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California’s Economic Recovery Timeline

**California’s real estate bubble peaks**
Home sales volume and prices skyrocket due to irrational exuberance. California’s economy soars to unsustainable heights. Homeownership peaks in California at 61%.

**The “Great Recession” begins**
New sales agent licensing drops 80%. Sales volume and prices are in a free fall.

**The “Great Recession” winds down**
Real estate sales volume and prices bottom and bounce briefly. This year marks the beginning of secular (long-term) economic stagnation. The Federal Reserve (the Fed) takes control of the market and lowers fixed rate mortgage (FRM) rates. All mortgage funding is made possible through Fed bond buying.

**A transitional period**
Home sales volume remains weak. FRM rates hit a 60-year cyclical bottom in 2012, heralding 20-30 years of rising rates. In 2014, jobs are restored to 2007 peak levels statewide, but do not catch up with intervening population growth of 1.2 million working-age individuals. A coastal economic recovery ripples toward inland areas.

**The bubble pops**
Home sales volume and prices take a dramatic fall from their dizzying heights of one year prior. Homeownership begins its long-term decline. Jobs hold steady for the time being.

**Financial crisis strikes again after 70 years.**
Massive layoffs occur. Bank failures begin as mortgage defaults mount and construction loans sour. Housing starts nearly cease. The U.S. government bails out the banks and stems the crisis.

**The Bumpy Plateau Recovery begins**
Zero lower bound interest rates prevent classic Fed monetary stimulus from creating jobs. Short sales, foreclosures and REO sales decline. The period is characterized by speculator acquisitions, flat annual home sales volume and volatile pricing. Homebuyer demand remains stifled and California’s homeownership rate continues to drop.
Demographics move the market: agents pour in

Job growth continues, satisfying California’s population gain since 2007 by 2019. Rents and prices rise dramatically with demand centered in urban areas. Smaller coastal cities resist requirements to lift zoning restrictions on much needed high-density multi-family starts. Members of Generation Y (Gen Y) enter the rental and home buying market; in a demand convergence, Baby Boomers retire, selling and buying again rather than renting. Home inventories build up as construction starts trigger tenant and homeowner turnover. New real estate licensees flood the market and sales volume peaks again.

A brief downturn

Home prices level in late-2017, held back by FRM rate increases and slowing sales volume. Cautious bond investors keep FRM rates from momentarily rising any higher, though adjustable rate mortgage (ARM) rates rise as the Fed acts to cool the economy. Homeownership rests at 54%. Wage growth exceeds the inflation rate.

The housing market stabilizes

Real estate pricing re-anchors to consumer inflation, with increases held down by higher mortgage and capitalization rates. Zoning advances permit residential construction to match population growth. Speculation and foreclosures are at a minimum, limited to cities with restrictive zoning. Not to be repeated for another generation is the mortgage malpractice which occurred after 1980, brought to a momentary end by the 2009 Dodd-Frank mortgage banking reform regulations.

Obstacles to expansion

Home sales volume rises gradually in 2015 as buyer-occupants take advantage of low FRM rates, only to level off in 2016. Mortgage rates begin their ascent in late-2016. Construction starts for multi-family properties fall back in 2016, with SFR starts at a reduced, but positive, pace.

The market adjusts to higher interest rates

Prices rise again by mid-2018 led by the cost of construction and returning speculator acquisitions, then end-user occupants. Construction starts begin to fill user demand for more housing in larger coastal urban centers. Strategic defaults and bankruptcies increase slightly in 2018. Large broker firms add sales agents to match sales volume.

A Fed-induced recession occurs

A modest V-shaped business recession, brought on by Fed action to cool the economy, takes place. The last of the negative equity homeowners who failed to strategically default and move on have paid their way out of insolvency. The housing inventory is adequate as residential construction remains strong, leading the economy in a recovery. Seniors, wealthier and living longer than in past generations, continue to own much of the SFR housing stock.
Tenant demand for **multi-family rental** units has increased throughout the recovery, fueled by the housing requirements of a greatly increased population for rentals and low-tier condominiums. However, multi-family construction growth leveled out in 2017 after decelerating in 2016.
Buyer-occupant demand for detached single family residences (SFRs) is gradually increasing in line with the pace of our job recovery while construction is seriously insufficient to meet demand.

As for 2018, higher mortgage rates and continuing stagnant real wages (wages anchored to inflation) will diminish today’s renewed interest in SFRs. This will include a shift to and increased demand for rentals and less costly multi-family ownership options. Thus, starts in the multi-family sector will recover more quickly, and will outperform SFR starts through the end of the decade.

Construction of SFRs rose 12% higher in 2016 over 2015, and increased another 15% in 2017. Homeowner vacancies statewide are below their historical average, which drives demand for SFRs. Thus, SFR construction has to increase to meet future housing needs if prices are to be brought back within reach. Further, buyer demand for SFRs will increase as more homebuyers enter the market. This is expected to peak in 2020-2021 with a recessionary turndown in the economy.

Detached residential construction trends

- 31,200 SFR starts took place in the six-month period ending September 2017. This is up 18% from the same period one year earlier, a numerical increase of 4,700 semi-annual starts.
- 49,400 total SFR starts took place in 2016. This was up 12%, or 5,300 starts, from 2015.
- The total number of SFR starts in 2017 experienced an increase of roughly 15% over 2016.
- For perspective, this cycle’s peak year in SFR starts was 2005 with 155,000 starts. The lowest year was 2009 with 25,000 starts. While at double the 2009 pace, we are presently operating at just one-third the 2005 pace.
- Final reports issued for new subdivisions by the California Department of Real Estate (DRE) increased 10% in 2017 while applications remained flat with 2016, a rise of around 20% from 2015.

Detached SFR forecast

- Realty Publication’s forecast for total SFR starts in 2018 is 68,000, 20% higher than 2017.
- SFR starts will begin to rise more quickly in 2018, once builders adjust to the new paradigm of rising mortgage rates and high-density zoning mandates.
- Subdivision final reports with DRE will continue strong as developers continue to sense a return of homebuyers on the horizon.
- The next peak in SFR starts will likely occur during the boomlet period of 2020-2021.
This chart illustrates the number of California residential construction starts during semi-annual six-month periods ending in March and September.

<table>
<thead>
<tr>
<th></th>
<th>Sep 2017</th>
<th>Mar 2017</th>
<th>Sep 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>SFR starts</td>
<td>31,200</td>
<td>24,500</td>
<td>26,500</td>
</tr>
<tr>
<td>Multi-family Starts</td>
<td>28,800</td>
<td>23,900</td>
<td>24,300</td>
</tr>
</tbody>
</table>

- 2017 multi-family housing starts totaled roughly 51,200. This is level with 2016, but with a present upward month-to-month trend.
- 28,800 multi-family housing starts took place in the six-month period ending September 2017. This is a semi-annual increase of 4,500 starts, or 19%, from the same period one year earlier. While multi-family starts briefly decreased in mid-2016 through mid-2017, this was a reversal of the generally positive trend experienced in multi-family starts since the end of the Great Recession.
- For perspective, this cycle’s peak year in multi-family housing starts was 2004 with 61,500 starts. The lowest year was 2009 with 11,000 multi-family housing starts.

- Multi-family housing starts will pick up in 2018 due to a late-2017 statewide loosening of zoning regulations and a focus from lawmakers on low- and mid-tier housing. These conditions with which we have no experience makes a forecast for total multi-family starts in 2018 forecast too speculative to calculate precisely;
- The next peak year for multi-family housing starts is likely to be 2020.
6,943,000 owner-occupied housing units existed in California in 2016, according to the U.S. Census Bureau. This is an increase of 1% over the prior year.

California population growth is increasing at a rate of 0.7% per year, as of 2016, having bottomed at the peak of the Millennium Boom and trending slightly upward since then.

16.8 million people were employed in California in September 2017. This is 1.2 million jobs above the pre-recession peak month of December 2007, according to the California Employment Development Department (EDD).

The trough month for employment was January 2010, with 13,686,400 people employed state-wide.

The rental vacancy rate at the end of 2016 was 3.6%, though this rose to 5% in mid-2017 as rents jumped dramatically due to the housing crisis generating rent gouging.

**Construction starts** will continue to increase gradually through 2020, perhaps significantly. The pace of the rise is speculative, as it is dependent on several factors, discussed below. [See Figure 2]
How do builders decide when and where to build?

Builders analyze trends in existing home sales, end user demand from buyers, local employment and mortgage lender interest rates. Together, an analysis of these and ancillary economic factors produces a prediction of future trends in the need for further construction.

How fast and how long construction starts for SFRs and condos will climb depends on end user homebuyer-occupant demand, building density allowed for residential construction and buyer ability to pay a price that includes a profit for the builder.

Currently, speculator acquisitions at less than 25% of ownership turnover no longer dominate California’s home sales volume (though still are significant enough to interfere).

This intervention subsided through 2016 and continued at an even lower rate in 2017. As prices level out in 2018, expect speculators to return to grab up properties in anticipation of continuous price rises into 2020-2021.

However, builders rely upon buyer-occupants to support new home construction, deliberately culling out speculators as buyers in staged tract developments and slower selling projects. Buyer-occupant demand in 2017 remains stunted, evidenced by relatively low sales volume, lagging participation and declining mortgage origination figures. Builders will continue to bide their time until sales volume figures for buyer-occupants pick up, likely by 2019 when prices begin to rise again — before the next recession, which now appears will come around 2021.

When speculators acquire SFRs, they interfere with home sales volume and pricing which then display a distorted picture of user demand. However, builders need to look to jobs data and mortgage rates as the primary impetus for demand when they set the level of starts that will likely sell.

California has finally recovered all jobs lost in the Great Recession but at wages which do not cover the interim inflation or represent stakeholder participation in dramatic GDP growth (read: corporate earnings before tax rate reductions). Still, considering the intervening population gain (around 3 million), full employment and labor force participation comparable to the December 2007 peak is not expected to be reached until 2019 when wages will see dramatic increases. [See Factor 1: Jobs]

Obstacles of concern to future construction starts include:

- rising mortgage rates — ARMs first, then FRMs — reducing homebuyer borrowing capacity;
- tightened credit for homebuilders and rising costs which exist going into 2018; and

Key factors for builders

End user demand drives SFR sales

Obstacles facing SFR builders
• restrictive zoning regulations, which discourage density in desirable living areas of the state, but need to be relaxed to provide greater density.

Until these factors are considered and a conclusion reached, builders (and their lenders) may not take for granted that construction starts will pay off. Expect starts to only modestly increase until these factors collectively improve, around 2019.

Chapter 10.1 Summary

Construction of new single family residences (SFRs) rose about 15% higher in 2017 over 2016. Homeowner vacancies are below their historical average. Thus, SFR construction needs to increase to meet the future rise in demand if prices are to remain within reach.

However, buyer demand for SFRs won’t appear until more homebuyers enter the market, expected to peak in 2019-2021.

Multi-family starts in 2017 were roughly level with 2016. The future of multi-family starts remain uncertain, as conditions for building continue to change. These include zoning regulations, trends in existing home sales, end user demand from buyers, local employment and mortgage lender interest rates.

Chapter 10.1 Definition

construction starts ................................................................. pg. 172
Blueprints for future construction

After reading this chapter, you will be able to:

• discuss the government action necessary to promote growth in the construction industry; and
• predict future builder behavior.

Key Terms

savings rate  zoning

tenants-by-foreclosure

Like many aspects of real estate, a given area’s construction industry tends to be most reflective of the local economic environment, including the political reactions of local governments.

To meet the expected demand for housing in urban centers, apartment and condominium (condo) builders will need the state legislature to set aside inner city locations for high-density, high-rise residential lodgings. Cities do not generally get the drift in population demands, or they cater to the few residents who see no benefit from increased population in their back yards.

Policy-makers who are forward-looking need to:

• increase the minimum number of residential units permitted per thousand square feet of ground;
• reduce the number of parking spaces per unit for vehicles; and
• permit mixed uses (both residential and non-residential) within the same high-rise structures.

Suburban sprawl has proven to be a poor long-term housing and retail strategy, in spite of the appeal of a mythic stand-alone-home on the prairie.

Local governments have a great deal of control over real estate price movement. However, that control is rarely the subject of rational discussion in California (evidence the population’s resistance to any infrastructure other than more highways to ever further away horizontally subdivisible parts of the state).

As the demand for any type of improved property increases, (evidenced by prices moving upward faster than the rate of consumer inflation when
excessive asset inflation sets in), local governments need to permit the higher and better use of existing subdivided parcels. This begins with the demolition of obsolete structures. With that, construction can take place to meet demand without delay.

New construction quickly placed online keeps property prices close to the mean price trendline as the demand for housing rises. Construction avoids the disruptions between employers and employees inevitably generated by price distortions in the market. [See Factor 12: Pricing]

Prompt action on the re-zoning of city center parcels will take advantage of vertical environment — build up, not out — to level out our next boomlet in sales prices, around 2020-2021, from turning into another market-killing pricing bubble. Rising resale prices of existing SFR housing will be tempered when new units can actually be added at prices comparable to home resale prices. But the pricing key to builder access and market stability is zoning. However, zoning is about making local political decisions, not general planning or economic choices. [See Factor 7: Inflation & CPI]

To accomplish these goals efficiently, cities need to implement zoning that allows greater height for buildings coupled with higher urban density. Also, smart zoning keeps down the need for new infrastructure to bring newly developed properties online as more remote lands are subdivided.

Successful zoning laws keep demand for government services at a consistent level when builders are allowed to demolish obsolete and inefficient structures and construct high-density housing on existing blocks and parcels within the centers of cities. Thus, the need to extend roads and utilities (which the cities will then be required to maintain) is avoided.

Local governments’ first responsibility for housing is to revisit current limits on height, density and onsite parking, as well as the mix of unit types (1-, 2- or 3-bedroom units). These limitations need to be modified with an eye toward the best use of inner-city parcels, which are now occupied by old, obsolete SFRs.

Intelligent zoning allows builders to meet the needs of homeowners and renters looking for jobs in the city’s core financial, governmental, educational, medical and other high-end service trades: this century’s growth industries for last century’s loft buildings.

The state legislature has already established a pattern of increasing density by adding low-income units to the permitted use. This includes authorization to construct granny flats (casitas) on SFR parcels everywhere.1

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1 Calif. Government Code §65852.2
City councils can increase building activity for marketable housing by **reducing permit costs** for the construction of units on central city parcels. The reason: additional infrastructure such as roads, sewers and utilities are not typically required.

Such cost-saving policies encourage builders not to jump outward from the urban center into remote, unsubdivided lands. Encouraging builders to build in urban centers make cities more favorably centralized. At the same time, **center city improvements** deliver the convenient apartments and condos the growing cultural flow of urban-dwellers most desire. Given the choice, most prefer to live near to where they work.

Of course, caution and prudence are the guiding words in all government activity. In recessionary periods, local governments tend to want to speed up construction in order to create jobs and support local builders, a good thing when the results help keep prices from ballooning.

As we move further into the expansion in this recovery, beyond 2018, the reverse is true. It is the responsibility of local governments to restrain excessive and economically misplaced building. Evidence is in the central valley cities’ issues of excessive housing from the 2000s. However, governments (both local and national) always lag behind the needs of the moment. Their policies, by political necessity, are enacted in reaction to events already in motion.

As such, government policies to prevent construction will often persist when they are no longer helpful. As a result, incentives created during a recession typically come too late and remain even when the market has improved. In turn, this leads to overbuilding and other fallout evils.

Moreover, local governments are motivated by needs other than those of homebuyers or the construction industry. Among their other concerns, governments need to always maintain their own revenue from the tax base.

One way of ensuring this revenue is to encourage construction during slow times, even in the absence of demand from homebuyers. Thus, the assessment rolls will grow. Such incentives are welcomed by builders, but excess inventory has in the past led to suburban sprawl, unacceptable designs and failure of onsite and offsite amenities — conditions helpful to no one.

In times of low **consumer confidence**, purchases go down and the savings rate goes up. Debt that looked non-threatening in boom times becomes a source of constant anxiety. Since 2007, California’s population has been frantically **deleveraging** — cutting down their debts in order to reduce overall expenditures, including **mortgage debt**, particularly mortgages on underwater homes. [See Factor 8: Consumer confidence and 9: Savings]

The decision to reduce and avoid more debt is healthy financial management for many families, but it is bad for sales volume, pricing and every service
provider connected with home sales. Deleveraging is even worse for the home construction industry. Contractors depend on new home sales (which are typically financed by purchase-assist mortgages) for their livelihood.

While retiring Boomers generally have the cash reserves (or home equity) to buy new homes without incurring more debt, first-time homebuyers rely on outside financing to support the price of their purchases. Without the willingness to take on financing, even at current low rates, they will remain renters at least until sufficient confidence returns and the urge to buy develops. [See Factor 15: First-time homebuyers]

Meanwhile, personal savings rates are extremely weak, down to 3.7% of personal income in the second quarter (Q2) of 2017. Such low savings rates are nonetheless up slightly from the mid-2000s when real estate sales volume and prices (and LTVs) were at their peak. The savings rate going into the 1980s was 10% of personal income, but declined to 3% by the 2005 period. This process reversed during the long economic recovery when the savings rate was slightly higher at 9% in 2012. But savings began to slip as the indebted sought to deleverage their debt and the underemployed and retirees drew upon savings to make ends meet. This trend will mostly continue for two decades as interest rates increase and induce savings. [See Factor 9: Savings]

In the long run, increasing savings rates today will benefit homebuyers and home builders alike. However, too few first-time homebuyers today can come up with a 20% down payment when purchasing a home. Thus, low down payment mortgage options remain popular, but come with very expensive private mortgage insurance (PMI) and government-guaranteed mortgage insurance premiums (MIPs).

Before SFR construction can rise, homeowners need to believe that buying a home is an economically beneficial decision. Going into 2018, home sales volume remained just above the seven-year low experienced in 2014, having remained mostly flat since 2012.

The brief rise in sales volume in the second half of 2012, as in 2009, was primarily due to speculator interference. However, this rise proved unsustainable in 2013 and in 2014 thanks to low levels of consumer confidence, fast rising home prices, a jump in mortgage rates and ongoing recovery of employment numbers. 2015 experienced a rise in sales volume roughly 10% by year’s end, due mostly to the boost received from declining mortgage rates coming off the rate jump in mid-2013.

39,000 new and resale home transactions closed escrow in California during September 2017. Year-to-date sales volume was roughly level with 2016. For comparison, monthly sales volume peaked at 70,000 in 2005.

Residential renters and owners work in a sort of pricing equilibrium since rents and homeownership have a financial ceiling of around 31% to 35% of personal income. However, monthly rent payments are driven beyond...
those percentages of income when the demand for rentals increases over the demand for homeownership, as is the case today with the failure to build to meet the demand. Soon enough, the costs of paying rent become greater than the total costs of home mortgage payments and the expenses and risks of homeownership.

When this balance tips financially in favor of homeownership, renters with cash on hand for a down payment will make the mathematically logical choice. They shift to homeownership, unless some other influence interferes such as the ongoing negative concepts about mortgage debt. Thus, although SFR construction is on the rise at the moment, circumstances of rising mortgage rates and resale home pricing have not paved the way for improved SFR buying conditions in 2018.

However, keep in mind that the last time this equilibrium pricing point for rent and homeownership costs crossed over was in the early 1970s. Since 1980, homebuyers have become accustomed to paying far more in mortgage and carrying costs for a home than the rental rate for the same or equivalent property.

For this, you can thank the common idea, developed over the past 30 years, that the family home is a growth investment capable of delivering more than just its value as shelter. That investment-centered thinking, spawned by three decades of dropping interest rates and inverse price movement, was mostly washed away by the 2008 economic tsunami. This thinking will in large part be kept at bay as long as wage growth remains tepid in the continuing recovery.

And as for former owners, now tenants-by-foreclosure, they are understandably disillusioned and reluctant to take on the risk of homeownership anytime soon. Most never will – nearly 90% – due to the humbling financial crisis they personally experienced.

Once property prices level out in 2018, driven down by the rising mortgage rates and flattened sales volume, look for home prices to rise haltingly through 2019 as they did between 1945 and 1964 (the years the Boomers were born). Home prices will likely rise at the rate of consumer inflation, an acceptably steady 2% to 2.5% annually. Prices will be held in place by rising mortgage rates and increased residential construction. After, prices will rise more quickly as first-time and retiring homebuyers flood the market in the next mini-boom in home sales circa 2020-2021.

This drop in the homeownership rate represents the fallout from roughly one million families who had owned and occupied homes in California before the Great Recession. They are now renters due to the destructive housing crash brought on by the Millennium Boom, many having moved in with others bringing on a more efficient use of existing housing.
However, almost all of these former owners will continue renting until the recovery of real wages is complete and their credit scores have been repaired, sometime after 2018. Even then, few will return to homeownership, probably 10-20% maximum of those losing homes to the dynamics of short sales or foreclosure sales.

Much of this shift is due to the challenges presented by the failure of job opportunities in the Great Recession and ongoing recovery.

Those prior homeowners will continue to rent once the current period of economic stagnation is over. This shift away from homeownership will interfere with detached SFR starts for a long time. But it will bolster construction and investment in multi-family units (rentals). [See Factor 5: Renting: the alternative to ownership]

Construction will first begin to blossom in the communities of coastal California, where high-tech information and service jobs and correspondingly high paid positions are increasingly centered.

Coastal communities also have the benefit of appealing to the retiring population, due to the temperate climate they offer and reputation for comfort and ease of living. Anticipate increased construction along the coast, especially of multi-family units located in core urban centers.

All this will continue to grow steadily and possibly quite rapidly throughout this decade, given proper rezoning to encourage builders and lenders to take on the risks of construction. The pace of SFR starts will be slower to increase, but will follow with a sharp upturn in demand around 2019, mostly around the periphery in adjacent inland valleys.

The *inland valleys*, on the other hand, will remain burdened by excess housing for some time to come. Their current populations are likely to flee in large numbers to the cities, to be closer to jobs and civic amenities, to be replaced with lower-earning, lesser-skilled and immigrant populations.

It will be far into the future before the Inland Empire and the Central Valley are able to return to the construction levels of the Boom years. They will, however, be helped by an increase in industrial employment, as industries move inland to take advantage of readily available, low-cost labor. [See Factor 22: Population growth and Factor 25: Regional housing indicators]
A region’s construction environment is dependent on local zoning regulations. To ensure an efficient use of land, local governments can loosen urban density and building height restrictions.

Multi-family construction will recover first, followed by single family residence (SFR) construction. This is due to the increased number of renters and the falling homeownership rate in the aftermath of the Great Recession.

**savings rate** ................................................................. pg. 178
**tenants-by-foreclosure** .............................................. pg. 179
**zoning** ........................................................................ pg. 176
Notes:
After reading this chapter, you will be able to:

- interpret the current residential vacancy rates in California; and
- understand the pressure of vacant properties on sale and rental inventories in the real estate recovery.

**Homeowner vacancy rate**  
**Rental vacancy rate**  
**Notice of default (NOD)**

**Residential vacancy data** are batched into two categories by the U.S. Census Bureau:

- homeowner vacancies; and
- rental vacancies.
Homeowner vacancies represent the total number of unoccupied homeowner housing units. The total homeowner housing units consist of single family residential (SFR) units which are:

- owner-occupied;
- sold and awaiting occupancy;
- vacant year-round (versus seasonally vacant, like second homes); or
- for sale only, not lease.

This figure portrays historic vacancy trends in California, contrasting those figures with construction levels for (SFR) and multi-family residences adding housing units to inventories.

Data courtesy of U.S. Census Bureau and Construction Industry Research Board.
Likewise, **rental vacancies** represent the total number of unoccupied rental housing units. Total rental housing units include those residential units which are:

- renter-occupied;
- rented units awaiting occupancy;
- vacant year-round and for sale or lease; or
- just for lease. [See Figure 1]

In recent recessions, vacancies rose steadily during the recessionary years and peaked well into the ensuing recovery years. The negative effects of a recessionary economy develop slowly. However, recessionary effects eventually diminish the ability of many individuals to make payments needed to stay in their current housing.

This effect historically is more dramatic in the rate of rental vacancies than homeowner vacancies. This is due to the more mobile nature of rental housing occupants.

The historical movement of homeowner vacancies is relatively tame. Homeowners are less likely than renters (or simply unable) to sell, pack up and move. Further, homeowners are generally reluctant to sell their property during a recession. They avoid selling their home for less than its original purchase price, or even its prior market price, all part of the money illusion held by most sellers.

The relationship of homeowner vacancy and rental vacancy trends is one of **undulating equilibrium**. When housing prices are high, it makes more financial sense to rent than to own, as started occurring in 2005. Thus, vacancies in rental housing units go down and vacancies in homeowner housing units go up.

Over time, the dominance of one type of housing (homeowner vs. rental) equalizes. In the demand transition, favor then shifts to the other type of housing.

For instance, as more and more individuals favor rental housing, the demand for rental housing causes landlords to increase rents until vacancies become unacceptable. Thus, landlords are able to increase their *net operating income (NOI)* from their properties. On the other hand, higher rent, in turn, eventually translates into more financially advantageous conditions for homeownership, shifting tenants to owners.

However, the lush lending conditions of the early and mid-2000s introduced massive inventories of new housing units into the market. This excess temporarily broke the historical trends in both types of vacancies.
Introducing new housing units into the homeowner/rental vacancy equilibrium is not in and of itself a disruptive event. Population growth absorbs newly added units. If the rate of absorption of new units is properly monitored by builders and lenders, and does not exceed or fall behind demand, vacancy rates will not be altered.

However, the sheer volume of real estate introduced into the housing-saturated Millennium Boom real estate market was not matched with sufficient population to absorb the numbers. Thus, it was very disruptive to housing vacancy rates. [See Factor 10: Construction]

At the outset of the 2000s, the economy was beginning to slip into an orchestrated corrective recession. However, the Federal Reserve (the Fed) prematurely altered its course. The Fed decreased interest rates to stimulate growth in an extreme monetary policy reaction to the September 11, 2001 attacks.

These low interest rates and by then greatly deregulated mortgage originations encouraged lenders to lend — which they did in spades.

Among those who took greatest advantage of this free-flowing money were builders, who borrowed and built since construction money was lent to them by most banks to do so. Contrary to popular belief, builders do not build to meet current or anticipated housing demand. They generally build because there is someone who will provide them with money (lenders, buyers and government subsidies).

*Editor’s note — Observe that even as the rental vacancy rate (the purple line) rose after 2001, builders did not cease their building of multi-family apartment buildings (the parallel red line). [See Figure 1]*

Zoning and the expense of building multi-family units kept the mid-2000’s apartment boom from reaching the proportion of the SFR building spree. It nonetheless illustrates the unrealistic doggedness of builders with money. Also, it is a blatant myth in the real estate industry that construction is a leading economic indicator. It clearly lags, but housing construction does employ a lot of people.

When the Millennium Boom began in 2002, rental vacancies began to rise as more people began to jump on the home buying bandwagon. The move was nothing like the shift of the Boomers from apartments to homes which peaked in the early 1990s.

However, note that the **homeowner vacancy rate** (the turquoise line) begins to rise with the rental vacancies. This occurs even during a period of time (2004-2006) when buyers were still pouring into the market. This increase kicks the homeowner vacancies to abnormal levels, upwards in excess of 3% by 2008. [See Figure 1]

In contrast, the previous peak in SFR building permits (the parallel orange line) during the late ‘80s was accompanied by a relatively modest, but
extended, homeowner vacancy rate of 2%. Overbuilding of SFRs during the late ’80s was fought off with the continuing strength in Baby Boomer household formations well into the 90s. The current real estate recovery does not have such a weapon. [See Figure 1]

As observed in Figure 1, the actual peaks of both SFR and multi-family housing unit starts came in the late ’80s.

Luckily, the blind overbuilding of that decade came at the same time the Baby Boomers (the Boomers) had jobs, were forming families and moving into rental housing or buying homes. The massive number of Baby Boomers thus relieved that market of much of its excess SFR inventory shortly after the recession shut off starts. [See Factor 14: Retirees and Factor 15: First-time homebuyers]

With the latest building spate, which began in 1996, builders charged full-steam ahead. They built housing beyond the needs of a declining market for housing demands. The Boomers had already settled into their properties and the generation immediately following them (Generation X) was far less populous and not at all able to buy. This left a glut of vacant housing units on the market throughout the 2000s.

In an attempt to drum up household formation (and at the expense of vacant rental housing), the federal government in the late ’90s began a campaign to push the homeownership rate above its traditional 64% national threshold. Part of this campaign came in the form of the Department of Housing and Urban Development (HUD) allowing seller kickbacks to buyers for the down payment when an FHA-insured mortgage was involved, now a highly regulated and prohibited practice.

The efficacy of the government’s push for homeownership can be seen in California’s homeownership rate. This rate is historically lower than the rest of the nation. California’s rate of homeownership shot up to its 60.7% peak in 2006 from around 54% in 1990. [See Factor 5: Renting: the alternative to homeownership]

Unfortunately, just like the careening train of construction, the government’s push for homeownership was running with a small-capacity fuel tank. Generation X simply did not have the population to keep the train running. Thus, the SFR construction boom of 2000-2001 was driven by money, not the fundamentals of demographics.

Homeowners lured out of the rental woodwork to push that homeownership rate were, by training, job experience and inclination, incapable of sustaining ownership. This was evidenced by the increase in the ratio of the unstable adjustable rate mortgages (ARMs) to the predictable fixed rate mortgage (FRM), and the rise of the now infamous and oversold subprime hybrid mortgage. [See Factor 6: Mortgages]
These temporary homeowners served to keep the homeowner vacancy rate down through the middle of the 2000s. In contrast, the rental vacancy rate at the time was trending steadily upwards.

Tenants were vacating their rented premises to move into homes. In 2006, homeowner vacancies and rental vacancies began to rise again. This was due to a lack of end user homebuyers in the market and the corresponding rise of buy-to-let investors and speculators.

Herds of speculators entered the real estate market in the mid-2000s hoping to profit from market momentum as prices were driven ever upwards by mortgage-funded, frenzied buyers. While the boom lasted, their effect was mainly on the homeowner vacancy rate. As they purchased properties from owner-occupant sellers and, in time, placed the properties back on the market for sale, the homeowner vacancy rate went up.

Eventually, the boom wound down and prices began to drop. Speculators were then left with unsellable properties (i.e., properties they could not sell at a profit).

Slowly the speculators’ “For Sale” signs became “For Rent” signs, then foreclosure postings. [See Factor 3: Real estate speculation]

As the Millennium Boom drew to an end, the Great Recession began to unravel many of the threads holding the real estate market together. But then another factor driving vacancies emerged like a bull from its pen: foreclosures.

In California, recording a notice of default (NOD) is the first step in the foreclosure process. The foreclosure process ends when the property is sold at a trustee’s sale, or possibly an intervening short sale or mortgage modification.

It was the influx of NODs and foreclosures that drove real estate prices back to their pre-boom levels (circa 1999) adjusted for inflation. This created a pocket of seemingly cheap real estate prices in the low-tier and (to a more limited extent) mid-tier properties. Again, relative pricing is part of the money illusion that does not allow people to look at present value and move forward, but constantly reflect on past valuations long gone.

That, along with the phenomenon of ‘Cash Is King’ (speculators as the source of mortgage lender liquidity in the recession) and the tax subsidies for buyers of both new and existing houses, temporarily made it easier for flippers to purchase and resell properties. Such circumstances are evidenced by the dip in homeowner vacancies from 2008 to 2009. [See Factor 7: Inflation & CPI]

Increased vacancy in rental property during this time can also be attributed to a tendency for households to consolidate during times of economic distress.
California has added population at a rate of less than 1% since 2005 (around 300,000 people) annually. After factoring for births, deaths and children leaving the proverbial nest roughly 150,000 of these Californians form new households and require housing each year. [See Factor 21: Population growth]

However, new residential construction is lagging far behind this number, with just about 100,000 new housing units started in 2017. As a result, vacancies are near historic lows in 2017. The Inland Valley communities are bearing the brunt of these vacancies.

The Boomers, instead of rescuing the market, are typically looking to retire and soon sell their properties and purchase replacement homes. Their sales continue to create competition for the existing homeowner vacancies available in the market.

This time around, Boomers are one side of a double-edged sword that cuts into the housing market’s ability to absorb existing inventory. Boomers in large part will not purchase their replacement home in the suburbs when they sell and retire. While selling in the suburbs they will adding listings to the inventory, but will also be consuming inventory on their relocation to another community. Both will be froth with difficulties by the need to have concurrent closings. [See Factor 14: Retirees]
By 2019-2021, Generation Y (Gen Y), those born in the ‘80s and ‘90s, will have finally become established in their careers and moved out of their parents’ basements or other roommate situations. Thus, they will begin to form households of their own and vacant properties will dwindle — both rental and homeowner. The open question is where they will be employed and where their housing will be located.

As has been the case since 2007, brokers and agents need to be wary of any reports of a real estate recovery until both these sources of inventories have been addressed.

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**Chapter 11.1**

**Definitions**

Two types of vacancies exist: homeowner vacancy and rental vacancy.

A single population of occupants is shared by both the homeowner and rental camps. Therefore, when one vacancy rate rises, the other typically decreases, a zero sum game.

In recent recessions, vacancies rose steadily during the recessionary years and peaked well into the ensuing recovery years. The negative effects of a recessionary economy develop slowly. However, recessionary effects eventually diminish the ability of many individuals to make payments needed to stay in their current housing.

This effect historically is more dramatic in the rate of rental vacancies than homeowner vacancies. This is due to the more mobile nature of rental housing occupants.

Temporary homeowners served to keep the homeowner vacancy rate down through the middle of the 2000s. In contrast, the rental vacancy rate at the time was trending steadily upwards.

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**Gen Y purchases the shadow inventory**
After reading this chapter, you will be able to:

- identify historic home price trends and home pricing techniques; and
- understand the factors that will change future California home pricing.

**Key Terms**

- debt overhang
- price tier
- sticky pricing

To understand the “bigger pricing picture,” the disparity between low-, mid-, and high-tier sales fluctuations, look to the *Standard & Poor's/Case-Schiller* home price index as the authority. The index is an invaluable source of price movement information, drilling down into price comparisons for California’s three major cities and thus the state as a whole. [See Figure 1]

*Editor’s note — Regional charts and further pricing commentary are also discussed in Factor 25: Regional housing indicators.*
The charts on the following pages track changes in separate price tiers by property values on a sale of the same house. Thus, they display how different layers or ranges of home prices in the market perform in comparison to one another.

The main difference between the Case-Shiller and other home price measures is Case-Shiller separates its index into three price segments of the housing market:

- low-tier sales;
- mid-tier sales; and
- high-tier sales.

Homes fit within these price tiers based on their original tier. That is, a mid-tier home will never become a low- or high-tier home based on market fluctuations alone. It will always be considered a mid-tier home due to its original sales price, regardless of how its price changes. In turn, the floor and ceiling for the home tiers change with market influences.

Viewing home price changes through the multi-tiered lens provided by Case-Shiller is most helpful for understanding how prices have changed and will likely adjust in the future. This is because average or median prices tell only the general surface part of what’s happening in the real estate market — the average price is a mathematical abstraction of little application to sales as it cannot be applied to any single property. On the other hand, the tiered price approach narrows down the price picture for a particular property significantly.

Important analytically, the Case-Shiller index uses the repeat sales method. In other words, it only counts homes which have sold at least twice, and only single family residences (SFRs) at that. This allows it to compare how a home’s price has changed over time. When aggregated with other repeat sales of individual homes in the area, Case-Shiller produces an index number for a specific region.

Brokers seeking the actual value of a specific property do well to remember there is no such animal as a “median priced home.” You simply cannot find it.

Alternatively, median price is a statistical point which fails to analyze any one price-tier of properties, much less an individual property.

To determine how a parcel of real estate will actually behave in the future, you cannot compare the price of a low-tier property with that of a high-tier property; it’s just common sense, but a median price does just this. Over time, all properties move in the same direction, be it up, down or flat due to consumer inflation and wages. However, properties in different tiers move in price at greatly different paces, different sales volume and for very different personal wealth and lending reasons.
Figure 1

Los Angeles Tiered Property Price Index: 1985-Present

Los Angeles Tiered Property Price Index: 2006-Present

San Diego Tiered Property Price Index: 1985-Present

San Diego Tiered Property Price Index: 2006-Present

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.
ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

Figure 1, cont’d

San Francisco Tiered Property Price Index: 1989-Present

Chart by Rent Theda
Data courtesy of Standard & Poor’s/Case-Shiller Home Price Index

San Francisco Tiered Property Price Index: 2006-Present

Chart by Rent Theda
Data courtesy of Standard & Poor’s/Case-Shiller Home Price Index

California Tri-City Average Tiered Property Price Index: 1989-Present

Chart by Rent Theda
Data courtesy of Standard & Poor’s/Case-Shiller Home Price Index

California Tri-City Average Tiered Property Price Index: 1989-Present

Chart by Rent Theda
Data courtesy of Standard & Poor’s/Case-Shiller Home Price Index
The best way to initially evaluate a property and set its price is to study comparable property values in the same demographic location (same house, same tract). Other ways to set the base and ceiling prices for a property include:

- cost per square foot (replacement cost); and
- income analysis methods.

The median price is an attractively simplistic “mathematical abstraction.” A one size fits all resolution. However, the comparison of median prices over time never produces a useful result when applied to an asset as unique and variable as a parcel of real estate.

The overall median price also gives an erroneous representation of the market to sellers and buyers. Agents as subjected to reality daily, mostly know better. The rate and extent of changes in property value prices varies dramatically both within and between low-, mid- and high-tier properties.

Low-tier properties generally change quickly and dramatically, as depicted in Figure 1. High-end properties are slower to react to the rise and fall of the general market. Different tiers often move in opposite directions for a short period of time until the other tier reverses course. When upward or downward price movement occurs in tandem, each tier experiences a different percentage of price change.

Median price is nothing more than a line bisecting the total of all sales prices. One half fall above the arbitrary line and one half fall below it. It never represents the price movement of any one property. The formula of median home price needs to be dumped in the trash bin of bad ideas for setting values.

Ask any agent who has had to explain to their seller why the listing price needs to be reduced to make a sale when the seller has just read in the local newspaper that the median price has risen.

For more accurate and refined data that gives a reasonably meaningful picture of market pricing, tiered pricing like those shown in Figure 1 offer a more sensible source — but not the best, which is local comparable sales and the cost of replacement.

Economic factors that thrust real estate prices into their decline is more important than ever. Also important is whether those factors can help predict the speed at which different segments of the California real estate market will recover.

For example, Japan’s real estate market collapsed in 1991-1992 following its last financial crisis. During the ensuing period, prices dropped in both residential and commercial real estate, and continued to drop for a decade, dragging government supported banks with them.
However, when Japan’s commercial real estate prices fell, they dropped dramatically faster and farther than its residential real estate prices. If the Japanese crisis-reaction precedent is the track our government stays on this decade, we can expect similarly dilatory results in our own real estate market. Here, again, is the secular stagnation situation in application.

Two factors are listed in “Asset Price Declines and Real Estate Market Illiquidity: Evidence from Japanese Land Values,” a report by John Krainer of the Federal Reserve Bank of San Francisco (FRBSF). These factors are price persistence and illiquidity.

Price persistence is also commonly called “sticky pricing,” “downward price rigidity” or “the money illusion.” These terms describe the tendency of listed prices in owner-occupied real estate to resist change. These listed prices stay high even when the market for resale homes has dropped. Of note, this does not hold for commercial property.

Illiquidity refers to the corresponding inability of the seller to cash-out on the sale of property. This is one factor in a vicious cycle which causes price stagnation. It inhibits recovery from a financial crisis and recession. Greater liquidity in contrast allows buyers and sellers to easily obtain money and get rid of property at agreed upon prices (read: market prices). This leads to a more fluid market with turnover or sales volume at normal rates.

In the case of a market collapse, home prices are unable to stabilize — bottom out — until property pricing comes to reflect cash values. On the other hand, sellers’ sticky pricing does extend artificially inflated property prices long after a collapse has occurred.

Price persistence in the real estate market is attributed to two causes. The first cause is search friction. Search frictions include the difficulty a buyer encounters to locate a property through a broker, agent or builder, and then analyzing disclosed property conditions and agreeing to an appropriate price.

In the hunt for a home, search frictions perpetuated by insiders impede property transactions and price adjustments reflecting current market rates. These conditions prevent deals from taking place when making a deal is what everyone has in mind. Thus, these frictions hinder the speedy resolution of a recession or financial crisis. Worse, they work to the detriment of the multiple listing service (MLS) environment.

The second cause of this price adjustment lag is the crippling load of excess mortgage debt underlying 3.2% of California’s mortgaged homeowners as of Q2 2017.

This debt makes leaving a property (for those who need to relocate) more difficult. This condition, called debt overhang, is one enabling cause of an enduring recession. Excess mortgage debt on a property forces buyers and
sellers to ascribe distorted values to real estate, both up and down since the owner wants to but no longer has a stake in the pricing. Such distorted values are part of the money illusion and speculator invasion driven by excess property debt.

Re-stabilized real estate market pricing and sales volume meeting the current economic reality is a prerequisite for the commencement of a recovery. Yet it is almost impossible until the mortgage debt overhanging property owners can be matched to, or reduced below, the property's value. This practice is called a **mortgage cramdown**.

Ultimately, negative equity homeowners are forced to become more financially rational. California's real estate fundamentals experienced a shock in the mid-2000s when homeownership was artificially increased by subprime lending to tenants not groomed to consider homeownership. The FRBSF's study indicates the speed of the initial home price drop and price recovery depends upon the listing price of properties. To a degree, this is something brokers can control.

When brokers can broadly agree upon an appropriate price, property values will reset constantly to their basic worth — *cash values*. Instead of rocketing to the artificial heights of a housing price bubble or the artificial lows of the bubble's collapse, prices and sales volume will adjust rationally. Thus, the historical (long-term) trend line of property prices will be more closely maintained from year to year. This may be boring, but it produces a more predictable and stable livelihood for all involved.

However, the combination of search frictions and mortgage debt overhang typically makes property owners reluctant, or unable, to sell for the property's current fundamental value. This is especially true in owner-occupied residential real estate.

Instead, sellers keep their homes on the market longer. In many cases, they hope to avoid default by finding the rare buyer who might be willing to pay a higher price. Here, the agent servicing this type of listing is involved in an inefficient investment of their time, talent and money.

Seller's agents, particularly in high-end properties, tend to pander to these instincts. This leads to price stagnation, in which the rise and fall of prices is unnaturally prolonged. Such stagnation is not a good thing, since it greatly extends the length of a market collapse by a failure of sales volume to remain at the same level.

This was seen in Japan in the 1990s and Mexico in the 1980s.

Japan’s financial crisis of 1990 included a collapse in both commercial and residential property values. Income property prices were especially volatile throughout the collapse. They ultimately fell faster and deeper than owner-
occupied residential prices, but bottomed sooner. Owner-occupied residential real estate had a much higher variety of pricing and a greater burden of debt. However, it also eventually fell catastrophically, though less dramatically.

Price movement differs greatly not just between price tiers, but also between different types of property. Income producing real estate is more easily evaluated and typically less burdened by high loan-to-value (LTV) debt ratios. Capitalization rates (cap rates), income flow and replacement costs supply information for rational evaluation.

Low LTV debt ratios also mean equity remains for the owner to work with. Solvency conditions of ownership make it easier for buyers and sellers to agree upon an appropriate price. Thus, the owner is provided the ability to cash out — greater liquidity.

The relative ease of income property evaluation makes this real estate market a more dynamic and less predictable field. Cap rates can change significantly from year to year, altering an income property’s market values in a moment. As interest rates move up over the next couple of decades, cap rates will follow to reduce the price buyers are willing to pay for income property.

Conversely, owner-occupied residential property moves slowly and steadily with sticky pricing prevailing as sellers fail to react to existing market forces (the speculator-driven, price-accelerating market of 2013-2014 and other periods are exceptions). As the FRBSF report points out, real estate pricing often fails to correspond to objective reality. The discrepancy between the prices that homeowners set and the prices homes actually garner in the market is due to the human factor.

Outrageous bubbles become more outrageous, and collapses become more devastating, due to a common set of irrational beliefs about market behavior held by the typical seller and buyer of real estate. The most dramatic example of market fallibility took place in the very recent past — the 2008 recession.
The main difference between the Case-Shiller and other home price measures is Case-Shiller separates its index into three price segments of the housing market:

- low-tier sales;
- mid-tier sales; and
- high-tier sales.

The median price is a statistical point which fails to analyze any one price-tier of properties, much less an individual property.

Price persistence in the real estate market is attributed to two causes. The first cause is search friction. Search frictions include the difficulty a buyer encounters to locate a property through a broker, agent or builder, and then analyzing disclosed property conditions and agreeing to an appropriate price.

The second cause of this price adjustment lag is the crippling load of excess mortgage debt, or underwater homeowners.
Between 2002 and 2005, the Millennium Boom ignited and left a mushroom cloud over the housing market. This boom ultimately vaporized trillions of dollars of personal wealth across the nation. How did this situation come about?

After the events of September 11, 2001, the Federal Reserve (the Fed) failed to maintain the short-term interest rates they had recently increased. The purpose of the series of increases in rates was to correct the 1999-2000 excessive ballooning of prices in the real estate and other asset markets. Thus, with prematurely lowered market rates post 9/11, accompanied by reduced tax rates and increased government and private spending, the Fed set the stage for the 2008 recession’s economic devastation of asset values, mortgage deregulation nearly fully in place at the time. Both real estate and stocks were affected. Asset price inflation was the goal, and the Fed got it in spades.

The devastated real estate prices brought on during the 2008 recession were also largely wrought with what became debt-leveraged erstwhile speculators. Lured by the false impression that prices would continually rise, speculators succumbed to the momentum of the crowd.

In 2002 and 2003, the first phase of the Millennium Boom, a large and growing percentage of U.S. households perceived it was an economically prudent time to purchase real estate. The administration’s policy to push up homeownership rates by American Dream propaganda and Freddie Mac was heavily at work. Prices had stabilized since 2000, but sales volume was picking up to bring on home price inflation.

72% of homebuyers cited favorable credit conditions of low interest rates as the cause for their enthusiasm. By mid-2003, when prices had risen beyond consumer inflation rates, 85.2% of the population felt it was a good time to
purchase a house. This occurred approximately two years before the peak of the sales volume boom, producing a bandwagon effect. This was precisely what government agencies sought, and got.

This enthusiasm, coupled with an overabundance of very cheap money supplied by the Fed, caused asset prices to naturally rise more rapidly through the second phase of the boom from 2004 into early 2006. Soon, the monthly upward resetting of prices by brokers dampened most households’ enthusiasm for homeownership. Thus, occupancy began to rise and vacancies dropped in residential rentals.

Instead of sales in the housing market cooling as potential homeowners withdrew, a relatively small but wealthy portion of the population rushed into home purchases. Their quest was to profit solely from the perceived continued rise in home prices, no occupancy intended. Their assumption was that future prices would continue to increase. They expected a steep trajectory similar to that established during the first phase of the boom between 2002 and 2003.

As reported by the Federal Reserve Bank of Minneapolis (FRBM), the housing price bubble was inflated to extravagant heights during the second phase of the Millennium Boom. This was due to the widespread belief that prices would perpetually escalate. The belief was contagious, and spread among speculators with epidemic-like swiftness and voracity.

In an average year, 9.2% of U.S. households are optimistic about the future trends of home prices. This means they believe it is a good time to buy a home since they see prices rising in the future. Thus, in tandem with the sudden increase in home prices in 2004 during the second phase of the boom cycle, a larger percentage of the population became optimistic about future home prices rising as a way to create wealth.

By the middle of 2005, 20.2% of households shared this belief. They became themselves momentum traders. They too became convinced that real estate prices could not fall below peak levels, as they previously did in 1991 and 2001. [See Factor 8: Consumer confidence]

When this psychology was paired with unprecedented short-term property price inflation and low consumer inflation, the result was a disastrous spread between market prices and the mean price trend line. Real estate prices were pushed further upwards in a self-enclosing circle.

Prices rose as more optimistic speculators made purchases, temporarily withdrawing property from the market, reducing inventory for buyer-occupants. The result was increased prices fueled by the optimism of even greater numbers of speculators entering the fray to make even more purchases at ever greater prices, a fool’s game.

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1 "Momentum Traders in the Housing Market: Survey Evidence and a Search Model," by Monika Piazzesi
Speculators accounted for 25% of real estate buyers in 2014 (more when including trustee sale acquisitions). They do not enter the real estate game with the intent of procuring a long-term source of earnings, as do investors in income property or land. Neither do they intend to occupy or otherwise use the properties they purchase.

They are hit-and-run buyers who perpetually flip their purchases. Property traders, much like day traders. All the while, they are conscious that the financial wave they are riding will eventually crest. But remember, real estate is a collectible representing a “store” of wealth, a producer of annual income and a hedge against inflation. For speculators, however, cash is the collectible.

Of course, speculators cannot tell precisely when the wave will lose momentum and crash in the sand. Thus, those remaining are often forced to take a loss when a hot market turns cold. They are prevented from flipping those last purchases at a profit.

Speculators' numbers increased between 2004 and 2005. However, they only accounted for approximately 3% of the total population. The majority of households believed housing prices had climbed erratically high. They opted to wait out the maelstrom, making the rational decision to remain tenants. Rental costs tend to be at or below one-half the rate required to own equivalent shelter under boom-time prices.

Most people after 2004 acquired a negative impression about the real estate market, based on the fundamentals of rental value. Others satisfied themselves with home improvements, content to stay put in their current homes during the second half of the boom. Thus, a large and increasing swath of the population was not involved in real estate activities. The ever-important turnover level declined, reducing sales volume, then prices.

With buyer-occupants leaving the market speculators became an even larger share of the transactions closed. Their market involvement effectively pulled housing, new and used, temporarily off the market and made property appear scarce. However, much of this property was to return later as real estate owned (REO) resale property after the 2008 crash.

In these transactions, optimistic speculators pushed home prices up by paying prices consistent with their starry perception of inflated future values. They believed any carrying costs expended would invariably be dwarfed by future gains. In this way speculators multiplied in tandem with the price increases.

They doubled up on acquisitions and became a powerfully influence on prices in the housing market. Even though they made up a comparatively small portion of the overall population, their effect on the market was significant.
But what caused this paradigm shift that turned regular households into speculators? What caused the speculators to collectively adopt the irrational view that this housing boom was incapable of deflating like all previous real estate booms did — 1974, 1981 and 1991?

Perhaps real estate agents, the gatekeepers of the real estate industry, are partially to blame for propagating this frenzy. Brokers gained knowledge through their professional experience in the early '80s and '90s. Yet, they failed to apply this knowledge to question the prevailing wisdom of speculators. Maybe they just did not understand the pervasive adverse impact of speculators, as do tract builders who abhor them, or did not care.

Like the population at large, many agents became optimistic about future home prices when prices spiked during the second phase of the Millennium Boom. In 2003, 10% of agents believed home prices would increase further. In 2005, during the second phase of the boom, this amount doubled to 20% (but then, so did the amounts of closings and fees).

Not surprisingly, the population of licensed agents spiked as if on steroids. To meet the long-term, public demand for licensed real estate services, California’s needs less than 1,200 new licensees per month. Yet, the number of new licensees in California swelled to 5,000 per month during the peak of the Millennium Boom. This continued for nearly three years through September of 2007 — nearly two years after the demise of flipping by speculators for lack of market momentum.

Then, new licensees plummeted, bottoming at 1,000 new licensees per month in 2012. This trend reversed direction following the most recent speculator over-activity. In 2017, 1,900 new agent licenses on average were granted per month, an increase over 1,800 new licensees per month in 2016. The short-term, speculator-induced boom in prices lured in new agents, directly related to mismatched fee perceptions and the realities of the real estate market.

Rising prices entice new agents while simultaneously weakening sales volume; fewer fees in turn drive expiring licensees away. The direct correlation between sales volume and agent licensing shows licensing movement changes 6-12 months after a consistent directional change in home sales volume. However, since home sales volume has been essentially flat since 2014, today’s wave of newly minted licensees is due to another reason: higher home prices.

But increasing home prices will end too, once mortgage interest rates begin to consistently increase — likely in 2018.
Chapter 12.2 Summary

The devastated real estate prices brought on during the 2008 recession were also largely wrought with what became debt-leveraged erstwhile speculators. Lured by the false impression that prices would continually rise, speculators succumbed to the momentum of the crowd.

Most people after 2004 acquired a negative impression about the real estate market, based on the fundamentals of rental value. Others satisfied themselves with home improvements, content to stay put in their current homes during the second half of the boom. Thus, a large and increasing swath of the population was not involved in real estate activities. The ever-important turnover level declined, reducing sales volume, then prices.

The direct correlation between sales volume and agent licensing shows licensing movement changes 6-12 months after a consistent directional change in home sales volume.

Chapter 12.2 Definitions

hit-and-run buyers ................................................................. pg. 202
momentum traders ............................................................... pg. 201
Appraisals solely to qualify property as security

After reading this chapter, you will be able to:

• understand the nature of the appraisal process preceding the making of a mortgage; and
• determine how the Dodd-Frank Act affects property appraisals.

Consider a buyer who locates a property and enters into a purchase agreement setting the price they will pay. The closing is contingent on the buyer obtaining purchase-assist financing. Thus, the property needs to be qualified as adequate collateral as security for repayment of the amount sought to be borrowed.

This weighty task of valuation by mortgage lenders is entirely outsourced to third-parties to the transaction, a property appraiser. Appraisers are always directly or indirectly hired by the lender, not the buyer who is paying for their services. Yet, the lender is unable to directly contact or discuss that evaluation or the amount of the fee the appraiser is to receive.

The appraisal to set the fair market value (FMV) of a property is conducted in accordance with data gathering and reporting guidelines set for real estate appraisers. The somewhat subjective end result of the report is another matter. This end result is presented in the form of a dollar amount — the property’s value as reported by the appraiser as their opinion.

Under ideal appraisal rules for setting a property’s value:

• the appraiser’s connection with the lender is severed, directly and indirectly;
• the independence of the appraiser is honored by all participants in a sales transaction; and
• the method for developing the current market value of the property is legislated to respect the lesser evaluation generated by the different methods for setting a property’s FMV.
However, the buyer’s price and terms of purchase no longer is the legislated
standard for setting the property’s value or the acceptable condition of that
property. The history of comparable sales, costs of replacement by construction
and current rental values keep property values from drifting upward quickly
enough to support the profits needed by speculators.

Of course, appraisals are reflective of past events. They are historical reports
since they are not forward-looking. A factor based on the current rate of
inflation may well be allowed as the only increase in value over the value
set by the appraiser.

Occasionally, the buyer and seller agree to a purchase price which is above
the appraiser’s FMV determination. In this case, the valuation gap (price-
to-FMV) may be filled by carryback financing, or more cash from the buyer.
The buyer and any carryback seller can then decide whether the anticipated
appreciation of the property’s value will, in their minds, justify the price.

These carryback conditions for financing were commonplace prior to late-
1985, the end of the era of subject-to mortgage takeover sales transactions.

It is unlawful to violate appraisal independence, including:

- coercing, extorting, colluding with, instructing, bribing or intimidating
  any appraisal professional into appraising property at a value based on
  any factor other than the independent judgment of the appraiser;

- mischaracterizing the appraised value of a property to secure a
  mortgage;

- influencing or encouraging an appraiser to meet a targeted value for a
  property; and

- withholding or threatening to withhold payment for an appraisal
  report or service.2

This does not prohibit anyone with an interest in the transaction from asking
an appraiser to:

- consider additional appropriate property information, including
  comparable properties;

- provide further details or explanations for the appraiser’s value
  conclusion; and

- correct errors in the appraisal report.

That said, it is well understood by all home sales agents that the appraiser is to
be advised of the price the buyer has agreed to pay by handing the appraiser
a copy of the purchase agreement. The result: the appraiser figures out how
to “hit the number” and place the value of the property in their opinion at the
purchase price the buyer agreed to pay.

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2 15 United States Code 1631 §129E
Thus, in practice, all the rules against interference with the subjective analysis of the appraiser are honored in the breach. Further, appraisers know that lenders do not much like to see an appraisal which sets the FMV below the buyer’s price and do in turn retaliate. Any such low-balling of the buyer’s price will likely put end to the mortgage application process without the origination of a mortgage.

No appraiser or appraisal company may have an interest, financial or otherwise, in the property being appraised.

When a lender is aware of a violation of appraisal independence, they are prohibited from using that appraisal report to make a mortgage. An exception to this rule applies when the lender confirms the appraisal does not misrepresent the value of the property.

Appraisers are to be compensated at a rate that is reasonable in the market area of the property being appraised. An appraiser may charge a greater fee for complex assignments. This fee reflects the increased time, difficulty and scope of the work performed.

A **fee appraiser** is someone not employed by the mortgage loan originator (lender) or appraisal management company contracting with the appraiser and is:

- a state-licensed or state-certified appraiser who receives a fee for their services and is able to certify that their appraisal satisfies the Uniform Standards for Professional Appraisal Practice; or
- a company that employs licensed or certified appraisers and receives a fee for the appraisals in accordance with the Uniform Standards for Professional Appraisal Practice.

Any violation of the above regulations by a mortgage loan originator (MLO) when arranging or originating a consumer mortgage will result in a civil penalty assessed by the Fed. This penalty may not exceed $10,000 for each day the violation continues. Any subsequent violation will result in a civil penalty. This penalty may not exceed $20,000 for each day the violation continues.\(^3\)

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\(^3\) 15 USC 1639e(k)
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It is well understood by all home sales agents that the appraiser is to be advised of the price the buyer has agreed to pay by handing the appraiser a copy of the purchase agreement. The result: the appraiser figures out how to “hit the number” and place the value of the property in their opinion at the purchase price the buyer agreed to pay.
After reading this chapter, you will be able to:

- identify a mean-price trendline for real estate pricing represented as the historical equilibrium level to which prices cyclically return; and
- analyze past and present prices paid for property in relation to the mean-price trendline.

The mean price trendline: the home price anchor

My house is worth how much? A property’s value seems to constantly change based on local market conditions. Is there any way to measure a property’s innate dollar value over time?

Indeed there is — by using the **mean price trendline**.

Boom periods are times of economic plenty. Sellers of property happily embrace them as prices skyrocket to produce excess profits on a sale. Builders rush in.

Boom-time markets, flush with cash and rising real estate prices, become momentarily untethered from historical price trends. During these short-lived **virtuous cycles**, sellers and seller’s agents dominate real estate transactions as buyers outnumber sellers.

The momentum and volatility of boom times appear strong on owner’s balance sheets. But they rarely last long.

Eventually, sales volume evaporates, and prices dip. The boom slips into a bust, a recessionary process known as the **vicious cycle**.

At some point, demographics and economic conditions drive buyer demand back up. Momentum builds, and prices rise again to exceed the trendline — a return of the **virtuous cycle**.

**Key Term**

The intersection of price illusion and reality

**Learning Objectives**

**mean price trendline**

A reflection of consumer inflation, to which property prices cyclically return.
Neither a boom nor a bust is sustainable in the long-term. They are, by their nature, short-term divergences. As such, pricing during these events is an unfit measure for long-term stability. However, as the booms and busts create their peaks and valleys, a trend develops between them. This is the mean price trendline for real estate.

Through the turmoil of booms and busts, prices repeatedly return to the mean price. Mean pricing is primarily dictated by the path of consumer inflation, as measured by the Consumer Price Index (CPI) in California, and the demographics of population density and their wages.

How does CPI affect housing price trends? There are two major ways:

- The CPI affects the fundamental measure of a property’s value: the replacement cost — the stuff of labor, materials and land.
- The CPI also reflects the changes in costs of other types of goods and services. To compensate for these increased costs, employers typically increase staff income in step with the CPI. As a potential homebuyer’s income increases, so does their purchasing power through their capacity to borrow money.

In the long-term, housing prices will fall back to prices dictated by replacement costs (reflecting the price of the property) and income (the ability of the homebuyer to buy). Thus, the mean price trendline represents the long-term value of property at any point in time, adjusted annually for consumer inflation and appreciation driven by changes in local demographics.

The mean price trendline is the benchmark to which prices return after a boom or bust. The big picture of California price movements can be understood by viewing the disparity between low-, mid-, and high-tier sales. These tiers vary based upon our population’s housing demands.

To best present a statewide view of price movement, we look to California’s three largest cities:

- Los Angeles;
- San Francisco; and
- San Diego. [See Factor 25: Regional housing indicators]

Each city’s sales prices are then segmented into three price tiers; low, mid and high.

Homes sales classified by price range show a clearer picture of how prices move in each tier of the market over time. Each tier’s pricing accelerates and decelerates at significantly different rates. Typically, pricing in the high-tier does not fluctuate nearly as much as in the mid- and low-tiers. [See Figure 2]
When home pricing is momentarily level with CPI, this **crossover moment** is akin to passing over the equator of a pricing sphere. You leave the *buyer's market* and enter the *seller's market*.

Seller's markets are periods in which prices exceed the mean price trendline. During these periods, sellers realize excess profits on the sale of their homes. In turn, families who enter the housing market as buyers overpay.

Of course, when the real interest rate on a *fixed rate mortgage (FRM)* is below 2.5%, a low nominal interest rate of say 3.5% will compensate for some excess price over the life of the mortgage. Cheap money allows for payment of a higher price — simple buyer purchasing power. However, this calculation only works if you do not sell for a decade or two.

Yet, once market prices reach that crossover moment at the mean price trendline, market prices do not hold stable.

As has always been the case, irrational exuberance, lax lending regulation and irregular monetary policy, all cause sales prices and the mean price to diverge after they cross paths. They are driven apart as though pushed by polar magnetic force.

**Figure 2**

*The black, orange and green lines track sales price fluctuations within the three single family residence (SFR) tiers in California's largest cities. The blue line is mean price trendline. The mean price trendline represents the historical equilibrium level to which property prices cyclically return.*

*Gray bars indicate periods of recession.*

*A comparison of current prices with the mean price trendline tells us how far prices have deviated from their historical norm, and the level prices will return to in the years ahead.*
A quick review of the recent past is needed to move understanding forward.

Prior to 2000, California real estate began experiencing the formation of a long-term pricing bubble. The experience commenced during the stagflation years of the late 1970s. These years saw the highest interest rates experienced since the creation of the Federal Reserve (the Fed) in 1913 to manage such things — monetary policy.

A 30-year bubble began to grow with the Baby Boomer (Boomer) invasion of the 1980s and 1990s. The period started with mortgage rates receding from the peak 18% range to a more normal 6% range. Eventually, rates moved to essentially zero by 2009 — evidenced by 3.25% mortgage rates by 2012.

The unrestricted expansion of the bubble caused its implosion in mid-2005 when home sales volume began a steep decline. Predictably, home prices followed one year later. The mean price of property once again came into stark view.

The causes of the decline in sales volume were many. Primarily, we saw:

- a lack of desire to own (vs. rent) the family home;
- price momentum speculation from 2002 through 2005; and
- interest rates increased by the Fed to fight consumer inflation beginning in August 2004.

Despite the resulting price decrease, home prices have yet to correct sufficiently to dip below the mean price trendline.

Prices in the late 1980s reverted to the mean price trendline after the July 1990-March 1991 recession. Between 1991 and 1999, prices were depressed and the cost of property was low, from a historical perspective. Accordingly, prices dipped below the trendline during this period. This condition is known as a buyer’s market.

Prices began to rise in 1997, growing to intersect the mean price trendline in 2000. At that time, the price index and California Consumer Inflation index were, for a fleeting moment, at the same price point: the crossover moment.

After crossing the mean price trendline in 2000, real estate prices were allowed to begin a skyward trajectory. The 2001 recession was short-lived, cut off before real estate prices corrected due to the over-anxious monetary and fiscal reaction to September 11, 2001.

As a result, the price of homes froze in 2001 at their artificially elevated, pre-recession peak. Instead of reverting to the mean price trendline, prices leveled out. This created an improper expectation that real estate prices do not drop in a recession.

Similarly, speculators can only pull profits on a flip going into or in a heated market. Speculators need market momentum to profit. For them, prices need
to be fast headed above and away from the mean price trendline. On the flip, excess money is siphoned from the real estate market, as the flipper quickly unloads their properties at ever-greater prices until the bubble naturally bursts.

After 2000, prices continued to rise going into a steep trajectory. This period is now known as the Millennium Boom. Real estate prices peaked going into 2006, then began their precipitous decline ending in 2009.

Once prices descend down to the trendline, they will not suddenly flatten and move in tandem with the trendline. Instead, prices sink below the trendline before they begin moving upwards again. Think of pricing as a buoyant item dropped into a swimming pool: it first dips below the surface, then rises back up. [See Figure 2]

The mean price trendline only adjusts upward beyond the annual rate of consumer inflation when wages across a population increase at a positive (real) rate, a figure exceeding the rate of inflation — something not experienced in the years since the Millennium Boom.

However, that has not yet happened in a sustainable fashion. The price jump in 2013-2014 was fueled by speculator over-activity, not by innate end user demand. 2015 through 2017 experienced slower price growth, though still above the rate of CPI. But 2016’s increase was due to an increase in buyer purchasing power, indicated by the drop in mortgage rates after 2014, which followed the “taper tantrum” jump in mortgage rates mid-2013 when the Fed announce it was ending quantitative easing (QE) activity. Expect this gradual increase to level out in 2018 due to lagging home sales volume — all in response to rising interest rates.

Once prices dip near the mean price trendline, upward momentum will build. Buyers, long-term investors and builders will begin to see the deal to be had in the newly-minted buyer’s market. If prices do not undergo this necessary drop to return it near the trendline, sales volume in the real estate market will languish and the bumpy plateau recovery (secular stagnation) will become further protracted.

Therefore, 2019 will see home pricing rebound. The housing market will be ushered into a mini-boom as the economy heats up following a full jobs recovery.

Now, the mean price trendline does not set the price of real estate. It sets the amount of distorted change in a property’s value at any point in time based on the fundamentals of homebuyer income. Similarly, consumer inflation does not directly affect home pricing, but it does affect how prices may increase. In other words, as its name implies, the mean price trendline sets the trend for changes in long-term real estate prices.
So, what is the realistic, organic value of a particular parcel of improved real estate? Fundamentally, the organic value of a property is anchored to its replacement cost, not its existing fair market value (FMV). Most typically, FMV is set based on a very short window period of recent comparable property sales, known as comps.

Comps merely buttress the price point in current sales activity, whether dominated by highflying momentum prices or recessive foreclosure and real estate owned (REO) prices. Thus, an appraisal based solely on comps is not helpful to a buyer or their agent when determining a property’s organic dollar value for long-term ownership. However, the mean price is.

Replacement cost is the actual cost of replacing the property’s improvements, adjusted for the degree of depreciation, obsolescence and deferred maintenance experienced. In appraisal vernacular, this is known as the replacement cost approach to valuation.

Under the replacement cost paradigm, the innate value of a property equals only the expenditures for land, labor and materials. Any pricing levels beyond this are mercurial and illusory. These price variances are primarily fueled by:

- speculation;
- interest rates;
- ARM lending;
- predatory lending;
- failure of builders to build; and
- external influences unrelated to the physical property, its amenities, location or the demographics of users for the property.

Roughly 75% of a property’s value comes from its improvements at the time of construction. The remaining 25% derives from the land it is situated on, a percentage that increases as permissible density is increased by zoning. The cost of construction (labor and materials) to replace the property if the existing structure is destroyed will only grow at a pace consistent with consumer inflation, no more.

The cost of labor and materials are at the very core of consumer inflation measures. Thus, the purchasing power of the dollar is the year-to-year measuring stick used for dollar-denominated assets.

The price of land can increase beyond the rate of inflation due to local growth in population density and wages. Also affecting the price of land is any increase in that population’s income beyond the rate of inflation. Increases in price due to demographics are a function called appreciation in value, not inflation.
Neither a boom nor a bust is sustainable in the long-term. They are, by their nature, short-term divergences. As such, pricing during these events is an unfit measure for long-term stability. However, as the booms and busts create their peaks and valleys, a trend develops between them. This is the mean price trendline for real estate.

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After reading this chapter, you will be able to:

- identify housing subsidies added to the tax code since the 1960s housing; and
- understand the price distortions that resulted from these housing subsidies.

Learning Objectives

Key Terms

Baby Boomers                      Generation Y (Gen Y)

A distorted demand with each new subsidy

To kick off the 30-year run to the top of the California Millennium Boom, a housing tax credit, also known as a subsidy, was enacted by Congress in early 1975. It encouraged people to unnecessarily, at the time, buy up newly built homes. These were as yet unsold by builders and real estate owned (REO) property lenders.

In turn, this set off a perverse run of home price inflation (which did not happen after the well-timed but short-lived 2009 housing subsidies). This inflation wasn’t knocked down until 1983, following the corrective reaction imposed by a nasty, double dip recession, the worst since the Great Depression.

In 1986, an income tax exemption allowing personal interest and property taxes paid on principal homes to be deducted was extended to include second homes and vacation homes. This subsidy successfully encouraged ever more homeownership by individuals. Thus, the second home or vacation rental has become a fixture in the real estate construction and sales industry.

These subsidies were unnecessary to get the economy going by selling more real estate. Thus, they merely contributed to the rise in asset and consumer inflation that was already underway. As it later turned out for the vacation home subsidy, it was necessary for members of Congress to be able to write off their second home in Washington, D.C.

As unintended consequences, these government-sanctioned tax policies artificially increased home prices (not homeownership rates). In turn, the hyper-inflated home prices re-sparked the pre-1930s idea that owning a home was an investment, not a savings program for parking personal wealth.4

4 Internal Revenue Code §280A et seq
Adjustable rate mortgages (ARMs), also known as zero-ability-to-pay (ZAP) mortgages, were first introduced for use by banks in March, 1982 by the U.S. Treasury though the concept had been around for some time (variable rate mortgages (VRMs) since 1969 in California). This was done before real estate prices had fully corrected and formed a trough. [See Factor 2: Interest rates]

An ARM allows homeowners to qualify for a bigger mortgage to buy a home with more amenities than they can afford under a conventional FRM. They became instantly popular and were part of an expanding government homeownership policy sought by lenders and builders. This policy encouraged homeownership as a social norm after an initial transitory stay in a rental.

The Federal Reserve (the Fed) eventually muzzled inflation (1% by 1984). This slowed the economy and allowed mortgage interest rates to decrease by half. The lowered inflation and interest rates eventually facilitated economic stability and recovery by 1984. However, the brevity of this recession was not strong enough evidence to break a misguided psychology. Many believed home prices would always rebound shortly after a drop. The Fed was to prove them right, until the Fed hit zero lower-bound rates and resulting economic stagnation some 30 years later.

Throughout the 1980s the Baby Boomer (Boomer) generation flooded the housing market. This demographic competed to rent and buy homes. They drove a need for much more housing construction. This torrent of new apartment dwellers kept the market from spiraling into a situation similar to our Great Recession of 2007-2009. Unlike the real estate market of the 1980s, the Great Recession witnessed a dearth of new renters and first-time buyers, again due to a very different age demographic.

Boomers got their first jobs in the first part of the 1980s. Builders responded with massive amounts of new apartment starts. Home construction starts followed in the last half of the decade as Boomers formed households, leaving the apartments behind. Home prices rose in response to their demand. Asset inflation expectations were embedded in the minds of this exploding population of homebuyers. The thought of stable home prices had now become fully unanchored. A home came to be considered primarily as a household’s investment, not shelter for the family.

In 1986, Congress eliminated the state prohibition against a second mortgage for homeowners. This gave Boomers even more incentive to purchase a home well beyond their means. This confirmed an illusionary symbol of the wealth homeowners believed they had simply by owning a home.

By permitting second mortgages, Congress intentionally triggered the ATM effect that quickly caught on. Using a home as collateral for increasing available cash eventually culminated in the crash of real estate prices in 2007.
Congress then further subsidized homeowners to borrow using what became known as Home Equity Lines of Credit (HELOCs). HELOCs provided cash on demand. After 1986, homeowners were allowed to deduct the interest on those equity loans. Reason: America had to brighten up the economy to stay ahead of Japan (whose economy fully collapsed four years later from a real estate boom).

In the 1990s, even more government housing policy encouraged homeowners to buy with the intention of profiting from a resale. Unlike previous movements, the primary purpose was not to provide long-term residency within a stable community. In 1997, married homeowners were given a $500,000 profit exclusion from paying taxes on the sale of their home.

Further, they were allowed to claim the profit exclusion again and again, every two years. This essentially sealed the deal for transitory homeownership — vagabond homeowners. People were now ever more convinced that owning a home provided a sure way to increase their net worth well beyond their employment income. As a result, renters unfit to be owners flocked to the Pied Piper’s tune of homeownership in the mid-2000s.

Interest deduction subsidies were expanded. Under new regulations, prepaid interest (points) was immediately written-off, all of it in the year of acquisition rather than over the life of the mortgage as otherwise required. Further, any default insurance required to get a no-down or low-down payment home mortgage, such as private mortgage insurance (PMI), was a subsidy deduction artificially defined as prepaid personal interest.

By the early 2000s, property investors had discovered more advantages from the sale of their real estate. They could buy a very nice home with tax-free profits — §1031 money — to close out the sale of an investment property by purchasing another investment property (the home) in a §1031 transaction. They could then rent out the home for a short period over two tax reporting periods, after which they take possession of it themselves as their primary residence. After another two years as their residence, they flip it and pay no taxes on profit up to $500,000 per couple. Stimulus on steroids, but this time it was selling that was encouraged, not mortgaged homeownership.

This was yet another unintended consequence of dishing out subsidies.

The worst of the 2008 financial crisis has passed. Amidst a prolonged and rough real estate recovery, potential first-time homeowners are confused. Their parents, the government and their own experience have taught them by inculcation to treat a home as a reliable investment.

As the Boomers’ children (also known as Generation Y or Gen Y) begin their journey towards homeownership during the second decade of the 21st century, they face a very different economic climate built around future
economic conditions flowing from current zero lower bound interest rates. They also express a very different personal ideology. This mentality extends to housing (as well as cars) and differs greatly from their parents’ (the Boomers).

Gen Y’s attitude about financial security is also very different. They lived in the homes their parents bought with unsteady ARMs and ATM second mortgages at the height of the boom. They watched as the homes’ values sank far below what their parents owed.

Data analysts project that a return to the peak real estate prices of 2005, adjusted for consumer inflation, is more than a generation away — 2035 and beyond since consumer inflation without rising mortgage rates is required to get there. However, coastal properties may see a bounce in housing prices to 2005 levels in the 2020 boomlet period if re-zoning does not relieve the demand for housing by permitting more density and height for new construction.

Yet new homeowners have unchanged expectations set from the asset-price inflation of the past 30 years. These years have left them convinced real estate prices will rise 10% each year of this decade. This is the impossibly irrational but very American Dream.

As we look back on the housing bubble that once captivated Boomers with visions of achieving the American Dream through homeownership, we need to focus on the forest of the marketplace instead of the trees of a few neighborhoods with unique demographics.

Outside of price bubbles, prices have historically trended with the rate of consumer inflation. Future real estate market conditions will shift the collective mindset back to viewing a home as a long-term necessity for the family. Prices will fail to accommodate frequent buying and selling for profit (read: no more flipping).

Once Gen Y enters the market in full force, they will be reluctant to buy in the flighty fashion of their Boomer parents. Their recent experience in the real estate market will have left no illusion of an ever-imminent price boom.

For this upcoming demographic of well-educated California homeowners, the decision to purchase a home will be carefully weighed, thoughtfully researched and well advised. The networking tools they have perfected will aid them in this selection. [See Chapter 15: First-time buyers]

The surge of information technology has left Gen Y much more socially passive than all prior generations. These homebuyers will thus rely heavily on agents and brokers as experts holding the information they need advice to make an educated, well-informed purchase.

Prepare for these young clients by learning how to communicate with them via social networking and multi-media listing presentations. However, do so advising only after you have done your homework and prepared for that conversation.
To kick off the 30-year run to the top of the California Millennium Boom, a housing tax credit, also known as a subsidy, was enacted by Congress in early 1975. It encouraged people to unnecessarily, at the time, buy up newly built homes.

In 1986, an income tax exemption allowing personal interest and property taxes paid on principal homes to be deducted was extended to include second homes and vacation homes. This subsidy successfully encouraged ever more homeownership by individuals. Thus, the second home or vacation rental has become a fixture in the real estate construction and sales industry.

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After reading this chapter, you will be able to:

- understand generational trends affecting the stock market;
- relate the ratios used in securities to ratios used in real estate to analyze value; and
- identify the differences between investment in stocks and real estate.

### Key Terms

- Baby Boomer
- capitalization rate (cap rate)
- dis-saving
- net income multiplier (NIM)
- price-to-earnings (P/E) ratio

Stock pricing is at the most basic level, a victim of supply and demand. The dramatic rise in stock pricing beginning in the mid-1990s accompanied a huge increase in investors (and their excess funds) as the aging Baby Boomer (Boomer) generation began to earn more and invest more heavily in stocks (frequently by default under their 401K programs).
Since 2008, the Boomers have started to retire en masse. At issue is the lifestyle they became accustomed to when in the labor force. If they intend to maintain that lifestyle in retirement, the Boomers will need to draw down their accumulated wealth — savings— and use it for the consumption of goods and services.

This behavior of “dis-saving,” or cashing in their savings, led to a decline in their investment in stocks. However, the effect went unnoticed due to the stock market crash of 2008 and the lack of other investment opportunities for the cash held by speculators and foreigners.

No force exists in the stock market of the 2010s to offset the influence of Boomer dis-savings on pricing, except for the Federal Reserve (the Fed) monetary policy reflected in interest rates and bank liquidity. In contrast, during the 2010 decade, home sales by Boomers will almost entirely be offset by their purchases of replacement homes.

The bump in stock prices experienced beginning in 2010 as fueled by speculators portrayed in Figure 1 did not inject enough fresh money into the system to replace the long-term investments being taken out by the constantly aging Boomer generation. Even in a casino, all the gamblers eventually leave the floor. Stocks will continue to drop while speculators decline in numbers during the upcoming years as a result of their own self-destructive practices in momentum markets. [See Figure 1]

The price-to-earnings (P/E) ratio is a simple abstraction used to compare the price of a stock with the earnings of the company. Related to multipliers for income property real estate, the price-to-earnings ratio is a multiplier equal to the net income multiplier (NIM) given in the marketing and analysis of income producing real estate.

In the market crash of 2008, stock prices dropped dramatically from their former heights. But as the P/E ratio demonstrates, the earnings of the companies that underlie those stocks dropped much further.

From the end of World War II to the late 1990s, the P/E ratio of the S&P 500 hovered between 10 and 20, averaging 16.5. However, around 1997, the P/E ratio reached unusually elevated numbers, which remained elevated until 2002. Part of the rise was due to an influx of Boomer investment funds driving up the overall price of the market (just as home prices were boosted by the surge of Boomers in the 1980s). Another major influence was the resulting momentum market effect which lured ever more speculators to the table. [See Factor 12: Pricing]

Nonetheless, after the stock market crash ended in 2002, the P/E ratio remained near 20 until the last quarter of 2008 (see the space between the darkened bars in Figure 1). Then it abruptly jumped from 25 to 60 as stock prices failed to quickly adjust to the drop in reported earnings.
Surprisingly, prices continued to rise despite the drop in earnings (mostly due to risk takers returning to the market), and the P/E ratio peaked at 122 in the second quarter of 2009.

After dramatic drops in the third and fourth quarters of 2009, the P/E ratio has since remained at more realistic levels, though gaining slowly since 2010, at 23.4 in Q3 2017. That is still too high at this point in the continuing
recovery, but a healthier number and closer to its historical link to earnings. The historical average P/E ratio in a healthy market is 16, in a range of 10 to 20, a 6% return on investment.

2009’s return to market norms came about due to a combination of gradually rising stock and bond prices and dramatically rising corporate earnings (and flat wages for employees). Recent greater corporate earnings are based primarily on cost cutting and other operating efficiencies that will disappear as the economy fully recovers, a few years yet to go. Provided the market gradually rights itself, investors will soon become more tolerant of risk. The economy as a whole will benefit as more hiring takes place (increasing personal incomes) and consumer demand rises (increasing personal spending). Also, a rising stock and bond market creates wealth which can be cashed-in and spent, which creates jobs, and so on.

However, stocks and bond pricing have risen dramatically in 2013-2017, a rise which certainly cannot be sustained as interest rates continue to rise in 2018 and the following years. Once stocks and bond prices do settle down, investors will adjust to the reality of rising interest rates over the next two-three decades as U.S. gross domestic product (GDP) increases. Investments will reflect this realization, returning the P/E ratio to between 10 and 20 and percent earnings between 5% and 10%. Thus, a measure of stability will return to the stock market.

The real estate and stock markets are very different in the nature of decisions that are made to buy, hold or sell. Of course, thoughtful real estate investors and brokers pay attention to the similarities. Stocks are alternative investment opportunities to real estate investments. Wise investors are even more aware of the very notable differences.

For instance, experienced real estate investors will never be satisfied with the 5% returns offered by stocks, which is where they are when the P/E is at 20. Long-term income property investors certainly do not buy real estate based on a 5% capitalization rate (cap rate). However, as in real estate, speculators are the outliers and only interested in price momentum and recession-period pricing, sometimes called bottom fishing. To the speculator, the fundamentals take a backseat, if not just thrown under the bus.

Problems that plague stocks, like spurts of inflation and short-term interest rates, are far less prone to affect real estate. Real estate investment pricing is driven by capitalization issues as annual income is the standard for valuation, not day trader profits.

A real estate “cap rate” includes a premium for the long-term rate of inflation, more management participation than with stock ownership, an annual rate of recovery of invested capital over time and a real rate of return on the invested capital. Another cap rate factor is the long-term ownership and foreseeable future cap rates as influenced by interest rates and bond rates, rates that will only rise in the coming decades to limit if not reduce property
values. These problems are less important to the earnings of companies listed on the stock market, including real estate investment trusts (REITs). [See Factor 13.2: REIT investment as stocks]

In the stock market, the price struck for a stock and paid by a buyer is expressed in terms of its relationship to the company’s earnings as a P/E ratio since the stock market analysis is initially about taking a profit on value changes.

Conversely, real estate prices are offered (and paid) based on the rate of return sought by the buyer, called a cap rate since real estate investment is based on income, not profits. It is only then that the NIM — the real estate equivalent to a P/E ratio — is determinable. The NIM for an income property is easily produced: it is simply the reciprocal of the cap rate. For example, a 5% cap rate (1/20) indicates a P/E ratio (NIM) of 20 (20/1) (see the left axis of Figure 1).
Chapter 13.2

REIT investments as stocks

After reading this chapter, you will be able to:
• describe the structure and use of a real estate investment trust (REIT);
• compare and contrast REITs to limited liability companies (LLCs);
• define the ownership stake of a REIT shareowner; and
• assess the value of a REIT in a diversified investment portfolio.

Key Terms
limited liability company (LLC)  real estate investment trust (REIT)  shareowners

Playing the real estate game from the sidelines

Real estate investment trusts (REITs) are the point at which the stock market and the real estate market collide. They are one way for individuals to invest in income-producing real estate, without purchasing and operating the property themselves. REITs allow investors to diversify into real estate without subjecting themselves to the liabilities of ownership and the oversight burdens of property management.

An ownership investment in a REIT does not resemble real estate ownership as known in the real estate market. In fact, shares in a REIT have much more in common with stocks than with property in terms of risk and merit. At the moment, 14 REITs are featured in the Standard & Poor’s (S&P) 500 stock market index.

REITs serve as a form of diversification for investors, spreading the risk inherent in the management and properties held by a particular REIT among the broad pool of its shareholders. Investors appreciate the diversity of REIT investments, since each REIT typically owns multiple properties.

Also, an investment in several different REITs is closely equivalent to the purchase of fractional ownership interests in numerous different properties and property management.

But what exactly is a REIT? How does it differ from other forms of syndication better known to the real estate market, such as the limited liability company (LLC) and the far more risky vesting for §1031 tenancies-in-common (TICs)?

Property owning corporations

real estate investment trust (REIT)  A security traded on the stock market made up of investments in income generating property, trust deeds and government securities.
REITs are essentially property owning corporations. Unlike publicly-held corporations, however, they avoid paying income taxes through a tax loophole by passing a minimum of 90% of their earnings on to investors in the form of dividends. In both REITs and LLCs, income, profits and losses are passed through to the individual members according to their share of the ownership of the entity.

For real estate syndication purposes, the REIT resembles an LLC. Both are unincorporated organizations formed for the purpose of group investment primarily in real estate. REITs provide limited liability for investors and pass-through of income for state and federal tax reporting to the investor (as do LLCs). The pass-through avoids the double taxation of distributed corporate earnings. The very different tax results of corporations favor the stock market vehicle of the REIT (or LLC).1

To qualify for federal tax reporting as a REIT, the REIT needs to have at least 100 shareholders. Also, 75% of the REIT’s business activities needs to be restricted to investments in:

• real estate;
• trust deed notes;
• cash; or
• government securities.

No such restrictions apply to an LLC. Another difference: a REIT soliciting investors in California needs to first qualify its investment program by obtaining a permit issued by California Department of Corporations (DOC). An LLC formed to purchase an existing income property, identified and fully disclosed prior to receipt of contributions by investing members, to own and operate it is not subject to this rule.2

Of crucial importance to real estate brokers and agents, REITs resemble a Chapter S Corporation. Both report profits without the payment of taxes while passing any income tax liability on to shareholders. Real estate brokers are thus barred from taking a broker fee on the sale or purchase of REIT shares (unlike an LLC, which is treated as a limited partnership under California state law).3

The end result for REITs is a greatly restricted ability for management to receive compensation for just about anything involving fundraising, representations, management fees or allocation of assets and cash reserves. In search of alternative income for their REIT involvement, members of REIT management often work as real estate brokers to take the front-end percentage fees paid when their REIT purchases or sells large assets. This risky behavior may be good for management, but it produces negative long-term ramifications for REIT investors.

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1 Calif. Corporations Code §23000; Internal Revenue Code §856
2 IRC §856(c)(4); Corp C §23000(b)
3 Business and Professions Code §10131.3
Problems of asset value arise when REITs buy property at prices based on capitalization rates that deliver low annual returns, say 5%, as has been the case for over a decade. While low annual returns are acceptable to stock market investors (think: day traders for profit on resale), they are not acceptable to real estate investors. Stock investors are accustomed to buying and selling business shares at price-to-earnings (P/E) ratios (multipliers) which reflect pricing, a profit taking point of view that never have been acceptable to prudent income property investors since they treat property like an income generating collectible.

Unlike businesses, which are all comparable to one another, parcels of real estate are unique, and their value cannot easily or quickly be judged by comparison or pre-set formulas. After all, businesses can logically grow and remain profitable for centuries. Businesses are not destined for eventual obsolescence as property improvements are, the depreciation premium of capital recapture built into cap rates for real estate income property investment analysis.

Businesses run with the crowd of their clients. Thus, they are not subject to the demographic forces that influence the value of a parcel of real estate. Due to real estate’s immobility, its pricing fluctuates over time with the relocation and income of the local population. Unlike a business marketing a product, a parcel of real estate cannot move to follow the buyers and tenants.

When REIT managers fail to consider these uncertainties, they make purchases at unrealistically inflated prices. REIT investors may applaud a purchase at what initially seems like a good rate of return for their expectations as stock investors. On the other hand, while informed property investors will sell to REITs at these inflated prices, they refuse to participate as buyers at those cap rates.

The multiplier represented by price-to-earning (P/E) ratios is used in the stock market to price many investments in REITs. Under this method of ownership, participants who invest in REITs are called shareowners. The shareowners hold transferable shares. Shares have relatively high liquidity since they are sold publicly on stock market exchanges.

As shareowners, individual investors are not liable for the debts and obligations of the REIT, closely comparable to membership interests in an LLC. The REIT is managed by officers called trustees who also are not liable for the debts and obligations of the REIT — a liability role comparable to the manager position in a member of an LLC.

REITs are unique among real estate investment vehicles since participation in them by investors is subject to the benefits and drawbacks of stock in a publicly-traded corporation. REIT investors are thus affected by stock market issues like short-term interest rates and stock price inflation and deflation.
Conversely, they are simultaneously subject to the capitalization issues of the real estate market that affect the setting of the values for the resale of properties they own.

This is a trade-off that many stock-market investors are happy to make for the convenience of owning stock held as a portfolio investment. In exchange for taking on the risks that come from the lack of control in REIT ownership, shareowners can diversify their real estate-based investments.

The investor thus avoids the need to conduct a *due diligence investigation* into the value of the underlying real estate. Investors are also freed from worrying over the income and operating costs of owning a particular property. Conversely, such factors are of primary importance to a real estate investor owning and operating a property for their own account.

No formulas, rules of thumb or guidance exist for REIT investors to use to make a quick analysis of value and pricing of share interests in REITs. Investors thus tend to apply the P/E ratios commonly used to evaluate stock issued by corporate business enterprises and sold through the stock exchange.

**Are REITs a good investment?**

They can be, for portfolio stock market investors willing to do their research. Today, REITs continue to regain shareholder value following a steep drop in all stock prices at the end of the *Millennium Boom*. While the general trend is up, REITs occasionally still show negative returns. [See Figure 2]

Gains in the share values of REITs, the profit issue, were produced by the recent surge in the stock market fueled by ambitious speculators. However, they lack support from underlying earnings and property values which still have a long way to go before recovering unlike the securities of the stock market.

The strength of the REIT market as a whole can be gauged in part by the strength of the *commercial real estate market*. Publicly traded REITs currently hold a full 10% of the nation’s commercial real estate.

However, at this time not all sectors of the commercial real estate market have recovered from the recession.

This is not to say that REITs will remain unable to eventually produce a profit for their shareowners when they sell an asset. When commercial property were in dire straits, some REITs used the recent recession to acquire additional cash by issuing more certificates of participation (stock by a different name) with the intention of using the cash generated to purchase property at reduced market prices.

This means the *capitalization rates (cap rates)* of the share pricing for REIT investors was nearly back to the real estate market norm of 9-10% (after dropping as low as 5% in the 2005 REIT purchasing frenzy). Those who invested in REITs involved in the California, Nevada and Florida markets
The above charts track the historic values and returns for all U.S. REITs. Share values for real estate investment trusts (REITs) in the third quarter (Q3) of 2017 continued to rise. Quarterly returns demonstrated normal fluctuations, but the trend in 2017 was up, following a brief decline in 2016.

Right now, REIT values are still bolstered by the continued strength of the multi-family market and continuing recovery in the commercial and industrial sectors. However, REIT investors need to be wary of imminent short-term interest rate increases. A rise in these rates will drive down share prices. REIT investors also need to be aware of longer-term mortgage rate increases which are coming and will drive down the value of property holdings over time.

At the same time, cap rates, which set investment property values, will rise in 2018 as property buyers adjust to increases in long-term interest rates. Property values will drop equivalently to offset these realities. Thus, the value of REIT holdings will continue to drop on each upward adjustment in mortgage rates.

Meanwhile, REIT revenues will hold steady since rent increases are controlled primarily by rates of consumer inflation. Rents move with demand for shelter from businesses and households and changes in income levels, without concern for property values or cap rates.

Property values increase at the rate of inflation when cap rates and investor demand are stable year-to-year, and as long as operating expenses do not increase faster than the rate of consumer inflation and increases in personal income.

during that frenzy now own certificates worth two thirds or less of what they paid. The rents collected in those locales remain stagnant or worse, and show little sign of increasing anytime soon, with the exception of multi-unit properties in the coastal areas or city centers.
A noticeable sales volume upturn in the commercial real estate sector will occur through the end of this decade. However, the rise in mortgage rates already occurring at the end of 2017 continues to contribute to a slow sales volume. In turn, home price increases are held back by slowing sales at the beginning of 2018.

Readers who follow the movement in mortgage rates, sales volume numbers and the quantities of jobs (existing, returning, and newly created) in California have already come to the same conclusion. [See Factor 1: Jobs]

By Q1 2013, REIT shares had nearly tripled in value from their low point in March of 2008 and regained the ground lost since the housing crash. This, in spite of the fact commercial real estate values continued to drop anomalously throughout this period. REIT operating income did not increase in this time — it actually fell — but investors felt optimistic about their ability to turn a profit in the stock market’s eventual recovery.

REIT share pricing depends in part on the stock market’s perception of the type of property held by the REIT. REIT share pricing thus tends to be strangely ephemeral. Share value is not directly affected by the market value of the underlying real estate owned by the REIT, cap rates, the REIT’s actual operating success, or any of the other factors that play a role in individual real estate ownership.

Cautious and uninformed investors prefer to purchase bundled shares of assorted REITs, thus mirroring the market as a whole instead of attempting to pick individual REIT winners. This approach requires less research, and by its diversification reduces the cumbersome due diligence investigation associated with purchasing any individual REIT. These investors may benefit from the historical information and timely reports available from the National Association of REITs (including the market data depicted in Figure 2).

More dedicated investors need to put in a greater amount of time and effort asking detailed questions about any individual REIT before purchasing shares. Does the REIT deal in hotels, self-storage units (considered riskier properties), or in apartments (less risky)?

When undertaking this research the most important factors to consider are:

• The REIT’s management. Management needs to have a history of operating property responsibly, not just buying and selling for the sake of short-term gains.
• Purchases need to be accomplished without losing cash capital to fees loaded on the front end of deals, and property management needs to be accomplished in an effective (few vacancies) and efficient manner (low cost ratios). If possible, the investor needs to analyze the REIT’s income reports to get a feel for its historic use of cash and property.
・ The **location** and **type of property** owned by the REIT. This information can be had on the REIT's operating statements. Perhaps most useful, for those willing to do the research, are the REIT's annual reports made to the U.S. Securities and Exchange Commission (SEC).

The SEC requires all REITs to report the number of properties they own, the number under construction and the amount invested. They also need to report details about the types of properties held, as well as other information about the REIT's activities and objectives. The report, which may run over fifty pages, lists potential risks to the REIT and its investors, details the trust's level of insurance, and provides a broad picture of the trust's position in the market.

Other questions to consider:

・ How has the REIT performed historically?

・ Is it currently burdened with property that has lost value in the recession but not been “marked-to-market?”

・ Does it have piles of cash to make new investments in the upcoming years?

If there is one thing that buyers have learned from the end of the residential and commercial bubbles, it is that there are no sure bets in real estate, just more or less risky ones.

**Knowledge of the market**

The best insurance against a mistake is always knowledge of the market and the individual properties involved. This is true of homeownership (for which there is no ability to diversify), it is true of direct ownership of income property, and it is equally true of indirect ownership through an REIT.
Real estate investment trusts (REITs) serve as a form of diversification for investors, spreading the risk inherent in the management and properties held by a particular REIT among the broad pool of its shareholders. Investors appreciate the diversity of REIT investments, since each REIT typically owns multiple properties.

Unlike publicly-held corporations, REIT investors avoid paying income taxes through a tax loophole by passing a minimum of 90% of their earnings on to investors in the form of dividends. In both REITs and LLCs, income, profits and losses are passed through to the individual members according to their share of the ownership of the entity.

REITs are unique among real estate investment vehicles since participation in them by investors is subject to the benefits and drawbacks of stock in a publicly-traded corporation. REIT investors are thus affected by stock market issues like short-term interest rates and stock price inflation and deflation. Conversely, they are simultaneously subject to the capitalization issues of the real estate market that affect the setting of the values for the resale of properties they own.

Dedicated investors need to put in a greater amount of time and effort asking detailed questions about any individual REIT before purchasing shares.
Chapter 13.3

Investing: stocks or real estate?

After reading this chapter, you will be able to:

• explain the history of stock bubbles;
• know both the benefits and disadvantages to investing in the stock market compared to the real estate market; and
• understand real estate investment as a hedge against inflation.

Key Term

Property appreciation

Home prices rise and fall in a generally smooth fashion, as seen in Figure 3. Stock prices, on the other hand, display more volatile movements. That’s because stock transactions occur more rapidly than home sales due to liquidity differences. It takes a minimum of several days (usually several weeks) to locate a buyer and close a home sale, while stocks can be traded — both bought and sold (and the reverse) — in an instant.

Thus, stocks have a tendency to move on momentum (gained or lost) much more quickly than home prices. They too frequently are bought on rumor, sold on facts. In late 2017, stock prices were at an unprecedented high — and expected to fall in 2018.

Like any real estate pricing, stocks cannot rise indefinitely. When they do fall, expect the drop to be dramatic, reflecting the magnitude of years of excess price build-up. Overinflated stock prices exist today due to a worldwide dearth of alternative investment opportunities, and massive sums of cheap, short-term money held by investors with no place to go but a savings account. There they sit, and gradually waste away, at less than the rate of inflation and far less than rate of growth in gross domestic product. Terrifying if you are very rich.

From 1950 until the 1980s (a period of rising interest rates) stock prices mostly bumped along at a gradual upward clip. Stocks picked up steam in the 1980s, then, the mid-1990s saw stocks begin to rise more quickly, a path dictated as interest rates declined toward zero, called the Greenspan Put. The upward price slope became a steep incline fueled by cheapened money, culminating in the dot-com bubble which peaked in March 2000 following the Federal Reserve’s interest rate increases mid-1998. The increase was intended to send the country into a routine business recession adjustment.
Stock bubbles occur when speculators essentially overvalue a stock, displaying a lack of concern for investment fundamentals. A long-term investor purchases stock they perceive is currently undervalued, in the anticipation it will grow in price to reach its full profit potential in the future. However, speculators only purchase stocks when prices are swinging upward, further inflating the already overvalued stock by buying and flipping on market momentum.

In the case of the dot-com bubble, speculators bought up any and all stock having to do with the internet. This activity vastly inflated dot-com stocks, evidenced by the fact many internet companies had large customer bases but typically operated at a loss as they burned through capital reserves (i.e. Amazon at the time) to build brand and market share.

The dot-com bubble burst in 2000, made worse by the nation’s response to the September 11, 2001 terrorist attacks. About half of the dot-com companies did not survive the burst.

The next stock bubble occurred in the mid-2000s, called the commodities bubble (or sometimes the commodities super cycle). This bubble imploded in 2008 when the financial (mortgage) crisis hit. However, the stock market recovered in 2009 with the advent of zero-cost money, and was still increasing.

The chart above displays two indices, which track price movement (not actual prices):

- California home prices (the blue line); and
- stock prices (S&P 500) (the red line).

The chart displays the average price index of homes sold in three California areas: Los Angeles, San Diego and San Francisco. Other types of real estate (i.e. commercial) are not included, but their pricing trend runs with the trend in home prices and for much of the same reasons.
as of September 2016 for the same reason, despite a brief dip in early 2016. The increase will soon end, now seven years on, with the beginning of the Fed regime of short-term interest rate hikes.

The current commodities bubble trouble isn’t due entirely to recent speculation. It started off as a reaction to a world-wide increase in the prices of commodities like oil, food and metals, largely due to the rise in voracious emerging markets that consumed these items. In recent years, speculators from all around the world have poured into the U.S. stock market, inflating it to unsustainable heights.

Real estate prices experience bubbles, too. They’re just not usually as explosive (save the Millennium Boom mortgage crisis experience — which was arguably primarily a Wall Street created event since they got into real estate by doing all the mortgage funding).

Compared to stock investors, who can lose a fortune in a single day, real estate investors have longer to adjust to changes in property prices, minimizing their losses if they must liquidate. Further, while real estate bubbles are very problematic for short-term investors, they have much less influence on long-term investors of income producing real estate.

That’s because property prices are drawn toward the mean price trendline and influenced by capitalization rates. Both measurements reflect the gradual upward movement of consumer inflation over the years. Stocks are not tied to labor, materials or ground, the prices of which are closely tied to personal income and population growth. [See Factor 7: Inflation & CPI]

The Millennium Boom was the most recent example of a vastly overblown real estate market, fueled by deceptively easy money and 30 years of building consumer expectations of ever-rising prices (the reciprocal outcome of the 30-year half-cycle of declining interest rates). More recently, real estate speculators blew a lot of hot air into the housing market for 24 months in 2012-2014, and have yet to resell and retreat due to the lack of other opportunities. This caused home prices to rise beyond the rate of inflation and income growth, and brought on a drop in home sales volume as the natural consequence.

In 2015, speculators diminished considerably as home prices increases started to decelerate. However, their influence lingers going into 2017 as home prices remain well above their place on the mean price trendline.

Real estate is a solid investment when based on its ability to produce rents, but only for long-term purposes due to the high cost of acquisition and resale — the collectible aspect. Forecasters are in agreement on what is going to happen to the stock and real estate markets in the next couple of years, as both are currently supported by unsustainable price momentum, zero lower-bound interest rates, a global recession with a lack of investment opportunities, and the speculator “fear of missing out” on ever more profits attitude.
Homeownership is an easy investment choice for mom-and-pop investors (willing to also invest a bit of their time paying attention to it). That’s because real estate is a store of wealth with an inherent **hedge against inflation**. Even savings accounts don’t keep up with inflation — though they are the safest place to park cash one holds in reserve.

Of course, stock prices have increased more rapidly than home prices in recent years, making stocks a more profitable investment — if you sell at the right time. However, given the casino-like instability of stock market investments, real estate is preferred by the long-term investor who oversees their investments for being both:

- less risky than the stock market; and
- more profitable than bonds or a savings account.

However, there are some extra costs and responsibilities that come with a real estate investment, including managing rental income to cover **carrying costs** and expenses like:

- maintenance;
- property taxes;
- locating tenants for income producing properties;
- acquisition costs; and
- the high cost of selling.

Another benefit of property investment is the predictability of **rents**.

Rents track personal income; prices of stocks and real estate react to interest rate changes. Rents are most stable when the location of the property is an urban center, not on its periphery.

Rents for all types of property are tied to incomes, be they personal income or business income. Everyone and every business needs to be sheltered, and it is their income that allows them to pay rent for that space.

However, in California single family residence (SFR) investors are in 2018 wrestling with the lowest **capitalization (cap) rates** in the nation, according to a recent HomeUnion study.

Real estate investors seeking to understand a property’s investment potential look first to a property’s **cap rate**. A cap rate measures the annual rate of return produced by the operations of an income property, stated as a percentage of invested capital. In terms of rental properties, it’s presented as the annual **yield** — the continuing receipt of net operating income calculated for each year of ownership — from rental operations in relation to the seller’s asking price.

For an investor buying property, the higher the cap rate the better, as this means a lower purchase price and a greater yield on invested capital.
The highest cap rates tend to be located in the middle of the country. Memphis, Tennessee tops the list with an average cap rate of 7.3% as of early 2016. The lowest cap rates are along the west coast (plus New York City), with average cap rates of just:

- 3.6% in Sacramento;
- 3.6% in San Diego;
- 3.2% in Los Angeles;
- 3.0% in Orange County;
- 2.7% in San Jose; and
- 2.7% in San Francisco.

Low cap rates become acceptable to cash-heavy speculators faced with few investment opportunities, as is the case in San Francisco and San Jose.

Recent years have seen rapid price growth, which has made individuals with excess cash more interested in profit — the one-time money-maker that occurs on the sale of real estate — than yield, which is ongoing annual income represented in the cap rate.

However, as interest rates increase over the coming decades, leaps in home prices won’t occur as regularly as they have during the past three decades of falling interest rates. In fact, the long-term home price increase is expected to be limited to about 3% per year, enough to keep up with inflation. Thus, cap rates will rise and regain the importance they had in slow-growth years, when investors turn their thoughts of profits to concerns over the annual income produced by their properties.

Prudent investors are to avoid the 2.7% average cap rate found in the Bay Area. Cap rates are extremely low in SF, partly due to the expectation that home values will increase quickly enough for investors to make a big profit. Investors have gotten recklessly complacent about paying prices that represent low cap rates; these days, annual yield is barely enough to cover the annual recovery of capital invested — a must for improved real estate — since they are looking forward to a profit on the sale.

Therefore, real estate investors are best served by making a commitment of several years. Property (located where population density and incomes don’t decline) increases in value as incomes (individual and rental) move upward with consumer inflation. Further, if the population rises or the increase in incomes is greater than the rate of inflation, property prices move beyond the rate of inflation, called property appreciation.

While rental income provides an annual rate of return on invested wealth (the economic equivalent of interest received in the world of those who hold cash), the wealth in the property is itself recovered on resale — including price inflation and appreciation in value. The same cannot be said of stocks, whose value is fleeting and intangible.
Home prices rise and fall in a generally smooth fashion. Stock prices, on the other hand, display more volatile movements. That’s because stock transactions occur more rapidly than home sales due to liquidity differences.

The current commodities bubble trouble isn’t due entirely to recent speculation. It started off as a reaction to a world-wide increase in the prices of commodities like oil, food and metals, largely due to the rise in voracious emerging markets that consumed these items. In recent years, speculators from all around the world have poured into the U.S. stock market, inflating it to unsustainable heights.

Real estate prices experience bubbles, too. They’re just not usually as explosive (save the Millennium Boom mortgage crisis experience — which was arguably primarily a Wall Street created event since they got into real estate by doing all the mortgage funding).

In California single family residence (SFR) investors are in 2017 wrestling with the lowest capitalization (cap) rates in the nation. For an investor buying property, the higher the cap rate the better, as this means a lower purchase price and a greater yield on invested capital.

Further, there are some extra costs and duties that come with real estate investment, including carrying costs and the like. Therefore, real estate investors are best served by making a commitment of several years.
Oil’s influence on mortgage rates

After reading this chapter, you will be able to:

• understand how oil prices and mortgage rates are related; and
• identify the relationship between the 10-year Treasury note and fixed mortgage rates (FRMs).

Chapter 13.4

Learning Objectives

The effect of cheap oil

Car owners undoubtedly noticed the savings at the pump during 2016-2017. Low gas prices are a welcome gift to consumers comparable in effect to a reduction in taxes. The effect on oil industry workers has been negative, causing a slight shift in the overall unemployment rate.

But many consumers are unaware of the influence cheap oil has on mortgage interest rates.

The Federal Reserve (the Fed) is arguably the number one influencer of mortgage interest rates. Due to a strengthening national economy, the Fed increased the short-term borrowing rate in December 2015, and three more times since then as of late-2017. The ripple effect is that interest rates on short-term rates key to adjustable rate mortgages (ARMs) immediately adjusted upwards. Further, when the Fed continues to increase the short-term rate in 2017, fixed rate mortgage (FRM) rates will increase as well.

The Fed knows this, and uses the short-term rate as a tool to slow inflation — or in today’s low inflation environment, anticipated coming inflation. However, FRM rates have actually remained mostly the same following the upward adjustment in the short-term rate, from 3.9% at the end of December 2015 to 3.8% in October 2017 — still near the historic low seen in 2012. [See Factor 7: Inflation & CPI]

Why have mortgage rates remained low despite the increase in the short-term rate?

Demand for a safe investment

The answer leads back to declining oil prices and ultimately the 10-year Treasury note, which, while influenced by the Fed’s movement of the short-term rate, is ultimately guided by investor demand. [See Factor 2: Interest rates]
Investors, discouraged away from the low or negative profits of the oil market and in search of a safe long-term investment, buy Treasuries. Investors are willing to accept a lower rate of return on the 10-year T-note (which is typically less than 2% in recent years) in exchange for the safety of their investment, backed by the U.S. government’s guaranteed rate of return.

Demand and yield have an adverse relationship. That is, high demand for the 10-year Treasury note drives the rate down. In turn, when the 10-year T-note is low, investors become more willing to accept lower returns from other long-term investment products — like 15-year and 30-year FRMs.

Thus, when the global economy is in turmoil (aided by those low oil prices), as continued to the case in 2017, the 10-year T-note gets more expensive to purchase. In turn, FRM rates are held down.

Expect mortgage interest rates to remain low as long as oil prices suffer. How long will this last?

The U.S. Energy Information Administration (EIA) projects oil prices will fall back slightly in 2018. Prices will be held down by what’s forecast to be the highest fuel production in U.S. history during 2018. The Fed knows this, and along with other economic factors — like jobs and incomes — will consider this information when deciding when next to raise the short-term rate.

To translate this discussion to the broader global economy: things probably won’t get worse, but they’re not getting much better anytime soon. Therefore, mortgage rates will likely remain relatively low until investors become more confident in other investments. Realty Publications, Inc. expects mortgage rates to experience a sustained increase in 2018.

In the meantime, homebuyers and sellers will continue to benefit from the boost in buyer purchasing power due to low mortgage rates. As a result, the average homebuyer saves tens of thousands of dollars due to today’s lower rates, which can be put to paying higher principal. Thus, positive buyer purchasing power keeps home prices on their upward incline, for now.

Watch the pump closely for indicators on where mortgage rates are headed. Once mortgage rates finally increase, expect home sales volume to trend down, followed by prices within a year.
Consumers are unaware of the influence cheap oil has on mortgage interest rates.

The 10-year Treasury note, which, while influenced by the Fed’s movement of the short-term rate, is ultimately guided by investor demand.

Investors, discouraged away from the low or negative profits of the oil market and in search of a safe long-term investment, buy Treasuries, which drives the rate down. When the 10-year T-note is low, investors become more willing to accept lower returns from other long-term investment products — like 15-year and 30-year FRMs.

Expect mortgage interest rates to remain low as long as oil prices suffer.
After reading this chapter, you will be able to:
- explain the effects on the housing market from the demands of Baby Boomers (Boomers) as they age;
- define “dis-saving” and why it is a planned part of retiring; and
- predict the future influence of Boomers on the market.

Learning Objectives

Key Terms

Retirees will move real estate, lots of it

The decision of senior citizens to leave the labor force — retire — is often swiftly followed by a series of lifestyle changes. Retirees take advantage of their newly increased liberty and accumulated financial power. One of the most significant of these changes is very frequently the sale of the retiree’s current home.

As you will discover in the next chapter, retirees will need relocation assistance from the brokerage community, as they will most often buy a replacement home when they sell.
As California’s more aged population (over 65) continues to grow rapidly, senior citizens will exert *increasing influence* over both the housing market and every other aspect of the California economy. Of initial importance to brokers and builders is that people aged 60-69 are more likely to own property than any other age group, a piece of their cultural fabric. [See Figure 1]

The accumulated equity in their homes, combined with their savings from a lifetime’s employment, allows retirees to exert a disproportionately strong influence upon the housing market statewide.

When these citizens begin to change their spending and living habits in retirement, they will accelerate real estate sales volume and create new opportunities for multiple listing service (MLS) brokers and agents who market single family residences (SFRs).

The number of people in California aged 65 and older is displayed on the second of the charts in Figure 1. This growing segment of the population — a 3% increase in 2016 over 2015 — traditionally comprises the retired and soon-to-be retired.

From 1995 through 2018, retirees exerted minimal influence on real estate transactions. During this period, the individuals aged over 65 were Depression and war-time babies, and comparatively few in number. Having been born during the Great Depression or World War II (between 1930 and 1945), these retirees did not have the numbers necessary to remold the housing market in their own image. That is about to change dramatically with the rising population of retiring *Baby Boomers* (Boomers). [See Figure 1]

As *Boomers* begin to retire, a process which has already started for first the born of that generation, every aspect of the state economy will change. The Boomers, the largest single age group in California, have spent the last 30 years accumulating their wealth (primarily in the form of stocks, not cash). Moreover, they generally live in large, suburban SFRs.

Although the Great Recession and concurrent financial crisis wiped out some of these savings and put a few of these SFRs on the market (or lost to foreclosure) before their time, the majority of the Boomers are still anticipating retirement, albeit later than expected.

The recent economic collapse briefly delayed the impending wave of retirees. Many seniors held the majority of their wealth in the form of paper stocks and saw much of it erased overnight in the stock market crash of 2008, turning their *401Ks* into *101Ks*.

However, Boomer retirements have not been cancelled. Now that the stock market has rebounded and home prices mostly have returned, retirees will likely regain most of their pre-recession confidence and perhaps some of their old spending habits.
The charts in Figure 1 track, respectively, homeownership by age in the Western Census Region (the blue bars indicate 2005 data, the blue bars indicate 2015 data) and California’s population of citizens aged 65 and over and 25-34, the typical age of potential first-time homebuyers. Combined, these two charts tell us about the future demands for real estate ownership and sales transactions among the rapidly growing population of California’s senior citizens, including forecasts by Realty Publications, Inc.
As they continue to retire in a massive geriatric shift, dis-saving will become a collective movement. They will liquidate their funds, sell their current homes and embark, unfettered, onto the next stage of their lives. In doing so, they will most often replace their current homes. In effect, theirs is an exchange and has two legs, the other the purchase on relocation. Those that do not sell will likely venture into brokered reverse mortgage arrangements to cash out their home equity over several years.

Property prices increased rapidly through 2013, and slowed to a level increase of 8%-10% annually in 2014-2017. Home prices will stall in 2018, before rising at a more sustained pace into 2019-2021. This positive movement will ameliorate the fears of most retirees who seek to relocate, though selling and buying in the same market is basically a push but for the onerous transactional costs. The shadow population of retirees as both seller and buyer will fully manifest itself in ownership turnover as a key factor in creating sales volume and adding needed inventory to the shrinking housing stock in 2018 and beyond.

Retirees want to sell and relocate, and most who sell will buy again. More than 70% will probably acquire a more modest (if not necessarily less expensive) residence. Raised on housing tax subsidies produced by Proposition 13 (Prop 13) property taxation, many will keep the current low property assessment on the home they sell and carry it forward to the home they purchase in reciprocating California counties.1

Home sales volume will remain depressed so long as the majority of senior citizens put off selling their suburban SFR homes. This is a story of accelerated demand the generation knows all too well, but one alleviated by a current sell-buy set of coupled transactions.

Due to their overwhelming numbers, the Boomers were educated in temporary grade school and high school buildings. They all hit the job market within too short of a time span and salaries dropped accordingly (e.g., Reagan fired Federal Aviation Administration (FAA) tower traffic personnel and was able to replace them with equally good and well-educated talent in only a few days).

The Boomers began renting apartments simultaneously in the early 1980s, driving up rents, leading to massive apartment overbuilding that took more than a decade into the mid-90s for the market and lenders to digest. By the end of the 1980s they traded their apartments for home ownership, leading to a similar overbuilding problem in the SFR home market. The boom in home prices which followed ended with the 1990 recession. Prices remained stable until 1997, a long period. [See Factor 10: Construction]

In the late 1990s, the Boomers began in earnest to invest their accumulating wealth in the stock market, which generated a stock pricing bubble. The ensuing collapse of that financial endeavor — the dot com bubble — wiped out much of their wealth.

1 Calif. Revenue & Taxation Code §69.5
Historical demand trends will now prove true as the Boomers sell their current homes and look to find new properties and live less burdened and freer lives.

The first Boomers to retire, those on the cusp of their population boom, will have somewhat higher average earnings than those who will follow. Consequently, the retirees of the mid-2010s will have the most money to spend, and will often have a second home to live in or sell.

Those retiring in 2020 and beyond will (generally) have somewhat less wealth and retirement income, and thus less purchasing power on retirement. Those who retire in a second wave in the early 2020s will be more disadvantaged due to the swelling competition from the initial wave of retirees in their generation and the first-time homebuyers of Generation Y (Gen Y).

The homes they sell in suburbia will fetch lower prices per square foot than will the urban condos and retirement-community dwellings where around half who sell will likely move. Worse, the urban housing will be largely occupied before they arrive, and prices will be rising. Watch the condo construction boom going into the 2020s as retiring Boomers peak out in their influence on the housing market by 2025.

The price reduction of large suburban SFRs caused by Boomer home sales will be further aggravated by a corresponding rise in the values of the replacement homes which are more desirable to retirees.

The collective shift in Boomer retirement housing will be a substantial factor affecting the market. Further, the nationwide effect from dis-saving by the Boomers will occur rapidly as an entire generation liquidates their securities over the same time frame. The Great Recession has worked to stall the Boomers from retiring, but retire they will sometime in the coming years.

The coming mass sell-off of the Boomers non-retirement residences will weigh on overall home prices. Such profound influence on the national market is unprecedented in other generations, but for Boomers this is hardly new.

Their collective move into adulthood caused apartment rents to rise in the early 80’s, and their next move to raising families in suburbia led to price increases in homes. By the same token, the Boomers united contributions to the stock market caused a price bubble, and now we can expect the same to occur for their next stage in life.
After reading this chapter, you will be able to:

- understand a retiree’s reason for moving out of their original home; and
- anticipate the demands for housing services of Baby Boomers (Boomers) and the corresponding benefits for brokers and agents.

Where will retiring Boomers go?

While one cannot predict with certainty which properties will be involved or just where they will be, historical and current trends give us some hints. Homeowners in California do not tend to become renters upon retirement, as shown by the first chart in Figure 1. The vast majority of retirees will continue to pursue some form of traditional ownership.

In fact, homeownership for those aged 75 and older is 13% higher than for any age group under 50. Homeownership is a well-entrenched concept among the Boomer generation; a fact not likely to change just because of increased age or the real estate crash of 2008.

However, this does not mean that retirees remain stationary. They very often decide to relocate somewhere closer to other family members or to a better climate. With their accumulated savings and home equity, most will have the resources to do so easily.

Retirees traditionally move to smaller properties that are closer to urban centers. Nine out of ten U.S. citizens aged over 62 lived in metropolitan areas in the year 2010 as reported by the U.S. Census Bureau, and the proportion has likely risen since then.
As the younger generations increasingly migrate to the cities, their parents are likely to follow. They will be attracted to the increased access to public transportation, the proximity to cultural and artistic institutions and (not least important) the closeness of their children and grandchildren.

Retirees are more often moving out of California than moving in. According to a 2016 United Van Lines survey, about a quarter of older residents are choosing to move out of state. Approximately 19% of survey respondents who moved out of California cited retirement as the main reason, while only 9% of those moving into the state said it was to retire here.

Heading in the opposite direction, young adults are most likely to move into the state rather than out of it.

Of those moving between California and other states, in 2016:

- in the 18-34 age group, 27% moved into the state, while 16% moved out of the state;
- in the 35-44 age group, 22% moved into the state, while 19% moved out of the state;
- in the 45-54 age group, 20% moved into the state, while 15% moved out of the state;
- in the 55 to 64 age group, 17% moved into the state, while 24% moved out of the state; and
- in the 65 and older age group, 14% moved into the state, while 24% moved out of the state.

The remainder of California moves in this survey occurred within California state lines.

Retirement and lifestyle expenses are both big catalysts for emigration from California. That’s mostly due to older folks on fixed incomes, and individuals of all ages in search of a place where their income will go further.

While retirees are more likely to remain homeowners, some will find renting more desirable. Rental properties allow a more flexible, mobile and cost-effective lifestyle than ownership of single family residences (SFRs). Condos and other high-density residences built for urban dwellers will also be of increased interest.

The most directly affected housing developments will be those that cater specifically to the needs of senior citizens. Senior-only housing developments are exempt from ordinary restrictions on age discrimination. As the demand for senior housing increases, more landlords will make the improvements needed to take advantage of this exemption.

Expansion of existing SFRs to accommodate new relatives-as-tenants is another phenomenon that will increase. In this area, also, the California legislature has paved the way. In 2003, the legislature required cities to permit...
the construction of what are generally referred to as casitas or granny flats; attached, freestanding or over-the-garage apartments with no direct access to the main house.

The construction of such a flat, in essence, transforms an SFR into a two-unit property within single family zoning — a good thing for improving land use to centralize and better accommodate our increasing population density. Casitas are sometimes used by homeowners to gain extra rental income, but they are most often used initially as a new residence for elderly relatives or in-laws.

Increased population density will thus exist not only in cities, but also in suburban downtown areas. They will reap the benefits of a more close-knit and energy-efficient population (namely, a better fiber of social, civic and cultural life along with the development of rapid transit, restaurants, theaters, bars, entertainment and specialty shops) – all brought on by higher density.

As retirees begin to relocate, opportunities will arise for real estate brokers and agents to assist them. Farsighted hometown brokers will prepare for this migration now, offering relocation services to Boomers when they sell. Brokers will require their seller's agents to inquire, report, and make arrangements to provide relocation services in the selection of another home. Thus they capture that second transaction and attendant fees.

50% of senior citizens who relocate choose to move to a new residence within the same community, reports the U.S. Census Bureau. Thus, listing a Boomer’s home for sale has a 50% chance of also becoming an agent-assisted purchase of another local home to which the Boomer will relocate.

On the other hand, the impact on the price of the suburban home due to the urban geriatric shift into replacement homes may be ameliorated by emigration. Many retirees have historically chosen to leave California for states with a lower cost of living and a more relaxed, retirement friendly reputation. Foremost among these retirement states are Florida, Texas, New Mexico and Arizona. Others with the lowest retirement benefits will relocate to Mexico and points further south. [See Factor 22: Demographic Change]

Brokers can be of service to these sellers turned homebuyers as well. They need to take the opportunity to suggest new residences in retirement-friendly communities where the broker has established contacts with other brokers. They can then profit from fee splitting for referrals and assistance on these relocations.

There will be a solid return of buyers-occupants to the housing market around 2019, likely peaking in 2021. Generation Y (Gen Y), a larger demographic when compared to the preceding Generation X (Gen X) of fewer homebuyers, will be looking and qualified to purchase their first residence. This growing influx of new homebuyers coincides perfectly with the beginning of their
parents’ retirement boom, which will release huge quantities of Boomer-owned SFRs onto the sales market, the **Great Confluence**. [See Factor 15: First-time homebuyers]

It remains to be seen, however, whether these old suburban SFRs will be of interest to young native-born homebuyers. Signs indicate that demand, among the young as well as the old, will be for commuter-friendly properties closer to the jobs and culture in urban centers. It has become the task of cities with foresight to provide zoning to support added density (and thus increased building heights), encouraging builders willing to create these urban residences, and brokers and agents willing to bring these properties to market.
Chapter 14.3

Boomers bust open doors to the real estate investment era

Learning Objectives
After reading this chapter, you will be able to:
• understand the coming change in preferences of investors due to demographic changes;
• explain the causes and results of the dis-saving that is to occur; and
• consider the viability of real estate as an appropriate avenue for investment of savings.

Key Terms
buy-to-let investment risk tolerance
diversification syndication
opportunity cost

Risk-averse retirees change the investment playing field
Although the financial crisis and 2008 recession delayed the retirement of many of the Baby Boomer generation, it remains a demographic certainty that the Baby Boomers will indeed retire throughout the next decade.

The wave of Baby Boomers looking to sell their single family residences (SFRs) in California’s suburbs, also called the periphery, and move to our inner cities for a healthy dose of urban amenities will have a direct impact on the real estate market. Baby Boomer retirement will also have a secondary, but no less important impact on real estate investments.

The stock market’s loss is real
The prime age for building wealth in the risky stock market coincides with the prime earning years of an individual’s life (and Fed monetary policy which creates wealth during recessions). This makes sense: any financial shocks experienced by a downward turn in the stock market can be borne with relative ease when one has a steady income and time to wait out its recovery.

As Baby Boomers grew into the peak savings and investment ages of 35-59 in 1981-2000, the stock market prices and earnings consequently jumped — a simple function of supply (limited availability of quality corporate stocks), demand (increasing amounts of disposable income) and declining interest rates (and thus capitalization rates).
However, as individuals approach retirement, their risk tolerance instinctively decreases. They have fewer working years to recover money lost due to a risky investment gone bad. Consequently, their interest in braving the volatility of the stock market to build wealth wanes. This timeline of risk tolerance throughout an individual’s life is a time-tested and predictable measure of how robust stock market growth will be.

And there lays the proverbial rub. As they retire, Baby Boomers will dis-save by taking much of their wealth out of the stock market and spending it to supplement their retirement income.

By the same supply and demand rules which boosted stock prices when Baby Boomers poured their savings into the stock market between the 1980s and 2010 to save for retirement, the growth and return (resale profits) on stock market investments will weaken as Baby Boomers dis-save throughout the 2015-2025 period before their children’s generation begins to save and invest. [See Factor 13: Stock market]

Generation Y (Gen Y), the children of the Baby Boomers, will reach their already-stunted professional strides and look around for ways of growing their retirement nest eggs. But, they will likely find conditions in the stock market and its management ill-suited to meet their intellectual and investment needs. [See Factor 15: First-time homebuyers]

Gen Y’s alternatives to the stock and bond markets are few: either deposit savings (which will bear near non-investment returns) or real estate.

Fortunes, it is generally noted, are made by steps taken during times of economic distress. California’s real estate market is no exception to this rule: as the stock market becomes increasingly less profitable, Gen Y investors will branch out and seek the inflation hedge provided by income properties situated close to strengthening population centers. The years remaining in this decade will be a prime period to invest in real estate positions — sole ownership, syndicated limited liability company (LLC) groups and real estate investment trusts (REITs).

Brokers and agents who plan to handle transactions for income property investors need to explain away two particularly prevalent misconceptions held by fledgling investors, whatever their age:

• the distinction between homeownership and real estate investment; and
• the diametric differences between short-term and long-term investing.

Many beginning real estate investors approach acquiring real estate income properties from the same standpoint they do when buying a home. Their first instinct is to purchase property when the herd purchases (as happened during the Millennium Boom buying frenzy. Recent examples include the 2009 tax stimulus rush and the speculator frenzy of 2013 and 2014). These are precisely the wrong conditions to purchase any property — be it shelter or investment.
Lost opportunity cost considerations

First-time investors often erroneously transfer their bundle of emotions, devoid of number crunching, that go with buying and owning a home or real estate investment.

For example, when the typical homebuyer purchases a home, they make an implicit sacrifice — the opportunity cost of putting their money elsewhere for a return — to financially anchor the homebuyer to their home. Further, they exchange the mobility allowed by rented shelter for the perceived stability of owning shelter — homeownership. [See Factor 5: Renting: the alternative to homeownership; see RPI Form 320-4]

As constantly happens, the shock of a lost job or the need to relocate to further a career (and income) puts financial pressure on the homeowner to sell their home. All the while the homeowner crosses their fingers in hopes they will find a buyer at a price high enough to recoup the hard-earned, after-tax money buried in their home.

These emotional risks pushing decisions by a potential homeowner, faced with the idea of needing to sell at the moment their timing places them at the mercy of a “bad” market, are misguidedly imputed to income property investments.

This inapposite comparison is especially pronounced for first-time income property investors. They typically try their hand at SFR income property investment, or use the quixotic example of the ill-informed (and sometimes lucky) short-term speculator as their model of real estate investing behavior. [See Factor 3: Real estate speculation]

No emotional attachment

In reality, long-term income property investors, also known as buy-to-let investors, have little or no emotional attachment to a property. They have no need to concern themselves with what will happen if they need to relocate their personal residence for any reason.

At the time of acquisition, they merely do the math on whether an investment (in a property’s income and expenses) will return annual earnings sufficient in amount and nature to justify its purchase for the long-term — “long-term” being the operative phrase. Income property, as understood, is a collectible; the family home, not.

Stock market investments are by nature a product of herd mentality, subject to short-term jolts and shocks representative of (often) ill-informed human reactions to momentum (even gossip), but not data. Wealth is quickly built, and quickly lost in a frenetic need to keep above water — a risky game, at best.

The durability of a buy-to-let real estate investment, on the other hand, is dependent on time-tested real estate fundamentals and tangible property.
Based on these fundamentals, the price paid for an investment property is:

- the **present value** of its future flow of net income, coupled with predicted growth in rents and price by consumer inflation rates, plus local value appreciation (demographics), generating profit over the long haul; and
- anchored by a “recession proof” location for weathering both the booms and busts of the inevitably recurring real estate cycle, not on the periphery of the population or community.

Unlike in a family shelter, which is subject to the employment conditions of the homeowner, income property need not be sold until the owner is ready to cash out at retirement. If the timing is not favorable for selling when an investor is ready to *dis-save*, they can collect rents on the property until the real estate cycle comes around to favor sellers. It will.

A centrally-located income property reaps the benefits of stable, more *recession-proof* rental income. Unlike volatile stock prices and spikes in SFR prices during real estate bubbles, residential rents in the desirable urban core adjust according to the rate of *consumer inflation* (as do the payroll receipts of employees) and remain on a relatively constant trajectory — excluding short periods of property speculation as occurred during the recent zero lower bound interest rate environment.

Residential rent from properties properly situated in non-periphery locations runs very close to the equilibrium trend lines for consumer inflation over long periods of time. This is something a homeowner cannot take advantage of since they simply buy and sell subject to the cyclical violence of a boom and bust existing when they need to sell.

These “wipesaw” financial conditions are not of great concern to investors of rentals. Investor expectations are tied to rents as a flow of income once they have made the decision to buy, not the price of a property. Think bonds, not vacant land.

Our current stagnant economic condition — following the financial crisis, housing bust, 2008 recession and elongated recovery — has changed investor preferences. The base of both new and experienced investors in the coming real estate investment era will be wary of putting down large sums of money in individual investments, or simply will not have the means to do so.

Expect to see a marked rise in group investments in the form of LLCs, limited partnerships (LPs) or tenancies-in-common (TICs), known collectively as **real estate syndicates**.

These investors will gain the financial protection brought about by group investments (sharing losses, as well as profits). Group investors also reap the benefit of having a built-in property manager for-hire in the broker arranging and participating in the investment.
By earning fees for arranging the deal as well as for the ongoing property management of the syndicated property, *syndication* makes sense as a brokerage business. Also, brokers and agents who know how to form and manage group investments can accumulate great wealth since they share as a co-owner in the future worth of the property and its income.

Learning how to find, control and market suitable investment properties gives brokers and agents a way of getting their foot in the ownership door while the real estate market is still poised to make its full recovery.

Brokers and agents need to get the message out that long term real estate investment is a viable — even necessary — alternative to the stock market. Rents do not move with market changes, they run with the level of employment and wages in the location of the property. The stigma of real estate as the lesser form of investment (an attitude inculcated during the *Millennium Boom*) needs to be dispelled.

The name of the game is *diversification*: no investment opportunity is a one-size-fits all situation. So as Gen Y comes of age and begins to look around for sound ways of working their money, real estate professionals need to consider packaging investment opportunities which benefit their clients while at the same time nurturing their own practice and personal net worth based on good advice.

Learn how to work with income properties, and the return on your time, effort and talent will be solid for this and the coming decade.
As they reach retirement age, an investor’s risk tolerance necessarily wanes. They move their capital out of the volatile stock market in unison with the natural dis-saving that occurs with retirement.

As the next generation of investors comes of age, they may see this weakened equities market as unsuitable to their investment goals and move to store their wealth in income producing real estate.

Long-term income property investors, also known as buy-to-let investors, have little or no emotional attachment to a property. They have no need to concern themselves with what will happen if they need to relocate their personal residence for any reason. Stock market investments are by nature a product of herd mentality, subject to short-term jolts and shocks representative of (often) ill-informed human reactions to momentum (even gossip), but not data. Wealth is quickly built, and quickly lost in a frenetic need to keep above water — a risky game, at best.

The durability of a buy-to-let real estate investment, on the other hand, is dependent on time-tested real estate fundamentals and tangible property.

Due to the severity of the 2008 housing crash, investors will be wary of putting large sums of capital in single investments. Therefore, investors may seek group investments known as real estate syndicates. Group investment, along with the alternatives, is important for the future investor in their attempts to diversify savings.
Notes:
Factor 15: First-time homebuyers

Household formations and trends in sales volume

After reading this chapter, you will be able to:

- understand the nature of household formations;
- be able to compare and contrast the impact of the Boomers and Generation Y (Gen Y); and
- comprehend the impact of speculators on the housing market.

Learning Objectives

Key Terms

California new housing and population aged 25-34

Each of the data outlined on the chart in Figure 1 affects the nature of annual single family residential (SFR) sales volume in California, and in turn, SFR pricing. The sales data includes both attached and detached SFRs, and new and resale SFRs.

Forecasted numbers for the 25-34 age group through the year 2020 were extrapolated by Realty Publications, Inc. They are based on current California population counts of those who will enter the 25-34 age group from year to year, adjusted for current rates of migration.
Observations of note:

- the numbers for the 25-34 age group last peaked in 1991 and 1992, consisting of the Baby Boomer (Boomer) generation; and

- the number of first-time homebuyers will peak again in 2019-2021, made up of Generation Y (Gen Y). This generation, comprised of the children of Boomers, is smaller and will not influence the housing market to the extent the Boomers did in the 1980s (renting) and 1990s (buying). [See Figure 1]

Housing starts in the 1980s for both SFRs and apartments outran demand by the end of that decade. This excessive supply caused housing starts (and prices) to crash in 1990 and 1991. The rise in foreclosures precipitated by the accompanying housing downturn was limited except in the periphery suburbs due to the housing demand of Baby Boomers who were still forming households in significant numbers.

Once those households formed, the demand led to a correspondingly strong absorption rate (for a recession) of the excess supply of homes which remained unsold and unrented from the late 1980s.

In contrast to the 1989 construction peak of 162,700 SFR starts, the recent peak of 155,300 SFR starts in 2005 (5% lower than 1989) was supported by 9% fewer homebuyers in the 25-34 age group. Worse, the steady expansion of the first-

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**Figure 1**

The above chart plots two data sets from 1980-2020:

- the population of typical first-time homebuyers, aged 25-34; and

- the annual construction of single family residential (SFR) units and multi-family units.

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**Gen Y does not follow their Boomer parents**

**absorption rate**

The estimated time required to sell or lease property within a designated area at its fair market value.
time homebuyer age group will not start supporting and enlarging current home sales volume levels until 2019 when the age group will develop more financial maturity.

Even then, they will wait longer to form households. Their entry will be a piglet-in-a-python routine compared to the massive effect their Boomer parents had as they consumed their way through new construction at the 1989 construction peak.

Due to easily-obtained mortgage money, support for the excessive construction of new home sales in 2005 came from short-term **speculators** (and quasi-speculative second home buyers). These speculators made up nearly half the buyers in 2005. They were not users of the SFRs they purchased and pulled off the market. [See Factor 3: Real estate speculation]

Their activity contributed to the freak and dramatic rise in sales volume, prices and construction. The real estate recession later yanked the speculator’s self-made spasm of support from the housing market. Many of these properties were dumped back on the market directly as short sales or foreclosures, becoming resales as **real estate owned (REO)** properties. Others that were encumbered were converted to (negative cash flow) rentals. All the while, levels of first-time homebuyers remained very low. As a result, construction starts from 2007-2011 remained at the lowest level since 1950.

Compounding the chaotic overbuilding from 2000-2007 was the federal government’s housing policy, based on a goal of driving homeownership from 67% in 2000 to 70% of the households in the United States by 2008. As a result, persons qualified only to be tenants purchased homes they were unable to own, financed by mortgages they did not understand, with repayment terms impossible to sustain. These were the **zero ability to pay (ZAP)** mortgages. When resale was not an option, owners faced with a **negative equity** defaulted, exercising their only viable option of forcing the mortgage lender to acquire the property.

These homes have mostly returned to the MLS market and been sold. Over one million home foreclosures were completed from 2007-2017 in California. Looking forward, foreclosures bottomed in 2014-2016. Foreclosure numbers will remain steady as home values continue to rise, lifting the few remaining negative equity homeowners — remnants of the 2008 recession — gradually above water.

Further, these remaining negative equity California homes will increasingly go to short sales, and less frequently to foreclosure sales and into REO inventory or speculators inventory (bought at trustee’s sales). Eventually they are placed back on the market and consumed by homebuyers (and alert buy-to-let property investors) when property prices adjust closer to the mean price trendline.
Hordes of speculators acquired MLS inventory in 2012-2014. These speculator-owned homes will be joining these resales when speculators flip their inventory, take their money and go on to opportunities elsewhere. The rise in home inventory for sale, however slight, will ultimately be a welcome sight to homebuyers.

Only when these speculator-inspired and invasive acquisitions are cleared out from their shadow inventory status will a long-term California real estate recovery be possible.

In spite of the 348,500 negative equity homes remaining in California in 2016, many of the forces fueling the recession in the housing market (job loss and personal debt reduction) are likely to be neutralized by 2018. By then, Gen Y — in small part compared to their Boomer parents — will have sufficient income to have saved some money for a minimum down payment and be willing to take on homeownership and mortgage debt going into 2019.

This uptick in Gen Y **household formations** initially increases rental demand. Their demand will trigger a jump in multi-family/apartment starts which will peak in 2020-2021. At that point in time, an equal increase in new single family residential (SFR) starts will take place as tenants shift to homeownership — leaving periphery apartments vacant and in foreclosure.

All of this action at the end of the 2010s will be tempered by the return of:

- mortgage lenders reluctant to manage originations in conformance with real estate lending fundamentals;
- somewhat lender-independent fee appraisers;
- altered credit agency attitudes toward creditworthiness rating standards; and
- very cautious builders

This group of providers will be wary of getting burned again so soon after the 2008 Great Recession.
In spite of the 3.6% of mortgaged homes stuck in a negative equity position in California in 2016, many of the forces fueling the recession in the housing market (job loss and personal debt reduction) are neutralized going into 2018. By now, members of Generation Y (Gen Y) — in small part compared to their Boomer parents — have sufficient income to have saved some money for a minimum down payment and are willing to take on homeownership and mortgage debt going into 2019.

This uptick in Gen Y household formations initially increases rental demand. Their demand will trigger a jump in multi-family/apartment starts which will peak in 2020-2021. At that point in time, an equal increase in new single family residential (SFR) starts will take place as tenants shift to homeownership — leaving periphery apartments vacant and in foreclosure.
The nomadic generation forges California’s real estate market

After reading this chapter, you will be able to:

• appreciate the factors driving real estate sales; and
• articulate why the younger generation of homebuyers is known as a nomadic demographic.

The 2008 recession, like all other recessions before it, had the oft-stated effect of hitting an economic reset button. Real estate trends that crystallized during the cash-flush years of the Millennium Boom portrayed in distorted ownership behavior and hybrid financing concepts ceased completely. These trends include:

• the belief in ever-increasing home-asset prices, beyond the rate of consumer inflation and demographic changes;
• the infatuation with suburban living and commuting;
• the arrogance of “as-is” type non-disclosures and delayed in-escrow disclosures; and
• seller’s agents’ laziness due to smugness about seller dominance.

In its wake, new market trends have taken root, sprouting in widely different directions like the arms of a newborn starfish. These fresh trends will grow from today’s greatly altered real estate market, but will be based on the realities of our present post-Boom era.

In the period since the official end of the recession in mid-2009, California’s real estate market has settled into a bumpy plateau recovery, built on weak sales volume, fast wavering prices, and historically low nominal mortgage rates (though historically high real rates due to below normal consumer inflation). All this is expected to be static until 2017 when nominal (and real) rates for fixed rate mortgages (FRMs) increase.
When a full recovery does arrive, it will be due to the market’s cyclical nature, the state’s favorable geography and its more youthful and better educated population. Included are native-born residents and those here by migration.

But what direction will a regenerated real estate market take after short sales, foreclosure sales and real estate owned (REO) and speculator-owned resales are fully purged and builders are permitted to provide housing? What geographic regions of California and segments of its population will carry the action and in turn be profitable for the real estate industry’s gatekeepers in the coming years?

What part of the real estate market will not survive the demographic shift, and will instead become rightfully extinct?

California agents and brokers — our licensed and entrusted gatekeepers — will not likely bank a fortune before 2019. True, home sale prices continue to rise, and with them the amount of real estate fees collected per transaction. But the continued low sales volume coupled with the rise in real estate licensees makes for fewer sales closed per agent each year. Until sales volume increases, likely around 2019, most active full time agents will only generate an income sufficient to support a minimal subsistence, nothing more.

However, many will position themselves by providing various real estate services to acquire great wealth by the end of this decade due to huge increases in turnover rates in rentals and homeownership.

In other words, a collective decline of roughly 66% in personal income for California’s real estate licensees handling sales has taken place since the Boom years of 2004-2005. This comes as a devastating financial blow to most.

Agents and brokers engaged in property management have fared much better, especially in residential property. That segment of real estate brokerage is mostly recession proof as it is consistently needed in good and bad times.

Forward-looking brokers and agents plan for their future incomes. They are taking the time now to acquire the specialization needed to build their reputations and develop expertise in segments of the real estate market that are beginning to expand (while others are or will be contracting). Rebranded as stand-alone experts in the most promising locations, they will be in an ideal position to profit when the market definitively rebounds.

The pace and quantity of new jobs in a community will dictate the flow of future real estate sales volume and leasing in that locale. Income is necessary to purchase and carry, or rent, a property, be it used to house employees, business inventory or family.
Thus, the future of real estate can be divined in part by:

- looking into employment trends — job creation going forward; and
- labor force participation (LFP) rate trends, the percentage of the population currently employed or actively seeking employment.

Like peering into a crystal ball, a critical study of LFP rates predicts the future movement of the California real estate market. However, some knowledge of California’s age demographic is fundamental to understanding and predicting LFP rates. Simply put, while jobs drive real estate transactions, it is job creation and LFP rates which initially drive demographics — which in turn drive real estate sales and rental occupancies. [See Factor 1: Jobs]

For example, the low LFP rate among this decade’s 25-34 year olds, known as Generation Y (Gen Y), indicates this segment of the population will enter the real estate market as first-time homebuyers aged much older than prior generations, if at all. Gen Y is taking more time than its their Boomer parents to accumulate the wealth (down payment) necessary to purchase a home, an amount equal to 20% of the purchase price. They also have massive educational debt which interferes with qualification for larger mortgage amounts. Their Boomer parents suffered no such indignity as the government mostly paid their way.

At the other end of the generational spectrum, a high LFP rate is presently being experienced among the generation aged 55 and above. This indicates this older generation, while growing fast in numbers, will work longer before they retire. Thus, they will delay the sale of their current home (most purchased in the 1985-1991 period), and in turn the ensuing relocation into another home. [See Factor 14: Retirees]

LFP rates, by demographic, are the focus of Labor Force Participation and the Future Path of Unemployment, an Economic Letter from the Federal Reserve Bank of San Francisco (FRBSF). Though the study deals exclusively with employment and demographic trends, Realty Publications, Inc. extrapolates this data and interprets what it means for California real estate agents, supplemented by data released by the U.S. Census Bureau (the Census).

Gen Y is taking longer to settle down. They are remaining transitory, both economically and physically, over a longer period than prior generations. 24% of young adults (25-34 years of age) have changed residences in the past year alone, compared to 22% of older individuals (over 55 years of age). Further, 74% of 25-34 year-olds in California are renters, 26% owning their residence. Contrast this with those over 55 years of age, who possess a combined rental rate of 31% and a homeownership rate of 69%, according to the U.S. Census reports on California housing.

Gen Y is also professionally untethered. The average person in Gen Y goes through seven jobs before they reach the age of 30 — the median age for first-time homebuyers.
Employment, more specifically an existing job, is the first and most integral step toward real estate acquisition by younger age groups. To purchase a property at age 25-34, the typical age of a first-time buyer, individuals in Gen Y need to borrow against the future income they will receive.

This is a prudent thing, since they benefit from a higher standard of living today, paid for with future earnings (which, presumably, will grow — unlike in the 2000s — and allow an even higher standard of living in the future).

The Great Recession and its destruction of jobs stifled Gen Y’s career development, permanently stunting the financial well-being of these recent college graduates and thus delaying their entry into the real estate market. That has been a career killer in other countries experiencing this sort of delayed job recovery since it greatly reduces their future incomes and standard of living — housing.

Lower-skilled adults aged 18 to 34 experienced the most pronounced increase in poverty in 2012 versus other age groups, according to the Census. This age group is composed of the Gen Y children of the Boomers. Unacceptable numbers of Gen Y individuals cannot now find any form of employment upon graduating high school or college. Most find it harder yet to get a job in the pre-selected field of study they pursued in academia. [See Factor 22: Demographic change]

Thus, most in Gen Y settle for a job in a different discipline, professionally stigmatizing them for later entry into their industry of choice. At best, this delays the age at which they will attain pay levels consistent with their desired standard of living. The delayed retirement of Boomers only adds to the lack of jobs for Gen Y.

Additionally, due to the lack of long-term professional experience among Gen Y, many shell-shocked employers are spooked by the recessionary cycle. They retain and hire only experienced workers since they have already proven themselves proficient at the jobs available.

Without an income flow from employment to develop savings, Gen Y has no immediate access to funds for a down payment on their first home, let alone the financial resources necessary to service the continuing costs of ownership and mortgage financing.

Similarly, without a job, the inverted debt-to-income ratio (DTI) of Gen Y will render them ineligible for purchase-assist financing, a condition referred to as financial atrophy.

This diminished economic standing of Gen Y has temporarily reduced the demand for housing. Many unemployed members of Gen Y have been forced to move back in with their parents in the suburbs, or to cohabitate with friends or partners.
California recovered all jobs lost since the 2008 recession in mid-2014. However, the working age demographic continues to increase by 200,000 each year. The continual entry of more working age adults into the labor market makes it harder for aspiring first time homebuyers to successfully find the gainful employment necessary to enter the market for a home. The state is expected to reach a full employment recovery for its increased population in 2019.

The future will bring buyers, and with them the demand needed to bring about a full real estate recovery. However, for agents it will take patience to wait until Gen Y is in an economic position to enter the housing fray. For California agents and brokers to position themselves to be of service to the home buying Gen Y, real estate professionals need to learn about and understand the psychological, social and financial conditions of this first-time buyer age group.

Realty Publications, Inc. predicts Gen Y will suddenly “get it.” They will come to understand that homeownership is a socially, if not financially, advantageous thing to do — the luxury versus necessity debate. Once this synchronized realization takes place, the rush will be on, just as it was with their parents in the late ‘80s. Although this time around, it will be tempered by Gen Y’s experience and observation of family debt management issues during the 2008 recession.

Like peering into a crystal ball, a critical study of labor force participation (LFP) rates predicts the future movement of the California real estate market. However, some knowledge of California’s age demographic is fundamental to understanding and predicting LFP rates. Simply put, while jobs drive real estate transactions, it is job creation and LFP rates which initially drive demographics — which in turn drive real estate sales and rental occupancies.

The Great Recession and its destruction of jobs stifled Gen Y’s career development, permanently stunting the financial well-being of these recent college graduates and thus delaying their entry into the real estate market.

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Homeownership declines among the young

After reading this chapter, you will be able to:
- identify the homeownership trends for those in the 25-34 age group;
- adjust to the younger generation’s opinion of the American Dream; and
- apply the concept of the power cohort and their expected homeownership trends.

Cramdown

Federal Housing Administration (FHA)-insured mortgage

Homebuyer confidence is subject to variation between age-group demographics. This is evidenced in home sales numbers over the past few decades. Between 1980 and 2004, the rate of national homeownership rose from 65% to nearly 70%. [See Factor 22: Demographic change]

Since 1980, the overall trend in the U.S. has been toward greater homeownership. Overall homeownership increases are attributable in greater percentages to the aging population. The rate of ownership among the age group over 65 jumped 7.5% between 1980 and 2000.

At the same time, the younger generation of post-1980 has followed a much different path to real estate ownership than have their parents. Homeownership among the segment of the first-time homeowner population aged 25-34 dropped dramatically between 1980 and 1990, and rose very little more by 2007. In 1980, the population aged 25-29 had a 43% rate of homeownership.

By 2000, the first-timer age group rate had dropped to 36%. Even within its own demographic, the percentage of homeowners aged 25-34 has fallen greatly over the past 25 years, in spite of several tax factors designed to encourage ownership.
Why aren’t young people buying houses as frequently as they used to? Has not social change and government innovation (tax breaks) worked to increase ownership?

This phenomenon of diminishing demand for homeownership in new generations is examined in a 2010 report from the Federal Reserve Bank of Chicago (FRBC), Why Has Home Ownership Fallen Among the Young? The FRBC report suggests that the increased ease of obtaining a home, brought about by higher rates of female employment and eventually by lower lending restrictions, was balanced — offset — by other more significant factors.

First, most predictably, is a decrease in income stability. Studies show that the earnings risk of being employed (the risk of losing a job) increased between 1966 and 1979, and remains elevated to this day. The job instability of those lacking a four-year college degree increased still more.

Consider that people who lack confidence in their present income are more likely to put off the purchase of a home. Until they have accumulated enough to be certain of making payments, or until their own financial situation improves, they are not going to buy.

The real estate bust of 2007-2009 and its lingering effects are fresh in the minds of the generation who came of age during the recession.

Meanwhile, those who might have wanted a home now prefer to remain single and enjoy the continued mobility that comes with renting. These individuals would have already been married if they lived in the 1970s, and thus ready to settle into homeownership.

The younger generation has demonstrated an increased tendency to delay marriage. Both women and men are now likely to wait until their thirties or later to get married, if they formally marry at all. Between 1980 and 2000, marriage rates for individuals 25-34 years old dropped 15%. The unmarried, more often than not, remain renters.

The younger generation, it seems, is not falling for the builder-lender generated American Dream flag-waving bit that seduced their less-educated parents. While aging Baby Boomers (Boomers) prefer homeownership to renting, the 2008 recession will make the decision to own a home less of a given for the coming generation of potential homebuyers.

Since 2007, roughly one million California families (out of the approximately 8.7 million single family residential units (SFRs) statewide with 7.5 million owner-occupied) have lost their homes to foreclosure. It will take time for them to return to homeownership again, and most likely 80% or more will not. Meanwhile, renting an apartment conveys all the benefits of condo ownership without the investment.
Expect the young among us to continue to express a healthy skepticism towards the time-honored benefits of homeownership when it comes to their willingness to buy and take on a mortgage.

Declining homeownership among the young will remain an important factor in real estate construction and brokerage services. On the other hand, changes within any one age group are negligible in comparison with general demographic trends.

The simple fact is that the aging population of Boomers has always been, and continues to be, the largest force of homeowners on the market. They are now retiring. Most will want to sell their big, empty nests, and head for wherever the grandkids live. There they will likely buy a nice new condo, transactions involving real estate brokers and agents.

Agents and brokers who choose to predict the direction and location where real estate services are most valued can still count on a renewed rise in actual home sales when Gen Y begins buying its first homes. This phenomenon will peak around 2019-2021. Until then, the purchasing power to control the market will remain with the older demographic (Boomers retire, sell their current home and buy another).

The lesson to learn from this factor, however, is that the younger generation is not a carbon copy of their Boomer parents. Also, the housing boom they bring will not be a duplicate of the boom of the late-1980s their boomer parents created.

When the housing boom does begin to develop at the end of this decade, it may be weaker than optimists expect. However, it may be they are accounting for the young population’s increased predisposition to rent. In this case they will be building the apartments they will desire. The future will reward those with an eye for sales and management of upper mid- and high-tier properties. Governments will need to get involved more heavily in low-tier valued housing if the continuation of services demanded by the wealthier are to be had.

For most of Gen Y, the prospect of homeownership, though inculcated from a very early age, has likely been severely stigmatized by the collapse of the real estate industry and broader economy. Young and impressionable, all this took place right when they were coming of age as homebuyers and attempting to enter the labor force.

Thus, the economic sting of the recession is all the more poignant to those who are just taking their first, tentative steps into the professional world. The failure of government to allow for a correction of the imbalance between home values and principal debt through mortgage reductions, called cramdowns, has not been lost on this well-educated Gen Y.
Agents need to also understand that Gen Y is highly debt-laden and generally unwilling (or unable) to take on additional debt — such as sufficient purchase-assist mortgage debt to fund the acquisition of a home with the quality they expect for themselves. Unable to find employment upon graduation from university, many have returned to college or university to do something productive with their time, or to avoid immediate payment of their past student debt for lack of better options.

Over the past 25 years, the percentage of unemployed students has increased from 40% to 60%. The very poor job growth all through the 2000s was particularlydamning for students wanting to leave the campus. The 2008 recession essentially doomed many of them to aging without collecting experience on the job.

These students are spending longer in school to acquire specialized training and skills. Ideally, that will translate to high-skilled (and high-paying) employment when jobs materialize. This is all good news for the future of California real estate values, as it decreases the size of the permanent low-skill and low-income native-born population.

In the process of their ambitious pursuit of higher education, Gen Y is also raking up unprecedented amounts of student debt. This debt is incompatible with mortgage financing standards. The questionable financial future of graduates — proper jobs but improper debt — will impact the starter-home market for a decade or more through reduced ability to borrow principal. This delay is also bad news for builders of free-standing homes. Debt-laden college graduates will in large part be too financially strapped to embark on first-time homeownership without time on the job and meaningful annual pay raises. Even if an indebted college graduate is interested in becoming a homeowner, lenders do not look favorably on a mortgage application for a conventional mortgage if the applicant’s total debt-to-income (DTI) ratio, including housing costs (the front-end ratio) and all other debts (which combined with housing costs make up their back-end ratio) exceeds 43% of their monthly income. Student debt, on average, puts most indebted graduates beyond that DTI ratio for the home in the price range they expect to own until it is paid in full.

A high DTI ratio for total installment payments leaves a typical college graduate who wants to become a homebuyer with the single option of Federal Housing Administration (FHA)-insured financing. Here, the maximum payment to the lender for principal, interest, taxes and insurance (PITI), mortgage insurance premium (MIP), homeowners’ association (HOA) fees and Mello-Roos assessments may not exceed 31% of gross income.

However, much of Gen Y, suffused with a higher-education and the accompanying expectations of a better life, won’t want to settle for the price-tier of a home permitted by FHA-financing requirements. Thus they will wait until their financial condition allows them to rise to the lofty expectations they developed in school.
Bachelor’s degree recipients in 2016 graduated with an average of $37,000 in cumulative debt, up by over $14,000 from 2008, and continuing to climb each year. When students continue on to graduate level education, the numbers for both undergraduate and graduate educational debt grow significantly.

But what does student debt mean to real estate transactions requiring purchase-assist financing? Take a look at the recession-induced math: 10% of those who graduated in 2010 had already defaulted on their student loans by 2012, according to the College Board. As a result, these recent graduates suffered a significant ding on their Fair Issac Corporation (FICO) credit score — primarily brought on by a lack of available jobs during this long-term, secular recovery.

Thus, an indebted college graduate who has defaulted on their student loans needs to first land a well-paying job (which itself may improperly be subject to good credit). Only then will they become financially stable enough to reinstate payments on their student loans. On application for a mortgage to purchase a house, their FICO credit score (if it is still used) will make then a huge gamble in the eyes of today’s risk-averse lender.

As a result, grads will be unable to qualify early on for a mortgage. Thus, they are forced to wait until the FICO scoring system slowly adapts to the post-Great Recession economic reality or lenders ignore it for a better standard. All this is merely training them to be successful as renters.

Though the heavy debt of graduates generally is a hindrance that will slow Gen Y’s entry into real estate ownership, this diminished economic condition is not perpetual. Pragmatic agents will take this debt-anxiety tolerance into consideration in their dealings with young buyers this decade.

As gatekeepers to the world of real estate ownership, buyer’s agents will inform Gen Y that it is socially acceptable and financially and economically prudent to borrow today against their future incomes. This is a proper leveraging of their personal present value which is based on their ability to earn.

Taking on asset-backed debt — a mortgage secured by a home — enables the employed members of Gen Y to immediately bring their standard of living to a level consistent with their specialized training and skills. The alternative is waiting until middle age when they have saved up enough money to buy a home without purchase-assist financing.

Agents planning their future income, and mindful of the buying habits of first-time buyers, need to factor in the effect of household formations on real estate sales. Half of all households, once formed, quickly start to shift from renting to owning.

Compounding the effects of a generally late financial development for Gen Y is marriage or equivalent partner arrangements. Setting up a family
unit is the requisite for most household formations. However, long–term commitments is occurring later in life with each successive generation in California.

In the early 1970s, the average age for marriage was 21 for women and 23 for men, according to the U.S. Census Bureau (Census). In 2009, the average age for marriage had increased by five years: 26 for women and 28 for men.

The trend indicates this age is still increasing. The greater need for education to prepare for better paying service jobs is the predominate force driving the mindset behind this trend. The present lack of a fully employed population — jobs — is an accomplice in this delay to own, or rent.

As part of this trend, Gen Y is not nesting up as early as past generations. Worse for SFR agents, they are not buying homes as early in life as prior generations. The percentage of married couples to non-married couples fell to a record low level in 2009. 52% of adults aged 18 and over are currently married, down from 57% in 2000. 46% of adults between the ages 25-34, spanning both Generation X (Gen X), those born in the ‘70s, and Gen Y have never been married. [See Factor 22: Demographic change]

Gen Y will blossom into a dynamic participant in the sale of real estate, when they find regular employment in large numbers and household formations peak. This will likely occur in the period of 2019 to 2021, during which a real estate boomlet will develop.

When Gen Y does eventually get out of their parents’ basements and start buying, where will they go?

Gen Y, equipped with higher-education, will soon be known as the power cohort making up the newly-educated working force of America. Those in the power cohort will likely migrate to denser urban areas, not sparsely populated suburbia as did their commuting parents, the Boomers.

Gen Y will settle in urban areas ripe with professional opportunities in desirable, high-paying jobs and the advantages of cultural significance. Places with professional and financial centers, sporting events, museums, schools, theater, eating establishments and so on, will be the most desirable.

Having acquired unprecedented amounts of higher-education, Gen Y will be able to obtain high-paying employment that takes advantage of these skills. In California, we long ago became a service economy. It is not the industrial/ manufacturing economy hiring unskilled laborers as in the distant past now robotic and more productive (leaving agricultural issues to the Central and Imperial valleys) which adversely affects the long-term economic development of central regions of the U.S.
Thus, a large portion of Generation Y will end up purchasing mid- to high-tier urban property reflective of their professional status. This is opposed to lower-tier property purchased with government-guaranteed financing (FHA) reserved for mostly unskilled laborers and the more impoverished newly employed among us.

As a negotiating tactic to be employed by agents representing Gen Y buyers, agents need to be aware that the trappings of success will be a great motivating factor when Gen Y goes shopping for a home. The trappings of success, such as how one dresses or the car one drives, and perhaps most importantly, where they live and what they own (the appearance of wealth), will weigh heavily on the psyches of Gen Y buyers. This demographic is eager to excel in the professional spectrum, and appearances are attitude.

For example, consider the dual purpose of housing on the Newport Beach coastline – shelter and luxurious style for the more successful. Living there makes a statement, and it is generally positive.

Owning property carries with it a level of prestige that is highly desirable for the well-educated and persistent members of Gen Y. Once graduated, they are eager to finally reach the developmental milestones of socially acceptable adulthood. Homeownership is a crucial component in the acquisition of personal power. Owning property demonstrates wealth, and along with residential longevity in the community, civic consciousness, personal achievements and that better education add up to significant earning power as time goes by.

California agents need to inform first-time homebuyers that it is economically prudent to build equity in a property — wealth that provides shelter, accolades and with it, power — greater capacity for achievement in our service economy.

When compared to previous generations, Gen Y is more susceptible to conformist trends and convention than you might think. As a result, they will make ideal (and willing) property owners — once they complete their academic training and find well-paying employment around 2018-2020.

Agents anticipating the coming tide of Gen Y homebuyers will take steps now to ensure they’re in position to profit by the time Gen Y ascends from the recessionary doldrums. As part of their preemptive action, agents need to consider relocating and operating their real estate practice in the urban areas of their communities that will likely experience the most action heading into 2019 and beyond.

By arriving early to the contest, these agents will become highly familiar with the unique nuances of their urban market of choice. They will develop professional notoriety in their target area and brand themselves as local experts — the “go to agent” – all before the flood of Gen Y homebuyers hit the market.
This rush of 25-34 year old first-time homebuyers will be the *shot of adrenalin* California now so desperately needs. It is likely the restorative effects of a youth rally that will fully rattle California real estate from its economic languor. We’ll just have to be patient and stand ready to participate in growing sales and rental volume during the years building up to 2019.

**Chapter 15.3 Summary**

Homebuyer confidence is subject to variation between age-group demographics. This is evidenced in home sales numbers over the past few decades. Between 1980 and 2004, the rate of national homeownership rose from 65% to nearly 70%.

Consider that people who lack confidence in their present income are more likely to put off the purchase of a home. Until they have accumulated enough to be certain of making payments, or until their own financial situation improves, they are not going to buy.

The younger generation, it seems, is not falling for the builder-lender generated American Dream flag-waving bit that seduced their less-educated parents. While aging Baby Boomers (Boomers) prefer homeownership to renting, the 2008 recession will make the decision to own a home less of a given for the coming generation of potential homebuyers.

In the process of their ambitious pursuit of higher education, Gen Y is also raking up unprecedented amounts of student debt. This debt is incompatible with mortgage financing standards.

Agents planning their future income, and mindful of the buying habits of first-time buyers, need to factor in the effect of household formations on real estate sales. Half of all households, once formed, quickly start to shift from renting to owning.

**Chapter 15.3 Definitions**

- cramdown .................................................. pg. 271
- Federal Housing Administration-insured mortgage ...... pg. 272
Generation Y incomes and the implications for home prices

After reading this chapter, you will be able to:

• analyze how Gen Y’s future income expectations will impact future home prices.

Myth: home prices will always increase.

Fact: home prices are dependent on the amounts homebuyers are qualified to pay.

Presumably then, home prices will fall flat or even decrease as the mortgage amounts on which homebuyers are qualified to make payments levels or falls. So what affects the amount of mortgage monies homebuyers are qualified to borrow? (Hint: the operative word is “qualified.”)

This is known as **buyer purchasing power**, primarily consisting of:

• annual incomes;
• personal savings; and
• mortgage interest rates. [See Factor 2: Interest rates]

Lucky for California’s housing market, annual incomes always go up, right?

Wrong. In fact, **per capita income** actually decreased dramatically after the 2008 recession and **nominal dollar** income only caught up in California five years later. Further, the annual pay increases that workers expect as they advance in the workforce are shrinking as the years go by, a long-term trend of **income inequality** that is more substance than noise.

College graduates born between 1921 and 1930 earned 3.5 times more after 30 years in the workforce, per a study by the St. Louis Federal Reserve. Graduates born in the next decade (1931-1940) earned 2.7 times more over the next 30 years. And those born in 1941-1950 earned only 2.4 times more over the next 30 years. [See Factor 21: Population growth]
Flash forward to 2018 and beyond. Today's would-be first-time homebuyer generation, **Generation Y (Gen Y)**, is trying their best to get ahead in the workforce, often settling for low-paying jobs to get their foot in the door. But these low-paying jobs are unlikely to produce the same long-term payoff for their level of education than it did for their parents' generation.

The reasons for this slowdown in earnings increases are many. Perhaps the largest contributor to this slowdown is the fact a greater percentage of the population currently has college degrees than at any other time in U.S. history. In California, 33% of the population had a bachelor's degree or higher as of 2016, according to the U.S. Census. As the supply of college graduates increases, the amount of pay employers are willing to offer to attract them becomes increasingly less competitive.

Further, during the 2008 recession when unemployment leapt, wages remained roughly level across all job sectors for those that remained employed. This is uncharacteristic, as increased unemployment usually puts downward pressure on wages (and vice-versa). Today, as unemployment slowly drops in California, wages are barely creeping along with the rate of inflation, sometimes falling below inflation rates.

The recession has created among employers a pent-up wage cuts demand that will slow income growth for the next several years. This phenomenon was demonstrated in the aftermaths of each of the U.S. recessions experienced since 1986. However, the magnitude of the 2008 recession has prolonged the stagnant income growth, which will likely continue even after the recovery is complete. The problem in this stagnation of wages is that inflation has marched on, exceeding the increases in pay and leaving workers with a lower standard of living — as today’s money buys less.

The second qualifying factor in the amount a homebuyer can pay is determined by the amount of their **down payment**. Unless our imaginary first-time homebuyer has a rich benefactor, this down payment relies on their savings.

This is not good news for the housing market. Average personal savings rates remain low nationwide, at 3.7% in mid-2017. For comparison, the savings rate peaked at over 12% following more than two decades of rising interest rates.

*Editor's note — When savings rates peaked in the 1980s, the interest rate on savings was two-to-three times greater than what it is today. [See Factor 9: Savings]*

Thus, on average, today’s potential homebuyers save less than a quarter of what their parent’s saved.

This low savings rate is compounded by decreasing income gains. This is, of course, if they have a job at all.
Gen Y has had the misfortune of entering the job market following the 2008 recession. For most, this has meant either:

- putting off employment (seeking asylum in graduate school where they take on student debt or hangout in their parents’ basements); or
- succumbing to underemployment.

Both of these realities will cause Gen Y to delay the purchase of a home for several years, past the expected typical first-time homebuyer age range of 25-34 years. As the average age of first-time homebuyers increases, expect California’s homeownership rate to continue to slip away. Homeownership rates will suffer until Gen Y finally gains enough income and savings to make their foray into homeownership, likely around 2019-2021. However, the homeownership rate here will still remain consistently lower than the national average.

Going into 2018 and years immediately after, home prices remain high, the pace of price increases having fallen back following the speculator-induced pricing bubble of 2013-2014. However, by taking future incomes and savings into account, we now know the long-term picture for sales volume, and thus prices, is somewhat less rosy than the moment’s price trend glitz.

The support real estate sales volume needs from end users (those buyer-occupants and buy-to-let investors) is simply not there in 2018. Jobs and incomes continue to recover — slowly — and buyer purchasing power will be inhibited in 2018 as fixed rate mortgage (FRM) rates increase.

This knowledge takes us back to the recently dispelled myth that real estate prices always go up. Rather, home prices go the way of buyer purchasing power, not the sticky price a seller or seller’s agent set. The pricing of homes follow the **mean price trendline** which is reflective of family income, and as the next couple of decades will demonstrate, is steered inversely by movement in mortgage rates. As purchasing power decreases due to rising mortgage rates and fewer and smaller pay raises, home prices — and seller expectations — will inevitably feel the downward pressure as well. [See Factor 12: Pricing]

So what are proactive agents to do with this potentially market-neutralizing information for 2018 and beyond? Take a look at the mean price trendline for a better understanding of the path of future home prices and strategize accordingly. [See Factor 12: Pricing]
Chapter 15.4 Summary

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Today’s would-be first-time homebuyer generation, Generation Y (Gen Y), is trying their best to enter the workforce, often taking low-paying jobs to get their foot in the door. But these low-paying jobs are unlikely to produce the same long-term payoff for their level of education than it did for their parents’ generation.

On average, today’s potential homebuyers save less than a quarter of what their parent’s saved. This low savings rate is compounded by decreasing income gains.

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The U.S. Treasury, the Federal Reserve and owners

Chapter 16.1

In 1998, America’s central bank, the Federal Reserve (the Fed), started raising short-term interest rates to induce a routine business recession. As planned, the recession took hold in early 2001.
However, the effort to cool the economy was short-lived. The administrative reaction of both the Fed with their monetary policies and the national government with security and defense to the September 11, 2001 attacks froze the price of homes at their artificially elevated peak.

As a direct result, real estate prices were not given time to return to their inflation level, historical pricing trend.

Thus, the stage was set for an unsustainable future for real estate prices. By this failure of the recession to continue and correct pricing, owners of real state were erroneously led to believe they had come upon a new paradigm in real estate economics.

This deleterious myth prophesied that the deregulated financial markets, which had evolved since 1980, would never allow real estate prices to fall below peak levels. Instead, they would merely stabilize for a period until ever increasing demand would again push prices upward.

Simply, it was thought prices could only move upwards, and at worst, remain level during recessionary periods until recovery. Economic pundits labeled this financial concept the “Greenspan Put.” This was in reference to a put option that sets the price at which you can sell when all else goes badly.

After the events of September 11, 2001, the Fed, the U.S. Treasury, Fannie Mae and Freddie Mac opened the mortgage money floodgates in response to perceived public panic. The Fed assisted by lending and buying Treasuries in the money markets.

This added large amounts of fresh cash to the supply of money available to homebuyers and homeowners. This cash was funneled to consumers through both mortgage bankers and Wall Street bankers. Thus, the seeds of the Millennium Boom took root. [See Factor 17: Monetary policy]

This cheap, short-term money provided upwards of $2 trillion dollars for housing in the form of adjustable rate mortgages (ARMs).

These mortgages were perceptively labeled in the early 1980s as either:

- **ZAP (Zero Ability to Pay) mortgages**; or
- **RIPOFF (Reverse Interest and Principal for Optional Fast Foreclosure)** mortgages.

These were offered at enticingly low teaser rates. The express government intent in all this was to induce tenants into homeownership.

With the availability of cheap and easy money, Wall Street bankers had the impetus to provide mortgage funds to as many borrowers as possible. As a result, an aggressive lending environment of money chasing homebuyers emerged, not an enduring scenario. Further, lending parameters became lax and subprime and emotionally unprepared tenants were lured into
homeownership. Exotic and hybrid ARMs were used under the belief owners would be able to quickly refinance to more favorable terms or sell for a higher price before the mortgage reset if trouble set in.

This practice was consistent with the government’s ultimate goal of driving the percentage of homeownership up in the U.S. This was accomplished, moving from the stable and historical 64% homeownership figure of the prior 20 years ending in 2000 to a destabilizing 70% of the population by 2006.

The potential disadvantages of homeownership were never part of the dialogue. Those who might need to later relocate to new or transferred jobs, seek out more pay for their skills, or cope with family dysfunctions such as divorce or disease were not considered.

Lifelong tenants were turned into first-time homeowners without concern as to whether they understood the consequences of owning their housing. They became owners of real estate without the requisite knowledge that they no longer would have the mobility to move freely about the country.

Eventually, they became essentially prisoners inside their brick and mortar shelters.

Government homeownership policy was another and significant triggering factor which fed into the Millennium Boom. Going into 2000, the American Dream of homeownership was aggressively pushed by state and federal governments onto tenants. Subsidies galore for mortgaged homeowners; nothing but a tidbit for tenants.

Real estate industry gatekeepers stoked the fire with the mantra “buy, buy, buy!” Real estate brokers and appraisers deliberately rejected the rational tone sounded by historic valuation techniques. These included the replacement cost approach, based on land, labor, and materials, and the income approach, such as the present worth of future benefits of ownership.

Even when the income approach to property valuation was implemented, appraisers used a capitalization rate (cap rate) they divined from comparable sales prices, not one built on real estate investment fundamentals, risk premiums necessary to structure real estate income cap rates. [See Factor 5: Renting: the alternative to homeownership]

Further, appraisers and agents deliberately failed to capitalize the net operating income (NOI) of a property with a rate which included:

- a return of capital (or a reserve for replacement of structural components);
- a long-term real yield on invested capital (as though the property was clear of liens);
- an inflation risk premium
- compensation for asset oversight; and
- a risk premium for adverse future changes in local demographics.
In the years leading up to the boom, the Fed hyperactively lent at very low rates through its open-market operations. This was coupled with the utter failure of regulatory agencies to perform and an unsustainable government housing policy. Together these caused the carnage in the 2007 real estate bust.

Like a drunken New Year’s reveler, it was only a matter of time before the excitement ended and the financial hangover set in. Almost overnight, the cash-engorged hey-day of the Millennium Boom segued naturally into the next economic epoch: the 2008 recession and concurrent financial crisis.

Deregulation had allowed mortgage lenders to take on ever riskier lending activity through 2007. That year, mortgage borrowers began defaulting en masse, drowning mortgage lenders with foreclosures caused exclusively by imprudent lending practices. [See Factor 23: Regulation]

The 2008 Great Recession decimated trillions of dollars of asset wealth across the nation, leaving around 3,000,000 California homeowners in a negative equity condition. The number of negative equity homes in California has fallen due to foreclosure sales, short sales and rising prices. Presently, we are left with just under 4% of mortgaged homes underwater, down from 7% a year earlier.

To compound owner stress, ARMs began to reset and amortize at higher rates. California homeowners who bought after 2001 didn’t have the loan-to-value ratios (LTV) necessary to obtain refinancing when their ARMs reset. Property had halved in value to well below the mortgage amount. California was thus faced with a foreclosure crisis of unprecedented and unmanageable proportions.

Congress was a willing accomplice. They deregulated mortgage lenders and their Wall Street bankers by removing what few restraints remained on lending in 2005. This was the culmination of 25 years of loosening controls over mortgage lending. The parameters within which lenders had to safely structure real estate mortgages were lost.

The forces of competitive advantage pushed Wall Street bankers to drastic leveraging — risk taking for greater profits — to keep investors in their programs. This drove them to take on the excessive risk of loss built into exotic mortgage terms, such as option ARMs.

Veterans of California’s the real estate industry knew the result would be a disastrous collapse of both property values and public confidence.

Going into 2018, home sales volume remains flat. Prices continue to rise at a steady 8%-10% annual increase, though this trend is expected to reverse due to continuing low sales volume and interest rates increases in 2018. When California’s housing market returns to pre-Millennium Boom stability, buyers will be able to acquire real estate at or below replacement cost with a respectable rate of return at an 8-10% cap rate. This is more suitable to a sustained income property investment — a return to basics once again.
In response to the **vicious economic cycle** – the implosion in 2008 – the U.S. Treasury, the Fed and California’s state government released a wave of aid. They specifically targeted the real estate construction, sales volume and mortgage sectors. This aid took the form of:

- massive government **subsidies** (tax credits) to homebuyers; and
- Fed actions to keep mortgage interest rates unnaturally low by buying up large quantities of newly-issued **mortgage-backed bonds (MBBs)**.

In California by 2010, $200 million from the state’s Treasury had been applied to the housing market on two separate occasions — subsidies totaling close to $400 million. The state’s 2010 subsidies granted $100 million in tax credits (prepaid taxes or refunds) toward the purchase of existing homes and another $100 million to the purchase of homes in builder inventory. These were primarily **real estate owned (REO) properties**.

Galvanizing action taken by the state and federal governments temporarily propped up the real estate market. It gave a bit of a sales volume and price boost in 2009 as intended. A majority of the improvements witnessed in the housing market were largely wrought by external “bridging” factors – government intervention by subsidies to move lender REO and builder inventory.

The required organic **industry growth** was not yet in place on expiration of these subsidies, and resulted in the *so-called bridge to nowhere*. Going into 2016, sustainable growth in the real estate market itself had not begun. 2012 through late 2013 witnessed a deluge of **speculators**, which upended the market’s fragile recovery. The speculator contribution subsided throughout 2014. [See Factor 3: Real estate speculation]

In 2015, real estate began to experience a return to more stable pricing, with the rapid price increase of 2012-2014 subsiding by deceleration to a more gradual rising pace. However, the coming rise in fixed rate mortgage (FRM) rates, which began at the end of 2015 but was put on temporary hold due to global economic uncertainties in 2016, is likely to continue in 2018. Higher interest rates will stifle the real estate recovery progress. Sales volume will slow within six months of the FRM rate increase and prices will start to slip 9-12 months after sales volume turns down.

Prices will not begin to rise and hold until late 2018, and thus will unlikely provide long-term help to the remaining underwater homeowners until after 2019.

As **Realty Publications, Inc.** explained in November of 2009, the economic recovery would not take the shape of the oft-cited “V,” “L,” “W” or “U” recessionary trends. Instead, as noted, it would look more like an aborted checkmark following the period of mid-2008 to mid-2009.
The Federal Reserve (the Fed) helped fund the real estate craze of the mid-2000s with easy availability of mortgage money. This pumping pushed the government’s American Dream policy and threw mortgage fundamentals out the window. Federal deregulation resulted in lenders’ ability to make even riskier mortgages.

ARMs began to reset at higher payments and left homeowners without sufficient loan-to-value ratios (LTVs) to refinance. Foreclosures skyrocketed, to be modest.

When the collapse came and the Great Recession set in, the government responded with housing subsidies and the Fed bought mortgage-backed bonds to keep mortgage interest rates low.
The Federal Reserve (the Fed) tends to garner more media attention during times of economic woe. This occurred during the recession of 1980-1981 and again during the 2008 recession. Most Americans lack schooling on the existence and purpose of the Fed. The intricacies of the significant policy
settlers that we as a country have entrusted with monetary policy are not frequently discussed. In this intellectual vacuum, myths about the Fed take on the life of implicit fact.

To begin this discussion, the Fed’s mandate is to keep our economy stable. It fulfills this task by maintaining sufficient dollars in circulation as our nation’s medium of exchange, and in doing so maintaining both job and price stability. Thus, the Fed plays an integral role in the overall economic and financial health of the nation.

The Fed’s current structure is the culmination of centuries of banking innovation, trial and error, false starts and economic needs.

The concept of a *centralized banking system* has always been controversial. Even the Founding Fathers were in disagreement as to its desirability. Thomas Jefferson and James Madison were the most notable of the many who adamantly opposed a central bank.

Some early citizens of the young U.S., mostly northern merchants, recognized the necessity of a central bank to unify the American monetary system after the Revolutionary War. A source of their motivation was the debacle surrounding the *Continental*. This was the form of currency issued by Congress after the start of the Revolutionary War. The *Continental* was counterfeited by the British to intentionally destabilize the American economy.

Alexander Hamilton, the first *U.S. Secretary of the Treasury*, is frequently credited as being the intellectual father of the U.S. central banking system. Under his guidance, the First Bank of the United States, located in Philadelphia, was given a 20-year charter by Congress between 1791 and 1811.

The First Bank of the United States, was modeled largely after the Bank of England. However, it only vaguely resembled the Fed as it exists today. Its scope of authority and monetary influence was comparatively limited and primitive. It provided only 20% of the nation’s money supply. Additionally, many citizens, particularly southern members of Congress, were distrustful of the central bank. They feared it favored the economic interests of the Northern colonies over those of the South.

At the end of 1811, the bank’s charter was not renewed. Dollar notes were created and issued by private banks for the next five years. However, the War of 1812 between the U.S. and Great Britain caused massive price inflation, making it difficult for the U.S. to procure adequate funds to finance the war.

The *Second Bank of the United States* was charted for the period of 1816 through 1836. However, this too was short lived due to the same public distrust of central banking – fears of political pandering and geographic favoritism.
After the closure of the Second Bank of the U.S. in 1836, many years of decentralized and inefficient banking ensued. 1837-1862 was the **Free Banking Era**, reliant exclusively on state-chartered banks. However, most state-chartered banks, with their own reserves and issuing their own bank notes, were highly ephemeral. Reserves and notes from these banks rarely lasted more than five-years — a bane to overall economic stability.

Under the Banking Act of 1863, a system of **national banks** was installed between 1863 and 1913. Initially, this system was created with the intent to provide funding for the Union army during the Civil War. Under the national banking system, a national dollar currency based on private bank purchases of U.S. Treasury Securities was established. The **Office of the Comptroller of Currency** was created to protect against counterfeiting.

However, each incarnation of the U.S. banking system lacked two fundamental, necessary traits:

- the ability to enact forward-looking monetary policies to keep *price inflation* in check; and
- the authority to act as a financial safety-net by lending dollars it created in times of extreme economic emergencies.

After the **Panic of 1907** in which the New York Stock Exchange precipitously plummeted 50% from its high of the prior year, it was clear that the *American central bank* needed an elastic money supply structure to ensure long-term financial longevity and to avoid future upsets. This money supply elasticity is something only a central bank authorized to create dollars can provide.

In 1913, nearly 80 years after the expiration of the charter on the Second Bank of the United States, the **Federal Reserve Act** became law, also called the **Glass-Owen Act**. Congress created the Fed and gave it authority to:

- conduct the nation’s **monetary policy**, with the ultimate goal of maintaining prudent long-term interest rates, high employment and stable prices; distribute dollars solely of their creation to private banks, to be re-lent to investors, businesses and consumers;
- supervise and regulate private banks’ monetary decisions to ensure long-term financial health; and
- stabilize the national economy in periods of financial distress.

The **Fed** remains substantively the same today. As its primary function of creating and distributing funds, the Fed daily pumps and withdraws dollars from the market. The Fed accomplishes the flow of dollars to the public by making loans to private banks.

In turn, private banks re-lend the funds to businesses, investors and consumers for all types of purposes. These include purchase-assist consumer financing (mortgages) and commercial lending. For this, the Fed has an unlimited and endless funding capacity as it alone may create dollars.
The vehicles through which the Fed distributes money are the twelve Federal Reserve Banks. Federal Reserve Banks provide funds to private banks within their districts in order to fulfill their short-term lending needs. The rate on the money private banks pay to the Fed is called the discount rate. [See Factor 2: Interest rates]

In economically unstable times, like the financial crisis of 2008, the Fed props up the financial market by ensuring that money is still available at private banks for loans to be made to business owners and asset holders. This is called liquidity. To encourage private banks to borrow more dollars from the Fed, the Fed lowers the short-term discount rate, which makes money “cheaper” for mortgage, commercial and Wall Street bankers alike. If borrowed, the money increases their cash on hand to lend to consumers, businesses and investors.

All nationally chartered banks and some qualifying state banks, called member banks, hold stock in the Fed. Unlike stock in a standard private corporation, Fed stocks cannot be traded or sold. Member banks receive a fixed 6% annual dividend on their stock paid by the Fed.

The Fed is a uniquely American variation of a central banking system. In response to the pre-1913 criticism that a central bank would cater to a particular political or business interest, the Fed was established as District Reserve Banks.

Collectively, the Federal Reserve District Banks form the operating arms of the Fed’s central banking system. The districts are strategically located throughout the nation and are under the supervision of the Federal Reserve Board of Governors in Washington D.C.

The Federal Reserve District Banks, which publish prodigious amounts of information about the states within their districts, are:

- First district
- Second district
- Third district
- Fourth district
- Fifth district
- Sixth district
- Seventh district
- Eighth district
- Ninth district
- Tenth district
- Eleventh district
- Twelfth district

The structure of the central banks

Federal Reserve District Bank
The 12 branches of the “central” bank.

- First district
- Second district
- Third district
- Fourth district
- Fifth district
- Sixth district
- Seventh district
- Eighth district
- Ninth district
- Tenth district
- Eleventh district
- Twelfth district

Boston;
New York;
Philadelphia;
Cleveland;
Richmond;
Atlanta;
Chicago;
St. Louis;
Minneapolis;
Kansas City;
Dallas; and
San Francisco, incorporating all of western America, including Hawaii and Alaska, and of course, California.
By dividing the “central” bank into numerous regions the Fed was decentralized. All political, economic and regional interests are taken into account and fully represented. Each Reserve Bank is governed by a Board of Directors containing nine members. This diversified arrangement has worked well for a century.

Unlike all other governmental agencies, the Fed acts independently within the government. However, it is not entirely independent.

Limited independence is a mandatory requisite for allowing the Fed to craft future-minded monetary policy unhindered by the temporary political influences of Congress and the administration. The Fed is able to maintain its semi-independent state by being structured as a hybrid of both public and private voices.

The District Reserve Banks are similar to private-sector corporations. Each Reserve Bank has a board of directors consisting of members of the public and individuals in private business. These individuals provide grassroots insight into the workings of their districts.

In each of the twelve districts, the non-politically appointed board of directors nominates one Reserve Bank district president to represent their district. In California, the twelfth Federal Reserve district, the president going into 2018 is John C. Williams.

But the Fed is beholden to the public sector as well. The Federal Reserve Board of Governors located in Washington, D.C. contains seven members, all of whom are appointed by the U.S. President and confirmed by the senate. The Board of Governors is the governmental aspect of the Fed. These governors may serve only one term. The term is fourteen years, substantially longer than most political positions.

The term for sitting as a member of the Board of Governors is unusually long since the Governors are expected to base their policy decisions on the future well-being of the nation. They need to be around long enough to answer for their decisions. Also, changes in the Fed’s monetary and regulatory policies take many years to reach fruition, are difficult to gauge in the short-term and are adjusted several times each year.

Five rotating Reserve Bank presidents and seven members of the Board Governors make up the Federal Open Market Committee (FOMC). One of the Reserve Bank presidents is always from New York, historically the most influential district nationally and internationally. The FOMC meets at least four times each year in Washington, D.C.

Since 1981, the FOMC has met more than eight times each year and more often when economic conditions necessitate it. Prior to each meeting, the Manager of the System Open Market Account compiles written reports.
These detail the current and prospective economic environment each district is encountering, called the **beige book**, including:

- the conditions of the financial markets;
- relevant data on foreign exchange markets;
- employment and production statistics;
- consumer income and spending trends;
- residential and commercial construction;
- interest rates; and
- fiscal policy.

The reports contained in the **beige book** analyze the entire country, not just the dense urban areas or political hotbeds.

The reports are studied by each FOMC member as well as nonmember Reserve Bank presidents. The FOMC members then discuss their views regarding the appropriate course of future monetary policy and provide recommendations to achieve these goals.

Once a consensus is reached among FOMC members regarding open market dollar funding operations and plans for long-term growth, it is reduced to a directive. The directive is implemented by the Federal Reserve Bank of New York (FRBNY), as it executes transactions for the System Market Open Account by participating in the action on Wall Street.

Open market funding operations are the conduit through which the FOMC influences the total amount of money and credit available in the nation’s economy. It is the ultimate goal of the Fed to ensure that the open market – private banks – retains enough cash reserves and credit to promote borrowing by businesses, consumers and investors.

The amount of funds introduced into circulation need to constantly be kept in check to ensure long-term price stability (inflation) and sustainable economic growth (jobs). If too much liquidity (cash) drowns the market causing inflation, called **easy money** conditions, the Fed increases their short-term lending rate to pull (repurchase) some of the excess money back in from private bankers not willing to pay higher rates of interest.

When the market becomes cash-starved, called **tight money** conditions, as occurred after the financial crash of 2008 due to bank hoarding, the Fed lowers its short-term interest rate, making cash “cheaper” for private banks to borrow. In turn, private banks lend to investors until all involved regain their financial footing and confidence. The private banks are the conduit through which the Fed provides cash as the **medium of exchange** — in lieu of barter — sufficient in amount for the economy to function.
The Fed receives no funding from Congress or the U.S. Treasury. It is entirely self-sufficient, a trait similar to a fully capitalized private corporation. The Fed funds its operating expenses and interest paid to its depositors through:

- the interest earned on the loans it makes to member banks from the dollars it creates;
- investments in government securities; and
- revenue collected for administering services for financial institutions.

The Fed is interested only in covering its own operation costs. If any residual profits beyond the cost of operations exist, it is refunded back to the U.S. Treasury.

Though the Fed is partially independent from the government, it is still fully accountable. The Board of Governors in the FOMC needs to keep meticulous records of their monetary actions and report them annually to Congress. The FOMC also needs to make the minutes of their FOMC meetings available to the public within three weeks from when the meeting was held. The Fed is designed to be entirely transparent to both the government and the public.

In addition to controlling the level of cash available — *liquidity* — in the markets, the Fed performs regulatory and administrative activities. The Fed assumes a supervisory role over its member banks and formulates regulations which provide the structure of the Fed’s long-term economic plans.

The Fed also ensures the U.S. payment systems, such as clearing and settlement services needed by banks and bank customers, are running effectively and accurately. Billions of dollars are processed in all District Banks on a daily basis, as are millions of checks, in a process called *check clearing*.

In contrast to the Fed, the *U.S. Treasury* is the entity which physically prints all U.S. currency, which they then ship to the Fed. The Fed, in turn, limits introduction of the printed currency into circulation, generally releasing it at the rate the cash is needed by the private banking system. Similarly, the Fed removes currency from circulation if it is damaged, worn out or believed to be counterfeit.

While the Fed lends a bulk of its money to member banks, it also functions as a lender for the federal government. The Fed is a depository for the payment of federal taxes and also processes the sale and redemption of government securitized debt instruments, called *Treasury Bills (T-Bills)*.

*T-Bills* are sold to the public, member banks and other financial institutions.

The Fed does not (and will not) issue or buy mortgages. This is one common misconception of Fed activity. However, it does buy and hold bonds. Many of these bonds purchased in the period of 2008 to present were backed by mortgages bundled and structured with priorities called *tranches*, and held in trust by “pools” which issue the bonds, called *mortgage-backed securities (MBS)*.
The Fed is entrusted with sustaining the U.S. financial market and acting assertively when financial crises strike. By mandate, the Fed is a monetary defibrillator, resurrecting a troubled economy by pumping large amounts of cheap money into a tight, illiquid money market. This activity encourages all users of money to borrow once again at lower rates. Once economic health is sufficiently revived, the excess funds of resuscitation are withdrawn. In doing so, rates rise.

Chapter 17.1
Summary

The Federal Reserve’s (the Fed’s) mandate is to keep our economy stable. It fulfills this task by maintaining sufficient dollars in circulation as our nation’s medium of exchange, and in doing so maintaining both job and price stability. Thus, the Fed plays an integral role in the overall economic and financial health of the nation.

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Definitions

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Rentiers and debtors: why can’t they get along?

After reading this chapter, you will be able to:

• distinguish between society’s rentier class and debtor class;
• identify the political ideology of the rentier class; and
• specify the beneficiaries of current fiscal and monetary policy.

Consider a large and powerful Wall Street investment bank. In the years leading up to the 2008 financial crisis, the bank creates $100 billion worth of tranche-complex and high-risk mortgage-backed bond (MBB) investments. Designed for public consumption by investors, MBBs are comprised of:

• residential mortgage-backed securities (RMBS);
• collateralized debt obligation (CDO) securities; and
• credit default swaps (CDS).
The bank sells most of the bonds to unsuspecting investors, without disclosing the high risk of loss that accompanies them. Then comes the financial crisis, causing homeowners to lose jobs and homes to drop 50% in value. These conditions bring on an unsettling number of mortgage defaults.

To maintain its profits and the fortunes of its MBB investors, the banker advocates public policies such as:

- low inflation;
- financial bailouts and subsidies;
- expansive monetary policies (including quantitative easing and depressed interest rates); and
- fiscal policies socializing/funding private banking losses.

These policies, however, prolong the suffering of the unemployed and mortgaged homeowners while allowing the bankers to prosper. This is, of course, the well-known story of Goldman Sachs; but, almost every other major Wall Street brokerage and every major bank (and, therefore, every major mortgage lender) has a similar tale to tell.

Mortgage borrowers during the Millennium Boom were misled. Bond market investors were defrauded. There were illegal foreclosures, retaliatory credit scorings, and insider bets against housing mortgage values. The lawsuits are now reported cases of facts and rules for all to know.

It ought to come as no surprise that borrowers, who make up the vast preponderance of the U.S. population—the 99%—continue to suffer a reduced standard of living. The plight is due to the long stretch of unemployment and slow income increases since the recovery took shape. At the same time, the Big Banks which were partially responsible for the recession continue to succeed and thrive economically.

As businesses, banks are designed to work in their own best interest. Their continued financial success indicates their business and political strategies are effective. Mortgaged homeowners had no voice until 2011 when the federal government created the Consumer Financial Protection Bureau (CFPB) as a first-of-its-type agency designed solely to protect borrowers. Transparency at the window for mortgage applications, processing, funding and remediation is now firmly in place. It a word: customary.

There is a fundamental economic distinction between:

- the rentier class, made up of those who lend money or let real estate; and
- the debtor class, comprising those who borrow or rent.

The rentiers exist in opposition to renters; the latter pay, and the former collect.
Rentiers are largely governed by the laws of large for-profit corporations. This entitles them to participate in behavior unavailable to individual members of the general public.

At the core of the bankers’ advantage is a fundamental contradiction. Banks are given access to money at extremely cheap rates by their unique ability to borrow from the Federal Reserve (the Fed), the initial source of all U.S. currency.

To stimulate spending in this recovery, the Fed consistently lent money to banks at essentially zero percent interest rates, until December 2015 when the rate increased for the first time since 2009. Still, the Fed’s target short-term lending rate is a very low 1.25% as of late-2017. In return, the banks are expected, though not required, to increase their own lending to private borrowers.

Meanwhile, insolvent bankers are able to escape their excess debts by passing them on to the Federal Deposit Insurance Commission (FDIC). In extreme circumstances, they receive massive government bailouts (recapitalization) funded by the U.S. Treasury, as occurred in 2008 under the Troubled Asset Relief Program (TARP).

When banks escape financial obligations they are unable to pay due to their own mistaken calculations and harmful behavior, it is considered a legitimate corporate business strategy. In contrast, mortgage-holding homeowners are left to repay their mortgage debt as bankers steadfastly resist any congressional attempts to make it easier for homeowners to escape (in bankruptcy) even the most egregious amounts of excess debt.

Homeowners can push for the same right as banks through cramdowns orchestrated in bankruptcy court or by walking away from an underwater mortgage. This decision to escape debt is at best a lender and government labeled moral failure; at worst a legal impossibility (although not in California, an anti-deficiency state).

As a result of bifurcated debt-resolution rules, the nation is divided into two separate and adverse economic classes, each of which ironically depends upon the other. Class warfare seems to be the inevitable result of this dichotomy, as the economy has not always been as clearly divided as it now is.

In reality, it is not at all difficult to envision a society in which the interests of rentiers and borrowers are far more closely aligned. To understand how this is possible, a clearer definition of the term “rentier” is required.

Rather than referring to a “lender class,” it might be useful to think of the rentiers as all those who receive fixed income yielded from tangible and intangible assets they own, not from a paycheck. While most of our population derives its income from the direct production or sale of a good or service they provide, rentiers profit by passively earning income generated by their holdings.
For example, a mortgage held by a hard money lender and an apartment/commercial property held by a property investor (as in portfolio and passive income tax category investments) make the owner a rentier.

On the obverse side of the coin are business people, professionals and employees who actively earn money for their efforts. Also on this side are speculators (day traders/flippers) who buy and sell property or other assets and profit on the resale. They need to go to work each day if they are to have an income flow, since they have not built up wealth which produces income independent of their efforts.

The political success of the rentier regime in the current post-recession, financial crisis economy is indicative of an overall reversal in economic policy from the Keynesian economics in force at the close of World War II (WWII) (the biggest fiscal stimulus ever). Those policies lead to 30 years of the greatest expansion the U.S. has ever experienced.

In that period of constantly rising interest rates needed to keep growth in check, the dominant group (the U.S. and allied forces) considered demanding overwhelming repayments from the defeated nation of Germany. However, they instead listened to the advice of John Maynard Keynes, from Britain. It was his (and Roosevelt’s) Bretton Woods monetary system that emphasized economic recovery for the winners and losers both. We grow together from the ruins.

Rather than the victors paying their vast war debt with money demanded from the defeated (a WW1 situation which did not work out well), the Fed tightly regulated the financial markets to reduce speculation and dramatically lower interest rates. The results were economically beneficial for both the defeated and the victorious: a monetary Marshall Plan.

In an ideal government, the conflicting demands of separate political contingencies — the few rentiers and the many debtors — will be balanced to the benefit of the largest contingency.

The austerity measures that are most beneficial to rentiers are unacceptable to the much larger group of debtors, and thus one might include the government. That debtor group is made up especially of homeowners, who benefit from economic stimulus and tighter regulation of lenders by government. The debtors make up most of the working population. They actively create items, provide services for sale and disproportionately pay a variety of taxes.

Thus, government agencies have an additional incentive to ensure the continued wellbeing of the populous debtor class. However, political differences about fiscal stimulus and austerity often slow or halt economic growth for the debtor class.
Rentier dominance has taken hold in contemporary U.S. and international politics. Salt-water economists submit that establishment economic policy is misguided and even harmful by the tenets of Keynesian economics. Present policy is predisposed to ensure that in times of economic distress, debts of individuals are enforced rather than being either forgiven or artificially reduced by temporarily high inflation.

After all, the increased purchasing of goods and services and the resale of homes is necessary for the economy to be robust. As seen in the long six years it took to reach a tentative recovery in California, when a vast swathe of the population’s income is diverted to repay principal and interest on underwater mortgages, the economy as a whole suffers.

This is not to say a secret cabal of rentiers controls U.S. politics. However, the ideology of the rentiers has embedded itself into mainstream political thought in a present-day form of trickle-down economics.

As a result, the rentiers as a class continue to be among the very few to reliably achieve continued financial success in this period of global wage stagnation. Their stocks, bonds and rental properties have fully re-inflated and in some instances surpassed their pre-recession levels (but not yet all homes).

Thus, rentier-friendly policies unavoidably pit Wall Street bankers against the needs of Main Street individuals for jobs and housing and assistance until jobs are available at full labor participation rates sufficient to support the national standard of living.

The inadvertent result of current world policy, which sets the interests of debtors against those of creditors, is a different form of conflict: class warfare.

Government funded projects are advocated as necessary Keynesian stimulus to repair the economy by elevating it to a level of activity that will be self-sustaining when the stimulus ends. Federal stimulus projects enacted during the Great Recession recovery did very little to improve the long-term status of homeowners threatened by foreclosure.

In contrast, excess speculator liquidity fueled by QE Fed programs has done much more to reflate home prices. The recent rounds QE of had the direct, immediate and pronounced effect of bolstering share and bond prices, commodities markets and income producing real estate, but not homes (except for speculation’s effect in the low-tier price range).

The sole present beneficiaries are Wall Street bankers and executives — the rentiers. Troubled Main Street homeowners with negative equities and few prospects for more jobs and higher wages soon did not benefit.

Essentially, these projects were neither properly directed to assist mortgaged homeowners nor sufficiently extensive to make an immediate, measurable difference.
The policies most valuable to all of society’s participants are those which lead to debt forgiveness, even at the rentiers’ immediate expense. These, however, we are unlikely to see.

Foremost among these options is temporarily increased inflation. The Fed easily manages inflation, as was seen by Fed Chairman Volcker’s 1980s ending of rampant inflation which the prior Fed management permitted. In contrast, deflation is very difficult to reverse unlike inflation.

When negative equity was still a drag on the housing market, there was also the much discussed principal cramdown of mortgage debt to the value of the home it encumbers. But addressing this calls for Congress to reinstate homeowner bankruptcy rights now only available to property investors – that rentier class distinction again. [See Factor 17: Monetary policy]

Debtors and rentiers will always be naturally troubled by conflicting interests. The current state of conflicting policies is the result of a peculiar set of regulations that apply to banks. Economic blogger Steve Waldman points out that “banks, after all, are not only creditors. They are also the economy’s biggest debtors.” All deposits they hold are amounts they alone owe their depositors, although guaranteed by the U.S. government. As such, banks are merely a conduit for flow of the nation’s cash.

In a rational world, without the assurance (if not implicit guarantee) of government bailouts, bankers will be as concerned about their own risk of insolvency and bankruptcy as are the homeowners whose mortgage debt they hold.

The advocated solution is a removal of policies which grant artificial security against loss to bankers — the socialization of business losses — while denying similar security to homeowners. Such policies are harmful since they include bizarre accounting regulations and the implied guarantee of bailouts behind the “too-big-to-fail” mentality. The current overly generous guarantee of newly originated consumer mortgages by the government via the Frannies/FHA/VA falls into this mentality.

These fiscal policies make it easy for banks to obscure their troubled assets from investors (as well as the lack of regulation that makes abuses, like Goldman-Sachs’, possible), which of course they do. That is, rentiers — like homeowners — need to know they are at risk of foreclosure by the FDIC if their debts (held by depositors) are not able to be repaid from the value of the assets that secure them as collateral.

It is important to remain aware of which class — rentiers or homeowners — stands to benefit from future changes in fiscal or monetary policy. Included are those changes ostensibly enacted in support of the homeowner. The pace of the economic recovery and the long-term personal financial success of all mortgaged homeowners depend upon the outcome.
The huge debtor class of homeowners (70% of California homeowners have mortgages) can preserve its ability to recover from a general financial crisis and create a future for itself collectively. However, it needs to emulate the bankers and rally to advocate political positions which allow mortgaged homeowners the same privileges rentiers take for granted. Perhaps most essential among these privileges is the existing guilt-free ability to legally walk away from mortgage debt in California. Within their own households, every California homeowner is “too big to fail.”
The rentier class is made up of those who lend money or let real estate. The debtor class comprises those who borrow or rent. Both exist in opposition to each other; the latter pay, and the former collect. As a result, the nation is divided into two separate economic classes, each of which depends upon the other.

As businesses, banks work in their own best interest, and their continued financial success indicates their business and political strategies are effective. Mortgaged homeowners had no voice until 2011 when the federal government created the Consumer Financial Protection Bureau (CFPB) as a first-of-its-type agency designed solely to protect borrowers. Transparency at the window for mortgage applications, processing, funding and remediation is now firmly in place, functioning and quickly became customary.

Government funded projects are advocated as necessary Keynesian stimulus to repair the economy by elevating it to a level of activity that will be self-sustaining when the stimulus ends. Federal stimulus projects enacted during the Great Recession recovery did very little to improve the long-term status of homeowners threatened by foreclosure.

In contrast, excess speculator liquidity fueled by QE Fed programs has done much more to reflate home prices. The recent rounds QE of had the direct, immediate and pronounced effect of bolstering share and bond prices, commodities markets and income producing real estate, but not homes (except for speculation’s effect in the low-tier price range).

Chapter 18.1 Definitions

John Maynard Keynes ..............................................................pg. 298
rentier ........................................................................................... pg. 296
Wall Street steps into the mortgage market

After reading this chapter, you will be able to:

• describe how Wall Street took over the lending system;
• identify the process by which Wall Street sells mortgages to investors; and
• understand the reasons why buyers need to seek out smaller banks for mortgages.

Most all Americans have a collective frustration in Wall Street following the many crimes perpetuated and brought to light by the financial crisis. The nation’s largest banks and insurance companies became less trusted by the working-class majority for their acts of:

• mortgage fraud committed and deliberately waived by the Securities and Exchange Commission (SEC);
• retaliatory credit scoring unchallenged by Congress; and
• Wall Street insider bets against mortgages leading up to the financial crisis.

Have the injustices perpetuated by New York’s rentiers called into question the benefit of maintaining the status quo on Wall Street?

The New York Times claims most people outside the U.S. have no access to institutions with the means to fund business endeavors, homeownership or other large purchases. Thus, there is little opportunity for upward mobility in the global middle class. They claim Wall Street is the only answer to the plight of low — and middle — class individuals with dreams of homeownership. But this is not so.

Almost the entire developed world has access to lenders through central banking systems operated by their governments. Central banks distribute money to users through private banks, similar to American Wall Street banks, community banks and other local savings institutions.

In turn, private banking operations lend to governments, businesses, consumers and homebuyers who use the money to buy the goods and services available to them. This printing, the primary job of central banks,
provides a medium of exchange — money — which eliminates the need for one to barter their goods and services to locate someone who has those they desire.

Additionally, the U.S. mortgage lending system of regional mortgage bankers (wholesalers) and community banks did quite well before Wall Street stepped in as lender. Wall Street assumed this role through acquisition of most mortgage banking operations in the 2000s and the bundling of mortgages into pools to be sold off as mortgage-backed bonds (MBBs) to the entire world of investors.

Homebuyers usually have more success qualifying for mortgages at competitive rates by going through community banks, savings and loans (S&Ls) and credit unions. Local institutions originate mortgages to keep or sell in conformance with the secondary mortgage market requirements of government guarantees.

Big banks now make a disproportionate share of new real estate mortgages. This is the direct consequence of government aid keeping their heads above water to the detriment of their smaller rivals who don’t have the political clout to receive the same assistance. Smaller banks have been slowly muscled out of the mortgage lending industry by big lenders looking to eliminate competition, with help from their friends at the Federal Deposit Insurance Corporation (FDIC).

As small-bank competition is eliminated, homebuyers are left with fewer lenders to shop. Their ability to bargain for lower mortgage fees and quoted rates is compromised.

As part of the New Deal after the Great Depression, the government created the Federal Housing Administration (FHA) and the Federal National Mortgage Association (Fannie Mae).

The original purpose of Fannie Mae was to create a liquid secondary market through which mortgages are sold to free up the capital of mortgage lenders so they can originate more mortgages, a process called mortgage warehousing.

Fannie Mae primarily bought Federal Housing Administration (FHA)-insured mortgages and sold them to Wall Street, who then pooled them into MBB tranches and sold them to investors. The purpose and end result was to facilitate economic stimulus and recovery with housing as the catalyst. Thus began the propagandized American Dream.

The process of fueling the housing market to resuscitate the economy has now become an abuse. The 2008 recession demonstrated the housing sector is not an appropriate economic driver.
Rather, housing is a mere indicator of the broader economy’s health. The government ought to have focused on the financing of small businesses, not houses, which were practically ignored (the Small Business Administration (SBA) being of no consequence except for political window dressing).

MBBs were originally used by Wall Street to entice individual investors from around the world to buy bonds for participation in pools of mortgages with low risk and mid-to-high yield — all directly or implicitly guaranteed by the U.S. government. This was a good thing as it freed lender capital to originate more mortgages and help pull America out of the depression.

The system turned sour in the 2000s when credit rating agencies (controlled through fee arrangements by those on Wall Street bundling and selling the mortgages) misrepresented the risk associated with MBBs. The goal of stabilizing the economy and assisting homeowners was abandoned in favor of maximizing profit.

In the post-depression economy of the 1930s and 1940s, Wall Street served as a vital conduit for connecting those needing home mortgages with the lenders funding them. Since the 1960s, Wall Street has become a facilitator of recession and financial elitism. It is an enabler of the very condition it was called upon to cure. The 2008 financial crisis is the most current evidence of this.

When home prices increased from 2002 to 2006, it was the Wall Street lenders who enticed unqualified borrowers into homeownership with offerings of unsustainable mortgage products like hybrid adjustable rate mortgages (ARMs). [See Factor 6: Mortgage]

Most of these exotic mortgage products carried no government guarantees. Instead, lenders blatantly counseled borrowers to refinance these ARMs before they reset at higher payments — a liquidity loophole available to minimize mortgage delinquencies. It might have worked, too, if the pull of gravity had not brought the overinflated values of homes (collateral) back to earth. Prices always return to the equilibrium of mean prices, but Wall Street does not understand this real estate fundamental. [See Factor 12: Pricing.]

The financial accelerator dynamic of ever greater mortgage amounts on jacked up prices of collateral lent to ever less qualified homebuyers and homeowners eventually led to the collapse of real estate prices. Excessive lending screeched to a halt with the 2008 recession.

Homeowners were left unemployed or otherwise unable to meet reset ARM payments, while lenders feigned ignorance in the fallout and failed on their promise of refinancing. Their finger was instantly pointed at mortgage brokers, appraisers and credit agencies for misleading them through the critical evaluation services outsourced to them by lenders.
The New York Times claims their uptown bankers are vital to the economy even though they single-handedly collapsed it with the blessing of Fannie Mae and Freddie Mac, Congress, the SEC, the Department of Housing and Urban Development (HUD) and the Federal Reserve (the Fed).

But as the government continued to play along with Wall Street’s purported innocence, the 99% faced foreclosure or the inability to refinance at current low rates. In the meanwhile, lenders and large companies (read: General Motors, Chrysler, the large banks and Fannie Mae and Freddie Mac) got bailed out with taxpayer dollars since they employed great numbers of employees.

No doubt the most recent financial crisis was sparked by the intensification of lending through big banks that colluded and merged with Wall Street bankers. It was the large lenders who created most of the option ARMs and hybrid mortgages that amassed into millions of foreclosures, not Fannie Mae and Freddie Mac. It was the large lenders who maintained the political clout to fend off the SEC and FDIC and control the credit rating agencies when their pools of nonperforming, misrepresented MBBs were sold to investors.

Worse still, it was the large lenders who made the wrong judgment calls about the real estate market (as they always tend to do – they are bankers, not investors) and lied about their solvency at mark-to-market portfolio prices for mortgages they held just days before the 2007 banking collapse began.

What’s a real estate agent to do? Homeowners scorned by boom-era bad decisions need a resident expert in their corner. As the gatekeepers of real estate, brokers and their agents are charged with the responsibility of teaching (advice) and encouraging the public to make financial decisions about their real estate based on market fundamentals.

Historically, homebuyers in the market for purchase-assist financing have been required to make a minimum 20% down payment. FHA-insured mortgages are an exception, primarily available to anxious first-time homebuyers with lesser qualifications and at far greater recurring cost.

The 20% requirement ensured the buyer as homeowner will have skin in the game, a vested equity interest sufficient to induce them to keep their mortgage current and the property maintained. The Millennium Boom lending craze did away with this prerequisite and introduced 100%-plus financing. Lenders alone made it easy for almost anyone to purchase a home by simply signing an application for a mortgage.

Of course, personal savings rates dropped to 0% at the peak of the boom as homebuyers realized they weren’t required to save. Expectations are everything when planning for the future. [See Factor 9: Savings]
Potential homebuyers waltzed into the first bank they saw and signed on the dotted line without even bringing their checkbook. Price and costs were no obstacle. The huge financial burden of owning a home was trivialized, until those same homebuyers saw the value of their properties plummet.

Many of the delinquencies and foreclosures in the years following 2008 were avoidable. Simply put, homebuyers were not properly counseled before committing to their mortgages and home pricing. It is not the job of banks to do so in their adversarial role in mortgage originations.

Real estate professionals, on the other hand, are armed with their statutorily mandated knowledge about the laws of real estate finance. They are thus poised to pull the public out of their boom-time expectations, back to the realities of a recovering, price adjusting housing market.

Regardless of Wall Street’s lending standards, agents can encourage potential homeowners to consider these fundamental elements of real estate financing before making decisions.

For those who plan to pay off their mortgage or move three to five years after they buy their house, an ARM can be a deceptively appealing money saver. Of course, the bet is they will be able to sell. The problem is that ARMs are most popular just as the ability to sell is about to disappear into a pricing recession.

For all but the most experienced investors, the fixed rate mortgage (FRM) remains the safest long-term bet to avoid unanticipated financial distress caused by external volatility. Realty Publications, Inc. opposes the use of ARMs to finance a homebuyer’s purchase, particularly when 30-year FRM interest rates remain at near-historic lows going into 2018.

The risk of loss imposed on a homebuyer by an ARM is too onerous for all but some of the very wealthiest homebuyers (who ought to pay cash, and would but for the tax deduction for borrowing subsidized money which avoids their using cash).

Purchasing a home is the single greatest financial decision in most people’s lives. However, the reality of American financing is that critical analysis is abandoned to the realm of economists. Worse, the home buying public and real estate agents pay little attention.

In a 2015 survey reported by the Consumer Financial Protection Bureau (CFPB), three-quarters of homebuyers obtain but one mortgage quote before buying their home. This is irresponsible personal behavior, but well known to take place by mortgage lenders who do not encourage the homebuyer to shop for a better mortgage commitment. [See Form 312 accompanying this chapter]
This is where buyer’s agents step in. Most homebuyers know very little about lending or what makes financial sense for them. Their misunderstanding translates into lackadaisical inquiries with their personal bank, which they already know and believe in, and responses that inadequately define the down-stream consequences of a mortgage or lack competitive spirit.

A lender is at odds and in conflict with homebuyers in spite of their advertising to the contrary (“we are your financial partner”). When a purchase-assist mortgage is a condition for closing, the buyer needs to be reminded of this.

Form 312
Mortgage Shopping Worksheet

NOTE: This form is used by a transaction agent and their buyer when a mortgage application is submitted to two or more lenders, to compare mortgage rates and origination costs offered by different lenders competing to make the same type of mortgage.

DATE: __________, 20________ at __________________________, California.

Items left blank or unchecked are not applicable.

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<td>Mortgage term (years)</td>
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<td>Total monthly payment to lender</td>
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<td>If taxes and insurance (TI) are not included in the monthly payment, what is the additional monthly TI amount?</td>
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<td>If private mortgage insurance (PMI) or mortgage insurance premiums (MIPs) are required, what is the monthly cost?</td>
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<td>If PMI/MIP is included, when may it be cancelled?</td>
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<td>Adjustable rate mortgage (ARM): [See RPI Form 320-1]</td>
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<td>Lender fees for processing the mortgage</td>
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<td>Other fees</td>
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<td>If there is a final balloon payment, when is it due and in what amount?</td>
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<td>If there is a prepayment penalty, what is the amount?</td>
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Date Prepared: __________, 20________

Prepared by: __________________________, 20________
Prepared for: __________________________

FORM 312 03-15 ©2016 RPI — Realty Publications, Inc. P.O. BOX 5707, RIVERSIDE, CA 92517
A stable and long-term recovery of the real estate market is enhanced when buyer's agents encourage homebuyers to inquire beyond just one lender in search of the best home mortgage.

The CFPB has new **Loan Estimate** and **Closing Disclosure** forms mortgage lenders are required to use in all consumer mortgage transactions. The CFPB disclosure forms significantly simplify comparative analysis by streamlining the mortgage lending process for homebuyers.

The **Loan Estimate** replaces both the initial Truth-in-Lending statement and the good faith estimate (GFE). The Loan Estimate is provided within three business days of the lender’s receipt of the application, and provides the mortgage terms and details quoted by the lender. [See RPI Form 204-5]

The **Closing Disclosure** replaces both the old final Truth-in-Lending statement and the HUD-1 Settlement Statement. The Closing Disclosure form is provided within three business days before the mortgage closing. It summarizes the “final” mortgage terms and details. [See RPI Form 401]

The buyer who submits at least two applications for the mortgage sought has ensured they will get the best deal. Only then, immediately prior to closing, will the lender of choice get competitive and say, “We will match their rate and costs.” Of course, they will; it’s all about taking a profit.

If a potential homebuyer does not have enough savings to make a down payment or their income is not consistent enough to ensure their mortgage will be paid, they are not ready to purchase a home. Beginning with the Boomer generation, Americans have overwhelmingly chosen to jump into the shackles of homeownership with little knowledge of the expectations. This is an undisputedly major proponent of the 2008 recession and the ongoing recovery.

Agents need to help the public make informed decisions about what is more important to them. People seeking shelter need to decide between:

- owning a home with the incumbent responsibility of a mortgage and a single location; or
- renting with a debt-free, solvent lifestyle that offers the mobility and freedom to pursue future wealth.

**Live within your means, dear buyer**
The U.S. mortgage lending system of regional mortgage bankers (wholesalers) and community banks did quite well before Wall Street stepped in as lender. Wall Street assumed this role through acquisition of most mortgage banking operations in the 2000s and the bundling of mortgages into pools to be sold off as mortgage-backed bonds (MBBs) to the entire world of investors.

Wall Street is not the only answer to the plight of low — and middle — class individuals with dreams of homeownership. Local depository institutions abound. A stable and long-term recovery of the real estate market requires agents to strongly encourage homebuyers to inquire beyond just one lender in search of the best home mortgage.
Chapter 19: Wealth from other nations

The global economy’s effect on local real estate

After reading this chapter, you will be able to:

• comprehend the influence of the growing number of foreign investors in California’s real estate market;
• understand how exchange rates influence investor decisions to purchase real estate in the U.S.; and
• explain the benefits and disadvantages of a large share of foreign investors in a local real estate market.

Given California’s enormous size — both geographically and economically — it’s a significant player in the global economy. In fact, it has the largest gross domestic product (GDP) of any other state, and the sixth largest GDP in the world, just ahead of Italy and Brazil.

How does California real estate fit into this global puzzle?
Most home sales are actually excluded from GDP measures, as only newly constructed home sales are included in GDP. However, a large portion of the state’s wealth is held in the housing market, and it’s not just U.S. citizens who want to get into California real estate.

Migrants from other countries pour into California in numbers far surpassing migrants from other states. We consistently gain over 100,000 international migrants each year, while actually experiencing a net loss of several thousand households to other states yearly. [See Factor 21: Population growth]

To that end, 29% of real estate agents surveyed by the National Association of Realtors (NAR) assisted in home sales with international buyers and sellers in 2017.

The survey also showed:

- the amount of money spent on homes by international buyers was 50% higher in 2017 than 2016, amounting to an increase of about $50 billion;
- the majority of international investors are from China, followed by Canada, the U.K. and Mexico; and
- about half of international buyers who purchased during 2017 were U.S. residents (though not citizens).

Some of these buyers plan to use their purchase as a vacation home, while others will use it primarily as an investment property.

In California, 71% of international buyers were from Asia. The next highest geographical region was Latin America, which made up 14% of international buyers in California during 2017.

The biggest reason international buyers purchased a home in California was to be closer to family or friends already in the state, according to the survey.

It is universally understood that California is a desirable place to live, with warm weather all year, a diverse geography and significant cultural appeal.

Editor’s note — The only other state more sought after by international homebuyers is Florida.

California’s pleasant climate and regional amenities are particular draws to international buyers in this state.

The high number of world-renowned universities in California is another reason why the Golden State is a beneficial place to establish a primary residence. It’s important to note that three of the top ten universities in the world are found in California, according to U.S. News & World Report. More international students study in California than any other state, with 149,300
international students here as of the 2015-2016 academic year, according to the Los Angeles Times. International student enrollment continues to rise, with most international students coming from China.

When the international buyer does not intend to live in the property, they are still motivated to purchase in California for investment purposes and the favorable tax advantages of homeownership found in the U.S. and California.

For those strictly concerned with dollars and cents, the U.S. has significant investment potential. The value of the dollar is relatively strong, especially viewed through the lens of less stable economies like Mexico, Canada, China or the European Union, etc. In fact, the U.S. dollar is the only currency that has grown stronger since mid-2014.

On the flip side, a stronger dollar (essentially a more expensive dollar to international clients) reduces the buyer purchasing power of international homebuyers. This resulted in fewer international buyers in 2017 across the U.S., as buyers wishing to pay with all cash found their cash unable to purchase as much house.

Editor’s note — A similar loss of buyer purchasing power occurs when mortgage rates rise, reducing mortgage amounts. This is another price dampening issue that will influence the market in 2018 and beyond. [See Factor 2: Interest rates]

Even with a strong dollar, the fluctuating exchange rate is one of the reasons why U.S. property can be a good investment. Consider a buyer from China who purchased a home in California in September 2015.

At the time, the Chinese yuan renminbi (¥) was trading at approximately 6.38 yuan per one U.S. dollar. The purchase price was $400,000, equivalent to ¥2,552,000 at the time.

Fast-forward one year to September 2016, when the yuan is trading at ¥6.67 per $1. In other words, the U.S. dollar has become more expensive to purchase using the Chinese yuan. With this increase, the same investment has grown from ¥2,552,000 to ¥2,668,000. This is an increase of ¥116,000 or $17,391 due to the weakening renminbi alone.

Further, consider the intervening increase in home values witnessed in California. Mid-tier homes increased in value approximately 7% from 2015-2016. Thus, the full increase would be closer to ¥269,120, or U.S. $40,248. While the home’s value increased 7% for the U.S. investor, for the Chinese investor the investment grew over 10% in renminbis.

This example covered a very brief period of time, just one year. However, real estate can be an excellent long-term investment vehicle, as property values tend to rise with or just above the rate of consumer inflation. Foreign investors

Follow the money

An example of profit gained

exchange rate
The fluctuating rate at which one currency is converted to another, such as for the purpose of purchasing in a foreign market.
are rarely looking for a short-term flip (unlike U.S. speculators). Rather, they usually hope to park their cash for a long-term investment, helped by the fact that many international buyers plan to reside in their U.S. homes.

The issue is, once again, two-sided.

The good: investors from other countries give home sales volume and pricing extra support and they bring wealth into the US economy.

This is especially helpful in today’s recovering real estate market, when owner-occupant homebuyers are still bouncing back from the lean years of the extended recovery. California just regained all jobs lost to the 2008 recession in mid-2014. With the population increase over the intervening five and-a-half years, we won’t likely reach a full jobs recovery until around 2019. Thus, from a short-term perspective, international investors are a boon to today’s real estate market, thirsty for end user homebuyers.

However, international investment presents a more complicated aspect to our real estate market.

The growing presence of foreign real estate investors signifies the instability of other nations’ economies. Thus, there is a modest concern the Federal Reserve (the Fed) will make policy decisions based on our relative success in the global market, perhaps acting too soon for our still fragile U.S. economy. [See Factor 16: Fiscal spending]

Foreign investors turning in larger numbers to the strong dollar pseudo-inflates our economy. In this case, the strong dollar does not alone indicate an inherently strong U.S. economy. Rather, it reflects a relatively strong position, in relation to the economic chaos across a majority of the globe. Another reason why U.S. currency is considered the world’s primary reserve currency. Accordingly, holding dollar denominated assets is the best way to hold foreign wealth in times of global economic stress as returns are better than the Euro’s negative rate of interest.

The Fed kept the short-term interest rate at essentially zero from 2009 through the end of 2015 in an effort to stimulate lending, and in turn encourage job creation and wage growth. This has allowed mortgage rates to remain low. The Fed now intends to raise the short-term rate very slowly, by only a couple of percentage points over the next two years or so. If the Fed increases interest rates before the economy is ready, the results will be further economic stagnation (and an even worse flattening of volume and prices in the real estate market).

Further, when the Fed does increase the short-term rate, economists warn the effect on global markets will be negative — particularly for residents of China, who have borrowed more U.S. dollars than any other country’s...
residents. When rates rise here in the U.S., the cost of borrowing will go up for international investors. Along the same lines, a stronger dollar also means more foreign money is needed to repay previously borrowed debts.

International real estate investors do not presently damage California’s market. However, their increasing presence means you need to keep an eye on mortgage rates and prepare for their eventual rise, which is expected to continue in 2017. At some point in the foreseeable future, much of this foreign money will leave California as the economies of these foreign countries begin to recover.

Migrants from other countries pour into California in numbers far surpassing migrants from other states. We consistently gain over 100,000 international migrants each year, while actually experiencing a net loss of several thousand households to other states yearly.

Since nearly half of all international buyers in California plan on using their purchase as a primary residence, our pleasant climate and regional amenities are especially important.

For those strictly concerned with dollars and cents, the U.S. has significant investment potential. The value of the dollar is relatively strong, especially viewed through the lens of less stable economies like Mexico, Canada, China or the European Union, etc. In fact, the U.S. dollar is the only currency that has grown stronger since mid-2014. The fluctuating exchange rate is one of the reasons why U.S. property can be a good investment.

The growing presence of foreign real estate investors signifies the instability of other nations’ economies.

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**Chapter 19.1 Summary**

**Definitions**

exchange rate ................................................................. pg. 313

gross domestic product (GDP) ........................................ pg. 312
Fixed mortgage rates respond to the global economy

After reading this chapter, you will be able to:
- identify the factors that influence fixed mortgage rates; and
- understand why global economic turmoil presently keeps fixed mortgage rates low.

The Federal Reserve (the Fed) began its initial short-term interest rate hike in December 2015. It held off increasing the rate again throughout 2016 in response to the fragile U.S. economic situation, worsened by global economic conditions. The short-term interest rate (called the Federal Funds rate) hovered in the 0%-0.25% range from 2008-2015, at 0.25%-0.5% in 2016. The Fed resumed rate increases in 2017, and the target Federal Funds rate is 1%-1.25% as of October 2017. [See Factor 2: Interest rates]

By keeping the short-term rate near zero for eight years, the Fed indirectly, but intentionally, kept mortgage rates low. This was initially accomplished after 2007 by purchasing all the mortgage backed bonds (MBBs) necessary to provide fixed rate mortgage (FRM) funds and keep leveraged home sales moving. In those years, a lowered Fed rate was intended to encourage borrowing by those forming households and operating businesses by making cheap money available to mortgage and commercial bankers. [See Factor 17: Monetary policy; see Figure 1]

The Fed’s consideration for increasing (or decreasing) the short-term interest rate is based on their targets for:
- a “maximum” nationwide employment rate; and
- consumer inflation expectations of 2%.

How does this work? At a basic level, when the short-term interest rate is lowered, borrowing, spending and inflation tend to rise. Alternatively, when the Fed raises the short-term rate, borrowing, spending and inflation cool down.

Editor’s note — The rate of consumer inflation at the end of 2017 remained below the target 2% inflation objective of the Fed for a normally functioning U.S. economy, due primarily to a poorly performing global economy and slow economic growth in the U.S.
Thus, the Fed kept the short-term rate low from 2009 through the end of 2015. Its goal was to encourage a higher rate of consumer inflation needed to invigorate the U.S. economy, which it has not achieved in eight years at basically zero rates. [See Figure 1]

Editor’s note — One reason we have not had sufficient consumer inflation is that the Fed has refused to lower rates below zero and go negative — lending to banks at a rate of, say, minus 2%, which enables banks to make more loans at ever lower rates.

By gunning for a higher inflation rate, the Fed indirectly (but intentionally) stimulates employment growth. This is due to the fact that higher inflation and full employment have a symbiotic relationship (with some limited exceptions). Simply put, when employees are well paid and their jobs are secure, their demand for goods and services increases. This demand results in rising price inflation, until the supply is increased to meet or exceed

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**Figure 1**

*Federal Funds Rate versus 30-year Fixed Rate Mortgage (FRM) Rate*

The interest rate for 30-year fixed rate mortgages (FRMs) — the most common type of mortgage for buyer-occupants — moves similarly but more gradually than the Federal Funds rate.

As seen in the chart above, the 30-year FRM rate rises with each increase in the Federal Funds rate. This occurred somewhat belatedly in 1994, 1999 and 2005-2006. The delay in the 2005-2006 rate increase was due to the massive flow of foreign and domestic funds into the mortgage market at the tail end of the Millennium Boom, orchestrated by Wall Street.

2018’s FRM rate increase will likely continue to increase gradually in belated reaction to the increase of the short-term rate, as occurred in 2005. This will be due primarily to global stagnation and austere recessionary fiscal spending, as well as lack of inflation, kept the 10-year Treasury Note rate in check in 2017 and thus FRM rates. Investors are looking for a safe place to park their money until the global economy stabilizes.
demand. When employment is low and unemployment is correspondingly high, demand for goods and services is low, keeping consumer price inflation in check. [See Factor 7: Inflation & CPI]

In 2018, the employment rate and labor force participation rate will continue to show improvement. Thus, consumer price inflation (CPI) is expected to reach its 2% target rate soon (though it’s not there yet and commodity prices have not yet found their bottom). Thus, the Fed is getting ready to raise the short-term rate as their concern for avoiding deflation has passed.

However, the Fed won’t be fighting high inflation this time around as it was in each recovery since the Great Depression. Instead, it will be attempting to build up a spread between the short-term interest rate and the zero lower-bound rate.

The Fed needs to raise rates to restore a necessary device to its monetary policy toolbox for keeping the economy in check. With a comfortable margin in the Fed rate above zero, the Fed will be able to reduce interest rates when the next business recession occurs to once again jumpstart the economy and promote prosperity when needed.

Otherwise, when rates linger at the zero lower-bound rate, not only will the economy eventually run amok (i.e., the Millennium Boom following the aborted 2001 recession) and later crash spectacularly (i.e., the 2008 financial crisis and Great Recession), but the Fed won’t be able to lower rates to help bring the nation out of the next recession. That is, unless the economy is so crippled that national politics does not interfere with the Fed going negative on short-term rates or permits government spending to stimulate the economy until business owners and consumers regain their confidence and return to normal levels of private spending.

What happens when the Fed increases the short-term rate?

Movement in the Fed’s short-term rate directly alters adjustable rate mortgage (ARM) rates — upward in this case. Those who are affected first are the property owners who have encumbered their property with an ARM. These owners will see their monthly payments suddenly increase. In the real estate market, pricing will lose support and sales volume will begin to slip.

ARM rate movement is tied to figures in one of several indices, each directly influenced by the Fed’s short-term rate. So when the Fed raises rates, these index figures rise, and in turn ARM rates rise an equal amount.

However, the effect on fixed rate mortgages (FRMs) is harder to pin down as FRMs are only indirectly influenced by the short-term rate. For analysis, the 10-year Treasury Note (T-Note) is the most important rate to watch for FRM rate movement. [See Factor 2: Interest rates]

10-year T-Notes are purchased by investors looking for a long-term safe place to park their money. In times of protracted economic uncertainty, investors from around the world pour money into 10-year T-Notes. This increases
demand which increases the price of the notes and keeps rates on 10-year T-Notes low. Low long-term interest rates reflect a negative perception held by bond market participants about future economic performance both here and abroad.

Thus, when the Fed raises the short-term rate to bring on a routine recession needed to cool inflation in the U.S. economy, the 10-year T-Note rises around the same time as the Fed’s action to accommodate the risk of future inflation. The Fed increases the short-term rate in anticipation of economic improvement (reflected via inflation and overemployment). In turn, investors in the 10-year T-Note re-direct their investments to other more profitable sources of growth, which become more readily available in the (usual) growth experienced as the U.S. economy heads into expansion.

Thus, FRM rates typically rise along with 10-year T-Note rate — both in anticipation of increased economic activity. The Fed fights anticipated inflation and bond investors concurrently look for other investment opportunities in the expanding economy.

However, 2015 through 2017 were a very different set of facts, recalling the Depression era environment.

The global economy continues to experience great turmoil going into 2018. Greece, Spain, the U.K. and other countries are casting doubt across the Eurozone, Brazil and Russia’s gross domestic product (GDP) is declining and China’s economy is slipping ominously, pulling Japan’s and surrounding countries down with it. The United Kingdom’s damaging and ill-timed “Brexit” from the European Union throws another wrench into this chaos.

This causes 10-year T-Notes to look highly attractive to foreign investors from all nations. They believe it will be a long time before the global economy recovers sufficient to provide proper investment opportunities — maybe ten years from now or longer.

As a result, when the Fed acts to increase short-term rates in a financial environment where no other country’s central bank is in any position to mirror the rise, not only are investors likely to remain invested in 10-year T-Notes for longer than they would have otherwise, but foreign currency holders are enticed to buy ever more U.S. dollar denominated investments. After all, where else are they going to safely invest their funds until the global economies recover and start to expand? Thus, the 10-year T-Note rate is likely to remain low for several years after the Fed raises short-term rates.

Now back to California real estate. While the 10-year T-Note remains low, FRMs will likewise stay near their current levels for leveraging buyers of homes.

How long will FRM rates stay low?
FRM rates will remain relatively low for as long as it takes for the waves caused by the various global financial uncertainties to dissipate. FRM rates began to rise slightly in 2017, and this rise will continue gradually through 2018 and the years following. Further, future Fed rate moves will cause some inflationary harm to most foreign economies as the imported goods they purchase will be more costly, but help bump up their exports to the U.S. The move will strengthen the dollar against other currencies — not a good thing for U.S. exporters or Fed goals of 2% inflation.

When FRM rates rise, expect the real estate market to react with decreased:

- buyer purchasing power immediately upon the FRM rate increase;
- home sales volume immediately following the rate increase; and
- home prices within nine to twelve months after home sales volume starts to drop.

Since FRM rates will continue to increase through 2018, home sales volume will persist at a level-to-down pace, exhibiting a downward pull on home prices, which will manifest by the end of 2018.

While FRM rates rise, ARM use will not likely pick up this time in the cycle. Upward movement in short-term ARM rate indices has become a public enemy with no sign of their popularity increasing. Thus, sales volume and prices will receive little to no support from ARMs to artificially extend borrowers’ reach. The foreseeable risk of a loss of their home due to the coming decades of rising short-term interest rates will put an end to this price overheating facilitated by ARMs.

Realty Publications, Inc. previously forecasted the next housing boom of rising sales volume and pricing to occur at the end of this decade, around 2018-2020. However, the Fed rate hikes in December 2015 and the following likely delay in FRM rate movement have pushed off the next boom for another year or so, to 2019-2021. By this time, home sellers and buyers will have adjusted their behavior – pricing – to reflect the new norm of rising interest rates.

More importantly, members of the next generation of first-time homebuyers (Generation Y) will have found sufficient employment and built up enough savings to qualify them for homeownership. At the same time, their Baby Boomer parents with large equities in their homes will be retiring in earnest, selling and downsizing. In large part they will be relocating and buying in more retirement-friendly areas of suburban California, other states and points south of the border.

Together, these years will see the Great Confluence of generations affecting home sales. In turn, the housing market will see a boom in sales volume and some bubble pricing.

However, patience is needed in the meantime.
Most all Americans have found common ground via a collective disdain for Wall Street.

The U.S. mortgage lending system of regional mortgage bankers (wholesalers) and community banks did quite well before Wall Street stepped in as lender. Wall Street assumed this role through acquisition of most mortgage banking operations in the 2000s and the bundling of mortgages into pools to be sold off as mortgage-backed bonds (MBBs) to the entire world of investors.

Wall Street is not the only answer to the plight of low — and middle — class individuals with dreams of homeownership. Local depository institutions abound. A stable and long-term recovery of the real estate market requires agents to strongly encourage homebuyers to inquire beyond just one lender in search of the best home mortgage.
Factor 20: Taxation

A nation’s housing policy as tax loopholes

After reading this chapter, you will be able to:

• describe the income tax subsidies available when buying, owning and selling a home; and
• explain why the price increases brought on by 2009 housing tax subsidy were unsustainable.

Learning Objectives

Key Terms

Tax credit subsidies in action

In 2009-2010, the California legislature and Congress separately granted tax credits to those taxpayers (with a taxable income) who acquired a home to occupy. The tax credits were granted to buyers, with or without the requirement of including a purchase-assist mortgage. Tax credits effectively reduce the income tax due the government. Since most taxpayers are
employees and withholding has already delivered the employees taxes to the government, the government sends a refund to the taxpayer via tax credit treatment.

The primary purpose for the tax credits was to:

- encourage tenants to buy a home and occupy it;
- clear out unsold builder inventories and stockpiled real estate owned (REO) properties; and
- stop the overall decline in sales volume and prices of homes.

Whether these objectives were met is the subject of much argument. The subsidy, however, did work its magic for as long as it lasted, evidenced by the bump in sales volume during 2009-2010, and the drop-off in sales when the subsidy ended.

Critics of tax credit subsidies for housing point to major flaws in the programs:

- a preponderance of the homebuyers who used the tax credit were likely to have bought homes in the immediate future without the incentive of the housing tax credit, thus failing to create sales as reported;
- thousands of individuals who received the tax credit were not eligible to receive it (the first two iterations of the federal tax credit did not even require proof of the purchase of a home);
- many homebuyers lured into the homeownership market by the tax credit were simply poached from the pool of future homebuyers, i.e., the tax credit merely robbed Peter, the future-homebuyer, to pay Paul, the present-homebuyer cannibalizing future sales circa 2011;
- sales volume and prices were propped up temporarily, but both disappeared on expiration of the tax credits (and sales volume fell below 2009 levels in 2014), the unintended bridge-to-nowhere result for lack of sufficient length in a slow recovery; and
- speculators were drawn into the fray by the momentum created by the stimulus frenzy, sandwiching themselves into tax credit driven transactions as flippers by acquiring REOs, bumping the price and immediately reselling to buyers ultra-anxious to get in on a double subsidy (and distracted from paying attention to price).

In retrospect, the stimulus simply bolstered sales volume in the period from early-2009 to May 2010 at the expense of sales volume over the following 24 months to mid-2012.

Housing tax credits are useful when inducing the purchase of homes by taxpayers who are already on the cusp of purchasing. But, while properly designed as a short-term effort at clearing out unsold home inventories, the down payment subsidies of the 2009 tax credit stimulus did not organically grow homebuyers as intended. After the tenants-by-nature bought, using tax
credits as a down payment, and the tax credits ended and were no longer available to entice the next set of tenants to buy a home, there were no sufficient buyers to replace them and sales volume fell.

The tax credits merely distracted the public from the deferred, underlying first step needed to be taken before homebuyers emerged organically (read: provide jobs). Stimulus via tax credits artificially drove up sales volume and prices. However, neither held their heightened levels for lack of a further stock of qualified and willing homebuyers to follow — those with jobs, confidence and inclination to borrow and buy.

Also to be considered is the liquid wealth (down payment) required to firmly root homebuyers to the property they purchased. Down payments provide a cushion to protect a homeowner against the inevitable ups and downs of cyclical real estate prices.

This equity cushion is not supplanted by gifts of tax credits politically engineered by builders and lenders who hold unsold vacant real estate in their inventories. Taxes structured as subsidies exclusively benefit builders and REO lenders as sellers since the entire subsidy passes through to sellers, the buyer gaining little to nothing. It is arbitraged away under the circumstances of pricing.

Those individuals who euphorically jumped on the tax credit as inducement to purchase a home were merely riding high on the emotional wave of tax avoidance. They did not ride purposefully with "skin in the game" towards the huge risk and responsibility of owning, carrying payments and maintaining a home. Worse, they did not consider the fact that they were paying too much for the home.

The discovery was made two or three years later as prices declined into mid-2012 (though home prices then rose in 2013-2014 due to another type of "stimulus," this time from speculators). Worse, any sale of these subsidy acquisitions to relocate had to be delayed until three years had run from purchase to avoid losing (paying for) the tax credits they had received. The properties sold by REO lenders and builders were from leftover unsold inventory due to their less desirable locations.

Another key factor in our sought-after real estate recovery is consumer confidence. The public was not generally nurtured to support the impetus the tax credit gave to sales volume. Thus, when the program ended, others were not willing to organically come in and buy. [See Factor 8: Consumer confidence]

Prospective homebuyers are ready, willing and able to start buying homes when they:

- feel secure in their jobs, and friends and relatives have found jobs;
Housing tax credits are useful when inducing the purchase of homes by taxpayers who are already on the cusp of purchasing. But, while properly designed as a short-term effort at clearing out unsold home inventories, the down payment subsidies of the 2009 tax credit stimulus did not organically grow homebuyers as intended.

After the tenants-by-nature bought, using tax credits as a down payment, and the tax credits ended and were no longer available to entice the next set of tenants to buy a home, there were no sufficient buyers to replace them and sales volume fell.

**Definitions**

- **consumer confidence** ............................................................... pg. 325
- **subsidy** ...................................................................................... pg. 324
Brokers, lenders and builders alike contributed in their own way to the decline in homeownership following the Millennium Boom peak. The drop in California was from 60% at the 2005 peak to 53% in 2017 (and likely stuck there until the end of the decade). Now all participants are doing everything in their power to encourage and promote legislation they believe supports their financial interests (read: increased homeownership, greater turnover and corresponding profits).

The allies they claim are the housing subsidies imbedded in the tax code, known as:

- the mortgage interest tax deduction (MID) and deductions related to property tax and private mortgage insurance (PMI); and
- the principal residence profit exclusion.

Those homebuyers who pay taxes and have home mortgages up to $1,100,000 can deduct all interest they pay on those mortgages to reduce their taxable income. In turn, their income taxes are reduced, the reduction being a refund of part of the interest they paid, a percentage of the interest paid equal to their tax bracket rate at the time they file their 1040 income tax return.

Likewise, homeowners who wish to sell — terminating homeownership — can permanently exclude up to $250,000 of profit per owner from being taxed. For a homeowner, the profit on a resale is the difference between the price they receive and the price they paid for the property.
These “housing policy subsidies,” contrary to popular myth, were not enacted to induce the nation’s population to buy or own a home. However, that hasn’t stopped the home mortgage and single family residence (SFR) construction industries (and broker trade unions) from exploiting these subsidies to their financial advantage.

Consider this priced-in effect. The buyer is merely a conduit who passes on these subsidies to sellers and lenders. Most brokers and agents know that if the MID subsidies were ended the price of homes would drop. Hence, it is the seller that will no longer get the subsidy as part of the price received, and the reduced pricing memorializes the fact.

The players in the real estate industry whose earnings are dependent on sales volume describe these policies as catalysts of the American Dream. They posit these tax policies induce homeownership by making it more financially feasible through a subsidy.1

The result of these tax loopholes, however, has not been increased homeownership. Rather, they have merely encouraged and increased mortgage indebtedness (the implicit purpose of the MID) and home resales (the tax-free profit). Homeownership rates are now where they were for 20 years prior to the Millennium Boom.

To get the homeownership subsidy, homebuyers are required to finance their purchase with a mortgage — otherwise they will not pick up the subsidy to abate the price if they pay cash. Acquiring a home free and clear of debt, or when paying off a mortgage and retaining it as the family residence, triggers no tax benefits (except deductible property taxes and only if the owner is not subject to the alternative minimum tax).

As a result, homeowners often justify mortgage debt by relying on the MID refund to pay the lender interest. Thus, the homeowner is betrayed by the so-called “subsidy” these tax deductions provide.

The MID deduction influences the homebuyer to pay an increased price for their home, a benefit that is ultimately experienced by the seller. Further, the subsidy is too small for most homeowners to tangibly offset the increased costs and risks of the larger mortgage needed to finance the purchase of the property.

Interest deductions took root in the late 19th century. The first federal income tax was established in 1894 and all forms of interest were deductible. However, homeownership was not what motivated Congress to enact such a policy. An interest deduction was viewed primarily as a business situation.

Most people at that time in history paid cash for their homes (as is the case today in countries with less sophisticated financial systems). Mortgages were generally only taken out by farmers or investors.

1 Internal Revenue Code §§121; 163(h)
Not until the 1950s did the home mortgage gain anything close to its current significance. Since then, the home mortgage has become the common concern of the housing industry. Without a mortgage, most tenants wait until they accumulate savings equal to the price. The tax deductions and exclusions are now considered entitlements for those homebuyers who need to borrow and for those homeowners who sell.

The true tax benefits to the taxpayer of interest rate deductions for buying and owning a home were lost long ago. They were arbitraged away by increased home pricing and interest rates. Thus, the benefits are passed on to the seller (increased price) and the lender (interest and charges on increased principal).

The howl today by industry insiders is that prices will drop if the deductions go away: exactly the evidence that subsidies go to the seller and the lender, not the buyer/owner.

The interest deduction loophole costs the Department of Treasury over $70 billion in lost tax revenue annually, to the benefit of sellers and lenders received indirectly via the buyer. However, the majority of debt-encumbered homeowners don’t see much for it, except for the wealthier among them. Only half of the tax filers who are homeowners are able to claim the deduction. Usually, they receive less than $2,000 in reduced tax liability (the rest have no mortgages and thus no risk of loss).

More than 50% of the federal tax benefit is taken by those few homeowners with incomes exceeding $100,000. It is fair to say those wealthier homeowners have the least need for a subsidy as an inducement to buy a home, since they are financially capable and most likely to purchase anyway.

Ironically, paranoid real estate agents and brokers have long avoided giving tax advice known to them about the benefits of owning a home.

Legally, a buyer’s broker has no affirmative duty to disclose or discuss the tax aspects of the purchase of one-to-four unit residential property. This holds even if the broker or the agent knows the tax rules and their very real impact on their client homebuyer. Thus, as a matter of inculcated custom, they don’t. However, even without this discussion of known tax aspects with buyers, homes still sell.

Most all agents are instructed by their brokers to refrain from explaining the tax aspects of a transaction, all part of the unprofessional dumb agent rules. Most homebuyers are given no expectation by their agent of the extent of the offsets in tax reduction they will receive.2

Ownership of family shelter is not motivated by tax considerations. However, tax subsidies do affect pricing.

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2 Carleton v. Tortosa (1993) 14 CA4th 745; Calif. Civil Code §2079.16
For example, in high-tier homes, the loss of annual MID subsidies to offset mortgage payments would cause many wealthier buyers to reduce the amount of mortgage funding they choose to take on. In turn, the price offered to buy a high-tier home would be less, equal to the lost subsidy’s impact. This may reduce mortgage borrowing.

Tax avoidance has a meaningful financial impact on wealthier homebuyers. In this case, the sellers no longer get the pass-through benefit of the MID subsidy. The arbitrage opportunity is gone.

Low-tier housing would not see a drop in sales volume. Buyers in this segment of the housing market gain nothing from the availability of the MID subsidy. Thus, they have nothing to gain by borrowing more and passing the difference on to the seller at a higher price facilitated by the financing. These buyers pay little to no income taxes in their quest for basic shelter.

Further, sales volume would only be depressed for a few months, if at all. It usually takes around 9-12 months for sellers to fully “un-stick” their prices to adjust to the new reality of a recurring business recession. Brokers and agents would quickly mediate the transition since their business is sales, and a new equilibrium would be found. [See Factor 12: Pricing]

As the post-recession bumpy plateau recovery continues, the national economy tiptoes on the brink of unprecedented personal debt levels.

As a result, the consuming and job-holding population is shedding debt. Strategic defaults by negative equity homeowners are a natural part of the deleveraging process.

Those homebuyers who pay taxes and have home mortgages up to $1,100,000 can deduct all interest they pay on those mortgages to reduce their taxable income. In turn, their income taxes are reduced, the reduction being a refund of part of the interest they paid, a percentage of the interest paid equal to their tax bracket rate at the time they file their 1040 income tax return.

Likewise, homeowners who wish to sell — terminating homeownership — can permanently exclude up to $250,000 of profit per owner from being taxed. For a homeowner, the profit on a resale is the difference between the price they receive and the price they paid for the property.

The result of these tax loopholes, however, has not been increased homeownership. Rather, they have merely encouraged and increased mortgage indebtedness (the implicit purpose of the MID) and home resales (the tax-free profit). Homeownership rates are now where they were for 20 years prior to the Millennium Boom.

principal residence profit exclusion ..................................... pg. 327
After reading this chapter, you will be able to:

- perceive how California’s population fluctuates due to birth rates, migration and immigration;
- interpret state and national population trends over the last thirty years; and
- understand the growing appeal of urban living.

**Key Terms**

- emigration
- Individual Taxpayer Identification Number (ITIN)
- undocumented immigrant
- universal homeownership

State population growth is essential for a stable housing market. Brokers and agents who know which demographics are likely to move to and from California’s diverse counties will be best positioned to accommodate the needs of those groups when they arrive.

To that end, both state and federal governments provide extensive information about California’s changing population.
California’s rate of population growth varies wildly from year to year. However, it has always increased over time. According to the California Department of Finance (DOF), a year without growth in California is almost unheard of. [See Figure 1]

Even though California’s population continues to grow, its growth rate since 1990 has been slightly lower than that of the nation as a whole. [See Figure 2]

The average population growth rate in California during the 1990s was 1.3%. It ranged from 1.8% in 1990 to 0.7% in 1994 and 1995, the first years of a job recovery after the 1990 recession. Growth in the 1990s and 2000s was far below the glory years of the 1980s, when California’s population grew by an average annual rate of 2.4%.

The low growth rates of 1994 and 1995 appeared to be nothing more than a passing abnormality brought on by the 1990 recession and a commodity boom in the central states. However, high housing prices carried over from the real estate boom of the 1980s and the economic crisis of the 1990s combined to make the mid-1990s growth figures the new norm remaining today. [See Figure 1]

For the first decade of the new millennium, the average rate of population growth in California was 1%. The greatest increase in population occurred in 2002, the year before a recession, with a one-year growth rate of 1.37%. A similar jump took place in 1989, just before the 1990s recession, when California’s population rose by a full 3.4%.
Population estimates from the U.S. Census from 1990 to 2016 show the percent change in population for California and the nation.

While populations in California and the nation as a whole increased throughout this period, the rate of increase fluctuated and cumulatively slowed.

In 2016, the rate of population growth fell in both California and the nation. In California, the population grew at a rate of 0.66%, below the 0.81% increase in 2015. The nation's growth rate was even lower at 0.53%, down from 0.79% in 2015. The population increases in 2016 were due mostly to births and to a lesser extent immigration.

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<td>0.81%</td>
<td>0.90%</td>
</tr>
<tr>
<td>U.S. rate of population growth</td>
<td>0.53%</td>
<td>0.79%</td>
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The smallest increase took place in 2006, at the height of the Millennium Boom and the peak in home prices. Here, the population’s decelerating growth rate slipped to 0.69%, the lowest rate in over a decade.

Numerous temporary factors influence the rise and fall of California’s population, including:

- birth and death rates;
- migration;
- cultural trends; and
- environmental factors.

The most important influences on population are economic. When jobs are plentiful, people feel empowered to realize the dream of residency in the fabled cities along California’s Pacific Coast. [See Figure 1 and Figure 3]
A strong economy is an incentive for both interstate and international immigration. A weak economy, like the one produced by the Great Recession, discourages optimists and causes people to stay where they are. Indeed, a state without jobs can even lose people to more employment-opportunity environments in other states.

Historical population trends are a valuable contextualizing tool for economic recessions (marked by gray bars in Figure 1).

The recession of the early 1990s, for example, corresponded with a dramatic decrease in the rate of population growth. The year-over-year increase in state population has never since risen back to its height at the end of the 1980s, when the plentiful Baby Boomer (Boomer) population came and formed households across the state. [See Factor 14: Retirees]

However, the Great Recession of 2007 had no comparable decelerating effect on the rate of California’s population growth. In fact, California’s population
Factor 21: Population growth

has increased at a greater rate since the start of the recession than at any time since 2003. This is due to the fact the recession of 2007 was accompanied by a tremendous drop in housing prices.

This drop returned prices to their historic trend of slow but dependable long-term increases. The price drop corrected for the distorted pricing that drove the population away from California in 2000-2006, a condition in pricing that is now underway in California’s Bay Area.

Suddenly, California real estate was once again available at prices comparable to real estate in the rest of the nation. Many who had waited to move west began to migrate to take advantage of the opportunity. More will doubtless come when jobs and small business startups become more prevalent. [See Factor 12: Pricing]

**Immigration**, both documented and undocumented, is a *crucial driver of population growth* on the West Coast. This includes migration to California from other states and other nations.

The vast majority of immigrants settle in Los Angeles County. Just over 76,000 documented migrants have arrived in Los Angeles each year since 1984. Orange County, Santa Clara and San Diego are also attractive destinations: each has an annual average of over 14,000 (documented) immigrants.

The number of documented immigrants tends to fluctuate at approximately the same rate as the total population. Although the state’s birth rate and statewide *emigration* are both crucial factors influencing state population, immigration has made up an average 58% of the yearly increase in state population for the last 25 years.

**Undocumented immigrants** are legally able to buy property, borrow mortgage funds and pay property taxes by use of an *Individual Taxpayer Identification Number (ITIN)*. Undocumented immigrants are of equal importance to the state’s housing market as documented immigrants. They need shelter, and they have after-tax money for rent and mortgage payments — and a taxpayer identification number permitting them to do all these things.

California’s high rate of immigration is a largely positive economic force. The high volume of immigration continues to improve the standard of living and employment situation for California natives generally.

Aside from age, other demographic factors played a smaller role in determining mover status.

Men are slightly more likely to relocate than women according to a California Department of Finance (DOF) study. Singles are more likely to move than couples. Holders of a bachelor’s or higher degree are more likely to relocate.
than those with less education. These profiles will drive Generation Y (Gen Y) into rentals, often in urban cultural centers. [See Factor 15: First-time homebuyers]

As usual, employment is essential to a stable population. The unemployed are considerably more likely to move than the employed. The rate of relocation among the unemployed is 24%, as compared to a rate of 17% among the employed. Those with incomes of $50,000 a year or over (typically older members of the population) are significantly less likely to move than those with lower incomes. [See Factor 1: Jobs]

From March 2000 to March 2003, the DOF tracked movers’ reasons for relocating. By far the largest proportion of those who moved in this time period relocated for housing-related reasons (53%). The next two most popular motives for moving were family-related reasons (25%) and employment-related reasons (17%).

Interestingly, this did not hold true for those who came to California from another state or another country. Out-of-state immigrants overwhelmingly tended to come to California for reasons related to employment.

In collaboration with the Census, the DOF monitors and forecasts both interstate immigration and intrastate migrations. They present a clear view for brokers and builders of which parts of the state are growing or shrinking fastest.

While some county populations have remained stable over the last ten years, others have seen their populations explode. By far the most notable increase occurred in Riverside County, which gained 815,600 people between 2000 and 2015; an increase of 53%. San Bernardino County was a distant second, growing 24%. Other notable increases took place in Los Angeles, Sacramento, San Diego and Orange Counties. [See Factor 25: Regional housing indicators]

The enormous popularity of Riverside County during the last decade is easily explained. For much of the last decade, housing prices in Riverside county grew at a steady rate (one which forecasters erroneously predicted would last forever) while still remaining far more affordable than the coastal cities of nearby Los Angeles, Anaheim/Santa Ana and San Diego.

It is to be noted that Riverside’s population boom was not without its disadvantages. The county did see new prosperity and expansion in the years leading up to 2007. However, it was also ravaged by some of the worst job losses, unemployment and negative equity problems produced by the Great Recession and financial crisis.

Areas which saw less dramatic growth, like San Francisco and parts of Los Angeles, suffered far less and recovered more quickly than Riverside.
Instead of a continuation of the suburban lifestyle, an increase in centralized urban populations is most likely. This is especially reflected by a boom in rental property and condo sales in urban centers. Urban locations offer access to a world of social and cultural activities which are unavailable in strip-malled suburbia.

More importantly, the 2008 recession exposed the folly of the U.S. government’s former policy of universal homeownership. New buyers will be far more likely to think twice before they invest their life’s savings subordinated to the risk of a long-term mortgage, in spite of the allure of mortgage interest deductions. [See Factor 5: Renting: the alternative to homeownership]

The shift to rentals, and to cities, will only be accelerated by the impending retirement of California’s most powerful demographic: the aging Boomers. Upon retirement, Boomers will sell their homes and move to new locations, often closer to the coast.

The Boomers are overwhelmingly a generation of homeowners. Most will continue to be in the future, regardless of where they relocate. The majority of them will remain in their current communities.

Others, however, will rent in more convenient locations or move in with family members. The first-time homebuyers Gen Y will be less numerous and less eager to buy homes (much less in suburbia) than their Boomer parents.

As the west’s largest city, Los Angeles will undoubtedly remain the population center for the foreseeable future. Los Angeles is forecast to have a population of 11.2 million by 2020, and will exceed 13 million by 2050.

For comparison, the DOF predicts California’s second and third largest counties in 2050 to be Riverside and San Diego, both with anticipated populations of just over 4 million. Orange County is predicted to fall behind. It has already shown signs of being hindered by its governmental and private restrictions on land use, development opportunities being dominated by a very few individuals.

Although nothing is certain when predicting the future, one thing does seem highly probable: California will continue to grow and to flourish. DOF forecasts expect the entire population of California to increase by approximately five million people every decade through 2050. Further, some forward-looking cities will double in size as they alter land use and height restrictions. Such zoning allows for population density to increase per square mile, and with it, commerce and culture.

While an increased population will pose new challenges in water management, energy and housing sectors, it will also be a source of new talent and new opportunities. No other state in the nation has the wealth, resources, geography, entrepreneurial spirit and innovative history that enable California to maintain its distinctive appeal to the rest of the nation, let alone the world.
State population growth is essential for a stable housing market. Brokers and agents who know which demographics are likely to move to and from California’s diverse counties will be best positioned to accommodate the needs of those groups when they arrive.

The most important influences on population are economic. When jobs are plentiful, people feel empowered to realize the dream of residency in the fabled cities along California’s Pacific Coast. A strong economy is an incentive for both interstate and international immigration. A weak economy, like the one produced by the Great Recession, discourages optimists and causes people to stay where they are. Indeed, a state without jobs can even lose people to more employment-opportunity environments in other states.

emigration ....................................................................................pg. 335
Individual Taxpayer Identification Number (ITIN) ........ pg. 335
undocumented immigration .................................................. pg. 335
universal homeownership .................................................. pg. 337
Migration and California’s housing market

After reading this chapter, you will be able to:

• understand the benefits of international migration for California’s housing market; and
• see why so many Californians choose to leave for other states.

California! A pleasant climate, giant sequoias, mountains, beaches, wind and solar farms, a thriving technology industry in the north and money-producing entertainment industry in the south all make the Golden State a great place to live.

So why are so many people leaving California for other states?

In 2016, 109,000 more individuals moved out of California than moved in from other states. 109,000 individuals is hardly a mass exodus in the context of California’s staggering 38+ million population. However, 2016 continued the negative migration trend experienced since the beginning of the 2000s. During California’s 2006 domestic migration trough, nearly 300,000 more individuals left the state than entered from other states.

Reasons why individuals might leave California for other parts of the country include:

• a high cost of living (including high home prices);
• higher state income tax rates;
• one of the highest sales tax rates; and
• a still-struggling jobs recovery.

Further, California’s foreclosure crisis was one of the worst in the nation. Many foreclosed homeowners who broke free of the bonds of negative equity chaining them to this state left to pursue employment opportunities elsewhere. So where did California’s domestic migrants go?
Texas was number one for domestic migration in 2013, netting 114,000 migrants from other states. What does Texas have that we don’t? Some major draws include:

- a low cost of living (including low home prices, contributing to a homeownership rate nine percentage points higher than California’s);
- no income tax; and
- a strong economy (stemming primarily from the oil and gas industry)

There is some good news. You’ll have to look a bit further beyond our national borders to find it.

Editor’s note — Even when migration to California was at its trough, the state’s population continued to rise (although at a slower pace than did the nation’s population growth.) This is due to more net births than deaths.

California usually receives more international immigrants than any other state. More than one in four California residents were born abroad — twice that of the U.S. average. (See Figure 4)
Approximately 2.6 million of California’s immigrant population are undocumented. Across much of the country, undocumented immigrants are unable to become homeowners. However, this is not the case in California.

To purchase a home and take out a mortgage, an undocumented immigrant need only obtain an Individual Tax Identification Number (ITIN). Still, fear of deportation and the need to be mobile to follow jobs (particularly for agricultural workers) has caused homeownership rates among undocumented immigrants to remain a low 17%.

As immigration reform progresses, a greater number of undocumented immigrants will become documented and seek out agents to buy a home. Likewise, the rate of homeownership among undocumented immigrants will likely grow from 17% to 28-34%, closer to the homeownership rate of documented immigrants, according to the National Association of Hispanic Real Estate Professionals (NAHREP).

California’s beautiful climate, cultural and educational resources, and diverse business environment will continue to lure new residents from around the world, particularly as the jobs recovery heats up.

Brokers and agents can benefit from California’s large international immigrant population by embracing the concept. Strategies include:

• learning the language of your area’s most populous immigrant community (Spanish, Mandarin, etc.) to become competitive; and
• becoming versed in the couple extra steps it takes for our 2.6 million undocumented immigrants to purchase homes.

Even the domestic migration out of California presents an opportunity. Agents can earn income from domestic migrants by joining a referral network to assist clients both leaving and entering the state to relocate. When you refer a buyer to an out-of-state agent, you receive income paid as a percentage of the other agent’s fee, and vice-versa.

Another way to make the most of California migration is to become a relocation agent. Many companies, including the larger franchises, offer relocation services throughout the country. Or, you can reach out to businesses on your own and offer your services to help employees relocate into and out of your area.

California will continue to lure the better skilled and educated, the talented and wealthier residents from around the world. Preparing to work with these newcomers will allow agents to excel in California, no matter the swing of migration.
California usually receives more international immigrants than any other state. More than one in four California residents were born abroad — twice that of the U.S. average.

Brokers and agents can benefit from California’s large international immigrant population by embracing the concept. Strategies include:

- learning the language of your area’s most populous immigrant community (Spanish, Mandarin, etc.) to become competitive; and
- becoming versed in the couple extra steps it takes for our 2.6 million undocumented immigrants to purchase homes.
Immigration’s impact on the housing market

After reading this chapter, you will be able to:

- understand how the immigrant population will contribute to California’s real estate recovery; and
- perceive how California’s immigrant population will not take jobs from U.S.-born workers.

The California real estate market continues to recreate itself as jobs make a comeback. As it does so, brokers and agents will be forced to break out of the mold of long-held misconceptions and practices.

Among other things, the new real estate paradigm requires a rigorous forward-looking examination of the past beliefs held about immigrant employment in California. This immigrant labor force will affect the future of the real estate industry, both in terms of construction employment and as a high-level demographic driving rental occupancy and homeownership, all needed to continue our real estate recovery.

Despite misleading arguments to the contrary, immigrant labor increases both the long-term rate of employment and income for native-born workers, according to a study by the Federal Reserve Bank of San Francisco (the Fed). The result is due to the different types of jobs taken by the two types of workers.

The less-educated, less English-proficient sector of immigrant workers typically work in the personal service and agriculture industries. They perform manual labor jobs with minimum pay. In contrast, the less-educated native-born workers are typically more English-proficient than their immigrant counterparts. They tend to specialize in jobs requiring greater communication skills, such as those found in customer service and retail sectors that pay more than manual labor jobs.

Thus, the less educated natives and immigrants among us do not compete with one another based on their immigrant- versus native-born status.
The split between types of jobs does not restrict itself to less-educated workers. More-educated native-born workers tend to be managers, teachers and nurses, occupations requiring better communication skills. More-educated immigrant workers tend to work as engineers, scientists and doctors.

The two types of workers exist in two separate spheres of labor. These spheres are not in competition with one another. Rather, they support and contribute to each other’s growth. They are complimentary.

Having a readily-available labor base is a good thing for California. Over time, the increased labor force, supplied primarily through the influx of immigrants, allows businesses to increase production. And they are able to do so without crowding out the native-born population from employment.

In turn, business expansion creates additional communication-based job opportunities (i.e., management or supervisory positions). Job growth in the private sector is the result, which is much needed in California to continue the recovery’s momentum.

Greater productivity in employment translates to more money in the California economy to buy things, pay rent and acquire real estate ownership. Both immigrant and native-born workers contribute to the economy by using this money on consumer goods and services. This further fuels growth in business production and in turn employment. These activities are all part of a virtuous cycle gaining a foothold in California’s economy following the Great Recession of 2008.

Consider also the positive effects of the nature of individuals who come to California to improve their economic and social situations. They are risk-takers, exactly what a growth economy needs to continue growing. The entrepreneurial spirit which led them to California is the same spirit that fosters innovation and new businesses. Many of these new businesses created during recessions grow to employ thousands, a result most other national economies are not structured to nurture or simply do not permit.

Adult immigrants create an immediate demand for housing when they arrive in California (as opposed to the increase in native-born population — through births — which need to grow into their role). This is the case whether they are immigrants from other states or other countries, with or without documents. Either way, they are all new consumers of California housing and goods.

However, the complex process of buying a home is especially daunting to members of immigrant communities who do not understand written English. Thus, they are often vulnerable to the deceitful phenomenon of asymmetry of information due to their inability to understand first-hand what they are contracting to do, except as told by industry representatives, the brokers, agents and builders as the gatekeepers to rentals and ownership.
The new real estate paradigm requires a rigorous forward-looking examination of the past beliefs held about immigrant employment in California. This immigrant labor force will affect the future of the real estate industry, both in terms of construction employment and as a high-level demographic driving rental occupancy and homeownership, all needed to continue our real estate recovery.

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**Chapter 21.3**

**Summary**

Editor's note — California legislation has made some progress in bridging this gap in information. Mortgage agreements for mortgages are now required to be translated into the language in which negotiations were completed.
Chapter 21.4

Population growth exceeds new housing; rents rapidly rise

After reading this chapter, you will be able to:
• identify the source of the rent crisis as population growth rises faster than cities permit residential construction starts; and
• examine the various solutions to the challenge of rents rising far beyond a suitable percentage of wages for growth in living standards.

New residents outpaced residential construction in all of California’s largest counties during 2016. For every 1,000 individuals arriving in the county from the end of 2015 to the end of 2016 (including children—but not including new births), there were:

- 71 new units built in Los Angeles County;
- 83 new units built in Orange County;
- 81 new units built in Riverside County;
- 67 new units built in San Diego County;
- 75 new units built in San Francisco County; and
- 49 new units built in Santa Clara County.

These figures show there isn’t enough new residential construction to accommodate new residents. The situation is even more extreme when you shrink down the area from the county level to these areas’ highly urbanized city centers, as originally reported by listing aggregate Zillow.

Population growth is always a good thing for the real estate market, as everyone needs shelter, whether rented or owned. Granted, not every single individual new to an area needs a new place to live. About 40% (give or take depending on the area) of each county’s residents are under 18 and thus don’t require additional housing units.

However, even after accounting for this reduction, new adults moving to the area still outpace new units being built. Just below three people make up the
average household in California. Thus, we need between 125,000 and 135,000 new units annually for the foreseeable future, apartments or SFRs, to meet the housing needs of population growth.

Where population growth outstrips new residential construction, these areas experience a correlating drop in residential vacancies. In 2016, the vacancy rate in California residential property was:

- 1.1% for property occupied by homeowners (including those sold to a homebuyer and awaiting occupancy and unsold, vacant homes not for lease); and
- 3.6% for rental properties. [See Factor 11: Inventory]

For historical comparison, 1.2% is about average for California homeowner vacancies. These vacancies rose during the overbuilding years of the Millennium Boom and dropped during the following recession to today’s level.

However, the rental vacancy rate is well below average. This indicates new residents in California are primarily seeking rental properties, not ownership. This is of course the prudent choice for new transplants. They are better off getting to know the area and ensuring the move is permanent before buying. However, when rental vacancies fall below average, the price of rents naturally rises.

Thus, new residential construction will undoubtedly be concentrated in the multi-family sector over the next few years. Builders build to meet demand, if permitted, and it’s clearly present in the newcomers choosing to rent. However, builders are held back by obstacles designed to keep people away, including:

- outdated zoning regulations, which continues to limit multi-family construction in the most desirable (mainly urban) areas; and
- tight access to credit, as lenders find safer places to park their reserves than the still recovering construction and housing industries. [See Factor 10: Construction]

All the same, expect multi-family construction to increase — albeit gradually — in 2018, then increase rapidly in the following years through 2021. The next Great Confluence of buyers is likely to occur during 2019-2021, when members of Generation Y and Baby Boomers are expected to hit the homebuying market in earnest. Then, multi-family construction will pick up in earnest.

Until multi-family construction catches up to the increased demand brought on by constant population growth, expect rents to remain high as new residents push demand for rentals. SFR sales are adversely affected by rising rents as excessive rent makes it difficult for renters to save up to become homebuyers. Thus, today’s cash-strapped renters will reflect tomorrow’s stunted homeownership rate.
In fact, California has the third highest rental housing wage in the nation (right after Hawaii and the District of Columbia). This means an hourly worker needs to make $26.65 per hour to qualify for an average two-bedroom apartment at 30% of their monthly income — the suitable share of income for sustaining the standard of living Californians have experienced in the past.

California’s average renter earns a lot less than $26 per hour.

Starting at the bottom, at California’s 2017 minimum wage of $10.50 per hour, a minimum-wage worker has to work:

- 168 hours a week to qualify for a two-bedroom apartment at 30% of their income (that’s four full-time minimum-wage jobs); and
- 138 hours a week to qualify for a one-bedroom apartment at 30% of their income (that’s three and a half full-time minimum-wage jobs).

The average-wage renter earns $18.96 per hour, twice more than the minimum wage but still well below the $26.65 rental housing wage. For this average-wage renter, they need to work:

- 56 hours a week to qualify for a two-bedroom at 30% of their income (that’s 1.4 full-time average-wage jobs); and
- 52 hours a week to qualify for a one-bedroom at 30% of their income (1.3 full-time average-wage jobs).

But California is a pretty big state with varying income levels and housing costs across its regions. The rental housing wage is broken down further in Figure 10. [See Figure 5]

The San Jose metro area actually has the best renter’s market in California based on the housing wage criteria. The average hourly wage in San Jose is basically equal to the rental housing wage ratio of 30%. Thus, an individual renter in San Jose can on average qualify for a two-bedroom apartment without the need for a roommate. In contrast, Santa Cruz-Watsonville has one of the worst renter markets in the state, since the average hourly wage is less than half the rental housing wage. There, it takes 2.5 average hourly wage earners to qualify for a two-bedroom.

All this being said, simply raising the minimum wage won’t solve California’s rent crisis. Increasing the minimum wage across the board has its own drawbacks as well as do excessive rent payments, from reducing business profits due to higher wages and thus possibly pushing out large businesses that find cheaper labor (due to lower rents) in other states. A better way to address the wage-rent imbalance is on a local scale.

Regions with higher costs of living need to have higher minimum wages. This will bring up the average wage in areas where rents are well out of reach for service workers. This treatment will reduce government subsidies for housing, food and health services which low paid employees are entitled to when the wages they are paid keep them below the poverty level.
A good way to do this is by following the local consumer price index (CPI), which reflects increases in goods and services in that area’s economy.

It’s universally common for salaried employees to receive annual increases to at least account for the dollar’s lost purchasing power due to inflation, so why shouldn’t hourly employees receive the same consideration? [See Factor 7: Inflation & CPI]

In fact, landlords have already caught on to this idea, as long-term nonresidential leases are often adjusted annually based on CPI. This rent inflation provision keeps the landlord’s purchase power from dropping due to consumer inflation. However, when demand outstrips supply — as is occurring in today’s rental climate — the price of rents rises more quickly than CPI, and thus more quickly than wages.

*Los Angeles’ minimum wage is set to increase annually to $15.00/hour by 2020.

The housing wage is set by the National Low Income Housing Coalition and represents the hourly wage needed to qualify for an average two-bedroom rental housing payment at 30% of a renter’s monthly income.
There isn’t enough new residential construction to accommodate new residents.

Where population growth outstrips new residential construction, these areas experience a correlating drop in residential vacancies. The rental vacancy rate is well below average. This indicates new residents in California are primarily seeking rental properties, not ownership.

Until multi-family construction catches up to the increased demand brought on by constant population growth, expect rents to remain high as new residents push demand for rentals. Rising rents make it difficult for renters to save up to become homebuyers. Thus, today’s cash-strapped renters will reflect tomorrow’s stunted homeownership rate.

Simply raising the minimum wage won’t solve California’s rent crisis. Increasing the minimum wage across the board has its own drawbacks as well as do excessive rent payments, from reducing business profits due to higher wages and thus possibly pushing out large businesses that find cheaper labor (due to lower rents) in other states. A better way to address the wage-rent imbalance is on a local scale.

To really get at the underlying economic resolution for high rental rates in a population, local policy makers — planning commissions and councils — need to loosen up zoning restrictions on multi-family construction. This allows builders to meet the increased demand from renters, cooling down overheated rents and keeping businesses from moving to cities where their employees can afford the rents. If permitted by city governments, excess rental rates bring on the competition from builders supplying more units.
Chapter 22.1

The distribution of California’s human resources

After reading this chapter, you will be able to:

• interpret information on education, income and age in California’s largest counties; and
• understand how brokers and agents can use localized data to perfect their expertise in real estate transactions.

Your success as a real estate broker and agent depends upon your ability to develop expertise in a specific type of real estate service and cater to a specific type of clientele. A master of all trades is soon discovered and just as quickly rejected by prospective clients.
This clientele may consist of older homeowners looking to relocate to a comfortable retirement. Or it may be made up of first-time homebuyers. Perhaps you cater to young business people or investors looking for commercial space.

The brokers and agents most likely to succeed are those most intimately familiar with the nature of both their clientele and locally-available real estate of their liking.

To guide proactive brokers and agents in their selection of clients, extensive demographic information is routinely released by the U.S. Census Bureau. By reviewing this information, you will learn the real estate related profile and attributes of your marketing area’s population. Armed with this data, you can anticipate future population-driven real estate sales, leasing and lending trends.

As the real estate recovery matures, once-proud suburban regions are falling behind urban areas, which have recovered jobs and incomes more quickly. In their place, formerly shunned cities will benefit from an increase in population density, personal wealth and new construction.

In the first decade of the 21st century, Riverside County’s population grew faster and in larger numbers than any other county in the state. Other areas also grew, like Los Angeles County, but registered slightly slower rates of growth which are likely to continue for the long term. [See Factor 25: Regional housing indicators]

Broad trends in population change are merely the tip of the agent knowledge iceberg. To cater to the local real estate needs of clients, brokers within each locale need to anticipate client needs even before they are addressed by the client.

Such agent foresight requires specific local data about demographic attributes. The most relevant of these statistics are those relating to income, age and education as shown on the figures accompanying this Economic Factor.

Figure 1 and Figure 2 present demographic information in the five most populous counties in Southern California and Northern California. It is accompanied with data for the state as a whole. Income numbers are not adjusted for inflation.

Together, these figures present the ten most populated counties statewide. California has become better educated, older and wealthier since 2000, and that impacts real estate pricing and needs. [See Figure 1 and 2]
Keep in mind, however, that the slight, nominal increase in personal wealth is largely attributable to inflation, not the real (post-inflation) income growth needed to improve one’s standard of living.

These data sets present the idiosyncratic elements that make each county’s population unique. While all of California’s counties have had population changes in recent years, and each continues to transform even now, progress as change has not been consistent from county to county.

Different age groups, educational tiers and income classes have different real estate needs. Homebuyers and sellers in separate communities often pay remarkably different levels of brokerage fees per transaction for substantially the same service and talent. Here again, it is location that burnishes the difference. Much of this hangs on the price-fixing influence of each area’s trade association steering industry-wide fee arrangements.

Also, the work done by the real estate agent to market and sell a low-tier suburban home to a first-time homebuyer is often more challenging mentally than the work undertaken by a commercial property sales agent. This condition exists even though it tends to pay dramatically less. Consider the property investigations and disclosures made, or not made, in each the residential and commercial fields. They are different, though both require the same level of disclosures for agency and property conditions.
Inspections and observations reported are the mantra of the single family residences (SFR) sales. Not so for commercial, where the user generally needs to beware of the brokerage environment of non-facts, pro forma guesswork and asymmetrical behavior.

The brokers who have the most success are those who specialize in a type of service most demanded by the local population.

For instance, San Bernardino’s general lack of college education and high-skilled individuals, widespread low income and a younger population, is certain to lead to greater demand for rentals and low-priced SFRs. Thus, brokers and agents need to be more efficient and learn to handle more transactions annually than agents located in coastal counties to attain the same earnings. In contrast, compare these conditions to the old and wealthy populations of Contra Costa or Orange counties and other coastal communities.

The contrasts are often even starker from city to city, as between Palos Verdes and Bakersfield, or Monterey and Stockton, or La Jolla and El Cajon. It is instructional for the reader to note each community’s relationship to the coast.

Census data also provides a picture of a county’s likely future development. During the 2000s, Orange County’s per capita income rose 33%, and its median age grew 9% older: the greatest rise in age of any of the ten counties displayed. [See Figure 1]
The homebuyer’s ability to pay rent or to buy, maintain the property and pay a mortgage is the crucial factor determining the property they live in.

**Per capita income** measures the average income per person in a population center. It also sets the average amount of money spent by members of the community — the main thrust of rentals and sales activity.

While income figures fail to show how accumulated wealth is spread across a local population, per capita income is a valuable measure of a community’s financial ability to pay the price to rent or to own one or another tier of property.

Thus, personal income and its rate of change moves the price point paid for property or rent within a given area. Combined with trends in local employment data, it is possible to extrapolate the likely price that segments of the local population will pay to buy or rent within a community.

For brokers and agents, personal wealth within a population determines both the type of client and the type of property they buy and own.

Real estate brokers and agents in most of the Bay Area or Orange County will need to dress for success and do thorough research if they want to impress the highly-educated white-collar professionals who live in their areas.

Those who live in the Central Valley or Inland Empire may have found home sales activity painfully lethargic in recent years, unless they temporarily turned to working with lenders on real estate owned properties (REOs) and owners-in-foreclosure short sales. For those years, conventional sales (homes with equity) were the exception. [See Factor 4: Home equity]

On the other hand, these same lower-income communities were the sites of the most vigorous development in the boom years. They thus retain that potential for explosive (and unsustainable) growth when the economic recovery begins once again; when housing in the valleys look great compared to pricing in the coastal areas. More turnover, more activity, more fees and the need for more agent efficiency.
Chapter 22.1
Summary

To guide proactive brokers and agents in their selection of clients, extensive demographic information is routinely released by the U.S. Census Bureau. By reviewing this information, you will learn the real estate related profile and attributes of your marketing area’s population. Armed with this data, you can anticipate future population-driven real estate sales, leasing and lending trends.

Different age groups, educational tiers and income classes have different real estate needs. Homebuyers and sellers in separate communities often pay remarkably different levels of brokerage fees per transaction for substantially the same service and talent.

Chapter 22.1
Definition

per capita income ........................................................................................................ pg. 354
After reading this chapter, you will be able to:

- apply age and education data to create a portrait of the real estate market; and
- study demographics to predict California’s diverse real estate markets and forthcoming trends.

**Key Terms**

**first-time homebuyer**  
A buyer of a home who has not previously owned their shelter. Typically aged 25-34.

**median age**  
The midway point between the older half of a population and the younger half.

Homebuyers may purchase a house at any time throughout their lives. However, certain age groups are more likely than others to buy and sell their homes.

Young adults aged 25-34 tend to become dissatisfied with renting. With little encouragement, they will purchase their first single family residence (SFR). This demographic is known as first-time homebuyers. [See Factor 15: First-time homebuyers.]

On the opposite end of the age spectrum, the newly-retired can be depended on to sell their oversized homes and buy a replacement home, often in a new location. Rarely do they forego ownership and begin renting. The newly-retired often relocate to areas along the coast to enjoy better weather, or closer to large urban areas in proximity to their professionally-employed Generation Y (Gen Y) children. [See Factor 14: Retirees]

While there is no hard distinction between “youthful” and “elderly” communities in California, some useful generalizations can be made.

As Figure 3 demonstrates, California’s median age is rising. The **median age** is over three years older in 2016 than it was in 2000. Some communities have grown more exclusive and less dense, and less appealing to young career-seekers, such as Orange County, and thus have aged faster than others.

Others, especially the counties of NorCal, have not significantly aged but remain older on average, a greater mixing and sharing of experience and wisdom and less balkanization. This is likely due to higher housing prices, a mature and specialized workforce and lower immigration numbers. [See Figure 3]
ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.

**Figure 3**

### Southern California Median Age

<table>
<thead>
<tr>
<th></th>
<th>Los Angeles</th>
<th>San Bernardino</th>
<th>Riverside</th>
<th>Orange</th>
<th>San Diego</th>
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</table>

Data courtesy of the U.S. Census

### Northern California Median Age

<table>
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<th>Sacramento</th>
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</tbody>
</table>
Editor’s note – Figure 3 through Figure 5 track age and education levels in 2000 and 2016 for the five largest counties in Southern California (SoCal) and Northern California (NorCal), as well as the state as a whole. Together, these figures present the ten most populated counties statewide.

The most dramatic changes have taken place throughout Southern California. Los Angeles and Orange County both aged faster than the state average. [See Figure 3]

This may be due to the boom in housing prices which drove out less established young homebuyers. While the young exited, successful older citizens with their accumulated wealth and smaller households were drawn in to buy a home. As prices drop and some of the youth are able to return, the recent age increase may level out.

San Diego was also influenced by this boom, but aged slightly less. This is perhaps due to its many universities, its proximity to the border (and thus to generally younger immigrants), its association with the military and generally more liberalized residential zoning allowing more multifamily density.

Brokers and agents in counties seeing expansive growth in the elderly population, like Orange County, need to prepare for a sort of calcification in their demographic.

The young population has concentrated itself in California’s Inland Empire. In the Inland Empire, low cost-housing is accessible within driving distance of major cities and the careers they offer.

Population growth in these inland counties was also fueled by international immigration from Mexico. Much of it was undocumented, but it directly added to the population of homeowners and renters. The influence of immigration has a much less direct effect on most of Northern California.

The counties of Northern California have aged more uniformly, generally keeping pace with the state as a whole. Orange County residents who want a glimpse of their future may look at Contra Costa County, which, at nearly 40 years of age, retains the highest median ages in the state.

Accompanying this population are high home values, strong employment in careers that cater to the elderly (especially in the field of medicine) and a low number of rentals.

An aging population equates to a different kind of home sales activity. Retirees very frequently remove their wealth from the stock market, called dis-saving. As they do, they relocate to a smaller, more comfortable home.
**Southern California Percent of Population with a High School Diploma**

<table>
<thead>
<tr>
<th></th>
<th>Los Angeles</th>
<th>San Bernardino</th>
<th>Riverside</th>
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<th>San Diego</th>
</tr>
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<tbody>
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<td>69.9%</td>
<td>74.2%</td>
<td>75%</td>
<td>79.5%</td>
<td>82.6%</td>
</tr>
<tr>
<td>2016</td>
<td>78.3%</td>
<td>78.7%</td>
<td>81.1%</td>
<td>84.9%</td>
<td>86.4%</td>
</tr>
</tbody>
</table>

**Northern California Percent of Population with a High School Diploma**

<table>
<thead>
<tr>
<th></th>
<th>Santa Clara</th>
<th>Alameda</th>
<th>Sacramento</th>
<th>Contra Costa</th>
<th>Fresno</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>83.4%</td>
<td>82.4%</td>
<td>83.3%</td>
<td>86.9%</td>
<td>67.5%</td>
</tr>
<tr>
<td>2016</td>
<td>87.2%</td>
<td>87.7%</td>
<td>86.4%</td>
<td>89.3%</td>
<td>74.7%</td>
</tr>
</tbody>
</table>
upon their retirement. This home may be in a different part of the state, but approximately 40% find a more convenient and central location within their own community.

Brokers in Orange County and most of NorCal need to work to prepare for these buyers and sellers looking to enjoy their golden years. [See Factor 14: Retirees]

NorCal’s exceptions were the less wealthy counties of Sacramento and Fresno. There, low home prices and available jobs in untrained positions served to keep the population young. The population in these counties, like that of Riverside and San Bernardino, lacked the accumulated wealth and home equity necessary to remain homeowners during the financial crisis and Great Recession of 2008. They rent for the most part.

More highly-educated populations tend to seek out higher-paying white-collar jobs. These jobs are most available in higher-density population centers, i.e., city centers. They also have a tendency to be more liberal in their civic concerns and more conscious of personal consumption, health and environmental issues. They satisfy these dispositions best by buying or renting in California’s urban centers. [See Figure 4 and 5]

Coastal areas in Northern California tend to be the most educated communities. This is due to:

- the high density of colleges and universities in those areas;
- the desirable technology jobs that make up local economies; and
- the general access to personal and business amenities. [See Figure 5]

Not surprisingly, these wealthier counties have a relatively old population compared to the state average. [See Figure 3]

These well-educated, well-employed and generally wealthier communities are among California’s most privileged. They are dominated by those who have used their education over a long period of time to work their way toward the top of their occupations.

On the opposite end of the spectrum are the state’s least educated counties, in which a high proportion of the population has neither a four-year college degree nor a high school diploma. [See Figure 4 and 5]

Although education reform in the last two decades has made great strides in high school retention rates, numerous students still fail to complete high school in these counties. The communities in which they live, and the real estate they occupy, are far different from the well-educated coastal cities. [See Figure 4]
Figure 5

Southern California Percent of Population with a BA/BS Degree

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles</td>
<td>24.9%</td>
<td>31.5%</td>
</tr>
<tr>
<td>San Bernardino</td>
<td>15.9%</td>
<td>20%</td>
</tr>
<tr>
<td>Riverside</td>
<td>16.6%</td>
<td>21.8%</td>
</tr>
<tr>
<td>Orange</td>
<td>30.8%</td>
<td>40%</td>
</tr>
<tr>
<td>San Diego</td>
<td>29.5%</td>
<td>37.4%</td>
</tr>
</tbody>
</table>

Northern California Percent of Population with a BA/BS Degree

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Santa Clara</td>
<td>40.5%</td>
<td>51%</td>
</tr>
<tr>
<td>Alameda</td>
<td>34.9%</td>
<td>45.4%</td>
</tr>
<tr>
<td>Sacramento</td>
<td>24.8%</td>
<td>29.8%</td>
</tr>
<tr>
<td>Contra Costa</td>
<td>35%</td>
<td>41.5%</td>
</tr>
<tr>
<td>Fresno</td>
<td>17.5%</td>
<td>20.2%</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realltypublications.com/charts for the most recent chart data.
In times of economic stagnation like we’re currently recovering from, renters by choice are augmented by renters by necessity. This segment of the population consists of those for whom traditional SFR ownership is no longer an economically feasible option.

With data presented in Figures 3-5, you might be tempted to make generalizations about California areas.

Remember, there are young people in Orange County, wealthy people in Fresno, and extremely well-educated people in the Inland Empire. Averages do not mislead, they focus attention on the core of the community.

Nonetheless, the real estate brokers with agents who develop a broad base of clients are those who most need to be familiar with the typical demands of tenants and buyers in their specific community.

Likewise, Figures 3-5 indicate some clear winners and losers in the competition to develop a stable and potentially productive population.

Contra Costa, for example, is among the nation’s best-educated and wealthiest populations. This fact is reflected in its 71% rate of homeownership between 2005 and 2009 and its 64% homeownership rate in 2016, over ten percentage points higher than the state average. Santa Clara also seems to have found a working formula for success. These counties can be expected to similarly do well in the future, thanks to the support of the aging Boomer population and its accumulated wealth.

In contrast, Riverside, San Bernardino and Fresno have remained unable to support widespread employment, education or housing. This lack of stability is rooted in a lack of reliable income, which has only now begun to recover.

Until employment catches up with population growth in California, the central valley (especially Fresno) and the Inland Empire will remain the most challenging homebuying environments in the state. Statewide, employment is expected to catch up around 2019.

Recovery for these inland valleys will be difficult. It will likely require a fundamental restructuring of the housing expectations of residents. The high-priced suburban model has proven, at least in these counties, to be an unsustainable and dangerous way to build a community.
Homebuyers may purchase a house at any time throughout their lives. However, certain age groups are more likely than others to buy and sell their homes.

Young adults aged 25-34 tend to become dissatisfied with renting. With little encouragement, they will purchase their first single family residence (SFR). This demographic is known as first-time homebuyers.

On the opposite end of the age spectrum, the newly-retired can be depended on to sell their oversized homes and buy a replacement home, often in a new location. Rarely do they forego ownership and begin renting.

**first-time homebuyer** ................................................................. pg. 357
**median age** .................................................................................. pg. 357
**renters by necessity** ................................................................. pg. 363
Factor 23: Regulation

Preventing the next real estate bubble

After reading this chapter, you will be able to:

• identify how the Federal Reserve (the Fed) can “lean on” the next asset bubble to prevent it from bursting;
• understand why the Fed’s “clean-up” policy was economically insufficient to alone stem the damage of the 2008 recession; and
• explain the new lending regulations formulated under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Learning Objectives

Key Terms

Consumer Financial Protection Bureau (CFPB)
Dodd-Frank Wall Street Reform and Consumer Protection Act
mortgage-backed bond (MBB)
qualified residential mortgage (QRM)
Harness market momentum excitement

The Federal Reserve (the Fed) uses monetary policy to preemptively quash consumer inflation booms. [See Factor: Monetary policy]

However, the Fed’s past policy for asset inflation booms has been to take “clean up” measures only after the bubbles have burst and recessions have begun.

The prevailing paradigm dominating the Fed’s use of monetary policy fails to take advantage of the Fed’s ability to “lean on” an economic bubble when it rises. It can do this and mitigate the ill effects of that bubble imploding and doing greater harm.

The Fed has scarcely ever stepped in to adjust monetary policy prior to a bubble’s implosion. This is particularly noticeable during the past 25 years, as each bubble and trough period became more expansive.

During the massive over-extension of mortgage credit during the 2000’s housing boom, the Fed did little to moderate the excess mortgage money in the market. In fact, the Fed did just the opposite both as policy and politics.

Easy money

In the years leading up to the 2007 financial crisis, the Fed refused to adjust monetary policy to prevent a bubble from growing unwieldy. Instead, the Fed lowered interest rates and injected more money into the market. Similar stimulative actions were taken whenever outside pressures threatened financial market stability and job growth.

Editor’s note — For a recent example, see the Fed’s handling of the dot-com bust, the tragedy of September 11, 2001 and the stock market bust.

No one complained during the easy money years. Those profiting from the flush conditions could hardly be relied upon to call an end to the party, such as speculators, lenders and builders.

Wall Street wunderkinds making money on volatile mortgage-backed bonds (MBBs) weren’t going to blow the whistle either. Rating agencies fully collaborated, adding a final layer to the Ponzi system, upgrading the junk MBBs into AAA investment portfolios. These investment portfolios were then made available for worldwide consumption.

What was the federal government doing during all this economic hedonism?

At the time, it could not have been more excited about the increase in homeownership, peaking close to 70% nationally. The Fed was golden. Its no-lean paradigm was vindicated — but only for the moment.

In 2007, the bubble officially imploded. Millions of homeowners with adjustable rate mortgages (ARMs) began to default en masse. The implosion sent disruptive waves across the U.S. and global financial markets. It also exposed the hidden depths of the varnished Wall Street MBB market.
Most federal fiscal stimulus investment during the 2008 recession and recovery was slow to take hold. It was also inadequate to do the job of keeping the nation’s workers employed by half.

What meager progress has since been made remains overshadowed by the enormity of the task involved to complete job creation. Job growth in California exceeded the December 2007 peak of 15.6 million jobs in mid-2014. However, during the jobs recovery, California’s working-age population increased by 1.2 million. Worse, wages were slow to rise even to match consumer inflation levels across California, finally catching up to 2008 incomes in 2012.

Labor force participation (LFP) has remained low throughout the recovery and even into the economic expansion taking place going into 2018. This low LFP rate is due to the failure to create the jobs needed to compensate for California’s population growth since the 2007 jobs peak. Thus, Realty Publications, Inc. anticipates the state will likely hit the target for a full jobs recovery in 2019. [See Factor 1: Jobs]

With each lurch in an economic cycle, the effects of the Fed’s boom-time policy missteps accumulate. These mistakes will likely result in deeper and longer downturns in the immediate future than we have experienced during the past 25 years. If our best efforts at jump-starting the economy have resulted in our current feeble recovery, what will happen when the next bubble forms, as it will?

Will the Fed use monetary policy prospectively and lean against a bubble to deflate it before it implodes and causes avoidable damage? Or will our central bankers rely on their monetary policy to merely clean up an imploded business bubble?  

Under the clean up monetary policy, asset bubbles in the credit cycle are left to grow unhindered. Once the bubbles implode, the Fed simply eases monetary policy by reducing short-term interest rates and passively allowing the private recovery of jobs and spending to recharge. Proponents of a limited clean-up policy argue this process has worked in past business recessions, and it ought to continue working into the future.

The clean-up policy did work in past Fed-induced business recessions prior to 2006. However, this is no ironclad guarantee that it will work in the future. It did not work for the Great Recession of 2008.

Increased globalization, securitization and leveraging of assets have fundamentally changed the function of our economy. It is a different animal than the one the clean-up policy was intended to keep in check. Further, the 2008 recession was compounded by the devastation left by the concurrent 2007 financial crisis, still correcting today.

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1 William R. White, Should Monetary Policy ‘Lean or Clean’?
Further, during prior recessions, the Fed exclusively used its ability to drop interest rates to stimulate the economy. In order to restore this tool to fight future recessions, the Fed has begun adding upward pressure to interest rates by increasing their key Federal Funds rate. [See Factor 7: Inflation & CPI]

The “lean on” argument to limit the growth of an asset bubble suggests it is time to consider a new monetary policy paradigm. Under the lean on argument, the Fed inhibits the growth of an asset-pricing bubble acting slowly as it occurs. This action is taken as opposed to allowing the bubble to implode, and then finally coming to the rescue and picking up the pieces.

The Fed is capable of determining whether a recession is taking place and reacts to that condition by lowering interest rates. It can just as easily determine a bubble (usually an equal and opposite situation from a recession) is taking place and correct it as well. Its job is to stabilize the economy with the proper flow of money, limit consumer inflation and create jobs.

Applied to real estate, a leaning monetary policy does not set a ceiling on the growth of housing prices. Instead, access to easy mortgage credit is tightened to prevent price increases unsupported by the rate of consumer inflation and any increase in demographic demands for housing.

The Fed let the real estate bubble of 2005 naturally implode in response to a recession it induced beginning mid-2004. The Fed, seeing the impending disaster, could have leaned against the bubble as part of their planning a recession. They did not.

Federal agencies can preempt an implosion of the housing market and ease its fallout from speculation by:

- raising interest rates that affect mortgages, not rates that affect consumer rates;
- raising the minimum down payment requirement on purchase-assist mortgages with the Federal Housing Administration’s (FHA’s) assistance; and
- forbidding the use of home equity lines of credit (HELOCs) for consumer purposes, depriving owners of the ability to pull all the equity out of their homes ATM-style without selling the property.

These steps do not legislate a cap on the price of homes or control ownership. Instead, they reel in the amount of irresponsible lending available in the pool of mortgage funds.

This the Fed can control, evidenced by their massive purchase of mortgage-backed securities beginning in 2007 and tapering off in 2017 to keep the home market from falling further.
This leaning policy would have slowed, if not stopped, the unsupported rapid acceleration of real estate prices in 2004 and 2005. The leaning policy would have resulted in less mess for the Fed to clean up and for the nation’s taxpayers and homeowners among them to bankroll.

The Fed’s biggest hurdles to a leaning monetary policy are the unpopularity of moderation and rhetoric of populist polls in a rising market. As seen in the events leading up to 2007’s financial fallout, those gatekeepers of the economy failed in their duty to protect not only consumers, but their own source of long-term revenue as well, for the immediate good.

Even as regulators tout the economic recovery, the public needs to learn about and understand monetary policy. This is especially true for agents and brokers, whose livelihoods are so dependent on a stable and enduring real estate market. Only then can we protect the hard-won and dearly-priced expansion to follow through the end of this decade.

Lending regulation is necessary if the housing market is to be stable in the future and society is to be shielded from the improper conduct of Big Banks. Without lending restrictions, the housing market remains a volatile and risky playground that is far too dangerous for regular homeowners seeking shelter. For evidence, look no further than the lax and short-sighted lending habits that catalyzed the recent 2000’s crisis.

In the aftermath of the financial crisis, numerous new regulations were formulated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) to control excesses in lending, specifically consumer mortgage lending.

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), and placed the CFPB in charge of implementing and regulating all consumer protection rules, including:

- the Truth in Lending Act (TILA)’s Regulation Z (Reg Z);
- the Real Estate Settlement Procedures Act (RESPA)’s Regulation X (Reg X); and
- the appraisal rules in the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which is regulated by other entities with guidance from the CFPB.

Many on Wall Street (and in Congress) used lobbyists to resist the changes mandated by Dodd-Frank. [See Factor 18: Politics]

Dodd-Frank established numerous new mortgage regulations, the most critical being:

- minimum standards for consumer mortgages;
- integrated consumer mortgage disclosures;

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2 15 United States Code §§1601 et seq.; 12 CFR
• loan originator compensation rules; and
• more stringent servicing rules

When a mortgage on origination is not classified as a qualified residential mortgage (QRM), the new mortgage regulations collectively place tighter parameters on a lender’s ability to originate the mortgage. Dodd-Frank strictly defines a QRM as a Real Estate Settlement Procedures Act (RESPA)-controlled mortgage (for personal purposes, not investment/business/agriculture-related). Further, the mortgage cannot be a Section 32, high-cost RESPA mortgage typical of equity mortgages and private money consumer mortgages.

The legislation also prevents brokers and agents who originate consumer mortgages, endorsed as mortgage loan originators (MLOs), from being unduly compensated through:

• yield spread premiums (YSPs); or
• kickbacks.

This removes the financial incentive for MLOs to originate mortgages homebuyers can’t afford to repay.

The long-awaited QRM rules were finalized at the end of 2014 by the six federal agencies charged with implementing Dodd-Frank. They took effect on February 23, 2015.

The rules align with the qualified mortgage (QM) rules published in 2013. To qualify as a QRM, the mortgage needs to meet the following standards:

• have regular, roughly equal periodic payments;
• not allow for negative amortization, interest-only or final/balloon payment features;
• have a term of 30 years or less;
• provide for total points and fees not to exceed 3% of the mortgage amount;
• when underwriting the loan, the lender is to take into account the monthly payment for any mortgage-related obligations using the maximum interest rate that may apply during the first five years after the first regular periodic payment is due;
• consideration and verification of the consumer’s income and assets; and
• a total back-end debt-to-income (DTI) ratio that does not exceed 43%.

Any changes made by the CFPB to the QM definition are automatically applied to the QRM.

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12 Code of Federal Regulations 1026.43(e)(2)
For their “skin in the game,” when lenders originate residential mortgages which do not meet QRM rules they must retain at least 5% of the non-qualified mortgages they sell on the secondary mortgage market.

The agencies are scheduled to review the QRM definition again in 2018.

A critical component of the QRM was expected to include a mandatory 20% down payment for low interest rate residential mortgages. However, in the final draft of the rule, this 20% down payment requirement was removed. Homebuyers will, in effect, have less skin in the game, at least until 2018 when the CFPB again reviews the rules.

Excluding a down payment requirement is a big miss for the QRM and buyers and sellers. The federal agencies charged with implementing Dodd-Frank reason a 20% down payment requirement currently restricts mortgage access for low- and moderate-income homebuyers, but it doesn’t. However, any down payment below 20% requires the added expense of private mortgage insurance (PMI). The premium on PMI inflates the borrower’s overall borrowing costs by 20% to 25% monthly, and significantly reduces the amount they can borrow and the price they can pay for a home.

However, it appears the agencies’ approach was to qualify as many mortgages as QRMs today, rather than actually making any improvements in the mortgage market. Or, in their words, their aim was “reducing regulatory burden” for the lenders who want government guarantees on all of their consumer mortgage originations.

In fact, more mortgages will now be originated due to the extended government guarantees, a steep price for taxpayers. With less than 20% down payments, mortgage principal amounts will be reduced due to PMI premiums, since they produce:

- increased monthly mortgage payments by 20% to 25% to cover the risk of increased defaults; and
- reduced maximum prices buyers can pay sellers to acquire property.

Imposing a down payment requirement is sure to decrease mortgage originations initially. But expectations that buying a home requires accumulation of savings will produce both savings programs and a more stable housing market over the long-term cycles of boom and bust. In the end, those who are going to buy still buy — they just have to wait until their savings are sufficient to do so, if they intend to avoid the impact of PMI/MIP being added to interest.

Homeowners with larger down payments automatically have more invested in homeownership — more skin in the game so to speak. This economic interest in the property deters them from walking away whenever home values take a turn for the worse, as they cyclically do.
Chapter 23.1
Summary

In the years leading up to the 2007 financial crisis, the Federal Reserve (the Fed) refused to adjust monetary policy to prevent a bubble from growing unwieldy. Instead, the Fed lowered interest rates and injected more money into the market. Similar stimulative actions were taken whenever outside pressures threatened financial market stability and job growth.

The “lean on” argument to limit the growth of an asset bubble suggests it is time to consider a new monetary policy paradigm. Under the lean on argument, the Fed inhibits the growth of an asset-pricing bubble acting slowly as it occurs. This action is taken as opposed to allowing the bubble to implode, and then finally coming to the rescue and picking up the pieces.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) established numerous new mortgage regulations, the most critical being:

- minimum standards for consumer mortgages;
- integrated consumer mortgage disclosures;
- loan originator compensation rules; and
- more stringent servicing rules.

Credit report oversight

Additionally, the CFPB has begun supervising large credit reporting companies. In the CFPB’s sights are big game like Experian Information Solutions Inc., Equifax Inc. and TransUnion, not to mention 27 other large credit reporting companies. Together, these credit reporting companies comprise 94% of the market’s annual receipts.

There is substantial reason to implement such vast oversight. A good credit score is crucial to obtain a mortgage on the best terms available. Most home purchases traverse through the credit portal, so an error or improper formulation of a reported credit score can be disastrous. The consumer is impacted first, then the broader economy.

The CFPB scrutinizes the nation’s largest credit reporting agencies to ensure consumers’ credit scores are reported accurately. The oversight is intended to prevent improper road blocks from arising on the path to prudent borrowing. It is also designed to help borrowers get the correct interest rate which truly reflects their propensity to repay debt as agreed.

The purpose of these changes is to protect mortgage borrowers, not mortgage and transaction providers.
Additionally, the Consumer Financial Protection Bureau (CFPB) has begun supervising large credit reporting companies.

<table>
<thead>
<tr>
<th>Term</th>
<th>Page</th>
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<tbody>
<tr>
<td>Consumer Financial Protection Bureau (CFPB)</td>
<td>370</td>
</tr>
<tr>
<td>Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
<td>369</td>
</tr>
<tr>
<td>mortgage-backed bond (MBB)</td>
<td>366</td>
</tr>
<tr>
<td>qualified residential mortgage (QRM)</td>
<td>370</td>
</tr>
</tbody>
</table>
Factor 24: Energy consumption

Energy efficiency 101: for California real estate agents

After reading this chapter, you will be able to:

• understand the basics of energy efficiency in homes, including: lighting, doors and windows, insulation, appliances, whole house fans, and solar panels; and
• persuasively educate buyers on energy efficient property features.

Learning Objectives

Key Terms

building envelope energy audit energy efficiency home energy score

Being green isn’t just about being trendy. Going green also means saving on long-term property operating expenses. Savings translates to a lower chance of default on the mortgage. Homeowners with energy efficiency improvements are up to 33% less likely to default on their mortgage, according to a study by the University of North Carolina.
More importantly, nine out of ten homebuyers say they prefer to purchase a home with built-in energy efficient improvements, even if the purchase price is two-to-three percent higher than a home lacking these improvements, according to the National Association of Home Builders. The prospect of a comparatively low utility bill makes spending more on the purchase price attractive for prudent homebuyers, like finding a lower interest rate for the mortgage.

So what constitutes “going green”? Going green means using building materials, appliances or methods which are:

- environmentally friendly;
- responsibly or locally sourced;
- recycled; or
- renewable.

Unless they’re wealthy or extremely energy conscientious, homebuyers are interested in how green improvements save them money. Watch your labels, here: “green” doesn’t always mean long-term savings.

Some green improvements are driven primarily by social intentions, and end up costing quite a lot. To reap the financial benefits of going green, green improvements need to be energy efficient. Energy efficiency aims to reduce the amount of energy used by the homebuyer, cutting down their energy costs.

The goal is to match up the savings on utility cost reductions with the cost of the improvements. So it’s important for an agent to differentiate between a purely “green” improvement and a truly energy-efficient one. With that understood, your personal object is to learn the ins-and-outs of energy-efficient improvements:

- how to make them; and
- how much they will cost (and save) your homebuyer clients.

First, start with an energy audit, formally known in California as a Home Energy Rating System (HERS) audit. It is prepared by a HERS auditor. Your seller or your homebuyer can order an energy audit of the property like ordering a home inspection report. The audit report is then included in the home marketing package by the seller’s agent and if not, the audit is made part of a prudent buyer’s due diligence investigation (which then leads to renegotiations of the price).

A HERS audit pinpoints existing energy-efficient improvements, and lists the home’s features in need of energy-efficient improvements. HERS auditors also give each home audited a HERS score based on the home’s energy saving capacity.
An official **home energy score** set by the HERS audit gives a seller who has made energy-efficient improvements a meaningful way to toot their energy-efficient horn to justify higher pricing. [See RPI Form 150, §11.h]

On the other hand, for homebuyers contemplating the purchase of a home lacking energy-inefficiency attributes, the audit becomes ammunition for setting the purchase price in line with the cost of energy improvements or long-term operating costs of an energy-inefficient house.

The six common energy-efficient improvements are:

1. efficient lighting;
2. sealing around doors and windows;
3. wall and ceiling insulation;
4. energy efficient appliances and venting;
5. whole house fans; and
6. solar panels.

The easiest low-cost way a homeowner can save money is by trashing energy-sucking incandescent light bulbs and upgrading to **light emitting diode (LED) light bulbs**. LED light bulbs last up to 25 times longer than incandescent bulbs, and consume 3-30% of the energy incandescent bulbs consume. Also, they don’t give off heat like other bulbs do, in turn reducing the cost of energy consuming air conditioning.

Lighting costs can also be reduced by installing dimmers in place of traditional light switches (although not all LED bulbs work with dimmers – make sure your homeowner checks). A homeowner can do a self-install for the cost of the dimmer ($20-$50).

Sealing the home’s **building envelope** (doors, windows, foundation, roof and walls) can dramatically reduce the costs of cooling and heating the home. Sealing materials include caulk, weather-stripping and expandable spray-foam.

The areas around doors and windows are the most obvious spots to check for sufficient sealing. An energy audit exposes the not-so-obvious spots. For example, the auditor will perform a blower door test to discover any leaks. The homeowner can do seal leaks themselves for the cost of the sealing materials, or have a professional do it.

The cost to seal a home ranges from $300 for a do-it-yourself project to $2,000 for a professional job. The savings average 20% of the annual heating and cooling costs along with 10% of the home’s total energy costs, according to the Environmental Protection Agency (EPA).
3. Insulation

Adding more insulation will, in most cases, reduce the energy bill. An energy audit will also identify where more insulation needs to be added.

A quick way for your homeowner to find out whether they have insulation in a particular area is to turn off the power and unscrew an electrical outlet. They’ll be able to see clearly whether or not there is insulation present (though a flashlight might help).

4. Appliances

More costly energy fix is to replace old appliances with new, energy-efficient appliances. These come branded with the EnergyStar label of approval. Appliances to consider upgrading include:

- refrigerator / freezers;
- washer / dryers;
- air conditioners;
- water heaters;
- computers;
- televisions; and
- dishwashers.

The EPA determines the qualifications required for appliances to earn the EnergyStar label. When the appliance costs more than a similar energy-inefficient appliance, the owner will recover the additional cost through the energy savings accrued by the EnergyStar appliance (within a reasonable time period).

5. Whole house fans

Whole house fans are on their way to becoming as commonplace as microwaves in California homes. Chances are you’re already familiar with this equipment.

The fan (usually installed in an attic) pulls cool air from outside through the interior of the home at night, pre-cooling the home for the hotter daytime hours. This augments the homeowner’s air conditioning system, reducing cooling costs on average 50%-90% a year.

The cost to purchase and install a whole house fan varies from $300-$1,500. The investment will usually begin paying off in less than two years.

6. Solar panels

Solar energy is very quickly making its mark on California’s landscape. However, the cost of solar panels can be prohibitive for individual homeowners. The average cost to purchase and install solar panels on a California residence is $34,800. That amounts to 15-20 years of use before the investment is recaptured and it begins to pay off.

Large commercial businesses are more likely to have the cash to install solar improvements. Lancaster, California recently became the first city in the world to vow to produce more energy (harnessed with solar panels) than it uses each day. The city is expected to save over $7 million in energy costs over the next 15 years.
Solar operators provide solar leases, which offer homeowners (as well as businesses and governments) the ability to receive electricity generated by solar panels owned by the operator. This option allows homeowners to benefit from solar energy without actually making a cash investment. The homeowner then pays the operator a reduced, set rate for the electricity they use for the length of the contract, which is typically 20 years.

Los Angeles customers of the Department of Water and Power (DWP) have the opportunity to sell back excess solar energy (which is what a solar operator does since they own the panels) to defray energy costs, known as a feed-in-tariff (FiT) program. Under the program, the DWP pays customers (the solar operator) 17 cents per kilowatt hour of solar energy delivered to the grid from the panels on the property (1 kilowatt hour can power a 100-watt incandescent light bulb for 10 hours).

Homeowners need to have large rooftops to participate. These types of property can include:

- multi-family properties;
- warehouses;
- school buildings; and
- parking structures.

For homeowners who wish to directly own their solar panels, government-sponsored rebate or financing programs are available. See GoSolar’s website at gosolarcalifornia.ca.gov for additional information.

Editor’s note — Solar leasing has its drawbacks. In fact, signing a solar lease clouds title and has unpriced buy-out options which have the potential to derail a sale down the line. To avoid these complications:

- ask the solar leasing company about the requirements for a solar lease assumption by a homebuyer before leasing the equipment;
- do the math, figure out if the monthly savings are worth the complications on an eventual sale; and
- if you decide to go with a solar lease, always disclose the solar lease to all potential homebuyers upfront to eliminate the risk of is becoming an issue affecting the sales price before closing.
Homeowners with energy efficiency improvements are up to 33% less likely to default on their mortgage, according to a study by the University of North Carolina. More importantly, nine out of ten homebuyers say they prefer to purchase a home with built-in energy efficient improvements, even if the purchase price is two-to-three percent higher than a home lacking these improvements, according to the National Association of Home Builders.

A Home Energy Rating System (HERS) audit pinpoints existing energy-efficient improvements, and lists the home’s features in need of energy-efficient improvements. HERS auditors also give each home audited a HERS score based on the home’s energy saving capacity.

Some common energy efficient improvements include installing:

- efficient lighting;
- sealing around doors and windows;
- proper insulation;
- energy efficient appliances;
- whole house fans; and
- solar systems.

Building envelope ........................................................................ pg. 377
Energy audit ..................................................................................... pg. 376
Energy efficiency ........................................................................ pg. 376
Home energy score ........................................................................ pg. 377
A property’s energy demands: an evolving factor in marketing

After reading this chapter, you will be able to:

• calculate the financial consequences of a property’s energy consumption;
• recognize why energy efficiency will increasingly affect the pricing of a home;
• understand how to quantify savings on operating costs for an energy efficient home; and
• implement strategies for marketing an energy efficient home.

Buyers and sellers of real estate are fast becoming aware that a household is a heavy consumer of electricity, gas and other fuel sources.

Utility bills have in the past been given and are still given the silent treatment by agents, yet every seller knows well the amounts paid. Utility expenses are a significant cost factor incurred to carry the operating expense of owning a home.

More than just the daily management of turning off unused lights or running the sprinklers fewer times a week, the way a home is built has a drastic impact on how much energy it consumes, and thus the size of utility bills.

The existence and cost of utilities consumed by a home are material facts a prospective buyer needs sufficient information about to consider homeownership, and one home over another. It might just engender negotiations, or send the prospective buyer away, which is why the utility costs are material and are disclosed.

Most owners do not presently realize the actual structure of a home has a positive or negative impact on the monthly cost of their energy consumption. However, buyers are becoming more aware of these impacts and sellers will feel the effect of energy efficiencies on the pricing of their home.
Living a “green” lifestyle is a concept now permeating the American psyche for more reasons than a reduction in utility bills. Public policy, social media and evolving general environmental culture all encourage individuals to make eco-friendly lifestyle choices.

The need for renewable resources has become mainstream thinking for reasons of science, not implicit beliefs, and this creates an enduring demand for efficient homes. The idea of renewables also plays a significant role in the training of real estate agents and education of homebuyers. The visionaries advocating environmental sustainability — builders and brokers — are looking at a shift in buyer decision making as a nod toward their demand for energy efficient new and used home in the future.

In today’s post-Millennium-Boom culture, homeowners are receptive to living more efficiently. Cutting living costs, deleveraging out of debt and building up savings have become acceptable family financial planning solutions following the Great Recession.

However, in their quest many owners and buyers are not aware of the government programs sponsoring and subsidizing energy efficiency to encourage smarter consumption. Forward looking brokers and agents will do a bit of professional homework and inform their buyers and sellers about the subsidies and grants available to renovate a home to improve its energy rating.

To put the concept to work, the federal government has developed Home Energy Score programs designed to:

- encourage homeowners to make their homes more energy-conscious; and
- motivate homebuyers to buy homes in locations and with improvements that consume less energy.

The federal home energy score is a rating assigned to each home by an energy specialist. Using this rating system, buyers can determine how much energy the home and its occupants expend due to its current physical condition and location in a community.

Homes with a high energy score require the expenditure of a large amount of energy brought on in part by the need to commute to work or convenient amenities. Conversely, homes with low scores are more energy efficient and better located for access to schools, services and jobs. For homeowners and sellers, the specialist will suggest changes to the structure to improve the score.

Builders also are motivated to construct homes with the home energy score in mind. They will be better able to compete with multiple listing service (MLS) resale agents. Agents do need to advise sellers to consider spending money on renovations if they are to drop their energy score to compete with new home sales.
Presently, very few homebuyers are advised by their agent to consider the energy efficiency of a home when deciding to purchase one. Energy disclosures are material aspects of a home since energy consumption data affects decisions about the carrying costs of owning one property or another.

All agents have a duty owed to prospective buyers to disclose known and knowable utility costs and energy efficiency data on a home before a price is set for a purchase. Operating costs are conditions of the property in the sales transaction they are negotiating.

A forward-thinking MLS agent will see these coming shifts in disclosures of property data and consumer thinking as an opportunity to label themselves as an expert in energy-efficient homeownership.

Buyers are motivated to purchase energy-efficient homes for two reasons. The first, and easiest to quantify, is the savings on operating costs.

Second, the social motivation present in energy efficiency (mostly in high-tier communities) gives a homeowner green bragging rights. Since most home sales involve mid- and low-tier housing, we will focus on the operating cost motivation in decision making.

When installing any home improvement, the homeowner needs to ask themselves: why am I doing this? In other words:

- Is this improvement going to increase their use and enjoyment of their residence now?; and
- Is the improvement going to increase the value of their home when they sell?

The vast majority of energy-efficient improvements will increase the home’s value to some extent, while also allowing the homeowner to save money on utility costs over several years. However, there are some notable exceptions.

First, leasing solar panels can prove tricky when the homeowner decides to sell. Most solar operators that provide solar leases are eager to transfer their service (but not ownership of the equipment) over to the buyer of a home subject to the existing lease. (More accurately, the solar company is leasing the roof area to place their electrical generating equipment so they can sell to the local utility the surplus electricity not used by the homeowner.)

But what if the homebuyer doesn’t want any part of a solar lease obligation and its encumbrance on title? There are several options, but – as experience has taught many agents – solar lease encumbrances can prove to be an obstacle when trying to close a deal.

Second, any energy-efficient improvements that are owned and part of the real estate (not a solar lease situation) need to be installed for a number of months or years before the homeowner’s investment will begin paying off.
The inverse is also true: if an energy-saving improvement is owned and has been installed for too long, it becomes outdated and obsolete. It can actually lower the value of the home.

Thus, timing and the ownership of the solar equipment is significant.

When your seller client has made energy efficient improvements (unless they fall under the exceptions listed just above) then you are in luck. Green homes are in high demand.

However, you need to let potential buyers know about the energy-saving improvements through your marketing efforts. To best do this, ask your seller to authorize you to order an energy audit. Then advertise this green condition when marketing the property to locate a buyer. Provide it to prospective homebuyers at an open house when negotiations begin – on their further inquiry into the property as a prospective buyer.

When your seller refuses to order a full energy audit, ask for cost-of-utilities information. With the data, prepare a cost-comparison sheet so buyers can compare the utility cost of your seller’s energy-efficient home with a similar energy-inefficient home down the block. Circle the monthly savings to bring it to the attention of potential buyers as justification for paying a higher purchase price. Prospective buyers who think green will be more likely pay top dollar. [See RPI Form 150, §11.h]

When given the opportunity to list a home with energy-efficient features, proper marketing is helpful to more effectively locate a buyer who is willing to pay the listed price for the property. Curiosity also stimulates the mines of those buyers not up to speed on efficient homes to inquire further. On learning, they will likely be more interested as energy efficiency has to do with money.

Seller’s agents need to demonstrate how the listed home stands out over other homes on the market. Essentially, how is the home uniquely different from the pack of other homes for sale in the area? The home’s neighborhood is pivotal, as every home in a neighborhood is going to trend toward an average price per square foot.

The marketing task of the seller’s agent is to communicate to potential buyers that the energy-efficient home is actually a better deal than comparable homes lacking energy efficiency. To best accomplish this, a cost analysis worksheet is prepared, itemizing data on the seller’s monthly operating expenses a buyer will likely experience as owner of the property.

Buying a home for most families is an emotional event. However, cost data on a worksheet speaks louder than feelings. Buyers who are well-informed about the conditions of a property by the seller’s agent feel comfortable that they are getting the most for their money. [See Figure 1]
Communicate the savings to potential buyers by comparing the operating costs of an energy-efficient home with that non-energy-efficient home down the street. This will show the buyer exactly how much they will save in ownership costs each month. An alert agent will further demonstrate the long-term savings the buyer will receive over the years. [See RPI Form 306]

An operating cost sheet, together with a comparable market analysis presentation, demonstrates a more expensive house with the right energy features pays off in savings over the long run. [See RPI Form 318]

A little effort is required of the seller’s agent and the seller to gather the utility cost data on the listed property. With the help of the utility company, an agent can determine the monthly energy savings for energy upgrades. Presently, much effort working with other agents is required to get them to release the utility costs incurred by comparable properties on the market which do not have energy-efficient improvements.

The seller’s agent needs to encourage the seller to give them authorization to order out a home energy audit from a Home Energy Rater certified by the Department of Energy.

Check out the fees charged by home energy raters. Be prepared to show the seller how they can help you assemble a comprehensive marketing package on the property.

The goal of the seller’s agent is to make the home buying process simple. Often, seller’s agents throw up their hands when dealing with inquiries from...
buyers and buyer’s agents, saying, “It’s not standard practice for the seller’s agent to get you this information.” That buyer is heading out the door and down the street. They will find another house offered by an agent who has done their homework – more buyer-friendly – and has the information in printed form to hand to them.

Further, first-time Generation Y (Gen Y) homebuyers will certainly look for an agent who knows every option available. One who will provide them with an informed, clearly stated opinion about operating costs. [See Factor 15: First-time homebuyers]

But what if the listed home is anything but energy-efficient – complete with minimal insulation, behemoth water heater and drafty windows?

You may have seen the TV show: a buyer visits multiple run-down listings with an agent and contractor in tow. The contractor informs the buyer how much improvements would cost, and what can be improved within their budget.

However, most buyers cannot afford to hire a contractor to accompany them to each house they’re interested in. Further, seller’s agents typically fail to invest time researching their listed property’s energy efficiency and buyer’s agents are not in a position to do so beyond asking for the information.

Seller’s agents of properties with built up deferred maintenance to be eliminated need to understand that they have legwork to do. By working with a contractor to find out how much it will cost to install energy-efficient improvements, the seller’s agent takes the guesswork about the property out of the equation for buyers and their agents – work done on behalf of the seller, the client.

The cost of energy-efficient improvements offers a higher rate of return than other, more cosmetic improvements. Thus, buyers can feel comfortable about installing suggested improvements.

*Editor’s note — In California, solar panels owned and operated by the homeowner create on average a 97% return on investment through an increase in property value after accounting for federal and state subsidies. This is in addition to the actual energy costs saved each month.*
The existence and cost of utilities consumed by a home are material facts a prospective buyer needs sufficient information about to consider homeownership, and one home over another. It might just engender negotiations, or send the prospective buyer away, which is why the utility costs are material and are disclosed.

The vast majority of energy-efficient improvements will increase the home’s value to some extent, while also allowing the homeowner to save money on utility costs over several years.

When your seller client has made energy efficient improvements you are in luck. Green homes are in high demand. However, you need to let potential buyers know about the energy-saving improvements through your marketing efforts.

The cost of energy-efficient improvements offers a higher rate of return than other, more cosmetic improvements. Thus, buyers can feel comfortable about installing suggested improvements.
Los Angeles County housing indicators

After reading this chapter, you will be able to:

• understand where Los Angeles stands on the path to economic expansion in its recovery from the Great Recession; and
• identify when the Los Angeles housing market is likely to experience a complete housing recovery, and what is needed get there.

Los Angeles County home sales volume in 2017 started out the year level with 2016 but weakened by mid-year, indicating a gradual downward slope for the remainder of 2017 into 2018. [See Figure 1]

In recent years, 2014 saw the lowest home sales volume, ending the year 7% below 2013 — a decrease experienced across the state. However, LA home sales volume increased in 2015, finishing out the year 11% higher than 2014, just above 2013. 2016 ended 1% below 2015, essentially level. Statewide, 2016 sales volume was also essentially level with 2015.
Looking back, after home sales volume plummeted during the Great Recession of 2008, volume rose briefly from mid-2009 to mid-2010 due primarily to the housing tax credit stimulus and a naturally recurring “dead-cat” bounce brought on by speculation at the end of every recession.

Sales volume fell back in 2011 for lack of end user homebuyers and a retreat in speculator acquisitions. Home sales volume picked up in 2012-2013 due to the return of heavy speculator activity. During this period, speculators burned through LA housing inventory, particularly in low-tier home sales.

At the same time, demand in the form of end users for low-tier homes subsided, driven down by very rapidly rising prices and increased mortgage rates mid-2013.

Sales volume going into 2018 feels downward pressure from rising sales prices in 2017 and the inability of incomes to keep pace. Sales volume at the end of 2016 showed a more pronounced downward trend in response to the Trump-jump rise in interest rates which dissipated during 2017. Thus, prices will dip going into 2018 before Los Angeles will see sales volume begin to pick up steam by end of 2018. [See Figure 1]

A complete recovery of around 110,000 annual home sales will likely occur in 2019-2021, as end user demand in Los Angeles County is buttressed by a Great Confluence of Baby Boomers (Boomers) and first-time buyers lured by employment opportunities combining with a legislated uptick in residential construction to produce more housing inventory.
Home sales volume depends in large part on the contributing force of turnover in homeownership and renters. The number of people moving from their residence each year is indicative of both the willingness and ability of homeowners to relocate and renters to move. Turnover rates are highest when jobs are sufficiently abundant to boost employee confidence in the economy and residential construction starts flesh out inventory to house population growth.

The most recent trough in Los Angeles’ homeowner turnover rate was during 2008, when California was at the depths of the Great Recession. The number of homeowners relocating since then has increased, due to turnover on foreclosures and short sales through the 2013 period. However, LA turnover has since slipped and remains relatively low going into 2018 with one in 16 homes selling annually. For reference, one in 12 homes sold in the peak year of 2005.

With home prices running higher and average turnover dropping in 2017, expect homeowner turnover reports to slip a little in 2018. Similarly, LA renters are motivated by the area’s exorbitant rise in rents to stay put for the time being, likely awaiting wage increases and a surge in urban-center residential construction before making a move. These conditions are not expected before 2019-2020.

Domestic and international emigrants will play a significant role in the county’s periphery housing — the suburbs.

The homeownership rate in Los Angeles County trended downward from the time the Millennium Boom ended in 2007 to its lowest point in Q3 2016 at under 45%. This low homeownership rate has since increased to 50% in Q1 2017. This is still down from 55% at the height of the Boom. The rate will likely remain low until about 2020, during the next peak in the current recovery-boom as we transition into the next business recession. [See Figure 2]

LA County’s homeownership rate has historically been lower than the state average, which was 54% in Q4 2016. LA County has a smaller share of homeowners since much of the county is urbanized, and renting is a convenience, if not a financial necessity. LA’s homeownership rate today is just above what may be considered a “normal” (pre-Millennium Boom) rate, which was 48% in 2000.

Along with the rest of the state, Los Angeles home prices skyrocketed during the Millennium Boom, then plunged to below mean price levels during the financial crisis and have been climbing out of the wreckage ever since. [See Figure 3]
Figure 2

**Turnover Rate: Los Angeles County Owners and Renters**

<table>
<thead>
<tr>
<th>Year</th>
<th>Homeowner turnover</th>
<th>Renter turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>6.7%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>6.0%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>5.7%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>LA County homeowner turnover rate</th>
<th>LA County renter turnover rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>6.7%</td>
<td>13.5%</td>
</tr>
<tr>
<td>2015</td>
<td>6.0%</td>
<td>14.7%</td>
</tr>
<tr>
<td>2014</td>
<td>5.7%</td>
<td>16.9%</td>
</tr>
</tbody>
</table>

**Los Angeles County Homeownership Rate**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>2017</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q2</td>
<td>48.3%</td>
<td></td>
</tr>
<tr>
<td>Q1</td>
<td>50.1%</td>
<td>46.5%</td>
</tr>
</tbody>
</table>
Like in other regions, there was a small bump in prices in 2009 driven by various economic stimulus programs. The increases proved unsustainable and, without the support of fundamentals, home prices dropped back fully in 2011 to the price level of early 2009.

During 2013-2014, Los Angeles saw another rapid price bump, most significant in low-tier home sales. This rapid rise fell back somewhat in the following years and home prices finished 2015 and 2016 about 6% higher than the previous years.

Prices continue to rise going into 2018, with low-tier prices 9% higher than a year earlier in Q3 2017. Mid-tier prices are 7% higher and high-tier prices are 5% higher.

The FRM rate increase that began in 2016 has decreased the amount of principal homebuyers are able to borrow while making the same sustainable mortgage payment. History has shown that prices naturally fall 9-12 months following commencement of a sustainable increase in mortgage rates. But FRM rates fell back somewhat in 2017, which has worked to offset the “Trump jump” in rates experienced at the end of 2016.

The key to long-term and stable price rises occurs when end users collectively gain access to jobs with more competitive wages. 2019 is the likely year for recovery on that front.

Multi-family construction starts have jumped significantly in Los Angeles County, far outpacing the near-flat trend in single family residential (SFR) starts. This is due to the increased demand for rental housing, evidenced by the steep rise in rents, especially in the urban city-center areas of Los Angeles County. Builders know this and lenders are catching on. [See Figure 3]

SFR starts ended 2014 one-third higher than the prior year. This increase slowed in 2015, rising just 10% over 2014. 2016 saw multi-family starts suffering, a trend experienced across most of the state. Overall, in 2016 SFR starts increased just 4% over 2015 and multi-family starts decreased 17%.

The next peak in SFR construction starts will likely occur in 2019-2021. Even then, SFR starts will not return to the mortgage-driven peak experienced during the Millennium Boom. Multi-family housing will then experience higher levels last seen in the mid-1980s, which accommodated the arrival of Baby Boomers to the housing market. This time, the need for multi-family housing will be fueled by their Gen Y children and retiring boomers.

Since homeowners and renters require employment to make housing payments (with rare exception), a full jobs recovery is key to the housing recovery. Over 4.4 million people are employed in Los Angeles County as of July 2017. This is about 450,000 more jobs than at the outset of the 2008 recession. [See Figure 4]
### Los Angeles Tiered Property Price Index: 1989-Present

<table>
<thead>
<tr>
<th></th>
<th>Low-tier annual change</th>
<th>Mid-tier annual change</th>
<th>High-tier annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>LA County home price index: Q2 2017</td>
<td>+10%</td>
<td>+7%</td>
<td>+4%</td>
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### Los Angeles County Monthly Construction Starts

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles County single family residential (SFR) starts</td>
<td>5,000</td>
<td>4,800</td>
<td>4,400</td>
</tr>
<tr>
<td>Los Angeles County multi-family starts</td>
<td>15,600</td>
<td>18,700</td>
<td>13,800</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.
Figure 4

Los Angeles County Payroll Employment

<table>
<thead>
<tr>
<th>Los Angeles County employment</th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4,407,500</td>
<td>4,345,500</td>
<td>+1.4%</td>
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</table>

Los Angeles County Employment: Construction & Real Estate Professions

<table>
<thead>
<tr>
<th>LA County construction jobs</th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>146,400</td>
<td>135,200</td>
<td>+8.3%</td>
</tr>
</tbody>
</table>

| LA County real estate jobs  | 83,400   | 82,700   | +0.8%         |

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.
Los Angeles’ jobs recovery rate has slightly trailed the statewide employment recovery in recent years and continues to slow. From July 2016 to July 2017, the number of jobs grew by a meager 1.4%. Contrast this with the statewide job growth of 2.3% over the same period of time.

In the housing industry, construction jobs took a huge hit and continue to plod along the path to recovery. Likewise, the number of employed real estate professionals has remained low throughout this recovery period. The number of real estate professionals is increasing very slowly, but will not likely rise to pre-recession levels until the next influx of buyers and renters enter the market around 2019-2021.

The average income earner in Los Angeles County earned roughly $55,600 in 2016 (the most recently reported year by the Bureau of Economic Analysis). For perspective, this figure is just slightly below the statewide per capita income.

Income per person in actual dollar amounts has only recently exceeded pre-recession levels in Los Angeles. However, when considering the inflation (loss of purchasing power) occurring during the intervening years, Angelinos’
wages and wallets still need some fattening up to regain the standard of living experienced in 2007 – around $1,500 more today is needed to cover the interim inflation to simply match income’s purchasing power in 2007.

As long as income remains diminished across most job sectors, increases in home prices and rents are limited. This is because buyers and tenants ultimately determine sales prices and rent amounts — collectively they can pay no more to buy or rent a home or apartment than their savings and income qualify them to. According to the U.S. Census, the average Los Angeles resident with a mortgage pays 51% of their income on housing expenses, as of 2015. Renters pay 52% of their income on housing costs. This high price for housing can’t be sustained at today’s incomes without a long-term drop in their standard of living and a rise in poverty and related symptoms.

Los Angeles County, hit hard by the 2008 recession, is nearing a housing recovery. Most importantly, Los Angeles finally recovered all jobs lost during the recession at the end of 2014.

Until 2015, the housing recovery had been driven primarily by investors in Los Angeles County. But expect the housing market to begin to continue showing more life from owner-occupants as employment and incomes continue to improve in 2017. The largest obstacles facing homebuyers in today’s market are home prices and interest rates, which have risen out of the reach of many, meaning competition in the low-tier is tight.
Chapter 25.2

Orange County housing indicators

After reading this chapter, you will be able to:

• understand where Orange County stands on the path of economic expansion following recovery from the Great Recession of 2008; and
• identify when the Orange County housing market is likely to experience a complete housing recovery.

Home sales volume low and rising

Home sales volume in Orange County remains weak and somewhat stuck at just over half the heights seen during the Millennium Boom. [See Figure 6]

While sales volume fluctuated in 2014 and 2015, just 700 more sales took place in 2016 than 2015, amounting to a modest increase of 1.9%. This slowdown continued in 2017, reflecting higher interest rates and an inventory shortage. Also, a sharp bounce in home pricing following the speculator interference of 2012-2014 has held sales volume back from any significant increase.

In review, 2009-2010 Orange County sales volume rose slightly with the introduction of the housing tax credit, falling back in 2011 for lack of end user demand. From the latter half of 2012 through most of 2013, speculator hyper-activity bumped sales volume artificially yet again, as it did in all of California. The speculator buying wave has since receded.

Looking forward, a complete recovery with annual sales volume of around 46,000 in Orange County will be reached only after end user demand is buttressed by labor force participation and normalized job levels, expected by 2019-2021.

Low turnover rate to continue

Without turnover, homes do not sell. The homeowner turnover rate in Orange County has remained mostly level since the end of the recession in 2009. The renter turnover rate has declined since 2010 and is at 18.5% for 2016, the most recently reported Census year.

Both homeowners and renters are demonstrating they will remain cautious about relocating until personal incomes and job security improve (which will lift their confidence).

Turnover rates are likely to rise dramatically in the convergent 2019-2021 boomlet period raising rental vacancy rates. Then, members of Generation
Y (Gen Y) will collectively rush to buy and Baby Boomers (Boomers) will retire en masse, selling and mostly buying replacement homes. International and domestic emigration into California will also play a significant role in suburban housing demand.

Orange County’s homeownership rate has fallen since its 2007 peak of 62.7%. The most recent homeownership data shows a 56.7% homeownership rate in Orange County. Statewide homeownership has historically been about two percentage points below Orange County’s. The state average was 55% at the end of 2017, thus homeownership in Orange County in 2018 will likely remain around 57%. [See Figure 7]

Expect Orange County’s homeownership rate to remain at its present low level until jobs catch up with its population increases, likely around 2019. Only then will the first-time homebuyer population gain traction.

However, don’t expect the rate of homeownership to fully return to the inflated heights seen in 2007 anytime soon. This rate was elevated by unfettered access to easy money, which mortgage regulators tamped down in 2014 with enforcement of ability-to-pay (ATR) rules to protect society from certain destabilizing types of mortgage lending. These rules limit mortgage funding to those homebuyers with the financial ability to actually repay their debts.
Orange County homeowner turnover rate  
6.7%  7.3%  6.8%

Orange County renter turnover rate  
18.5%  20.0%  20.9%

Orange County homeownership rate  
56.7%  56.6%  57.4%
Thus, the housing market won’t see a repeat of those Millennium Boom homebuyers who lacked the proper finances. Though this translates to a slightly lower homeownership rate in the near term, it fosters a more stable future housing market in Orange County and the state. The shift of Gen Y to rentals for a longer period before buying a home than in past generations also puts a cap on home sales volume.

New building permits issued for housing — displayed here as construction starts — put Orange County well on the road to recovery with roughly 12,000 total housing units started in 2016. However, a sharp decline in multi-family starts reflects a shift in types of housing units being built. [See Figure 8]

Multi-family starts in Orange County totaled 7,700 in 2016, having exceeded full recovery in 2014 at just over 6,000 starts. This upward trend in starts will face the headwinds of vacancies in the period following 2020 as Gen Y shifts from renting to owning their housing, a repeat of the late 1980s Boomer generation shift.

On the other hand, don’t expect the SFR construction recovery to occur anytime soon. The next peak in SFR construction starts will likely occur in 2019-2021 as renters shift to becoming homeowners. Even then, SFR starts are unlikely to return to the mortgage-driven numbers seen during the hyperactive Millennium Boom.
**Figure 9**

**Orange County Payroll Employment**

<table>
<thead>
<tr>
<th>Year</th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Orange County employment</td>
<td>1,585,300</td>
<td>1,574,300</td>
<td>+0.7%</td>
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</tbody>
</table>

**Orange County Employment: Construction & Real Estate Professions**

<table>
<thead>
<tr>
<th>Year</th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>104,200</td>
<td>98,000</td>
<td>+6.3%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>39,600</td>
<td>39,300</td>
<td>+0.8%</td>
</tr>
</tbody>
</table>

**ONLINE UPDATE**
Visit realltypublications.com/charts for the most recent chart data.
California regained all jobs lost at the end of 2014, but Orange County didn’t catch up until the last quarter of 2015. The number of employed individuals in Orange County has stalled below 1.6 million in July 2017, just 36,300 above the number of jobs held before the recession. However, since Orange County’s population has grown significantly since jobs previously peaked in 2006, the real recovery is still further down the line. [See Figure 9]

As seen in Figure 9, job additions have been one-third slower to come about during this recovery compared to the 2000s recovery, and at half the pace of the 1990s recovery, echoing the secular stagnation of the 1930s. When will all of these jobs catch up with Orange County’s continuously growing population?

When Orange County does catch up, likely in 2019, the housing market will finally find real steam in Orange County as end users will then have the financial support of jobs. One obstacle facing home sales volume will be the mitigating effect of increased mortgage rates in reaction to increases in bond market rates, likely in 2017. Thus, multi-family starts will continue to surge, ending in the 2020 period as tenants increasingly shift out of rentals into homeownership.

The number of individuals employed in the real estate and construction industries fell during the recession, beginning to show mixed improvement in 2012. While the number of real estate professionals is now level with pre-recession levels, construction workers are still well below their Millennium Boom peak. Both construction and real estate job numbers will continue to grow slowly in the coming years, as they are tied to the housing industry’s very slow recovery.
The average income earner in Orange County made just over $62,000 in 2016 (the most recently reported data from the Bureau of Economic Analysis).

Sustainable home price increases (not driven by cash-heavy investors or market momentum) are limited to a ceiling set by personal income, the annual rate of increase from 2015 to 2016 being 4.0%. These annual income and price increases will remain low until an optimal employment level is attained with a full jobs recovery for the 10%+ population growth since 2007. Orange County will likely achieve these job numbers in 2019 or 2020. Meanwhile, price increases will remain low since homebuyer occupants ultimately determine selling prices — they can only pay as much for a home (or rent) as their savings and income qualify them to pay — nothing more for a sustained period of time.

Expect per capita income to increase concurrently with increases in job numbers. As a result, income — and home prices — have remained stunted even as they grow, significantly below income growth trends in prior recoveries, through at least 2018.

Orange County’s housing market is on a slow but steady path to full recovery. Home sales volume remains low, as does job creation. However, Orange County’s construction industry is seeing signs of resurgence, particularly in multi-family construction starts.

A full housing recovery won’t occur until that all-important economic factor controlling home sales — jobs — catches up with the population gain which has taken place since the 2008 great recession. The next 30 years are going to be an about-face of the past 30 years of repetitively declining mortgage rates and regulations. Rising mortgage rates began to put downward pressure on home prices following the late-2016 “Trump jump” in interest rates. However, this has been offset somewhat by slipping mortgage rates through much of 2017.
Riverside County housing indicators

After reading this chapter, you will be able to:

- understand where Riverside County stands on the path to economic expansion following its recovery from the Great Recession; and
- identify when the Riverside County housing market is likely to experience a complete housing recovery.

Home sales volume in Riverside County has remained relatively level in the years since 2011. The exception was 2014, when the area was hit particularly hard by the rapid exit of speculators, sales volume ending the year 9% below the prior year. Riverside recovered from that exodus in 2015, when sales numbers rebounded to 11% above 2014. Flash forward to 2017 and a true recovery still has not materialized, as annual sales volume continues to plod along. [See Figure 11]

For some context, home sales volume fell quickly before and during the recession, then demonstrated a textbook example of an aborted checkmark recovery. Volume bounced back briefly in 2008-2009, initially due to what economists term a dead cat bounce recovery, which was extended another year by the home buying tax credit stimulus. Sales volume remained flat in Riverside until late-2013 when it began to trend down, bottoming in early 2015.

The most optimistic among us will point to the price boost low-tier properties received from late-2012 through 2014 as presaging a broader recovery across Riverside’s housing market. However, this price rise in its initial phase was due entirely to the overactive speculator presence edging out buyer-occupants in what became a level-to-down sales volume market, consistent with the market statewide.

As speculator acquisitions have largely left Riverside’s housing market, end users of property are left to drive the housing recovery. Thus, sales volume won’t fully recover for a few more years, likely around 2019-2021, at which point first-time Generation Y (Gen Y) homebuyers and Baby Boomer (Boomer) retirees will converge to drive up sales volume and prices.
Without homeowner or renter turnover, homes do not sell. In Riverside, the number of homeowners and renters moving in recent years peaked in 2009 due to the tax stimulus and high level of foreclosures, which temporarily lifted sales volume as tenants became homeowners. In a reversal, turnover has swiftly declined since then as potential end users have chosen more often to remain where they are.

The renter annual turnover rate fell from above 26% in 2013 to just 20% in 2016 (the most recently reported Census year). On the other hand, the homeowner turnover rate rose slightly from 2013-2015, only to drop dramatically in 2016. Homeowner turnover is still below the level needed for a full recovery in home sales volume.

As slow job growth and wages continue to stagnate, residents lack the confidence (and more importantly, often the financial ability) to move. The turnover rate will rise once employment catches up with population growth and wages improve sufficiently, as these increases boost confidence in the economy and reduce fears of carrying mortgage debt.

Turnover rates are likely to rise dramatically across the state in the convergent 2019-2021 boomlet period. Then, members of Gen Y will collectively rush from their apartments to buy and Baby Boomers will retire en masse. Boomers generally buy replacement homes after they sell. Further, immigrants will also play a significant role in boosting Riverside County’s suburban resale housing demand. Apartment vacancies will rise as they did in the early 1990s when the boomers took to buying homes.
Figure 12

**Turnover Rate: Riverside County Owners and Renters**

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riverside County homeowner turnover rate</td>
<td>6.7%</td>
<td>9.1%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Riverside County renter turnover rate</td>
<td>20.3%</td>
<td>21.4%</td>
<td>24.5%</td>
</tr>
</tbody>
</table>

**Riverside County Homeownership Rate**

<table>
<thead>
<tr>
<th></th>
<th>Q2 2017</th>
<th>Q1 2017</th>
<th>Q2 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riverside County homeownership rate</td>
<td>58.4%</td>
<td>61.0%</td>
<td>62.6%</td>
</tr>
</tbody>
</table>

Visit realtypublications.com/charts for the most recent chart data.
Riverside County’s **homeownership rate** fell steeply during the recession. Riverside’s rate of homeownership hovered around 68% from 2000 through the end of the Millennium Boom. As of Q2 2017, the homeownership rate appears to have risen from its bottom, now at 58.4%. Further, this is higher than the state average, which is still 55%. [See Figure 12]

The return of significant numbers of buyer-occupants depends primarily on the creation of more jobs with better pay than the new jobs that have come on line as we go into expansion from this recovery. By the end of 2014, the jobs lost in the Great Recession of 2008 were finally recovered, several months following the statewide jobs recovery. But with the intervening eight years of population increase, the ultimate jobs recovery with the strong wage rises needed to support high sales volume and in turn price increases will wait until 2019. The homeownership rate will remain below pre-recession levels until then, only to rise when members of Gen Y collectively gain enough income to become first-time homebuyers.

Residential construction starts are recovering marginally in the Riverside Metropolitan area. Single family residential (SFR) construction continued to improve in 2017, while multi-family starts increased gradually following a significant dip in 2016. [See Figure 13]

Here, the focus on multi-family construction is far less pronounced than in regions closer to the coast. Nevertheless, increased demand for rental housing during this recovery translates to stronger growth in this sector than in SFR construction.

Construction increased dramatically during the Millennium Boom as the population moved from the urban centers of Los Angeles, Orange and San Diego Counties into the **bedroom communities** of Riverside County. Builders kept pace with buyer demand for new housing. Eventually their starts overran the 2006-2007 decline in buyer demand. The excess starts resulted almost exclusively from distortions in mortgage and construction financing with personal guarantee arrangements.

When the housing bubble burst in 2006, the sale and thus the construction of SFRs and multi-family housing plummeted. Small builders went bust in droves. Today, the general trend for SFR starts in Riverside County is displaying signs of stability with no signs of reaching 2004 and 2005 numbers in the foreseeable future.

The next peak in SFR construction starts will likely occur in 2019-2021. Even then, SFR construction starts are very unlikely to return to the mortgage-driven numbers seen during the bacchanalia of the Millennium Boom.
Before end users can provide sufficient support for the housing recovery, they will need to acquire income — i.e., jobs with wages exceeding the rate of consumer inflation. [See Figure 14]

The number of individuals employed in Riverside County finally surpassed its December 2007 peak in Q4 2014. As of July 2017, 119,400 more individuals are employed than at the outset of the recession. However, it will likely take another couple years to build the jobs sufficient to support the population added since 2007 and generate wage inflation needed for housing.

Many of Riverside's top employing industries have yet to recover from the recession. Still, the good news is that the number of employed real estate professionals have grown nearly 7% this past year in Riverside, which is more than can be said for the state as a whole. The number of real estate and construction professionals employed will see a significant increase when the next confluence of buyers and renters (members of Gen Y and the Boomer generations) enter the market around 2019-2021.

**Per capita income** in Riverside is one of the lowest in the state. Low per capita income holds down rents and thus new multi-family starts. Annual income rose beyond 2008 peak year amounts in 2013 — and that’s before accounting for the purchasing power reduction brought on by interim inflation.
Figure 14

Riverside County Payroll Employment

<table>
<thead>
<tr>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riverside County employment</td>
<td>1,419,700</td>
<td>1,378,000</td>
</tr>
</tbody>
</table>

Riverside County Employment: Construction & Real Estate Professions

<table>
<thead>
<tr>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>109,700</td>
<td>93,900</td>
</tr>
<tr>
<td>Real Estate</td>
<td>19,100</td>
<td>17,900</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.
The average employed individual in Riverside earned just $36,800, according to the most recent Bureau of Economic Analysis reported year of 2016. The statewide average income is over 50% greater than Riverside’s. However, the average resident of Riverside spends less of their income on housing expenses than those living in urban coastal cities.

However, as the recovery heats up, underemployment and unemployment will become less common and per capita income will increase. With more jobs available and incomes higher, homebuyers and renters alike will spend more on their residences each month. Jobs and the pay received by locals is why homebuyer occupants ultimately determine selling prices. Buyers can only pay as much for a home (or rent) as their savings, income and credit score qualify them to pay — nothing more, no matter the price demanded by sellers.

Expect per capita income to increase concurrent with increases in job numbers and the competition that brings employer demand for more employees.
Chapter 25.3
Summary

Riverside is the fourth most populous county in California with nearly 2.4 million residents. Much of the region’s population growth took place during the Millennium Boom years, when construction jobs and new home sales skyrocketed.

The recession left the region with deep losses in home sales volume, construction starts and employment. Eight years after the end of the 2008-2009 recession, Riverside’s economy remains in a state of prolonged recovery. Of course, recovery gains momentum as lost jobs are regained. Employment finally exceeded the number of jobs prior to the Great Recession at the end of 2014, though has yet to catch up with the intervening population gain between 2007 and today. It will likely take another couple of years to build the jobs sufficient to support the population added since 2007 and generate wage inflation needed for housing.
The homeownership rate in Sacramento County varies greatly each quarter, though the general trend has been downward over the past decade. The typical annual cycle for this part of California is a peak mid-year, which falls off in the fourth quarter (Q4) of each year. [See Figure 16]

The homeownership rate is very low for this area in Q2 2017, just 59.7%.

The homeownership rate peaked at 67% in 2005. Following the conclusion of the housing bubble, many homeowners lost their homes to foreclosure. This is pictured in the swift decline in Sacramento County’s homeownership rate experienced in 2010, bottoming at 57% in 2011. Some buyer-occupants have returned to the market since then.

The relatively good news for this area is that Sacramento’s average homeownership rate is usually well above the state average, which is at 55% as of Q2 2017. Further, don’t expect Sacramento’s homeownership rate to increase much in 2018, as the job market is still on shaky ground. Owner-occupants won’t return in solid numbers until Sacramento’s jobs market has a chance to fully recover, as discussed below.

A real estate agent’s living is contingent on residential turnover. Without it, property doesn’t sell, tenants stay put and mortgage originations go nowhere.

The good news is owner-occupant turnover is relatively stable, according to the most recent U.S. Census Bureau (Census) data. Owner-occupant turnover (the percentage of homeowners who moved within the last 12 months) bottomed in 2007 just as the Millennium Boom began to explode. Homeowners found the courage to move a bit more in 2008-2009 (due partially to the government stimulus that encouraged homebuying), only to fall back by mid-2010 when the stimulus ended. Since then, turnover by owner-occupants has remained steady at around 9% each year.
On the other hand, renters are moving less and less each year. Renter turnover peaked in 2009 at a massive 40%. For perspective, that means four out of ten renters moved in 2009 — a significant sum for California. A lot of this turnover was due to former homeowners selling (often by short sale or foreclosure) to buyers who were tenants or to investors who rented to relocating tenants. Renter turnover has fallen each year since, at less than 20% in 2016.

Like the homeownership rate, expect homeowner turnover to rise once jobs fully recover to the 2007 level in Sacramento (expected by 2019). With the support of a healthy jobs market, renters will be financially willing and able to become homeowners — whether it is their first time buying or returning to homeownership after being burnt in the recession.

Construction in Sacramento County is struggling. In the past couple years, there have been several months where builders started zero new multi-family or single family residential (SFR) construction projects. Just how dormant has the situation become — and when will things look up? [See Figure 17]

The good news is SFR construction has gradually increased in recent years, having bottomed in 2011 and rising slowly thereafter. However, this stability isn’t the kind Sacramento needs, since construction has stalled well below...
**Figure 17**

**Turnover Rate: Sacramento County Owners and Renters**

<table>
<thead>
<tr>
<th>Year</th>
<th>Homeowner Turnover Rate</th>
<th>Renter Turnover Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>8.0%</td>
<td>28.4%</td>
</tr>
<tr>
<td>2015</td>
<td>8.4%</td>
<td>24.6%</td>
</tr>
<tr>
<td>2016</td>
<td>8.2%</td>
<td>19.2%</td>
</tr>
</tbody>
</table>

**Sacramento County Monthly Construction Starts**

<table>
<thead>
<tr>
<th>Year</th>
<th>Single Family Residential (SFR) Starts</th>
<th>Multi-Family Starts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>1,600</td>
<td>25</td>
</tr>
<tr>
<td>2015</td>
<td>2,300</td>
<td>750</td>
</tr>
<tr>
<td>2016</td>
<td>2,700</td>
<td>620</td>
</tr>
</tbody>
</table>
the levels experienced during the Millennium Boom. In fact, the peak year of 2003 saw four times more SFR construction starts than the 2,700 SFR starts experienced in 2016.

On the other hand, the situation is worse for multi-family construction. Multi-family starts peaked in 2004 with just over 2,800 units built that year. 2016’s performance of 620 multi-family units started is a vast improvement over the 25 units started in 2014. However, some progress needs to be made before reaching a stable multi-family recovery. [See Figure 17]

So when will construction definitively recover? For a hint, check out local vacancy rates.

A healthy vacancy rate is just above 1% for owned homes (for new construction, this generally refers to SFRs) and 5% to 6% for rentals (multi-family construction). In Sacramento, vacancies of owned homes were relatively low, below 1% in 2016. However, the rental vacancy rate was higher than normal, averaging 8.2% in mid-2016, the likely reason for so few multi-family construction starts.

Thus, expect SFR construction to continue to pick up slightly 2018. Multi-family construction will continue at a slow pace, not to pick up significantly until later this decade as rents increase dramatically in the wake of strong regional job creation and personal income growth.

Sacramento was one of the last counties in California to reach a pre-recession jobs recovery. Its lagging recovery can be attributed partially to Sacramento’s dependence on state and local government jobs, which are slow to return. [See Figure 18]

Further, Sacramento’s population has grown about 1% each year since the 2008 recession. With working-aged individuals making up some 60% of this added population, Sacramento will need an additional 55,000 jobs for adequate employment following 2015’s initial recovery for total employment to match population levels. At the current pace of job additions, this will occur by 2019.

The recovery in jobs for those in the real estate and construction industries has been slow. Keep in mind that while the chart above shows a steady rise in both real estate and construction jobs, the actual number of construction jobs is displayed at seven times that of real estate jobs on the chart (the chart is displayed in this manner to make the change in real estate jobs perceptible). Thus, while Sacramento real estate professionals are 1,500 jobs below the pre-recession peak, construction jobs have much more to regain, at 16,000 below the pre-recession peak.

Many, but not all, of these jobs will be restored when homebuyers return in full force. Jobs will rise to meet the region’s population increase by 2019,
Figure 18

**Sacramento County Payroll Employment**

<table>
<thead>
<tr>
<th></th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sacramento County employment</strong></td>
<td>966,400</td>
<td>949,300</td>
<td>+1.8%</td>
</tr>
</tbody>
</table>

**Sacramento County Employment: Construction & Real Estate Professions**

<table>
<thead>
<tr>
<th></th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Construction</strong></td>
<td>56,300</td>
<td>57,800</td>
<td>-2.6%</td>
</tr>
<tr>
<td><strong>Real Estate</strong></td>
<td>15,000</td>
<td>14,800</td>
<td>+1.3%</td>
</tr>
</tbody>
</table>

Visit realtypublications.com/charts for the most recent chart data.
filling wallets and in turn fueling *household formations*. Expect to see a mini-construction boom as builders rise to that demand, likely around 2019-2020.

**Income rising**

Sacramento County surpassed its 2008 (pre-recession) peak of $39,671 in *per capita income* just three years after the recession in 2011. In contrast, most of the state didn’t catch up with pre-recession income until 2012.

Sacramento County’s average income remains nearly $8,000 below the state average in 2016, an adjustment typical to the region. Government employee compensation is less than state averages but more long-term in duration than the private employment turnover throughout the state.

Income finally surpassed the pre-recession pace of around 3% a year in 2015, only to fall back to a meager 2.7% increase in 2016. This is about level with the target rate for consumer inflation. Thus, incomes were able to exceed the ever-increasing price of goods and services in 2016, granting residents a higher standard of living.

For housing, incomes are keeping pace with the annual rise in the historic *mean price trendline*: the home price anchor and point at which prices invariably return. But annual home price movement during a business cycle is another matter. Property prices often rise or fall dramatically from year
Sacramento County, encompassing California’s capitol and cities like Elk Grove, Citrus Heights and Folsom, is home to the Department of Real Estate (DRE).

This region is suffering through an elongated economic recovery following the 2008 recession. Homeownership and construction have stalled, still waiting for the jobs recovery to arrive.

Sacramento was one of the last counties in California to reach an initial pre-recession jobs recovery, and has a long way to go to catch up with population gain. Its lagging recovery can be attributed partially to Sacramento’s dependence on state and local government jobs, which are slow to return.

Many, but not all, of these jobs will be restored when homebuyers return in full force. Jobs will rise to meet the region’s population increase by 2019, fueling wallets and in turn household formations. Expect to see a mini-construction boom as builders rise to that demand, likely around 2019-2021.

Expect incomes to rise beyond the rate of inflation once jobs rise to meet Sacramento’s growing population, around 2019. Then, employers will begin to pay more to answer competition for new employees. This boost in income will add support to a burgeoning housing market, expected to rise to a cyclical peak around 2020.

Chapter 25.4 Summary

to year without regard to the annual rate of consumer inflation and wage increases before returning to the mean price trendline. In any given year, home pricing is controlled by factors such as:

- mortgage rates;
- jobs;
- personal savings;
- housing starts; and
- individual confidence in the future.

Expect incomes to rise beyond the rate of inflation once jobs rise to meet Sacramento’s growing population, around 2019. Then, employers will begin to pay more to answer competition for new employees. This boost in income will add support to a burgeoning housing market, expected to rise to a cyclical peak around 2020.
Home sales volume in San Diego County saw its last significant increase in 2015, which was 12% higher than 2014. This boost was partly due to lower mortgage rates in 2015 and to the area’s relatively swift jobs recovery. Since then, sales volume as continued at a steady rate.

Today’s flat sales volume can be attributed to end users who have yet to return to the market in significant numbers. Total sales volume in 2016 was just 1% above 2015. Sales volume continued to slow in 2017, following the increase in mortgage rates at the end of 2016. [See Figure 20]

A full recovery of jobs lost in the recession took place in 2014. However, with the intervening population gains, jobs won’t reach a complete recovery until around 2018. At that time, home sales volume will take off, reaching its cyclical peak around 2020-2021.

The percentage of San Diego County homeowners moving in 2016 increased over 2015, while renter turnover declined slightly. This trend is much more promising than most parts of the state, where renter turnover has declined sharply over the past few years. This improvement demonstrates San Diego is farther along the path to a complete housing recovery. However, turnover rates for both owners and renters remain well below pre-recession levels.

Lower turnover rates are indicative of cash-strapped households that simply cannot afford to move, whether they are homeowners or renters. When turnover is low, home sales volume is hindered.

The turnover rate in San Diego County has not suffered as much compared to the rest of Southern California. This is partly due to a better jobs outlook and San Diego’s large military population, which traditionally experiences high turnover. Agents can gain an “in” with this population by familiarizing
themselves with the various benefits available to military renters and homeowners such as Veteran’s Administration (VA)-guaranteed and CalVet mortgages, then advertising themselves as experts.

San Diego County’s homeownership rate has followed the general statewide and national trend of decline in the years following the Millennium Boom. It peaked at 63% in 2006 for San Diego County, finding a low of 52% in 2010. 2014 saw a surprising jump in homeownership in San Diego County, peaking in mid-2014. It’s currently near this same level, at 57.9%. [See Figure 22]

The homeownership rate in San Diego County has historically been comparable to the rest of the state, though it is slightly above the statewide average of 55% in Q2 2017. With elevated home prices and the imminent rise in mortgage rates late in 2016, the homeownership rate won’t rise significantly until homebuyers return in larger numbers around 2019-2021.

The price of low-tier housing in San Diego County skyrocketed after the latter half of 2012. 2015 experienced another price increase. This is likely due to the boost given by decreased mortgage rates throughout 2015 and 2016. [See Figure 22]
San Diego County homeowner turnover rate

<table>
<thead>
<tr>
<th>Year</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>9.0%</td>
<td>7.8%</td>
<td>7.7%</td>
</tr>
</tbody>
</table>

San Diego County renter turnover rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Q2 2017</th>
<th>Q1 2017</th>
<th>Q2 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>56.1%</td>
<td>57.9%</td>
<td>52.1%</td>
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</tbody>
</table>
### San Diego Tiered Property Price Index: 1989-Present

<table>
<thead>
<tr>
<th>Price Index</th>
<th>1989</th>
<th>1991</th>
<th>1993</th>
<th>1995</th>
<th>1997</th>
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<th>2011</th>
<th>2013</th>
<th>2015</th>
<th>2017</th>
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<tr>
<td>Low Tier ($0.00 - $522,301)</td>
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<td>130.00</td>
<td>140.00</td>
<td>150.00</td>
<td>160.00</td>
<td>170.00</td>
<td>180.00</td>
<td>190.00</td>
<td>200.00</td>
<td>210.00</td>
<td>220.00</td>
<td>230.00</td>
</tr>
<tr>
<td>Mid Tier ($522,301 - $728,667)</td>
<td>120.00</td>
<td>130.00</td>
<td>140.00</td>
<td>150.00</td>
<td>160.00</td>
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<td>240.00</td>
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<td>High Tier ($728,667+)</td>
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<td>250.00</td>
<td>260.00</td>
<td>270.00</td>
<td>280.00</td>
<td>290.00</td>
</tr>
</tbody>
</table>

### San Diego County home price index: Q2 2017

- **Low-tier annual change**: +10%
- **Mid-tier annual change**: +8%
- **High-tier annual change**: +6%

### San Diego County Monthly Construction Starts

<table>
<thead>
<tr>
<th>Construction starts (units)</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
<th>2011</th>
<th>2013</th>
<th>2015</th>
<th>2017</th>
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<tbody>
<tr>
<td>Single family residential (SFR) starts</td>
<td>200</td>
<td>300</td>
<td>400</td>
<td>500</td>
<td>600</td>
<td>700</td>
<td>800</td>
<td>900</td>
<td>1,000</td>
</tr>
<tr>
<td>Multi-family starts</td>
<td>100</td>
<td>200</td>
<td>300</td>
<td>400</td>
<td>500</td>
<td>600</td>
<td>700</td>
<td>800</td>
<td>900</td>
</tr>
</tbody>
</table>

### San Diego County single family residential (SFR) starts

<table>
<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Diego County single family residential (SFR) starts</td>
<td>2,500</td>
<td>3,200</td>
<td>2,200</td>
</tr>
</tbody>
</table>

### San Diego County multi-family starts

<table>
<thead>
<tr>
<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Diego County multi-family starts</td>
<td>4,100</td>
<td>6,100</td>
<td>7,800</td>
</tr>
</tbody>
</table>

**Figure 22**

Visit realtpublications.com/charts for the most recent chart data.
Lower mortgage rates free up more of a buyer’s monthly mortgage payment to put towards a bigger principal. Thus, San Diego’s high home prices continue to find fuel — not from speculators as in 2012-2014 — but from increased **buyer purchasing power**.

The flat performance in home sales volume following the rise in mortgage rates in late-2016 forecasts flattening prices in 2018.

**Residential construction starts** began to show signs of life in San Diego County in 2013, but the rise waned throughout 2014, only to pick up again in 2015. Thus far the recovery has been concentrated in **multi-family starts**, due to the increased demand for rental housing experienced during this recovery. [See Figure 22]

Fueling this increased rental demand are:

- a demand shift from suburban living to city dwelling by the youngest generation of homebuyers, Generation Y (Gen Y);
- an increased resistance to homeownership following the housing crash; and
- the higher barriers to homeownership due to the return of mortgage lending fundamentals which tightened mortgage lending.

Today, the general trend for **single family residence (SFR)** construction starts in San Diego County is up, but still far below 2002-2004 numbers. The next peak in SFR construction starts will likely occur around 2020. Even then, SFR construction starts are highly unlikely to return to the frenzied mortgage-driven numbers seen during the Millennium Boom.

Before **end users** can provide sufficient support for the housing recovery, they will need to acquire income in the form of **jobs and wage increases**. San Diego continues to outpace the state’s jobs recovery, which is clearly good news for San Diego’s housing industry. [See Figure 23]

The number of individuals employed in San Diego County in the second half of 2015 saw a rapid increase from one year earlier. Unlike much of the state, San Diego has far surpassed the level of jobs held prior to the 2008 recession. However, with the working-aged population increase of roughly 250,000 individuals in San Diego County since 2007 (compared to the 94,000 increase in jobs), the real jobs recovery which will bring on mass wage increases isn’t expected until around 2018. Home prices will follow that increase.

In the housing industry, construction jobs took a huge hit and have just barely started the recovery process. Likewise, the number of employed real estate professionals has remained low throughout this recovery and will not likely increase until the next confluence of buyers and renters (members of the **Generation Y** and **Baby Boomer** generations) converge and enter the market around 2019-2021.
Figure 23

### San Diego County Payroll Employment

<table>
<thead>
<tr>
<th>Year</th>
<th>Jul 2017</th>
<th>Aug 2015</th>
<th>Annual Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Diego County employment</td>
<td>1,441,300</td>
<td>1,420,900</td>
<td>+1.4%</td>
</tr>
</tbody>
</table>

### San Diego County Employment: Construction & Real Estate Professions

<table>
<thead>
<tr>
<th>Year</th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>29,800</td>
<td>28,400</td>
<td>+4.9%</td>
</tr>
<tr>
<td>Construction</td>
<td>79,900</td>
<td>77,500</td>
<td>+3.1%</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realltpublications.com/charts for the most recent chart data.
The average per capita income in San Diego County is $55,100 as of 2016, the most recently reported year by the Bureau of Economic Analysis. This shows an average increase in income of 2.2% over 2015. Income took a hit in San Diego during the recession, and it took three years for income to finally catch up to 2008 levels.

After factoring in an additional 10%-11% increase in income needed just to cover eight years of interim inflation, homebuyers in 2016 had only slightly higher purchasing power to buy a home or rent as they did in 2008 – all else remaining unchanged. Per capita income in San Diego County is roughly level with the state average, and exceeds levels in the inland valleys by over 50%.

As long as income remains diminished across most job sectors, home prices and the price of rents are limited. This is due to the reality that buyer occupants ultimately determine selling prices in this economic environment — buyers can only pay as much for a home as their savings and income qualify them to pay — nothing more, unless lenders and landlords want to take on more risky, less qualified individuals. The same fundamental truth is also applicable to tenants’ capacity to pay, which ultimately works to set the ceiling on rental amounts.

Expect per capita income to rise with increases in job numbers. When considering the jobs needed to cover population growth of one percent per annum in the years since 2007, it will take until 2019 for employment numbers and income to again drive demand for significant additional new housing.
San Diego County continues its steady recovery from the 2008 recession and financial crisis. Jobs and income are recovering quickly — a good sign for San Diego’s housing market. In San Diego, as in other regions, the strength of home sales volume depends on a complete jobs recovery.

Residential construction continues to falter. Thus far, multi-family construction has experienced a quicker recovery than single family residential (SFR) construction. Expect the demand shift from SFRs to rentals to continue, injecting growth into multi-family construction in upcoming years, peaking around 2019-2020. Vacancy rates will then increase, as tenants will increasingly go for homeownership.
Chapter 25.6

San Francisco County housing indicators

After reading this chapter, you will be able to:

- understand where San Francisco County stands on the path of economic expansion following its swift recovery from the Great Recession; and
- identify when the San Francisco County housing market experienced a complete recovery, and where it is expected to go in the future.

Home sales volume slips

Home sales volume in San Francisco County always runs a step ahead of the rest of the state. San Francisco home sales volume peaked in 2004 — a year before the statewide peak — before receding in 2005-2006. Since then, home sales have bumped along at a relatively level-to-down annual pace. This is a symptom of the out of sight home prices in the region. [See Figure 25]

The increased use of adjustable rate mortgages (ARMs) in San Francisco County is an ominous indicator of buyer overreach in the mid- and low-tier properties, but the uptick is nowhere near the dangerous percentage of ARM use seen during the extremes of the Millennium Boom.

In 2017, homebuyers felt discouraged by too-high home prices in the area. Sellers are likewise hesitant to list for fear of not finding the right replacement home. A turndown in volume San Francisco is likely to continue going into 2018 for these reasons.

Turnover rates are mixed

San Francisco’s renter turnover rate fell in 2016 after rising the previous year. On the other hand, the homeowner turnover rate (producing sales and relocating buyers) continued to rise in 2016 to 9.0%. This is roughly level with the level of homeowner turnovers occurring before the 2008 recession.

Renter and homeowner turnover rates indicate both the willingness and corresponding ability of renters and homeowners to move. With the loss of jobs and income during the Financial Crisis and 2008 Great Recession, turnover rates in San Francisco fell. However, both renter and homeowner turnover rates recovered more quickly in San Francisco than elsewhere in the state due to the region’s swift jobs recovery and high concentration of employers.

Following the recession, renters in particular regained a higher level of mobility, as the young professional class inhabiting San Francisco is often
more inclined to rent than own. However, the significantly high rents in San Francisco are now swiftly pushing renters out of the city and into the nearby counties of Alameda and Contra Costa. Those with rent-controlled apartments strive to stay put which kills turnover and new construction.

Looking forward, turnover rates will likely be highest in 2019-2020, one year ahead of the rest of the state. These years will see the confluence of Generation Y (Gen Y) first-time homebuyers and retiring Baby Boomers (Boomers) hitting the home buying market at once.

The homeownership rate in the Bay Area tends to vary more wildly than other parts of the state. However, the general trend from the end of the Millennium Boom until 2015 had been down. The homeownership rate climbed in 2015, only to drop back in 2017 to its current level of 55.1%. [See Figure 26]

However, the homeownership rate in San Francisco has not suffered quite as much as the rest of the state during this protracted recovery due to the job support delivered by its successful tech industry. All the same, as the homeownership rate in the rest of the state catches up to pre-recession levels in the coming years, don’t expect San Francisco to follow. Due to the high cost of housing and the allure of city living, renting is often preferred in San Francisco.

---

**Figure 25**

San Francisco County Monthly Home Sales Volume

<table>
<thead>
<tr>
<th>Year</th>
<th>2017 Projection*</th>
<th>2016</th>
<th>2015</th>
<th>2003: Peak Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Francisco County home sales volume</td>
<td>5,500</td>
<td>5,900</td>
<td>6,100</td>
<td>8,130</td>
</tr>
</tbody>
</table>

*Realty Publications, Inc.’s projection is based on monthly sales volume trends, as experienced so far in 2017 prior to the printing of this material.

---

Visit realtypublications.com/charts for the most recent chart data.
### Turnover Rate: San Francisco County Owners and Renters

<table>
<thead>
<tr>
<th>Year</th>
<th>Homeowner Turnover Rate</th>
<th>Renter Turnover Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>9.0%</td>
<td>16.1%</td>
</tr>
<tr>
<td>2015</td>
<td>8.0%</td>
<td>17.3%</td>
</tr>
<tr>
<td>2014</td>
<td>7.4%</td>
<td>16.9%</td>
</tr>
</tbody>
</table>

### San Francisco County Homeownership Rate

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Q2 2017</th>
<th>Q1 2017</th>
<th>Q2 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Francisco County Homeownership Rate</td>
<td>48.3%</td>
<td>50.1%</td>
<td>46.5%</td>
</tr>
</tbody>
</table>
Home prices in San Francisco continue to exceed prices of a year earlier, but month-to-month changes are beginning to decrease in the mid and high tiers. Low-tier prices are 7% higher than a year earlier as of Q2 2017. Mid-tier and high-tier prices are 7% and 5% higher than a year earlier. [See Figure 27]

San Francisco home prices are characterized by rapid starts and stops, as viewed in the bumps in the chart above — particularly in the mid- and high-tiers. Pricing in Southern California markets form a smoother line.

San Francisco’s low supply situation is partly to blame, creating a volatile home sales market. The city’s preference for low-density zoning restricts builders from meeting the ever-increasing demand for local housing.

Use of adjustable rate mortgages (ARMs) and jumbo loans keep home prices high in a momentum-hot market, as homebuyers quickly lose purchasing power due to upward shifts in interest rates and pricing outruns income growth. When ARM use increases as rapidly as it has in the area, the outlook for stable sales volume and pricing in the housing market becomes less optimistic. Prices adjust downward following periods when ARM-to-loan ratios rise and fixed mortgage rates do not.

Very few single family residences (SFRs) are built in San Francisco County each year, though this number is increasing slightly. Multi-family construction starts, on the other hand, nearly doubled in 2013 over the prior year. This rise slowed significantly in 2014 but picked up slightly in 2015, the rise continuing in 2016 and increasing sharply in 2017. However, the long approval and permitting process in San Francisco holds down construction starts of all types. [See Figure 27]

As jobs continue to increase in San Francisco, multi-family construction may feel the benefits. San Francisco’s high-paying tech industry draws a younger population (members of Gen Y), who are most likely to reside in multi-family structures close to the urban amenities San Francisco offers.

However, archaic zoning limiting building height and the density of units in each structure will impair multi-family starts, population mobility and job growth going forward while driving up rents and causing employers to consider other communities.

San Francisco’s jobs market has well surpassed the point for recovery. Homeowners and renters require income (generally from employment) to make mortgage or rent payments. As a result, San Francisco’s housing market has recovered more swiftly than the rest of the state due directly to its quick healing and expansion in the jobs market. [See Figure 28]

Jobs have met and exceeded residents’ need for employment, even including San Francisco’s population increase of roughly 70,000 working-
Figure 27

San Francisco Tiered Property Price Index: 1989-Present

<table>
<thead>
<tr>
<th>Year</th>
<th>Low-tier annual change</th>
<th>Mid-tier annual change</th>
<th>High-tier annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>+9%</td>
<td>+7%</td>
<td>+5%</td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

San Francisco County home price index: Q2 2016

Figure 28

San Francisco County Monthly Construction Starts

<table>
<thead>
<tr>
<th>Year</th>
<th>Single family residential (SFR) starts</th>
<th>Multi-family starts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>123</td>
<td>4,400</td>
</tr>
<tr>
<td>2015</td>
<td>64</td>
<td>3,600</td>
</tr>
<tr>
<td>2014</td>
<td>35</td>
<td>2,700</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realtypublications.com/charts for the most recent chart data.
### San Francisco County Payroll Employment

<table>
<thead>
<tr>
<th></th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Francisco County employment</td>
<td>1,115,900</td>
<td>1,096,600</td>
<td>+1.8%</td>
</tr>
</tbody>
</table>

### San Francisco County Employment: Construction & Real Estate Professions

<table>
<thead>
<tr>
<th></th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>42,300</td>
<td>39,300</td>
<td>+7.6%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>22,400</td>
<td>21,300</td>
<td>+5.2%</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realltpublications.com/charts for the most recent chart data.
Employment in the real estate industry has exceeded pre-recession levels. The construction industry is also recovering, its pace quickening in recent months. Future growth for these industries will rely on the success of the multi-family housing sector, which will continue to see growth throughout this decade.

Per capita income in San Francisco is nearly double that of California’s. Further, San Francisco’s per capita income has far exceeded its pre-recession peak.

However, San Francisco residents spend on average a debilitating 41% of their income on housing expenses. Many more simply cannot afford to live in the city and are forced out to the suburbs, the only place where their paycheck qualifies them for housing.

If you’re looking for indications of where California’s housing market will be in two to three years, take a look at San Francisco County. Here, jobs and income have fully recovered. All the same, home sales volume remains stuck in its bumpy plateau — flat. It’s likely to pick up consistently in 2018 due to increased demand from end users, fueled by San Francisco’s enviable jobs recovery.
If you’re looking for indications of where California’s economy will be in a couple years, take a look at San Francisco County. Home sales volume is nearly level with the pre-Millennium Boom years and jobs are fully recovered due to the presence of the high-paying tech industry in San Francisco.

All the same, high prices and limited inventory have shut out many would-be homebuyers, causing sales volume to remain stuck in its bumpy plateau — flat. Sales volume is likely to pick up going into 2019 due to increased demand from end users, fueled by San Francisco’s enviable jobs recovery.
Santa Clara County housing indicators

After reading this chapter, you will be able to:

• understand where Santa Clara County stands in the expansion of its economic recovery from the Great Recession; and
• identify when the Santa Clara County housing market is likely to experience a full housing recovery.

Santa Clara County home sales volume is more of the same each year, now headed into its eighth year of stagnation. During 2010-2015, home sales volume remained mostly level while accounting for seasonal bumps and dips. Total 2016 sales volume declined 4% below 2015. [See Figure 30]

And the reason for Santa Clara’s flat-to-down home sales volume? Home prices in the Santa Clara/San Jose area are inflated, sending end users further afield where they are able to buy more home for the same amount of money. This is not what local real estate agents want.

Sales volume will continue to be pulled down in 2017 since — while incomes are rising — prices are rising faster. Worse, the mortgage rate rise which began in November 2016 further reduces the buyer purchasing power of Santa Clara residents.

**Personal incomes** have risen at a much slower pace than home prices. Personal incomes rose nearly 7% in 2015 in the county. While this is higher than the statewide average, it’s still below the year-over-year increase in Santa Clara County home prices.

It’s no surprise Santa Clara County’s housing turnover rate is stagnant, given the county’s flat home sales volume. With home prices still excessively high at the end of 2017, it’s simply not the prudent time to buy. However, the area’s solid jobs recovery ensures new residents continue to pour in at a rapid rate.

Santa Clara’s population continues to grow more quickly than the state. This pace of growth will help churn Santa Clara County’s turnover rate, first as increased renter turnover followed by a rise in homeowner turnover. The caution in these forward observations is the tech and information bubble developing in the area and whether it will come to the point of bursting and putting end to further job growth for a few years.
On the other hand, renters continue to move less each year. As rents rise rapidly in San Jose and Santa Clara, tenants are discouraged from moving out of their current situation.

While varying greatly from quarter to quarter, Santa Clara County’s long-term homeownership rate has trended downward since 2005, oscillating around 57% most years, indicated by the dotted line on the chart. [See Figure 31]

However, in Q4 2015 homeownership dropped to its lowest in recent memory, to a very low 45%, rebounding to its current level of 55%.

The rest of the state has experienced a swift decline in homeownership since the 2008 recession, peaking at over 60% in 2006 and settling at 55% in Q1 2017. Santa Clara’s long-term rate of homeownership is mostly stable, due both to its successful jobs market and high home prices.

Elevated prices keep homeowner turnover from rising to unsustainable levels (as occurred across the state during the Millennium Boom). Likewise, Santa Clara County’s strong jobs market bolsters its homeownership rate.

However, the recent downtrend in homeownership does not bode well for the local housing market. End users of real estate are being pushed out of the market as prices rise beyond the reach of incomes.
Santa Clara County homeowner turnover rate

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>7.9%</td>
<td>7.3%</td>
<td>7.1%</td>
</tr>
</tbody>
</table>

Santa Clara County renter turnover rate

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>20.4%</td>
<td>21.6%</td>
<td>21.9%</td>
</tr>
</tbody>
</table>

Santa Clara County homeownership rate

<table>
<thead>
<tr>
<th></th>
<th>Q2 2017</th>
<th>Q1 2017</th>
<th>Q2 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>54.6%</td>
<td>47.0%</td>
<td>51.0%</td>
</tr>
</tbody>
</table>
Figure 32

Santa Clara County Payroll Employment

<table>
<thead>
<tr>
<th>Year</th>
<th>Santa Clara County employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>1,084,500</td>
</tr>
<tr>
<td>2015</td>
<td>1,074,000</td>
</tr>
<tr>
<td>Annual change</td>
<td>+1.0%</td>
</tr>
</tbody>
</table>

Santa Clara County Monthly Construction Starts

<table>
<thead>
<tr>
<th>Year</th>
<th>Single family residential (SFR) starts</th>
<th>Multi-family starts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>1,600</td>
<td>4,300</td>
</tr>
<tr>
<td>2015</td>
<td>1,900</td>
<td>5,100</td>
</tr>
<tr>
<td>2014</td>
<td>1,800</td>
<td>7,700</td>
</tr>
</tbody>
</table>

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Visit realtpublications.com/charts for the most recent chart data.
Figure 33

Santa Clara County Employment: Construction & Real Estate Professions

<table>
<thead>
<tr>
<th></th>
<th>Jul 2017</th>
<th>Jul 2016</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>49,000</td>
<td>51,000</td>
<td>-3.9%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>14,200</td>
<td>14,200</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Santa Clara County Income Per Capita

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2014</th>
<th>Annual change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Santa Clara County per capita income</td>
<td>$88,920</td>
<td>$85,354</td>
<td>+4.2%</td>
</tr>
<tr>
<td>California per capita income</td>
<td>$56,374</td>
<td>$54,718</td>
<td>+3.0%</td>
</tr>
</tbody>
</table>

ONLINE UPDATE
Visit realltpublications.com/charts for the most recent chart data.
Construction was recovering quite well in Santa Clara County – until 2016. **Single family residential (SFR)** and **multi-family** starts are well above the numbers experienced this past decade, but have fallen abruptly beginning in mid-2015, continuing down throughout 2016. [See Figure 32]

Multi-family starts leaped in 2014, ending the year 33% above 2013. The multi-family market grew due to two factors:

- Santa Clara County doesn’t face the same outdated constrictive zoning as nearby San Francisco County; and
- Santa Clara County’s high **cost of living** makes it more cost-effective to reside in a multi-family dwelling with communal amenities, as opposed to a distant large suburban SFR.

The good news is annual rent increasing have fallen from a high 11% a year ago to just over 2% in Q3 2016, according to Zillow. SFR and multi-family starts will likely hit their peak following Generation Y’s entrance into the housing market in 2019-2021.

Santa Clara County passed the milestone of its pre-recession employment peak in early 2013. Accounting for a population gain of just over 100,000 individuals in Santa Clara County since the 2008 recession, it finally reached a full jobs recovery for its population in Q1 2015. In contrast, the state of California only just reached pre-recession employment numbers at the end of 2014 and has yet to reach a post population-gain recovery. [See Figure 32]

The full **statewide** jobs recovery (including jobs needed to account for population gain) won’t occur until 2019.

Why has Santa Clara’s job market recovered more quickly than the rest of the state? Of the 143,000 jobs added since the level set by the 2008 recession, roughly one-quarter of those jobs have been in the Professional-Business Services industry. This includes all of those tech industry jobs. The bulk of other new jobs can be found in industries that support the tech industry.

Expect the construction and real estate industries to continue to grow steadily in 2017 and in the coming years as construction starts rebound.

Santa Clara County personal incomes are well above the statewide average. Further, from 2015-2016 incomes increased 4.2% in the region, while incomes increased statewide a modest 3.0%.

Still, incomes need to increase even faster if home prices and rents are to be maintained. Since this isn’t the way home pricing functions, home prices need to either fall in line with homebuyer incomes, or else homebuyers need to resort to risky adjustable rate mortgages (ARMs) to make up the difference...
Santa Clara County is well on its way to a full housing recovery. Residential construction is booming and buyer incomes continue to rise at a much quicker pace than the rest of the state. However, annual home sales volume has remained level since 2010, marking the end of the housing tax credit stimulus.

Santa Clara’s success is due to its successful jobs market, particularly in the Silicon Valley area. However, the region’s high cost of living, reflected in steeply rising home prices, is a heavy drag on demand, reducing home sales volume and turnover rates.
1-year Treasury Bill .................................................. 46
One of several indices referenced by lenders to adjust the rate of an adjustable rate mortgage. This index is one of the most volatile.

10-year Treasury Note .................................................. 13
A leading indicator of the direction of future fixed rate mortgage rates. Influenced by worldwide demand for the dollar and anticipated future domestic consumer inflation.

§1031 transaction .................................................. 52
A sales transaction in which sales proceeds are reinvested by the acquisition of a replacement like-kind property, the profits on the sale deferred until the investment is cashed out.

80-10-10 financing .................................................. 119
A first mortgage recorded concurrent with a seller carryback for 10% of the price on a 10% down payment by the buyer, a private piggyback financing arrangement.

91-Day Treasury Bill .................................................. 52
The rate used by sellers to impute and report interest when a seller is not paid interest on their §1031 monies.

absentee homebuyers .................................................. 56
A group composed of speculators, buy-to-let investors and renovation contractors.

absorption rate .................................................. 260
The estimated time required to sell or lease property within a designated area at its fair market value.

adjustable rate mortgage (ARM) .................................. 11, 117, 282
A note with an interest rate that varies based on a chosen index figure plus a set margin. The rate usually adjusts on an annual basis subject to annual and lifetime ceiling and floor rate limitations. [See RPI Form 320-1]

American Dream policy .................................................. 283
The government’s push to increase the homeownership rate from the historical 64% to 70%.

applicable federal rate (AFR) .................................................. 50
A rate set by the Internal Revenue Service and used by carryback sellers to impute and report as minimum interest income when the note rate on the carryback debt is a lesser rate.

appraisal .................................................. 205
An opinion estimating a property’s value on a specific date resulting from an analysis of facts about the property.

appreciable asset .................................................. 68
A collectible, such as real estate. The value of this asset may increase with time beyond the rate of consumer inflation.

asset price inflation .................................................. 135
A rise in the price of assets, such as stocks, bonds and real estate.

Baby Boomers .................................................. 217, 222, 244
The post-WWII generation responsible for a sharp increase in the U.S. population. Their collective activities have a sizeable effect on the market.
balance sheet

An itemized, dollar-value presentation for setting an individual’s net worth by subtracting debt obligations (liabilities) from asset values. [See RPI Form 209-3]

beige book

Written reports compiled by the Manager of the System Open Market Account detailing the current and prospective economic environment each bank district is encountering.

bona fide purchaser (BFP)

A buyer other than the mortgage holder who purchases a property for value at a trustee’s sale without notice of title or trustee’s sale defects.

building envelope

The doors, windows, foundation, roof and walls of a property. Sealing these areas can dramatically reduce the costs of cooling and heating the property.

bumpy plateau recovery

A recovery characterized by a prolonged pattern of short-term increases followed by short-term decreases in home sales volume and pricing, resulting in little or no long-term recovery trend, called secular stagnation.

buy phase

The ideal moment to buy property, characterized by low prices, low interest rates and few willing buyers.

buyer purchasing power

A homebuyer’s ability to purchase property funded by a purchase-assist mortgage based on 31% of their gross income for the buyer’s mortgage payment at current interest rates.

buy-to-let investment

Long-term income property investment.

C

capitalization rate (cap rate)

The annual rate of return on invested capital produced by the operations of an income property. The cap rate is calculated by dividing the net operating income by the property’s price.

casitas / granny flat

Attached, freestanding, or over-the-garage apartments that have no direct access to the main house.

commodity

A marketable good or service.

community banks

Small and local banks not tied to the “too big to fail” Wall Street banks.

competitive advantage

Increasingly drastic lending measures motivated by the desire for ever greater earnings and strategic advantage over one’s rivals.

construction starts

Building permits issued before builders may begin construction.

consumer confidence

An economic indicator measuring the degree of optimism consumers feel about their personal financial situation and the state of the broader economy.

Consumer Financial Protection Bureau (CFPB)

An independent federal agency fathered by the Dodd-Frank Act responsible for regulating consumer protection with regards to lending products and services.

Consumer Price Index (CPI)

The CPI measures and tracks the rate of consumer inflation. This is presented as an index of fluctuations in the general price of a wide selection of consumable items – goods and services.
consumer price inflation
An increase in the general price level of all goods and services consumed in the economy.

Continental
An early form of currency issued by Congress after the start of the Revolutionary War.

Cost of Funds Index
One of several indices referenced by lenders in adjustable rate mortgage notes to adjust the note’s interest rate. This index is one of the steadiest.

cramdown
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

creditworthiness
An individual’s ability to borrow money, determined by their present income and previous debt payment history.

D

dead cat bounce
An initial brief rebound in home prices following a crash in property pricing; not indicative of the beginning of a true recovery.

debt overhang
Excess mortgage debt on a negative equity property.

debt-to-income ratio (DTI)
The front-end DTI ratio is the percentage of a buyer’s monthly pre-tax gross income spent on housing costs. The back-end DTI ratio is the percentage of the buyer’s income spent monthly on all debt payments.

discount rate
The interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.

disequilibrium
An extreme imbalance in supply and demand which prevents the market from reaching equilibrium in pricing.

dis-saving
The act of cashing in savings and liquidating assets to spend on goods and services.

diversification
Varying the types and areas of investment in a portfolio to mitigate risk.

Dodd-Frank Wall Street Reform and Consumer Protection Act
A federal consumer protection law which created minimum standards and oversight for consumer mortgage origination.

E

easy money
When there is too much cash in circulation causing excessive inflation, rectified by the Federal Reserve increasing short-term interest rates.

emigration
The act of leaving a country or state for another.

end user
A buyer who will occupy the property as their residence or own it as income property for long-term investment purposes.

energy audit
An inspection which pinpoints home’s energy-efficient improvements and features in need of energy-efficient improvements.
energy efficiency Using building materials, appliances or other methods to reduce the amount of energy used by the homebuyer, thereby reducing their energy costs.

entrepreneurial spirit Individuals exhibiting creativity and ingenuity. Willing to adopt new, innovative techniques to succeed.

exchange rate The fluctuating rate at which one currency is converted to another, such as for the purpose of purchasing in a foreign market.

fair market value (FMV) The price a reasonable, unpressured buyer and seller would agree to for property on the open market, both possessing symmetric knowledge of material facts.

Fannie Mae A government-sponsored entity operating in the secondary mortgage market.

federal funds Overnight funds lent to banks with insufficient reserves by the Federal Reserve and other banks with excess reserves.

Federal Housing Administration (FHA)-insured mortgage A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value ratio and high mortgage insurance premiums, typically made to first-time homebuyers.

Federal Open Market Committee (FOMC) Consists of five rotating Federal Reserve District Bank presidents and the seven members of the Board of Governors. The FOMC discusses future monetary policy and establishes goals to meet those policies.

Federal Reserve The central bank in control of regulating the U.S. monetary system and charged with maintaining proper employment levels and managing inflation.

Federal Reserve Board of Governors The governmental aspect of the Federal Reserve which decides future monetary policy, consisting of seven members who each serve one fourteen year term.

Federal Reserve District Bank The 12 branches of the “central” bank.

fiat money A form of currency controlled by a central bank and backed by the national government. It has no direct tie to an underlying commodity or other store of wealth.

financial accelerator The cyclical phenomenon of increasingly larger loan amounts based on increasingly inflated prices of the same collateral.

financial atrophy The continuing inability to qualify for purchase-assist financing due to outstanding consumer debt.

first-time homebuyer A buyer of a home who has not previously owned their shelter. Typically aged 25-34.

flipping Buying and quickly reselling a property to obtain a large profit, the basis of speculation.

forbearance agreement An agreement by a mortgage holder to temporarily forego exercise of their rights on a default while the property owner takes steps to bring the mortgage payments current.
Free Banking Era ................................................................. 289
1837-1862. No central banking system existed during this time. States chartered their own banks and held their own reserves.

G

Generation Y (GenY) ...................................................... 100, 219
The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

going negative ............................................................... 139
The Federal Reserve’s charging of interest on the excess reserves of lenders, stimulating lending activity.

Great Confluence ............................................................. 251
The convergence of retiring Baby Boomers and Generation Y on the same urban real estate.

Greenspan Put ............................................................... 15
The practice of lowering the Federal Funds Rate to encourage investing during recessionary periods, with an implicit guarantee of continuing interest rate stimulus to keep profits up. Implemented by Fed Chairman Greenspan from 1987 to 2000.

gross domestic product (GDP) ........................................... 164, 312
The market value of all goods and services produced within a country calculated over a set period of time.

gross revenue multiplier (GRM) ......................................... 94, 105
Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

H

hit-and-run buyers ......................................................... 202
Flippers who purchase real estate with the intent to quickly resell it at a profit produced by market momentum, not fundamentals.

hold phase ................................................................. 26
A period in which investors hold onto their cash and property, which usually occurs twice during a real estate cycle: after a purchase in the buy phase and after a sale in the sell phase.

home energy score ....................................................... 377
A rating system established by the Department of Energy quantifying the energy performance of a home.

home equity line of credit (HELOC) .................................... 74
A mortgage loan enabling a homeowner to borrow against their home’s wealth, as an ATM.

homeowner vacancy rate ............................................... 186
The percentage of unoccupied homeowner housing units.

household formation ...................................................... 262
Individuals who acquire their own property, such as adult children leaving parents’ households or singles leaving shared housing.

housing wage ............................................................. 348
The hourly wage needed for a worker to qualify for an average priced residence.

I

illiquid asset ............................................................... 88
An asset that cannot be converted into cash quickly without a loss.

implicit rent ............................................................... 74, 95
The value of an owner’s use of their property to house themselves or their business.
**income approach**
The use of a property’s rental income to set its value.

**income inequality**
The uneven distribution of wealth across the population.

**individual taxpayer identification number (ITIN)**
A nine digit, tax processing number issued by the Internal Revenue Service to individuals who don’t have a social security number.

**inflation**
The price changes over time in consumer goods and services, quantified in the consumer price index.

**installment sale**
Financing provided by a seller when extending a buyer credit for deferred payment, typically payable monthly with accrued interest, of a portion of the price paid for real estate, also known as carryback financing.

**inventory**
Properties available on the market for sale through the multiple listing service.

**invested capital**
The total amount of cash and mortgage principal an owner has used to acquire and improve a property.

**investor**
A purchaser who holds a property long-term on a buy-to-let basis as an income producing investment. Contrast with a speculator who buys-to-flip a property for fast profits, rather than annual income.

**John Maynard Keynes**
An economist well-known for his stance that governments needs to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

**leveraging**
The concept in real estate finance that a mortgage either increases the return on their investment or increases the owner’s risk they will lose the property (and their investment) to foreclosure.

**liability**
A financial debt or obligation owed to others.

**limited liability company (LLC)**
An organization formed for the purpose of group investment. The members of an LLC are not liable for the LLC’s debts and obligations.

**liquidity trap**
A condition in which injections of cash into the banking system by the Federal Reserve fail to stimulate lending and economic growth. In the instance of California’s current crisis, cheap cash is sitting in lenders’ reserves and not being lent to prospective buyers.

**loan-to-value ratio (LTV)**
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property’s fair market value.

**long-term rate**
An interest rate fixed for the duration of the mortgage.

**luxury vs. necessity**
Housing as a consumer good that enhances one’s social status versus housing as a solution to one’s basic need for shelter.
**M**

**mean price trendline** ................................................................. 209, 279
A reflection of consumer inflation, to which property prices cyclically return.

**median age** .............................................................................. 357
The midway point between the older half of a population and the younger half.

**momentum traders** .................................................................. 201
Buyers relying on the emotion of frenzied market participants, rather than property price inflation, to profit from buying and reselling property.

**monetarist economic view** ......................................................... 132
An economic view which holds it is the role of the government to control the amount of money in circulation, not a commodity or other currency. In the U.S., this is performed by the Federal Reserve and the U.S. Treasury.

**monetary policy** ........................................................................ 19
The Federal Reserve’s use of short-term interest rates and other infusions and withdrawals of dollars in circulation to control pricing and employment in the economy.

**mortgage-backed bond (MBB)** .................................................... 366
An asset-backed security representing a claim on the cash flows received on a mortgage.

**N**

**negative equity** ......................................................................... 84
The condition of a property owner owing more on a mortgage than the current fair market value of the encumbered property.

**net income multiplier (NIM)** ...................................................... 94, 222
The property’s price as a multiple of the net operating income.

**net operating income (NOI)** .................................................... 17
The net revenue generated by an investment property. It is calculated as the sum of a property’s gross operating income less the property’s total expected operating expenses. [See RPI Form 352]

**notice of default (NOD)** ......................................................... 188
The notice recorded to begin the nonjudicial foreclosure process.

**O**

**operating costs** ......................................................................... 383
The total annual cost projected to maintain and operate a property for one year. [See RPI Form 306]

**opportunity cost** ........................................................................ 74, 254
The cost of an action that is forgone in choosing to take an alternative action.

**P**

**per capita income** ....................................................................... 354
A measure of average income per person in a population center.

**price appreciation** ....................................................................... 111
Any increase beyond the rate of consumer inflation above the price paid for property experienced by the owner on its resale.

**price tier** .................................................................................... 192
A segment of the housing market, either low- mid- or high-tier, with low and upper price limits that change based on market factors. As opposed to the median price figure, the movement of the market is best understood through an analysis of individual price tiers.
price-to-earnings (P/E) ratio .......................................................... 222
The market value per share divided by earnings per share. This is a quick way to measure the price
level of the stock market or an individual stock.

prime offer rate .......................................................... 48
A base rate used by banks to price short-term business loans and home equity lines of credit, set 3%
above the federal funds rate.

principal residence profit exclusion ........................................ 327
A tax exclusion on profit from a home sale up to a set dollar amount.

property appreciation ...................................................... 238
The portion of the increase in property prices beyond the rate of inflation.

put option ................................................................................. 11
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of
mortgaged real estate the right to default and force the mortgage holder to first sell or buy the
property through foreclosure for the amount of the mortgage debt.

Q

qualified mortgage (QM) .......................................................... 155
A consumer mortgage which meets ability-to-repay rules under the Truth in Lending Act.

qualified residential mortgage (QRM) ........................................ 156, 370
A consumer mortgage – a consumer purpose loan secured by a one to four unit residential property –
which meets low-risk criteria, exempting it from the 5% risk retention rule. QRMs meet ability-to-
repay requirements, including the maximum debt-to-income ratio of 43%.

quantitative easing (QE) .................................................... 133
The purchase of government or mortgage backed bonds by the Federal Reserve to drive down
interest rates and increase liquidity.

R

real estate investment trust (REIT) .................................................. 226
A security traded on the stock market made up of investments in income generating property, trust
deeds and government securities.

real estate owned property (REO) .................................................. 79
Property acquired by a lender through foreclosure.

real demand .................................................................................. 2
The demand of end user buyer-occupants in the real estate market.

real rate of return ......................................................................... 19
The desired fixed rate of return on the investment in excess of the future rate of inflation.

rental vacancy rate ................................................................. 188
The percentage of unoccupied rental housing units.

renters by necessity ........................................................................ 363
Households for whom traditional ownership of their shelter is not economically possible.

rentier ......................................................................................... 296
The class of earners whose income is earned passively, generated from owned tangible and
intangible assets rather than through their labor.

return on investment (ROI) .................................................... 116
A measure of earnings in relation to capital invested.

risk tolerance .................................................................................. 253
The amount of investment risk an investor is willing to accept.
### Glossary

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<td><strong>savings rate</strong></td>
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<tr>
<td>The percentage of an individual’s monthly disposable income which is not spent.</td>
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<td><strong>securitization</strong></td>
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<td>The process of Wall Street bankers breaking up mortgage pools into mortgage-backed bonds and selling these bonds to various banks and individual investor.</td>
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<td><strong>sell phase</strong></td>
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<td>The ideal moment to sell property, characterized by rising prices, monthly decreases in sales volume and a yield spread falling for at least six months.</td>
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<td><strong>senior</strong></td>
<td>249</td>
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<td>Those over the age of 65.</td>
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<td><strong>shadow inventory</strong></td>
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<td>The inventory of properties whose pending release onto the market (e.g., REOs, foreclosures, speculator holdings) will destabilize real estate sales volume and prices.</td>
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<td><strong>shareowners</strong></td>
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<td>Investors in real estate investment trusts (REITs) and other securities. Shareowners are subject to the gains and losses experienced by the company issuing the security.</td>
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<td><strong>short-term rate</strong></td>
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<td>A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.</td>
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<td><strong>skin in the game</strong></td>
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<td>A risk management measure of a purchaser’s stake in an investment, such as a homebuyer’s down payment on a home purchase.</td>
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<td><strong>speculator</strong></td>
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<td>A real estate investor who owns property short-term, sandwiching themself between the seller and end user of the property.</td>
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<td><strong>statement of financial position</strong></td>
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<td>A balance sheet prepared by a homeowner which lists the dollar amounts of the homeowner’s assets and liabilities. [See RPI Form 209-3]</td>
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<td><strong>sticky pricing</strong></td>
<td>43, 123, 196</td>
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<td>A seller’s irrational reliance on past home pricing as a basis for setting current pricing, called the money illusion.</td>
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<td><strong>subsidy</strong></td>
<td>285, 324</td>
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<td>The government support of a particular entity or activity. For homebuyers, these come in the form of tax credits.</td>
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<td><strong>syndication</strong></td>
<td>59, 255</td>
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<td>When a group of investors form a limited liability company to fund the purchase price and carrying costs of owning real estate.</td>
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<td><strong>teaser rate</strong></td>
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<td>A temporary, low introductory interest rate found in some adjustable rate mortgages.</td>
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<td><strong>tenants-by-foreclosure</strong></td>
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<td>Former homeowners who were forced out of their homes by foreclosure in the wake of the 2008 recession, now employed but in need of housing and forced to rent.</td>
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<td><strong>tranches</strong></td>
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<td>Bonds issued by investment pools divided into various levels of risk, reward and rate of maturity.</td>
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Treasury Bills (T-Bills) .........................................................293
Government securitized debt instruments. T-bills are sold to the public, member banks and other financial institutions.

turnover rate .................................................................391
The percentage of households relocating each year, whether from rentals or ownership.

U

undocumented immigrant ................................................335
An individual who enters a country without the approval of that country.

universal homeownership ...............................................337
The idea that everyone can and should be able to own a home. Similar to the American Dream policy.

V

vicious economic cycle ..................................................285
The economic climate in which growth slows after a boom, causing property owners to lose when selling also referred to as a buyer’s market.

Y

yield spread .................................................................18, 27
The difference between the 10-year Treasury Note rate and the 3-month Treasury Bill rate, forecasting economic conditions one year forward.

Z

zero ability to pay (ZAP) ..................................................261
The household financial situation where a mortgage debt commitment when coupled with other necessities exceeds disposable income.

zero lower bound interest rates .......................................140
Economic conditions characterized by a very low nominal interest rate. As the interest rate is at or near zero, the Federal Reserve (the Fed) cannot lower it further to stimulate the economy without going negative.

zoning .................................................................176
Building and land use restrictions enacted by local policy makers to ensure a consistent flow of improvements to meet the demand of population growth.