

November 11, 2008

Treasure Valley Housing Market – Volatile Sales, Home Prices Higher Than Income

After setting a 7-year record low of 139 new home sales in January of this year, subsequent sales numbers have been slightly, but consistently, higher. That ended last month. In October new home sales set a new 7-year record low of only 121 single-family new home sales.

It is important to remember that one month does not a trend make. And, there is evidence that November will be higher, at levels closer to August and September. Still, October's downturn is an important and disturbing reminder of the fragility of the Treasure Valley market for new homes. And, the real test will come in two months when we get data on January 2009 sales. Historically, January is the lowest month of the year for Treasure Valley new home sales. See following Chart 1.

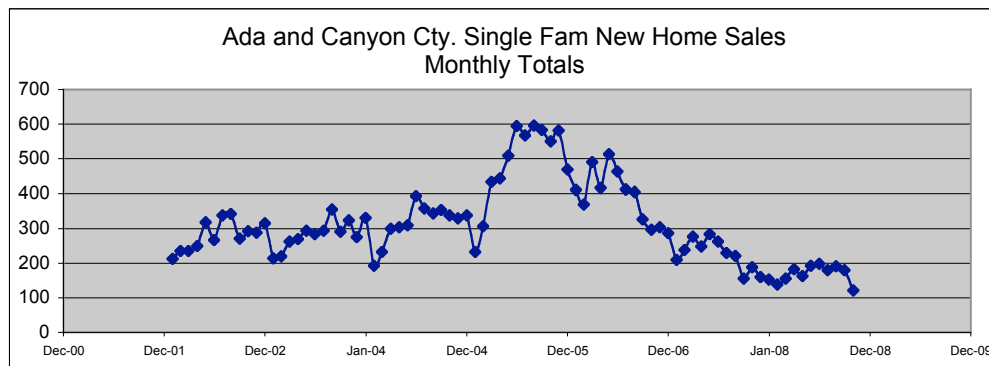


Chart 1

It would be convenient if there were a simple, overriding explanation for the decrease in October sales, such as sellers demanding too high a price. However, that does not appear to be the case. Prices were firm at an average of \$230,000 per home, very close to the to price averages for the past seven months. See Chart 2 on the following page.¹

¹ Note –All prices and dollar amounts, both current and historic, are presented in inflation adjusted 2008 dollars.

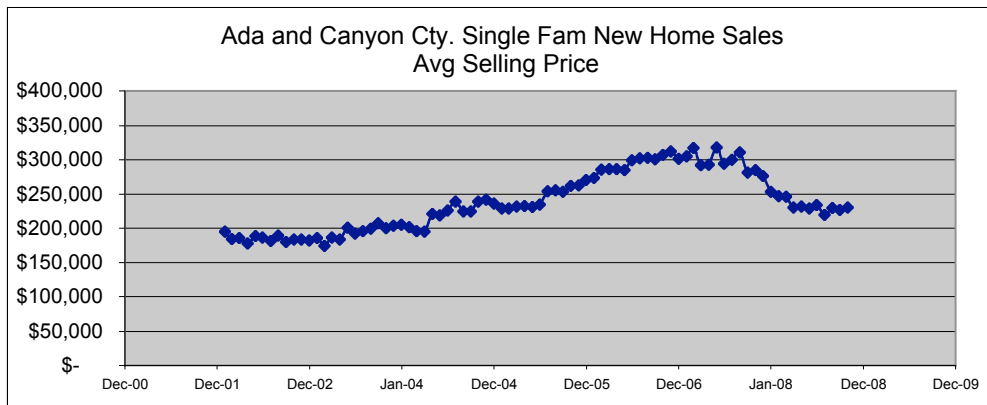


Chart 2

A better explanation is that buyers last month found relatively better value for their money in the existing home market. Sales fell in the existing home market as well, but not by the same percentage rate as they did in the new home market. While new home sales decreased 33 percent from the previous month, sales of existing homes declined by “only” 24 percent, from about 492, to about 395. See Chart 3 below.

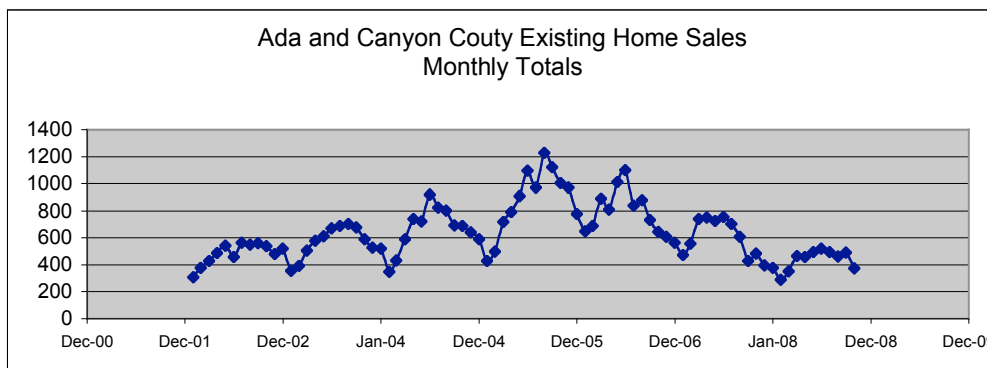


Chart 3

It is worth noting that, to the extent that sales of existing homes were somewhat firmer than sales of new homes, the firmer sales were at least partially supported by a further softening of existing home sales prices. Prices of existing homes have been on a gradual, but steady, downward trend for the past 15 months, from a high of about \$250,000 in mid 2007, to about \$211,000 in September. The trend continued with a further decline in average prices of about 5 percent to about \$200,000 in October. Please see Chart 4 below.

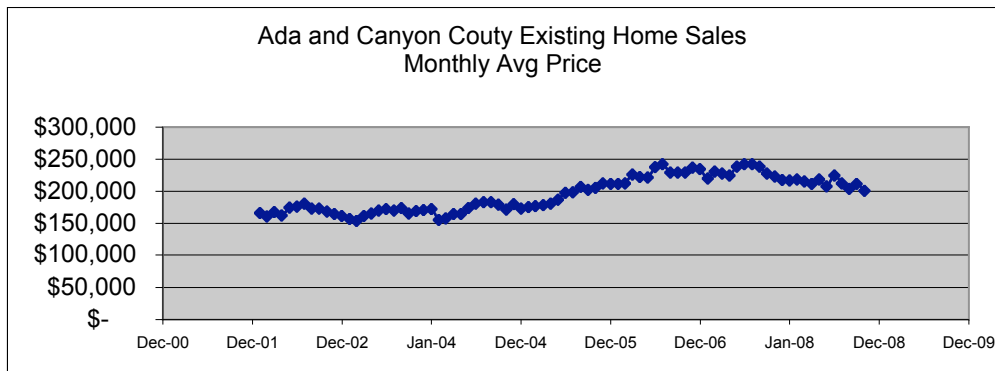


Chart 4

Since both new and existing home sales fell by substantial amounts at the same time, it is also reasonable to place some of the blame on the debacle that is the current finance industry. Demand for homes may be lower than in recent years but, at this lower level, the demand is reasonably firm. One doesn't have to listen too hard to hear stories of qualified borrowers that cannot find mortgage financing. The effect is hard to quantify. And clearly, many buyers are finding financing. Roughly 615 buyers successfully obtained sufficient financing last month in this valley. Still, problems with the lending industry do seem to be having a negative impact on area home sales.

Sales curves may be interesting in their own right, but the persistent question is: What is the driving force behind current sales levels, and what will it take to return them to historic levels?

A couple of years ago there were some reports in the media to the extent that housing prices in California were so high that a majority of California residents could not afford them. Neglecting for a moment that such an untenable situation wasn't a major concern of the building or banking industries at the time, this is an important issue for several reasons.

First, people who were lucky enough in the early years of this century to sell their homes in California and other west coast cities at then extant exorbitant prices formed a substantial part of the in-migrants to Idaho that fueled the market for high end homes in the Treasure Valley. Subsequently, the collapse of the west coast housing market also meant that people who were once selling relatively high end homes and heading inland with equity parachutes, are instead now often facing foreclosure and bankruptcy. More succinctly, it means that much of the foundation for the demand for high-end homes in the Treasure Valley has ceased to exist.

Second, let us return to the point about area residents not being able to afford homes where they live. Housing prices, on average, cannot exceed purchaser's average ability to pay for extended periods of time. Either people will be forced to move away and sales will suffer. Or, builders will have to cut prices, and profits will suffer. This is true whether we are talking of San Francisco, California, or Kuna Idaho. While the situation in the Treasure Valley may not have been as extreme as it was in California, there is strong evidence that the same factors were, and to a lesser extent still are, in play.

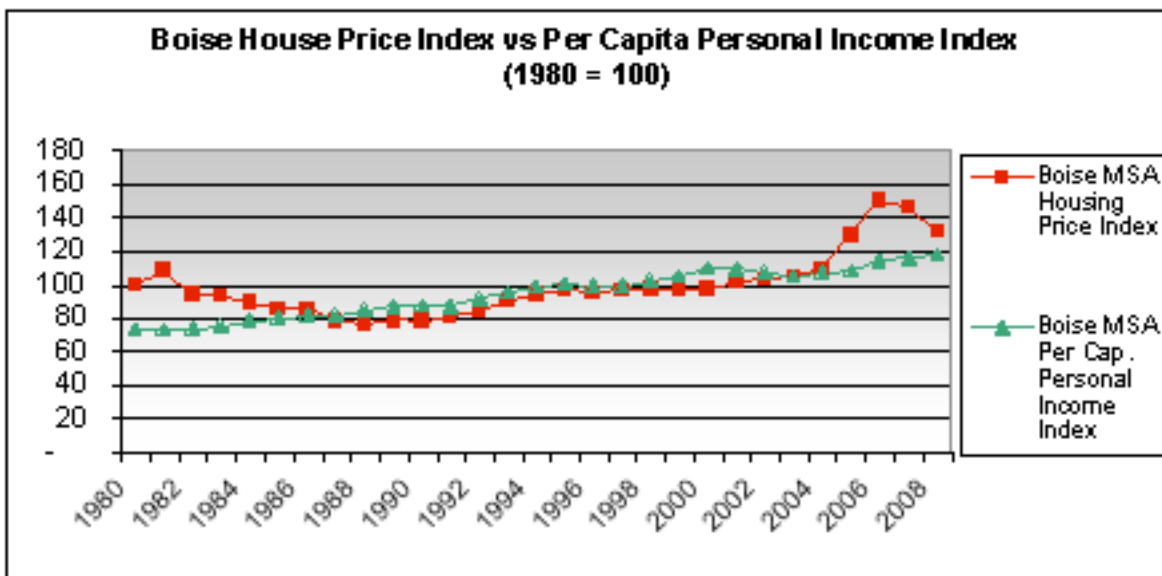


Chart 5²

The last major correction, prior to 2006, to hit the Boise housing market occurred in the early 1980s, ending in about 1986 or 1987. That time frame corresponds to the first downward sloping portion of the Housing Price Index line in Chart 5, above. From 1986 through 2004, the local housing market was reasonably stable with Treasure Valley housing prices tracking Boise Metropolitan Statistical Area (MSA) per capita personal income very closely.

Then, in 2005, the two measures sharply diverged. In 2005 the housing price index increased by 20 points while per capita income only increased by two points. And, the same thing, to a slightly lesser extent, happened the following year. Indeed, from 2004 through 2006, Treasure Valley housing prices increased by a full 36 percent while per capita personal income only increased by 7 percent.

² Both indexes are adjusted for inflation. June 1995 = 100.

It should be no surprise that in the absence of a perpetual supply of west coast equity fugitives coming to Idaho, and in the absence of 20 percent annual increases in Idaho per capita incomes, the local housing market was headed for a “correction”.

By the numbers, the interplay of the housing prices and the personal income supports the intuitive concept that the housing market will be troubled as long as prices increase faster, or remain higher, than is supportable by income. For the 18 years from 1986 through 2004 the ratio of home prices to per capita personal income oscillated closely around 1:1. The lines diverged sharply in 2005 and the ratio peaked at 1.31:1 in 2006. Currently, even after two years of moderation, the home price to income ratio is still 1.12 :1. In other words, home prices in the Treasure Valley are still about 12 percent higher than historically sustainable home prices relative to income.

Needless to say, no builder, developer, realtor, or home seller, wants to cut another 12 percent off their already reduced prices. And, keep in mind that we are in a recession/depression. Incomes may decrease by a percent or more over the next year or two. To achieve a 1:1 home price to income ratio in this economic situation, current home prices may need to be reduced by more than 12 percent. Perhaps 14 percent, or even more.

For new homes, this means average prices of about \$202,000. For existing homes it means average prices of about \$176,000

Summary

Last month, I stated that the Treasure Valley housing market appeared to have bottomed. The fact that this month's numbers are even lower, doesn't necessarily contradict my earlier statement. One month does not a trend make. However, it does serve to remind us of the fragility of the current housing market. The local market is quite volatile at the moment, and will likely remain so for several months. Even though they have retreated substantially in the past few months, prices of both new and existing homes are probably still about twelve to fourteen percent too high. Bringing prices in line with area income levels, and returning a sense of order to the lending industry, will go a long way towards stabilizing the Treasure Valley housing market.

Footnote – Home Foreclosures and the National Economy

No two ways about it, the current state of the economy is cause for concern. The root of the problem, we are told over and over, is the collapse of the housing industry, with particular emphasis placed on sub-prime lending, which leads directly to millions upon millions of people facing foreclosure and losing their homes.

Moody's Economy, a research firm, estimates that as many as 7.3 million American homeowners are expected to default on their mortgages between 2008 and 2010, with 4.3 million of those losing their homes.

Fore perspective, the US Bureau of Census tells us that there are 127 million housing units in the United States.

If 4.3 million families lose their homes, as Moody's suggests is possible, it will only amount to 3% of the total housing stock. And, most of those homes will simply be resold and occupied by other people at reduced cost. This will reduce the total effect of the foreclosures to about 1%, perhaps less. Finally, most of the foreclosures have not yet happened!

Rocky Mountain Econometrics does not mean to downplay the trauma to the unfortunate individuals who have, or will, lose their homes. At the same time, the author has to wonder at the grand scale Henny Penny effect (The sky is falling!) at work here. It seems inconceivable that an entire industry, let alone the entire country, can be brought to its knees by a 3 percent, or less, mortgage loss.

The trouble is, large-scale economies do operate on a sort of Henny Penny effect. The more-elegant economics term is "Rational Expectations." If enough people think the housing market will tank, regardless of its aggregate strength, it will tank. If enough people expect the stock market will crash, regardless of its inherent strength, it will crash.

The good news is that the reverse is also true. If enough people think the market is sound it will recover, and quickly too. The trouble is, it is difficult to be optimistic in troubled times. It seems to this author that a good start can be made in that direction by getting the press to understand that we are only talking about 3 percent. And, yes, there are also some structural problems that need to be resolved. However, the problem is fixable. When it is all said and done, it is important that we don't throw out the baby because 3% of the bathwater is dirty.