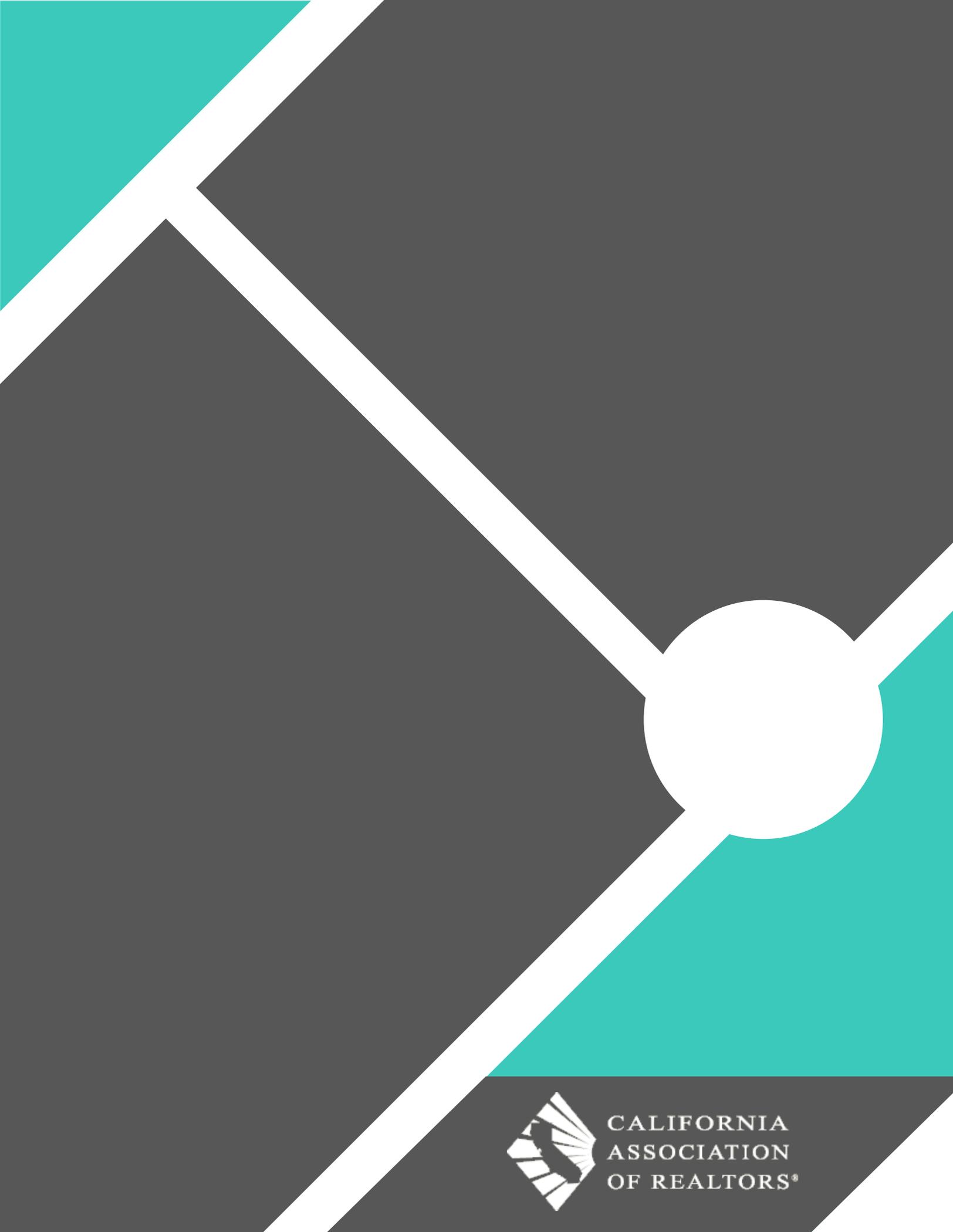
This report is also available online.

Please visit <https://www.car.org/marketdata/surveys/bword> to view or download.

For more information, please contact our Chief Economist: Leslie Appleton-Young:



Leslie Appleton-Young
525 S. Virgil Ave
Los Angeles, CA 90020
213.739.8325
lesliea@car.org



CALIFORNIA
ASSOCIATION
OF REALTORS®