& MONEY

Strong Demand and Climbing Values Keep California Floating

by JOHN D. McMAHON

BEYOND THE ANALYSES, statistics and academic theories, the driving forces behind most businesses are emotions and money. When emotions are good, money is spent, and when emotions are down, money is not spent. The dichotomy between that axiom and the current thriving real estate market in Southern California is that nowadays there is little to feel warm and fuzzy about. The international scene is as unstable as ever, the economy is still difficult and unemployment has started to become a significant problem. Despite these conditions, Southern California not only remains afloat in the world of real estate, it in fact flourishes. The answer to this puzzle has two parts. The world at large is already very different from the one that we have begun to comprehend, and by the time our comprehension has caught up with the new reality, the world is likely to be even more different than presently imaginable. Our ability to understand the wider ramifications of the present, not to mention the future, is hampered by the massive collapse, especially in the advanced civilizations of the world, of almost all established values. The role of religion in defining moral standards has declined while an ethos

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of consumerism passes itself off for ethical standards.

In these days of post-Enron accountability, not even Martha Stewart's homespun version of the American dream holds much promise of integrity. More and more, large businesses are forced to restate their earnings, resulting in equity investors losing confidence in America's great corporations and their leaders. The market value of stocks has declined by approximately $2.5 trillion during the past year. The economy will weather the present storm on Wall Street, and there will be an ebb and flow to the stock market as there always has been. But the sickness in Wall Street is merely a symptom of the fundamental issue of corporate integrity. Simply stated, investors have begun to think that many senior corporate executives are a bunch of crooks. People are reacting to this lack of confidence by putting their money into more tangible assets...things that they can see and feel...things over which they can have more control...real estate. Real estate, the basis of most wealth. The only thing that we are not making any more of.

Real estate is the oldest, most tangible and basic investment of all. While the rest of the economy floundered in the middle of the May 2002 recession, new home sales in Southern California were at record levels, and existing home sales remained near the record levels. While the stock market declined by about $2 trillion, the value of real estate owned by households increased by about 3/4 of a trillion. What is this figure?

The failing confidence in Wall Street has contributed to the boost in the real estate market, but that's only half of the equation - the emotional half. The other half of the equation is low interest rates, which are at a 41-year low. We are witnessing an interest rate climate that is a new and rare phenomenon for this generation of real estate professionals. And we probably will not see interest rates like these again in this lifetime.

Pat Robeson of First Team Real Estate said, "When prices went up, payments went up. Then there was an artificial reduction in prices by the interest rates coming down. This caused the payments to go down despite the prices going up. The interest rates adjusted for inflation and there was an appreciation on property. This was the savior of everything!"

The weakened economy has exerted tremendous downward pressure on interest and mortgage rates. With the falling rates, houses have become more affordable to larger segments of our society. All reports indicate that this trend will continue across the country, making 2003 another exceptional year for housing.

In Southern California, strong demand for housing and steadily rising home values held down the number of houses going into foreclosure. While

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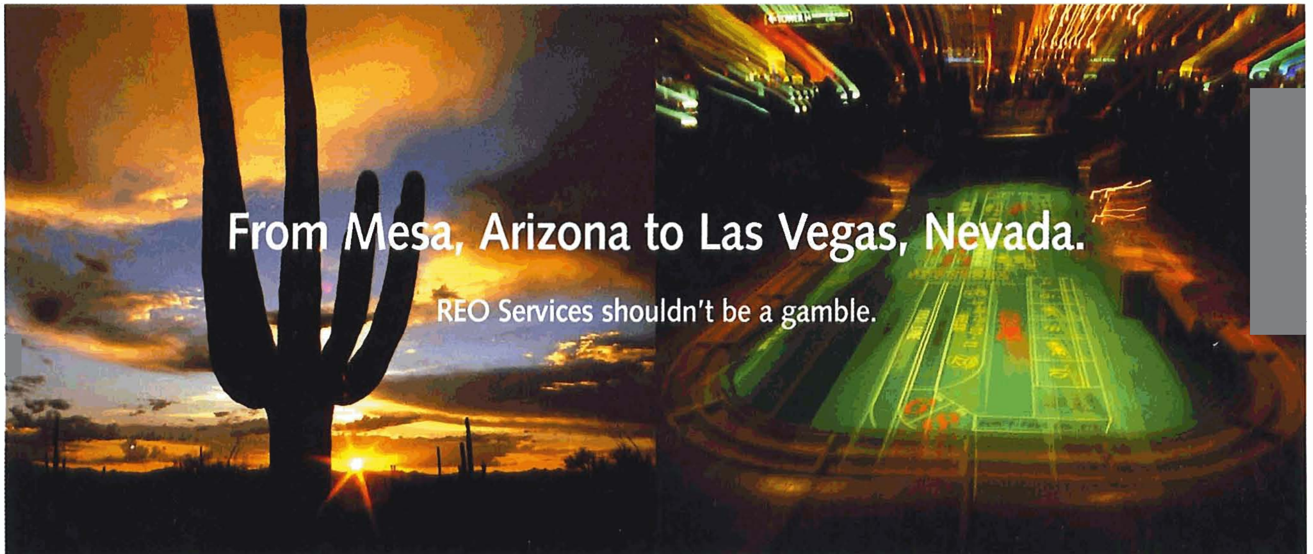
there has always been a certain base level of foreclosure activity, Southern California foreclosure numbers are actually a bit low right now. As home price appreciation rates ease however, a rebound in foreclosures is expected. DataQuick president Marshall Prentice said that the "numbers will also go up because of some of the newer and riskier so-called 'sub-prime' loans." Apparently, this rising trend has already begun, albeit slowly. Foreclosures in Southern California fell 8.5 percent (from 48,017 in 2001 to 43, 921 in 2002) as home prices went up 16.5 percent (from $231,000 to $269,000). The story was quite different in San Francisco where default activity increased 23 percent (from 10,567 to 12,993) and the median sales price increased 7.2 percent (from $377,000 to $404,000).

Despite the dismal financial condition of the Golden State from the governmental side, California is still one of the stronger states in the nation. There is a lot of money in the state of California: there are people with millions and millions of dollars just for themselves. Orange County in particular is in its own bubble. Many high tech, service and manufacturing firms have corporate headquarters in Orange County and there is a substantial distribution of healthy employment.

The large increase in foreclosures in the late 80s and early 90s was one of the worst seen in recent history. Banks frequently made loans to people believed to be low risk but ultimately proved to be poor investments. Many people who lost their jobs were forced to sell their homes at artificially low prices, resulting in many buyers getting below-market deals. Having learned their lessons, banking institutions are now much more organized and have implemented sophisticated systems to reduce the number of future problems in making loans.



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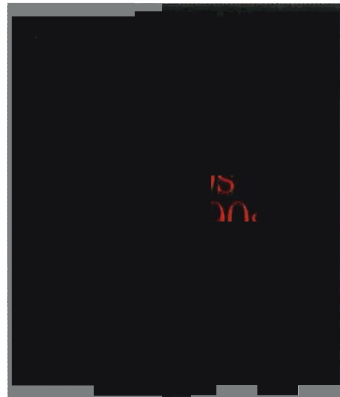
More than 80 percent of the homeowners who found themselves in default during this period in time were able to stop the foreclosure process by bringing their mortgage payments current, or by selling their homes and paying off the mortgage. Compare that to the mid 90s when only half of the distressed homeowners were able to bring their loans current or sell their properties and pay off their loans.

In this era of "The Suze Orman Show," more and more homeowners are becoming keenly aware of their financial options. Like the lending institutions, homeowners are becoming more sophisticated in their approach to handling their mortgages, which Pat Robeson confirms.

"Right now, with the amount of equity in most homes, nobody is going to allow themselves to go into foreclosure unless they just lose their jobs, get kicked out of the state, or just want to get out and leave the keys to the house, or there is some type of problem or defect that causes them to say 'This isn't worth it,'" said Robeson. During the last foreclosure period, between the late 80s and early 90s, one bank averaged 1,000 annual foreclosures in Orange County alone. As of May 1, 2003, the same institution has only 75 REOs all over the nation.



There are a significant number of "Notice of Defaults" where people have fallen behind in their payments, but most are struggling to keep it going, not catching up in their payments, but not falling any further behind either. Many homeowners have a lot of equity in their homes, enabling them to get a second or third mortgage to cover their loan payments for another six months to two years. For these people strong emotions come into play as they are simply focused on being able to meet their monthly mortgage payment obligations. They are not looking 20 or 30 years down the road of life.

At some point in the future, real estate prices are going to come down or at least stabilize. When buyers start to fade out and there are 10 listings for every two buyers, two of the owners are going to win and eight others will need, in time, to reduce their listing prices because they simply are not going to get any offers.

There are three factors affecting offers: condition, location and price. If the condition is good, the location is good and an owner is still not getting offers, then there is a problem with the price. Those three factors are integrated. If an owner doesn't get an offer, then after 30 days he will probably reduce the listing price. And after another 30 days pass, he will probably reduce the price again. So the prices start coming down, but it is a long period. On the average, it takes twice as long for prices to go down as it did for them to go up.

Doug Duncan, MBA senior vice president and chief economist, said that delinquencies have peaked and as the economy continues its recovery, the housing market will continue to make its contribution. All in all, things don't look so bad for a continuing recovery. Certainly, there are always unforeseen circumstances, but all indicators point towards a slowly growing economy and a strengthening job market.

The seasonally adjusted delinquency rate for mortgage loans on one-to-four unit residential properties was 4.66 percent at the end of

the third quarter of 2002. This represents a drop of 11 basis points from the second quarter and a drop of 17 basis points from the third quarter of 2001. The decline in the total number of delinquencies was driven by a drop in the percentage of loans that were 30 days delinquent, from 3.20 percent in the second quarter to 3.06 percent in the third quarter. the 60-day delinquency was unchanged at 0.79 percent and the percentage of loans 90 days or more past due increased from 0.78 percent to 0.82 percent.

Remember, the two things about business are emotions and money. If emotions are good, money is spent. And as recent history has demonstrated, less positive emotions can influence very specific buying decisions. But as things improve, the more positive emotional-economical climate will, over time, dry up a lot of listings, which in turn is going to create some potential inflation. That, inevitably, causes interest rates to rise. It's the raise in the interest rates that is going to be a big part of the hurt box: a rise in interest rates is going to price many people out of the market. It might take one year, two years, or even five, but the prediction is that there will be a number of Californian residents wanting to sell their home at a higher rate but won't be able to because the buyers simply won't be there.

In any event, we as an industry, as a state, as a country and as global citizens are in for a roller coaster ride during the next few years, so hold on. It's survival of the fittest. If you are organized and have relationships with financial institutions that give you property listings, you will be absolutely on fire! You could receive five to 10 listings a month, so it's important to take time now to create these institutional relationships. And if you do a good job, stay strong and maintain high integrity, you're always going to win.

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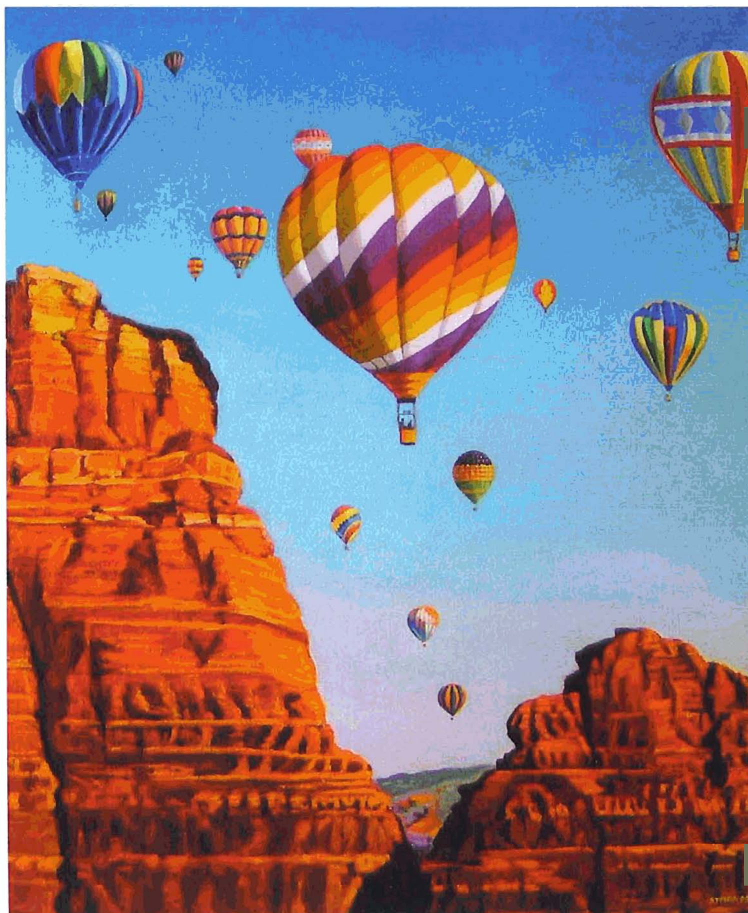

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